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The Stock Market: Challenging Walk-up to the Midterms

The second year of the presidential cycle is the most challenging year of the four for stocks. That is true if measured from World War II or from 1960 or (as we often do) from 1980. The first year of the cycle presents a brand-new or successful second-term president with optimism and momentum in their wake. The third year sets up the second half of the presidential term, often under a reconfigured Congress. And the fourth can be dominated by both parties developing and refining platforms that they will present in the general election that wraps the year.

The second year of the presidential cycle features a presidency no longer in the first bloom of victory and facing the normal challenges and obstacles of governing. Mainly, the second year of the cycle culminates with the midterm elections, which historically have seen some loss of power by the president's party.

In addition to the second year of the cycle being the most difficult of the four for stocks, the months immediately preceding the midterms are particularly challenging. Investors are anticipating that the current political dynamic will be disrupted. Preelection advertising is highly negative, potentially contributing to any preexisting consumer anxiety. The months following the midterms can also be difficult, as the new political road map has been drawn and investors contemplate the consequences.

The Presidential Cycle and Midterm Election Year

For all years from 1980 through 2025, the S&P 500 has averaged capital appreciation of 10.6%. There is, however, quite a bit of variability across the presidential cycle.

According to Argus analysis and based on closing prices for the S&P 500 over the 1980-2025 time period, the third year of the presidential cycle has produced the best returns, with an average gain of 16.5% for the index. Of the 11 third years since 1980, the market has failed to appreciate in double digits four times; excluding those years, the average gain is 25.2%.

In the third year, the midterms have been settled. Typically, the sitting president's party loses seats in both the House and Senate. That often leads to political stalemate. Historically, periods of Washington stalemate allow companies to conduct their business planning and operations without heightened risk of political interference. Wall Street is said to favor such periods.

The second-best year of the cycle is the first year of the presidency. With optimism and energy in full force, the S&P 500 since 1980 has averaged a gain of 15.5% in the first year of the presidency. In only two of the 11 years since 1980 has the S&P 500 declined in the first year of the presidential cycle.

The fourth year of the presidential cycle shows an average gain of just 5.4% since 1980. That percentage return is distorted by inclusion of 2008, when the Great Recession kicked off and the S&P 500 declined 38.5%. Excluding 2008, the average gain in the final year of the presidential cycle is 10.3%, not far off the average gain of 10.6% for all years from 1980 to 2025.

The second year of the presidential cycle, the midterm election year, has averaged a gain of 3.3% on the S&P 500 since 1980. Five of the 11 midterm years since 1980 were negative, by far the worst track record of any single year in the cycle. The best and worst midterm years are tightly clustered. In 1998, the S&P 500 rose 26.7%, as the 1990s stock rally approached its peak. And in 2002, the index fell 23.4% in the wake of 9/11 and as the dot.com boom imploded. In the most recent midterm year of 2022, the S&P 500 declined 19.4%, as inflation peaked at 40-year highs.

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The Three Months Heading into the Election

In the three months of August through October in the second year of the cycle, the national mood turns from carefree summer enjoyments to a more serious tone ahead of the pending elections. For all midterm years from 1980 to 2025, the S&P 500 has averaged a decline of 1.1% from the eighth month through the 10th month.

The worst such period was in 1982, when the S&P 500 fell 19.9% from August through October. The 1981-82 recession was among the deepest postwar downturns, amid soaring inflation. The best of these three-month stretches occurred in 1990, with the market rallying 17%, as the decade-long stock rally was getting underway. Most recently, stocks rallied 6.7% in August through October 2022, as inflation climbed down from peak levels.

Once the midterm election is past, and negative political ads are no longer ringing in our ears, the market should have room to rally — but, unfortunately, it does so only sporadically after the election. On average, the S&P 500 has declined an additional 1.9% in November and December of the midterm years.

Most recently, the index rallied 8.2% across the final two months of 2022. In the first two years of his first term, President Donald Trump was backed by solid Senate and House majorities; the House flipped to majority Democrat in the 2022 midterms. Mainly, November 2022 featured the launch of ChatGPT. Inflation was coming down off its highs, and the artificial intelligence (AI) gold rush was about to begin.

Conclusion

Particularly after Labor Day, both parties will shift into high gear as they seek to drive voters to the polls for what has historically been a low-turnout event. News flow is dominated by the various campaigns, and political ads dominate traditional TV broadcasting. Given that more and more consumers get their media outside of traditional venues such as radio and broadcast TV, political ads spill across social media, podcasts, and other nontraditional sources. The year 2026 will likely feature an environment in which consumers will be hard-pressed to differentiate between candidate-generated content and the onslaught of AI-generated or AI-modified political content.

Normally, the president's party would lose Congressional seats in the midterms. But gerrymandering that is net favorable to the GOP and the president's popularity with the MAGA core could make the election a toss-up. The war with Iran is now mainly an economic war. Bond yields have moved to multiyear highs, and inflation could move higher without some kind of resolution in the Strait of Hormuz.

These are not the only factors in the equation, of course. Corporate earnings have never been stronger, and gross domestic product growth (adjusted for AI-related imports) is solid. Stocks are up in low-double-digit percentages heading into September, about where they were heading into August. These positives may be enough to sustain or even build on double-digit stock gains in this second and toughest year of the presidential election cycle.

Jim Kelleher, CFA,
Director of Research

KEY ECONOMIC FORECASTS

- The $32 trillion U.S. economy remains on course for productive long term growth, powered by corporate investments in Artificial Intelligence. Nvidia CFO Colette Kress estimated, on May 20, that AI infrastructure spending is on track to reach $3 - $4 trillion annually by the end of this decade.
- Real Potential GDP – the sustainable speed limit of the US economy is poised to increase to 2.1%, on average, through 2030 according to the Congressional Budget Office. AI is likely to raise productivity, offsetting slower growth in the labor force from an aging population and reduced immigration.
- Our 2026 gross domestic product growth forecast is 2.1%. Our 2027 forecast is 2.2% In the Monetary Policy Report to Congress, the Federal Reserve said, “Overall, economic activity is expanding at a solid pace despite elevated uncertainty that owes, in part, to the conflict in the Middle East.”
- National gasoline prices once again exceed $4.00 a gallon as tensions between the U.S. and Iran remain. Gas prices below $4.00 are important to consumers with the holidays around the corner. Inflation is likely to be a key issue in fall elections for control of the House and Senate.
- The Misery Index, which is the Consumer Price Index (CPI) inflation rate plus the unemployment rate is below the average of 9.2% since 1949, but it rounds to 7.4% from 6.7% in January. Unemployment is low at 4.1%. Inflation remains elevated, but CPI did ease to 3.4% in July from 3.5% in June.
- We are monitoring financial conditions and high-frequency indicators. They show ongoing economic resilience and financial system stability that accommodates saving, borrowing, and investing.
- Argus expects S&P 500 EPS to rise almost 25% to $340 in 2026 and increase about 15% to $390 in 2027. EPS is helped by an increase in operating margins to about 19% this year, well above 13.9% in pre-pandemic 2019. Growing tech giants such as MSFT and NVDA have operating margins of 47% and 64% respectively while Dow stalwarts Walmart and Caterpillar earn 4% and 19%. Argus expects the S&P 500 to trade in a range of 6,730-8,225 over the next 12 months. Our year-end 2026 price target for the S&P 500 is 8,000 based on a multiple of 20.5-times our 2027 EPS estimate.
- The Federal Open Market Committee voted 9-3 in July to maintain the federal funds target at 3.5%-3.75%. Argus Fixed Income Strategist Kevin Heal expects the Fed to maintain the current funds target in 2026 and cut rates by 25 basis points in the second half of 2027. We expect the dollar to be flattish in 2026. We see foreign demand for shares of innovative U.S. companies, tempered by lower prospects for Fed tightening and concerns about the U.S. budget deficit.
- Gold is likely to remain at high levels amid global uncertainty and concerns about the budget deficit. The ancient safe-haven asset reached a record above $5,000 an ounce in 1Q. It briefly dropped to about $4,000 before rallying back to $4,700.
- What could go right? Low unemployment, spending by wealthy consumers, strong S&P earnings, strong capital investment in Artificial Intelligence, productivity gains, and ongoing innovation.
- Risks: Strains on affordability from years of elevated inflation, uncertainty related to hostilities with Iran, higher interest rates, increased borrowing by AI companies, a weak housing market, low income consumers are struggling, spending by affluent may depend on stock market gains.

CURRENT ECONOMIC RELEASES

Current Economic Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
20-Aug	Leading Index	July	**-0.1%**	0.2%	0.1%	**0.2%**
25-Aug	New Home Sales	July	**678K**	630K	620K	**607K**
	Consumer Confidence	August	**90.2**	90.0	90.2	**89.4**
26-Aug	GDP Annualized QoQ	2Q "Second"	1.5%	1.5%	1.5%	**1.5%**
	GDP Price Index	2Q "Second"	6.2%	6.2%	6.2%	**6.4%**
	PCE Deflator	July	3.7%	3.6%	3.6%	**3.7%**
	PCE Core Deflator	July	3.3%	3.3%	3.3%	**3.3%**
	Personal Income	July	3.9%	3.5%	NA	**3.7%**
	Personal Spending	July	**6.4%**	5.5%	NA	**5.9%**
	Durable Goods Orders	July	9.2%	16.0%	NA	**12.9%**
1-Sep	ISM Manufacturing	August	55.6	56.0	NA	NA
	ISM New Orders	August	56.7	57.0	NA	NA
	ISM Prices	August	71.1	70.0	NA	NA
2-Sep	Factory Orders	July	7.4%	10.0%	NA	NA
3-Sep	Trade Balance	July	-$73.3 Bln.	-$75.0 Bln.	NA	NA
	ISM Services Index	August	54.1	54.5	NA	NA
4-Sep	Nonfarm Payrolls	August	-23K	50K	NA	NA
	Unemployment Rate	August	4.1%	4.1%	NA	NA
	Average Weekly Hours	August	34.3	34.3	NA	NA
	Average Hourly Earnings	August	3.2%	3.2%	NA	NA
	Total Vehicle Sales	August	16.3 Mln.	16.4 Mln.	NA	NA

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