The Midterm Effect:
The Market Takes Comfort in Gridlock

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Market Commentary & Analysis

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As we embark upon the new year, no question figures more prominently among investors than "What are your market expectations?" Such queries carry greater urgency, as a three-year period of extraordinary market returns ended abruptly in 2022 with the worst S&P 500 performance since 2008 and the Global Financial Crisis. Meanwhile, aggressive Federal Reserve action and various inverted yield curves raise fears of a coming recession. When asked about our market expectations, we typically reply that we are not market prognosticators, preferring to focus on the long-term outlook for the stocks in which we invest and avoiding the distraction of short-term market gyrations.

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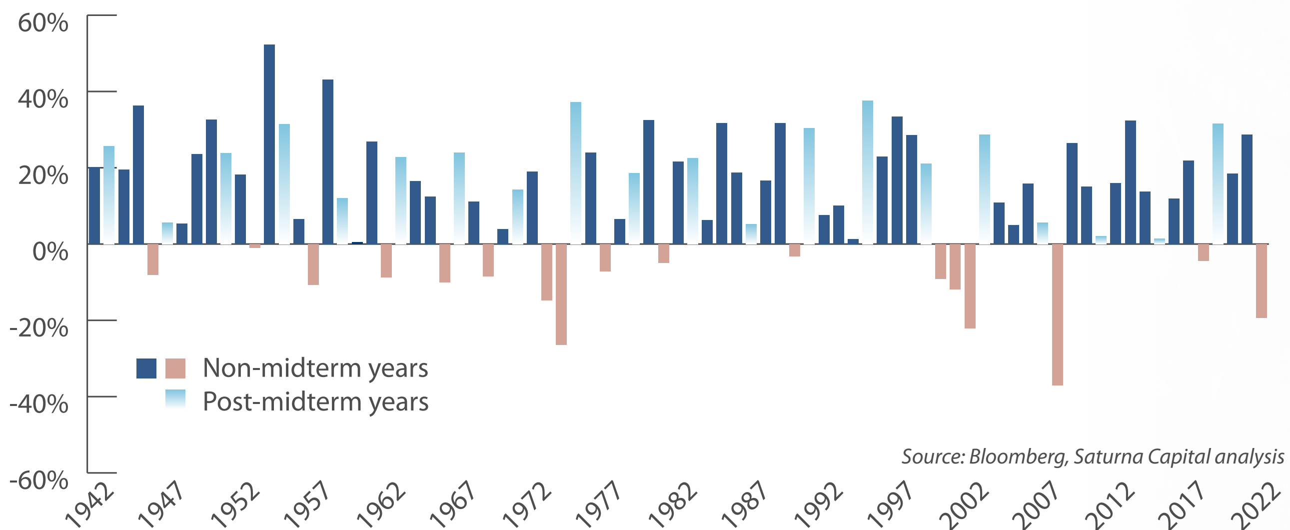
Every four years, however, we arrive upon a phenomenon with an unblemished multi-decade record of calling the market over the next year – the Midterm Effect. When we last wrote about the Midterm Effect in 2010,[1] we called this anomaly the "third year effect." Between 1945 and 2007, the calendar year return of the S&P 500 was positive in 16 out of 16 of the years following a midterm election, correlating to the third year of presidential terms. Over that span, the average third-year market return was 17.15%. After we first wrote about the "third year effect," its winning streak continued in 2011, 2015, and 2019, with S&P 500 returns of 2.11%, 1.38%, and 31.49%, respectively. As of year-end 2022, the calendar year return of the S&P 500 was positive in 19 out of 19 of the years following a midterm election, with a still impressive average third-year S&P 500 return of 16.28%, compared to an average return of 7.99% in the other years.

We believe the Midterm Effect primarily results from policy certainty over the next few years as the loss of seats by the president's party makes it more difficult to pass new legislation. Midterm elections typically mark a reversal of the enthusiasm that brought the president to office and regularly lead to a change of control of at least one of the houses of Congress, as we saw last November.

The lower likelihood of major legislation or contentious regulation makes it easier for business leaders to plan

Presidents typically begin their terms with an ambitious agenda and a desire to reward the voters of their party who helped them win election. The president's actions, in coordination with party actors, appear to sour the opinion of swing voters, who switch votes to opposing-party candidates contesting legislative races in the midterm elections. According to FiveThirtyEight analysis, "the president's party has performed an average of 7.4 points worse in the House popular vote in midterm elections than it did two years prior" since 1946.[2] The president's party has only gained vote share in midterm elections once, in 2002, when George W. Bush maintained unusually high presidential approval in the wake of the September 11 terrorist attacks.



To the extent that lower vote share translates to a loss of legislative seats — especially if it also swings control of a chamber to the other party — it constrains the president's ability to work with Congress on partisan legislation. Chastening midterm election results are also likely to temper the president's ambition. The lower likelihood of major legislation or contentious regulation makes it easier for business leaders to plan and easier for investors to forecast earnings. Improving earnings visibility, in turn, can lead to willingness to pay a higher multiple for those earnings, and may help explain a cause of this anomaly.

S&P 500 Calendar Year Total Returns, 1942-2022: "The Midterm Effect"

Year Type	Observations	Average Return	Standard Deviation	Up Years	Down Years
All Years	81	12.98%	17.03%	64	17
Non-Midterm Year	61	10.66%	17.96%	44	17
Midterm Year	20	20.06%	11.53%	20	0

The Student's t-test, a common statistical technique, tests the hypothesis that two related sets of data share the same average. The results of that test suggest that the probability that the average returns in midterm and non-midterm years were the same but the large observed difference between them was just a fluke[3] is just 0.07% — one chance out of 1,456. There is valid reason to believe that something is different about the year following midterm elections.

Considering the present environment, the stock market performed poorly leading up to the midterm elections, and returns were negative in 2022. From 1945 to 2022, there have been 17 down years for the S&P 500 — an event that happens about one out of every five years on average. But there were only three pairs of consecutive down years since 1945 (1973-1974, 2000-2001, and 2001-2002) in that 77-year span. This perhaps provides another reason to be optimistic about the prospects for positive equity market returns in 2023.

Footnotes

[1] *The Saturna Sextant. Myth of the Third Year Effect. December 2010, Vol. 4 No. 12.*

[2] *Skelley, Geoffrey and Rakich, Nathaniel. "Why the President's Party Almost Always Has A Bad Midterm." FiveThirtyEight, January 3, 2022. https://fivethirtyeight.com/features/why-the-presidents-party-almost-always-has-a-bad-midterm/*

[3] *By "fluke" we mean something like flipping 11 heads in a row on a fair coin (probability of 0.05%)*

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Scott Klimo, Chief Investment Officer, joined Saturna Capital in May 2012. He received his BA in Asian Studies from Hamilton College in Clinton, NY and also attended the Chinese University of Hong Kong and the Mandarin Training Center in Taipei, Taiwan. Mr. Klimo has over 30 years' experience in the financial industry, with the first several years of his career spent living and working in a variety of Asian countries and the past 20 years working as a senior analyst, research director, and portfolio manager covering global equities. Mr. Klimo is a Chartered Financial Analyst (CFA) charterholder and an avid cyclist. He is a supporter of various environmental organizations and served for several years on the Board of Directors of the Marin County Bicycle Coalition.

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