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POLITICIANS AND INVESTORS MAKE STRANGE BEDFELLOWS
Gridlock and the Markets

What will you get when you put more "tax and spend" Liberals in the same House with "tax-cutting" Conservatives for the next two years? Well, investors are hoping that answer is "not much." (No, this isn't the latest Reality TV programming idea.) As the approval ratings of President W and the Republican-dominated Congress continued to plummet, voters felt that a dramatic change inside the Beltway was needed. In November, they sent several Republicans packing (and onto the unemployment lines) and gave Democrats the majority in both Houses of Congress for the first time since 1994. The conflict in Iraq was raging out of control; the budget surplus had become a monster deficit; scandals and partisanship were now the political norm.

Meanwhile, investors monitored the campaign season closely and attempted to anticipate how the shift in political power would impact the markets. For years, the most common school of thought claimed that Republicans were more business focused than Democratic "idealists" and the markets clearly favored their approach. And yet, during the current period with a Republican President and Congress, the major indexes underperformed and many investors were left scratching their heads about what they believed should have been a period of prosperity without much "Liberal" interference. Instead, they watched as government spending soared by an annual rate of 6.6% during the Republicans' watch with numerous pork barrel projects approved and political cronyism at an all-time high. Was Wall Street suddenly thinking that Democrats actually may be more fiscally responsible these days? (Any thoughts, Senator Kennedy?).

While "independent thinkers" believe that the difference between Republicans and Democrats has been blurred over the past few years, many investors feel that ***gridlock*** (different political parties in control of the different branches of government) would be most advantageous for the markets. After all, gridlock often leads to inaction: government bureaucracy should be held in check; no major partisan legislation would be enacted; nothing significant can occur except through open and honest dialogue and compromise. (Isn't that how Washington is supposed to work?)

The Survey Says…

So what do investors think? Numerous studies have been conducted through the years that attempt to find correlation between political power and the markets. (So much for the Random Walk Theory.) Standard and Poor's claimed that conventional wisdom was correct and a Republican dominated government greatly benefits the investor. According to its analysis, since 1945, during years with a Republican President and Congress, stocks have skyrocketed by an average of 14.5 percent. The study also showed that when a Republican President is forced to work with a Democratic Congress in both Houses (like the upcoming period), equities only returned 7.1 percent annually.

Another study conducted by Ned Davis Research depicted that, contrary to popular belief, gridlock is NOT advantageous for the markets in the aftermath of an election. The firm measured market performance over two year periods after mid-term elections. Since 1901, during a Republican-dominated government, the Dow Jones Industrial Average increased by 7.6% annually. When Democrats controlled both branches, the benchmark averaged 7.2% returns; during periods of gridlock (neither party in control), the Dow rose by a mere 4.86 percent.

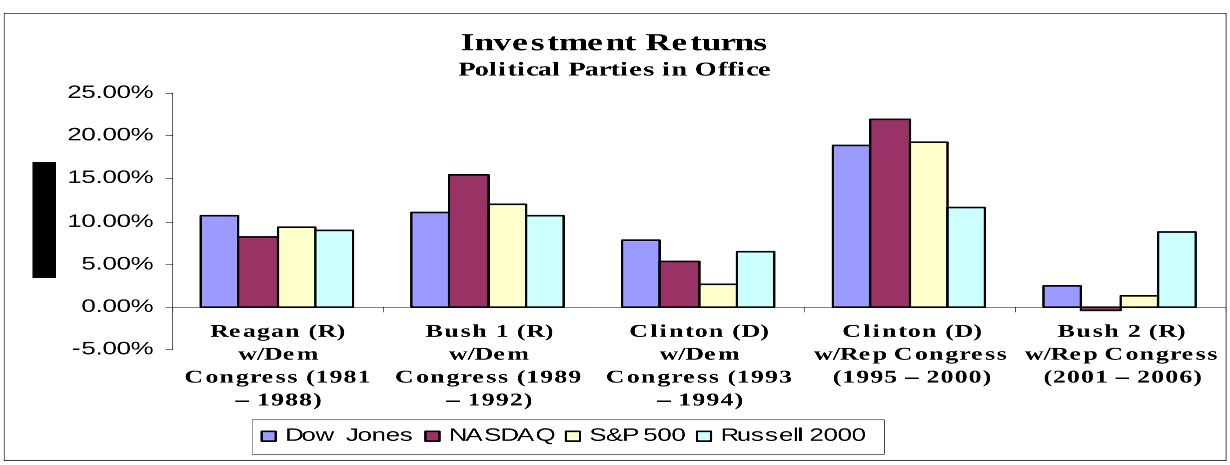
Finally, a Little Encouraging News

While neither study offers much optimism for the years ahead, investors should take some comfort in the fact that modern history suggests very different (and favorable) results. Since 1981 and the beginning of the Reagan years (with a Democratic Congress), gridlock has clearly been favored by investors. Bear in mind, the markets have also changed dramatically since 1901 and even since 1945. Though still quite random in its selection, the year 1981 may represent a more legitimate benchmark from which to begin measuring. Since that time, the increased popularity of retirement accounts has allowed more individuals to participate in the markets than ever before. No longer was investing considered a hobby reserved for institutions and the "rich and famous." Volatility increased as hard working Americans began contributing to IRAs and 401(k)s and were impacting prices just like the big boys. Many believe that tax reform initiated during the Reagan/Democratic Congress terms contributed to increased participation and helped transform the way America invests.

Despite the analyses from those other studies, a look inside the numbers since 1981 should lend significant optimism to investors for the next two years. The equity market returns experienced during each of the three periods of divided government (Reagan/Democrats from 1981-1888, Bush 1/Democrats from 1989 – 1992, and Clinton/Republicans from 1995-2000) outperformed the partisan government years (Clinton/Democrats from 1993 – 1994, and Bush 2/Republicans from 2001 to present). While gridlock may have reduced partisan legislation and government bureaucracy, compromise actually led to tax reform (during Reagan) and welfare reform (during Clinton), two very significant political accomplishments. Additionally, the technology revolution (and the dot.com era) contributed to tremendous market returns and a budget surplus with Democrat Clinton and Republican Gingrich running their respective shows.

Index	**Reagan (R) w/Dem Congress (1981–1988)**	**Bush 1 (R) w/Dem Congress (1989–1992)**	**Clinton (D) w/Dem Congress (1993–1994)**	**Clinton (D) w/Rep Congress (1995–2000)**	**Bush 2 (R) w/Rep Congress (2001–2006)**
Dow Jones	10.67%	11.08%	7.78%	18.82%	2.51%
NASDAQ	8.25%	15.42%	5.39%	21.93%	-0.39%
S&P 500	9.36%	11.92%	2.67%	19.24%	1.24%
Russell 2000	8.93%	10.66%	6.43%	11.59%	8.72%

* annual returns per Morningstar



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A Crystal Ball …

So what's an investor to do? Bear in mind, these studies are based on raw numbers only and do not delve into the economic or geopolitical climates during the various terms. Recessionary times, acts of terror, natural disasters, ongoing wars (and even impeachment proceedings) occurred during these years and each had great impact on the markets. Plus, as every investment compliance officer will state, "*past performance is not indicative or a predictor of future results.*" However, based on the equity indexes performances over a 26 year period and five distinct political cycles, the analysis clearly indicates that gridlock (and especially compromise) may be deemed quite positive for the markets.

So will President Bush find an ability to compromise with his "sworn enemy," Congresswoman Pelosi? (Clinton and Gingrich somehow worked it out). How will the Speaker's ties to technology impact performance of that sector? Will "Big Oil" find many friends in a Democratic Congress? What about Halliburton (with a lame duck Cheney)? Will ex-VP Gore suddenly gain an audience to promote alternative energy companies? And don't forget the Fed.

The next two years should be quite interesting, indeed. Hopefully, more interesting than Reality TV?