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It's the Cycle, Stupid!

By SY HARDING

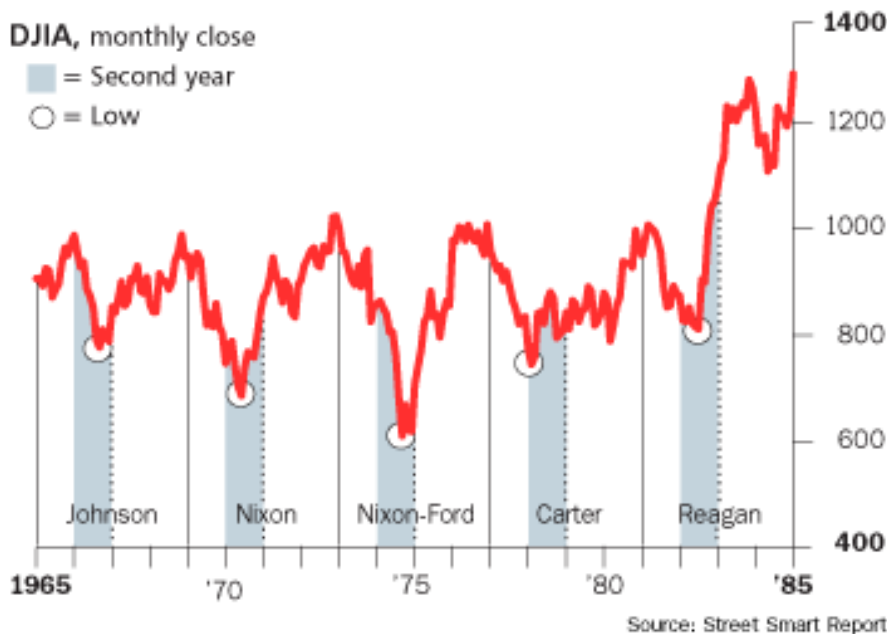
UNLESS I'M LOOKING AT the wrong calendar, stocks are headed for a rough patch next year. That's because 2006 is the second year of a presidential term, and the market historically hits a significant low in those years.

The trend has been strongest in long-term, or secular, bear markets, such as the period of 1965 through 1982. But the pattern has been clear through bull and bear periods alike -- and through war and peace, rising and falling interest rates, high and low inflation -- regardless of which party was in power.

The good news: Stocks' low point in a presidential term is usually followed by a strong rally. In fact, counting all presidential terms since 1934, the Standard & Poor's 500 rose an average of 50% from the second-year low, to the high in the next year. So, the slump of 2006 could well mark another tremendous buying opportunity.

The Two-Year Itch


Stocks often hit a low during the second year of a presidential term, before Washington tries to boost the economy for the next election. That's especially so during long-term bear markets, such as 1965-1982.



The forces behind the pattern are just as clear as the pattern itself. In the second year of a term, Washington launches stimulus efforts to make sure the economy and the stock market are in good shape by the time the next election rolls around. This has been true even for second-term presidents like George Bush. After all, they want their party to remain in power.

The problem is that those efforts usually create excesses that need to be corrected after the elections, so the market often takes some hits in the first two years of a term.

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Wall Street's seers assure us that markets can't be timed. But the fact is, an investor would have reaped a compounded return of more than 300% from the 1965-to-1982 secular bear market by simply moving to cash at the end of each election year and not buying again until the low in the second year of the next presidential term. In contrast, the Dow climbed just 38.5% during this span.

THE PATH TO NEXT YEAR'S LOW is likely to be bumpy: Stocks have a history of hitting lows in October or November and then performing favorably until May.

That seasonality is created by the huge extra chunks of money that flow into the market beginning in the fall and continuing until the spring. They include capital-gains distributions from mutual funds; year-end dividends and bonuses; year-end contributions to 401(K) and IRA plans; and income-tax refunds. When the flows end in the spring, the market becomes increasingly vulnerable to any selling pressure.

As with stock trends in presidential cycles, many on Wall Street dismiss seasonality as a myth. But, again, the results are clear: Over the past 50 years, a strategy of investing only in the favorable seasons and sitting out the other months would have almost tripled the performance of the S&P 500.

The Bottom Line: Stocks could suffer seasonal downdrafts in the next two months and reach a significant low in 2006. But if past presidential cycles are any guide, the market then may climb 50% in the next year.

The pattern didn't hold up in 2003, when the market continued to soar through its usually unfavorable season. As a result of a massive stimulus package from Washington, the economy and the market got the same type of boosts in 2003's unfavorable season that they usually get only in the favorable season. That's unlikely to happen often.

Despite the seasonality of stocks and the clear trends during presidential cycles, many on Wall Street have been sounding a bullish note. They're convinced that stocks can't top out while the economy and earnings remain strong, and that the market will do even better if the Federal Reserve stops raising interest rates.

History suggests otherwise. After all, the economy and earnings also were strong in early 2000 -- so much so that the Fed kept raising rates through May 16. It was not until after the Fed stopped raising rates that the market really turned south, becoming the 2000-2002 bear.

Just a few things to think about.

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