What impact will the U.S. presidential election—and the political environment in general—have on stock market performance in 2012?

No one, of course, knows for sure, but presidential election years have generally coincided with favorable markets, particularly when the incumbent party wins.

The S&P 500 index has risen in 12 of the 16 election years since World War II. While that's about the same percentage of all up years in that time, the index had an average gain of 9.2% when the incumbent party won and just 2.2% when it lost, according to Ned Davis Research.

The market has declined, however, in two of the past three Presidential election years.

Whatever the outcome, other factors such as the economy, interest rates, and corporate earnings typically have more relevance for investors than the elections themselves.

"Investors should not let the political environment weigh too heavily on their strategy because stocks have done well during both Republican and Democratic Administrations," says Larry Puglia, manager of the Blue Chip Growth Fund. At the same time, Mr. Puglia and other T. Rowe Price managers say that this election and, more broadly, the political dysfunction in Washington could significantly influence markets and companies.

"We are facing major challenges, including structural deficits that only government action can address," Mr. Puglia says. "Unfortunately, just when we need bold policy actions, political leaders have not been able to come up with effective strategies for reducing the deficit and resolving other problems. That can certainly have a negative effect on stock valuations and even the fundamentals of individual stocks."

Brian Rogers, the firm's chairman, chief investment officer, and manager of the Equity Income Fund, adds: "Rarely have we seen such a disturbing pattern of bipartisan inability to deal with serious issues affecting our nation. Since last summer there has been a lack of foresight, a lack of responsibility, and clearly a lack of courage. It certainly does not give you confidence that the problems will be resolved."

**TREMENDOUS UNCERTAINTY**

The nation's fiscal crisis makes this election "more important than most others," says John Linehan, director of U.S. equities. "At some point we need to put our fiscal house in order or we run the risk of losing access to credit.
“Right now we don't know if we are going to get Draconian cuts on defense spending, what the regulatory environment or tax rates will look like in 2013, what is permissible in M&A [merger and acquisitions] activity, or whether the new health care act will be repealed. So, many corporations will stay on the sidelines.”

Bill Stromberg, director of global equities, also calls this year’s Presidential election “one of the most important the country has had in many years. The two parties are diametrically opposed in their philosophies on how to attack our long-term fiscal issues and we need to see leaders make the hard choices to contain the potential long-term liabilities.

“Markets are just not confident that we can curtail that growth over time. Once the general population sees that we will be in sound fiscal condition 10 or 20 years from now, it will be much easier to invest in equities again.”

Markets at benign interest rates. The market will cheer if a structural solution is put in place regardless of which party is in power.”

Mr. Linehan notes that “corporations are sitting on tons of cash and balance sheets are strong, but there is tremendous uncertainty, so they are waiting to invest until we get more clarity in terms of economic and regulatory policy.

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