Perspectives

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Presidential Panics

REQUISITE
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> The two most powerful warriors are patience and time.
>
> —LEO TOLSTOY

January isn't over and it already feels like it has been a long year. After 2021's lack of volatility, with a peak-to-trough decline of only 5%, the historical average of 14%[i] seems to be just around the corner. The S&P 500 has already seen an intra-year decline of 12.37%,[ii] and there has been considerable damage under the hood. The Nasdaq-100 is down 18% from its all-time highs and over 40% of the stocks listed on the Nasdaq are down over 50%.

There is a well-known truism that the market is a "forward-looking mechanism." The market prices today its expectations about the future, as the market has priced in multiple interest-rate hikes, plus quantitative tightening. The reality is the Fed has yet to do anything but continue to purchase bonds (quantitative easing). Markets tend to overreact on both the upside and downside. What the market is not pricing in is the slowing of the economy, which would make the Fed more dovish. We believe there is a decent probability that the latter ends up happening, but currently the focus is on inflation and Fed hawkishness. If history is any guide, the rout in certain growth stocks becomes overdone, creating opportunities. It is important to remember that stocks move up on an escalator and come down on an elevator.

On top of inflation, interest rates, high valuations, and the revolving door of regulatory policies around COVID, investors have one more worry to tackle—midterm elections. Historically, the second year of a president's term, the year of midterm elections, has been the worst, with the third year being the best year.[iii]

S&P 500 Four-Year Presidential Cycle
1928–2020

Years	Percentage Change (%)
1	5.75%
2	4.32%
3	13.51%
4	6.17%

How have stocks fared during midterms[iv]? Looking back to 1950, the average intra-year peak-to-trough decline during midterm years was 17.10%. But what happened one year after those declines? The average return one year later was a stellar 32.30%.

S&P 500 Index Pullbacks During a Midterm Year
1950–2018

		S&P 500 Index Return	
Year	**Date of Low**	**Intra-Year Pullback**	**Return One Year Later**
1950	07/17/50	-14.00%	30.90%
1954	08/31/54	-4.40%	43.90%
1958	02/25/58	-4.40%	36.30%
1962	06/26/62	-26.40%	32.70%
1966	10/07/66	-22.20%	33.20%
1970	05/26/70	-25.90%	44.50%
1974	10/03/74	-37.60%	34.60%
1978	11/14/78	-13.60%	11.30%
1982	08/12/82	-16.60%	57.70%
1986	09/29/86	-9.40%	40.60%
1990	10/11/90	-19.90%	28.80%
1994	04/04/94	-8.90%	14.30%
1998	08/31/98	-19.30%	37.90%
2002	10/09/02	-33.80%	33.70%
2006	06/13/06	-7.70%	24.50%
2010	07/02/10	-16.00%	31.00%
2014	10/15/14	-7.40%	8.70%
2018	12/24/18	-19.80%	37.10%
	Average	**-17.10%**	**32.30%**
	Median	**-16.30%**	**33.50%**

Long-term earnings drive returns. Consensus estimates for S&P 500 2022 earnings are $222[v]/share, which equates to a ~8% growth rate year-over-year. If earnings (E) grow as estimated and stock prices (P) continue to decline, overall P/E multiples contract, creating opportunities for investors.

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As we wrote in December, "The Nasdaq and the S&P 500 are at their top decile of 10-year returns historically and have annualized about 20% and 16%, respectively. Mean reversion exists, especially in finance, and investors should expect lower returns over the next five years."

We anticipate that with growth slowing and a U.S. debt to GDP at ~123%,[vi] the Fed may have the willingness to raise rates, but will not have the ability to raise rates much over what is already priced in.

If the last two years have taught investors anything, it's how quickly things change and how the patient investor reaps the gains. As Leo Tolstoy said, "The two most powerful warriors are patience and time."

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i JPM Guide to Markets: average annual peak-to-trough decline since 1980 was 14%, 12/31/21

ii the chartstore.com S&P 500 1/4/22 high of 4818; 1/24/22 low of 4222
NASDAQ 1/4/22 high of 15852; 1/24/22 low of 13094

iii Bespoke

iv LPL Research. Factset 1/10/22

v FactSet: $222.32; https://insight.factset.com/industry-analysts-expect-sp-500-to-report-record-high-eps-in-2022

vi https://fred.stlouisfed.org/series/GFDEGDQ188S