

# Global Equity Strategy

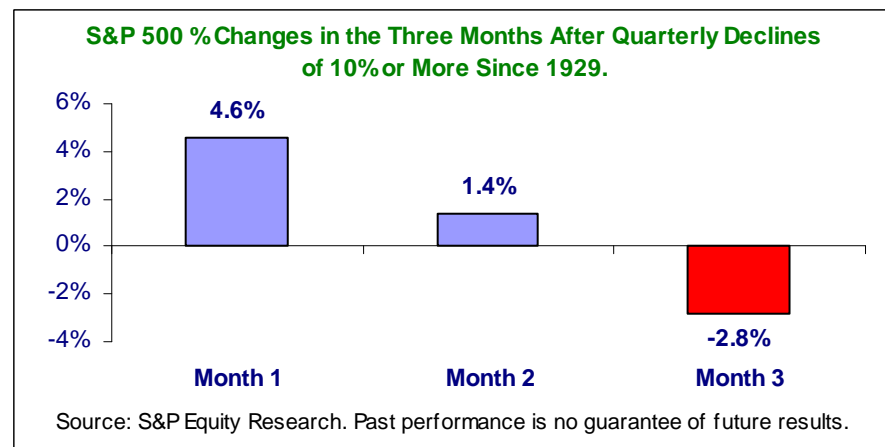
## U.S. Sector Watch

Equity Research / North America

**Monthly Moves and the Mid-Term Election**  
*Sam Stovall, Chief Investment Strategist*

**July 30, 2010**

July has been very forgiving to equity investors, as the S&P 1500 climbed 6.8% through July 29, with component gains of 6.9% for the large cap S&P 500, 6.5% for the S&P MidCap 400 and 6.4% for the S&P SmallCap 600. What's more, all 10 sectors of the S&P 1500 gained on the month, from 0.5% for Health Care to 11.3% for Materials. Finally, only 10 of the 145 sub-industries in the S&P 1500 declined this month (Commodity Chemicals -0.4%, Gold -9.8%, Health Care Distributors -5.7%, Health Care Equipment -0.7%, Health Care Facilities -7.0%, Health Care Services -7.9%, Life Sciences Tools -6.6%, Oil & Gas Refining & Marketing -3.3%, Photographic Products -7.1%, and Real Estate Development -9.1%), while four advanced by more than 20% (Automobile Manufacturers +28.1%, Fertilizers & Agricultural Chemicals +24.4%, Forest Products +27.5%, and Motorcycle Manufacturers +21.5%.)



July's strength likely was the result of better-than-expected earnings reports both here in America and abroad, as well as being very oversold as a result of the near 12% decline during the second quarter. Since 1929, following a quarterly decline of 10% or more (there have been 35 such occurrences), the S&P 500 rose 4.6% in price during the first month after that decline (and advanced in price 69% of the time, or 24 of 35 times), gained 1.4% in the second month following the down quarter (also recording a 69% frequency of advance), but declined an average 2.8% in price in month three (and recorded only a 37% frequency of advance). So if history should repeat itself, and there's no guarantee it will, we could see another slight gain for the S&P 500 in August, followed by a decline in September, which is a traditionally weak month for the market.

The unanswered question is whether last month's advance was simply a counter-trend rally within a larger topping pattern for the equity markets, or a true end to the most recent correction, which saw the S&P 500 decline 16.0% from April 23 through July 2. Several factors hint that the worst may be over and that the concerns surrounding a dreaded double dip are dead. Many of the worries emanating from Europe have eased, as recent economic growth reports from Germany and the U.K. came in stronger than expected, credit default spreads have narrowed, ECB purchases of private debt have slowed, and the euro has rebounded to a shade above \$1.30. Also, U.S. corporate EPS reports for the second quarter were robust, and guidance, when offered, was upbeat. Finally, a few recent U.S. housing reports were slightly encouraging, and the recent decline in gold prices is seen by some as

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**Sam Stovall**  
 Chief  
 Investment Strategist

212-438-9549

sam\_stovall@sandp.com

55 Water Street  
 New York, NY  
 10041

signaling an increase in investor confidence. Yet S&P's Investment Policy Committee believes risks remain elevated and recommends investors tread cautiously, as less optimistic macro news flow may likely again overtake EPS euphoria.

**Mid-Terms and the Market**

The S&P 500's performance during the three calendar months leading up to the presidential election has been a good predictor of whether the president or his party would be reelected or replaced. From 1928-2008, this presidential election-prognostication technique recorded a 79% accuracy rate in predicting the re-election of the party in power and an 86% success ratio in calling for a change of party. (It worked in 2008.) But can the same be said for predicting mid-term elections? If the market rises or falls in the August through October period, will the present leadership in Congress be altered? My conclusion is that while presidential elections are national, congressional elections are regional. That is another way of saying "No," as the S&P 500 has typically declined during the months leading up to the mid-term elections for first-term presidents, regardless of the party in power, and leadership changes have been rare.

Does S&P 500 Price Action from August to October Foretell Congressional Elections? S&P 500 Price % Changes and Election Results 1930-2006							
1st Year Party	Num of Mid-Term Elections	S&P 500 % Changes		Senate		House	
		Aug. - October	Next Calendar Year	Avg. Seat Chg.	Leadership Changes	Avg. Seat Chg.	Leadership Changes
<b>Democrats</b>	5	(5.9) 5 Declines	21.3 5 Advances	(2)	2 Losses: 1946, 1994	(24)	2 Losses: 1946, 1994
<b>Republicans</b>	6	(1.6) 3 Advances 3 Declines	10.0 5 Advances 1 Decline	(1)	1 Loss: 1954 1 Gain: 2002	(18)	1 Loss: 1954

Source: Standard & Poor's, [www.senate.gov](http://www.senate.gov), [clerk.house.gov](http://clerk.house.gov)  
Past performance is no guarantee of future results.

Democrats controlled the Senate 14 times leading up to the 20 mid-term elections during presidential first terms since 1930. They controlled the House 15 times. The Republicans regained control of the Senate as a result of the first-term mid-term elections in 1946 (after Harry Truman became president upon the death of FDR in April 1945, only three months after FDR was sworn in for his fourth term in office) and 1994 (after Bill Clinton defeated George H.W. Bush and Ross Perot).

In order for the Republicans to regain control of the Senate in 2010, they would need to pick up 10 seats – a tall order, since the average number of Democratic seats lost since 1930 (following first-term mid-term elections) has been two, and Republicans picked up 10 or more seats only twice – 1942 and 1946. To regain control of the House, while the task is less onerous at 40 seats, it is still a long-shot as the average number of seats lost by Democrats was 24, and only in 1946 and 1994 did Republicans pick up 40 or more seats.

So if history is any guide, for it's never gospel, the market will likely decline from July 31 through October 31. However, it will not offer much help in predicting the outcome of this mid-term election. A silver lining to this inconclusive analysis is that the S&P 500 may record a strong performance during President Obama's third year in office. Since 1930, the S&P 500 rose in five of five calendar years following the mid-term elections during Democratic first terms, and recorded an average advance of 21.3%.

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A+	Highest	B-	Lower
A	High	C	Lowest
A-	Above Average	D	In Reorganization
B+	Average	NR	Not Ranked
B	Below Average		

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CY- Calendar Year  
DCF- Discounted Cash Flow  
EBIT- Earnings Before Interest and Taxes  
EBITDA- Earnings Before Interest, Taxes, Depreciation and Amortization  
EPS- Earnings Per Share  
EV- Enterprise Value  
FCF- Free Cash Flow  
FFO- Funds From Operations  
FY- Fiscal Year  
P/E- Price/Earnings  
PEG Ratio- P/E-to-Growth Ratio  
PV- Present Value  
R&D- Research & Development  
ROE- Return on Equity  
ROI- Return on Investment  
ROIC- Return on Invested Capital  
ROA- Return on Assets  
SG&A- Selling, General & Administrative Expenses  
WACC- Weighted Average Cost of Capital

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**Standard & Poor's**  
**55 Water Street**  
**New York, NY 10041**  
**(212) 438-2000**

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