**What to Expect When You’re Electing**

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## What to Expect When You’re Electing

## ABSTRACT

*This paper analyzes security-market returns relative to the political party of the president, the Federal Reserve’s monetary policy, the year of the president’s term, and the state of political gridlock. Contrary to prior studies, which evaluated the influences separately, we jointly evaluate these variables. Our analysis supports the notion that security returns are significantly related to shifts in Fed monetary policy, political gridlock and the year of the presidential term; however, returns are generally invariant to the president’s political party affiliation. Overall, our findings suggest that investors should focus less attention on the party of the president and instead more closely monitor Fed actions. Furthermore, it appears that political harmony should be welcomed by equity investors, but not debt investors. Finally, regardless of the political outcome, if the past serves as a guide, investors may have to wait until year three of the next presidential term to enjoy the fruits of the current political season.*

**What to Expect When You’re Electing**

As the 2012 presidential election approaches, the news sites are filled with articles reviewing relationships between security-market returns and the outcome of the election.[[1]](#footnote-1) Perhaps the most common question is, “Which political party is better for the stock market?” Another element of the political background that draws considerable interest around an election is the impact that political gridlock has on security returns. Gridlock, which exists when Congress and the White House are controlled by different parties, is commonly identified as a factor that influences stock-market performance. Still another heavily analyzed political phenomenon is the presidential cycle effect. This anomaly refers to the fact that market returns have been highest during the third year of the presidential term. Finally, in addition to the influence of the political landscape, security market returns are often tied to the actions of the Federal Reserve (Fed). Within the context of certain economic conditions, the Fed chairman has been called the second most powerful person on earth, and many analysts would argue that this understates the importance of the position.

The academic literature is rich with studies that consider the aforementioned political effects and the influence that monetary policy have on the markets. To date, however, these factors have not been jointly considered when examining returns. This paper considers several dimensions of the political landscape ─ the party of the president, the presence or absence of political gridlock, and the presidential term cycle effect ─ in conjunction with Fed monetary policy in examining long-term security returns. By examining the relationship between security returns and both political and monetary conditions, we provide robust evidence regarding the relationships. Our findings indicate a recurring and significant third-year effect on equity returns. However, we note that Fed policy dominates most political considerations when included in models used to explain security returns. Remarkably, the impact of the party of the president in explaining market returns is not robust and most often insignificant in the context of the other factors. Last, in contrast to popular opinion, we find compelling evidence that political gridlock is not beneficial to equity-market performance.

**Previous Evidence**

The theoretical motivation for studying security returns relative to monetary conditions and the political structure is obvious. Specifically, numerous studies link political and monetary conditions to the state of the macro economy (e.g., Friedman and Schwartz [1963], Alesina, Roubini and Cohen [1997], and Drazen [2000]). Related studies, discussed below, complete the link by showing a corresponding relationship exists between security returns and political and monetary conditions. Together these papers put forward the notion that both monetary policy and politics influence the markets.

Fiscal and monetary policies represent fundamental variables believed to impact general business conditions, and thus, security returns. The President, the U.S. Congress, and the Fed have significant influence in implementing fiscal and monetary policy. While the two policies are set by independent bodies, they are frequently applied in a coordinated manner to achieve an economic objective. The following section details past studies that relate security returns to the political landscape, and separately, security returns to monetary policy.

Some of the first politically-based studies investigate the short-term, or announcement period, reaction of the security markets to presidential elections and Fed policy announcements (e.g., Niederhoffer, Gibbs and Bullock [1970], Reilly and Drzycimski [1976], and Smirlock and Yawitz [1985]). These studies investigated the market's short-term assessment of a change in political or monetary conditions. In contrast, our analysis focuses on the long-term implications of shifts in political and monetary conditions. By considering long-term security returns our analysis is more likely to identify return patterns that correspond with the ramifications of shifts in monetary policy and political structure.

Numerous studies identify prevalent patterns in long-term security returns associated with the party of the president. In particular, these studies show that stock returns are substantially higher during Democratic relative to Republican administrations. For example, Santa-Clara and Valkanov [2003] report that excess stock returns (stock returns less the T-bill rate) are nine percent per year higher during Democratic relative to Republican administrations. Further, the authors find that the return difference for small stocks is of greater magnitude, reaching 22 percent for the smallest size-decile.[[2]](#footnote-2) Santa-Clara and Valkanov show that the higher returns earned during Democratic administrations cannot be explained as compensation for higher risk since the volatility of returns is actually greater during Republican administrations. Finally, the authors show that the return differences persist even after applying several robustness checks and controlling for changes in business conditions; they conclude that their findings represent a political cycle puzzle.

While the stock market has generally prospered during Democratic administrations, Beyer, Jensen and Johnson [2004] show that bond returns exhibit superior performance during Republican administrations. Specifically, they find bond returns are over twice as high during Republican relative to Democratic administrations.

Political gridlock represents another dimension of the political landscape that is often associated with economic conditions and security returns. The economic rationale that links gridlock to the financial markets is that significant fiscal policy actions, which tend to disrupt the financial markets, are more likely to occur during political harmony than during a state of political gridlock.[[3]](#footnote-3) Just before the 2000 election, a *U.S. News & World Report* article by Butler [2000] quoted Edward Yardeni, chief investment strategist at Deutsche Banc Securities as stating that, “Gridlock has been very good for the stock market.” Several recent popular press articles assert that gridlock is beneficial for the security markets. An article by Lowery [2010] quotes billionaire Kenneth Fisher as stating that, “Markets love gridlock, what the market wants to see is no change – less legislation that engages in changes in taxes, spending, or property rights.” A *Yahoo Daily Ticker* article by Korn [2011] quotes David Kotok, chairman and chief investing officer of Cumberland Advisors, as saying “A divided government is positive for the stock market, it’s more bullish.” A *USA Today* article by Shell [2011], declares, “The mere thought of political gridlock normally makes investors smile.” However, contrary to this conventional wisdom, Beyer, Jensen and Johnson [2006] find that gridlock is not good for the equity markets. In fact, the authors report that political harmony is better for equities; most notably for the smaller stock indexes where annualized returns are reportedly 22.38% higher during harmony as opposed to gridlock.

Allvine and O’Neill [1980], Booth and Booth [2003], and Beyer, Jensen and Johnson [2008] identify a temporal anomaly in security returns related to politics – the presidential term cycle. These authors document significantly higher returns during the last two years of a presidential term, with year three being greater than the other term years. Beyer, Jensen and Johnson [2008] find that in year three the S&P 500 returns twice the return of any other year (24%). They also note that the small stock annualized return (38%) is more than twice that of any other term year. Sizemore [2012] reports that over the past 60 years the returns associated with term year three are over twice that of every other year. In an attempt to explain this effect, Abelson [2006] suggests that presidents are “keen on getting the ugly stuff out of the way early in their tenure so they can act expansively the rest of the way.” Sanford [2005] forwards a similar argument, and also postulates a monetary dimension to the presidential cycle.

The influence of Fed monetary policy on the security markets has been the subject of perhaps the most numerous analyses. As indicated above, our focus is on long-term security returns associated with Fed policy actions; therefore, the following discussion omits reference to the many studies of the short-term or"announcement effect" of Fed policy changes.[[4]](#footnote-4)

The finance literature is rich with studies that identify systematic patterns in security returns associated with prior changes in monetary policy. Specifically, stock returns in periods when the Fed is following an expansive policy are shown to be superior to returns during periods of restrictive Fed policy (e.g., Jensen, Mercer and Johnson [1996], Patelis [1997], Thorbecke [1997], Jensen, Johnson and Mercer [1998], and Bordo, Dueker and Wheelock [2008]). Perhaps more intriguing, the monetary-policy-related return patterns identified in these studies have two characteristics that are generally consistent with the political puzzles: 1) the patterns are substantially stronger for small stocks, and 2) the patterns cannot be attributed to differences in volatility or business-conditions uncertainty.

Our analysis extends the previous research in several ways. First, we consider the political landscape (party of president, gridlock, and presidential term) and monetary conditions jointly when examining security return patterns. The theoretical justification for a joint examination of these factors comes from the observation that monetary and fiscal actions are often coordinated in an attempt to achieve a desired economic result. Second, we use a more valid measure of monetary policy that considers Fed policy stance (long-term strategy) and stringency (short-term actions). Third, we consider real and nominal returns for both equities and fixed-income securities. Finally, we investigate return patterns over a long time frame that encompasses recent political and monetary policy developments.

In the remainder of the paper, we investigate the monetary and political factors in the following manner. First, we investigate the aforementioned empirical results and similarities between the political structure and the monetary-policy-related return patterns. Second, we establish the investment implications of these four areas of research, and by jointly investigating these areas we are able to discern which effects tend to dominate the others. Finally, while most of the prior research has focused exclusively on equity markets, we examine two alternative fixed-income indices, and the rate of inflation in addition to equity indices.

**DATA AND METHODOLOGY**

## We evaluate nominal monthly returns from Ibbotson & Associates for the following five indices: large-company stocks [S&P 500 total return index], small-company stocks, long-term corporate bonds, U.S. 30-day Treasury Bills, and U.S. inflation. The sample period covers the range of returns starting in January 1965 (the beginning of the monetary policy data) through December 2008 ─ the most recent, complete, presidential cycle.

The monthly congressional and presidential calendar data is from the *Congressional Directory*. Gridlock is determined based on each congressional period, measured as the two-year period from January to January corresponding to the congressional cycles.[[5]](#footnote-5) Similarly, the party of the president is established based on a four-year January-to-January period that coincides with the presidential cycle.[[6]](#footnote-6)

Qualitative classifications are used to establish binary variables associated with all three of the political variables considered in the analysis. The alternative binary classifications are: Republican versus Democratic president, political gridlock or political harmony, and whether or not the returns take place during the third year of a president’s term or in a different term year.

Drawing on the most recent updates to the literature, similar to the method in Jensen and Moorman (2010), we capture the monetary policy effects using a more refined qualitative classification. Monthly data is tabulated as expansive monetary policy, restrictive monetary policy, and periods in which the monetary policy is indeterminate. In order to observe the impact of each classification’s impact we create two separate binary variables, expansive versus not expansive and restrictive versus not restrictive periods. The excluded case is the indeterminate monetary policy environment, in which Fed policy cannot be clearly established as either expansive or restrictive.

Many of the previous studies on monetary policy rely on two different types of indicators to identify changes in monetary conditions. Several studies use a refined measure of monetary conditions designed to identify a short-term change in the degree of monetary stringency (e.g., Thorbecke [1997]), while other studies rely on broad indicators designed to identify a long-term fundamental shift in the Fed’s policy stance (e.g., Jensen and Johnson [1995]). It is important to note that both measures are shown to have a significant relationship with security returns, supporting the robustness of the monetary policy return patterns. Other work verifies this notion and supports the use of both measures to most effectively capture monetary conditions (e.g., Becher, Jensen and Mercer [2008] and Jensen and Moorman [2010]). Consistent with this recent research, we rely on a combined monetary policy measure and implement the measure to create separate binary variables for expansive and restrictive periods. Specifically, we follow the recent research and combine two metrics to capture Federal Reserve monetary policy. The first metric is based on changes in the federal funds rate. This metric adjusts for Fed stringency in the short-term market. The second metric is based on changes in the Fed discount rate. This metric captures fundamental long-term shifts in overall monetary policy. Utilizing both variables more accurately assesses whether the Fed is pursuing an expansive or restrictive monetary policy (see Patelis [1997]).

The Stringency metric is considered expansive for a particular month if the effective fed funds rate decreases from month *(t-1)* to month *(t).* If the fed funds rate increases from month *(t-1)* to month *(t)* Stringency is considered restrictive. When the fed funds rate does not change from its value in the prior month Stringency retains its value from the prior month. Changes in the discount rate are used in a comparable fashion and identify fundamental shifts in the Fed’s monetary policy stance. Shifts in Fed Stance occur much less frequently than the shifts in Stringency.

This classification of fundamental shifts has been shown in previous analyses to effectively differentiate monetary conditions. Jensen, Mercer and Johnson [1996] and Jensen and Moorman [2010] show that this approach defines periods with significantly different levels, and rates of change, in monetary and reserve aggregates. To avoid any look-ahead bias, we reclassify the monetary environment in the month following the announced change in a policy rate.[[7]](#footnote-7)

We conduct three levels of analysis to examine the relationship between security returns and political and monetary conditions. First, we review the differences in each of the four political and monetary factors independently of each other. Second, we use standard difference-in-means tests across various classifications to examine the primary relationships between security returns and: the party of the president, political gridlock, the term cycle effect, and monetary conditions. The primary relationships examine the variable of interest without controlling for the remaining qualitative variables. Last, for each index, we estimate regressions with return as the dependent variable and four sets of qualitative variables corresponding to: the party of the president, the presence or absence of political gridlock, whether or not returns occur in the third year of the term cycle, and the monetary policy stance of the Fed. This regression analysis allows us to control for the other three factors when examining the relationship between a particular variable and security returns. Since security returns are likely to be influenced by both fiscal and monetary policy, failure to control for the three omitted variables is likely to result in mis-specified models and increases the likelihood of producing biased findings.

## RESULTS

Figure 1 illustrates the return differences under Democratic and Republican Presidencies from 1965-2008. As suggested in prior research (e.g., Johnson, Chittenden and Jensen [1999], Santa-Clara and Valkanov [2003], and Sy and Zaman [2011]), returns are higher when a Democrat is president and are lower when a Republican is president. This difference is magnified for the small stock index.

Figure 2 depicts the mean annualized return differences during periods of political harmony versus political gridlock. Again, as suggested in prior research, (e.g., Beyer, Jensen and Johnson [2006] and Sy, Zamon [2011]), returns for the small stock index are notably higher during periods of harmony. On the other hand, large stock index returns are virtually identical during periods of political harmony and political gridlock.

Figure 3 shows the mean annualized return differences during the third year of the presidential term versus the remaining term years. Prior work on the term cycle effect, (e.g., Booth and Booth [2003], and Beyer, Jensen and Johnson [2008]), finds notably higher returns during the third year of the presidential term versus the remaining years. Figure 3 confirms return differences for both the large and small stock indexes.

Figure 4 presents the size specific returns during expansive monetary policy, restrictive monetary policy, and indeterminate monetary policy. This evidence, confirms that much greater returns occur during expansive monetary policy periods relative to restrictive periods and indeterminate periods.

Exhibit 1 presents the mean annualized returns for each of the five asset classes. The exhibit is separated into four panels corresponding with four alternative conditions, the influence of the party of the President (Panel A), the influence of political gridlock (Panel B), the influence of the Presidential term cycle (Panel C), and the influence of monetary policy (Panel D).

Panel A shows initial support for the notion that equity returns are higher during Democratic administrations; under Democratic presidents the S&P 500 returned 6.87% more than the return earned under Republican presidents. This difference, however, is statistically insignificant. More noteworthy, the returns for small stocks are substantially higher, 16.73% higher, under Democratic relative to Republican presidents. This return difference for the Small Cap index is both economically and statistically significant. These results are consistent with previous findings (e.g., Johnson, Chittenden and Jensen [1999], Santa-Clara and Valkanov [2003], and Sy and Zaman [2011]), and suggest that fiscal policy actions enacted by Democratic presidents have been more favorable for equity performance than the policies enacted during Republican administrations.

In contrast to equity performance, the Exhibit 1 findings show that long-term corporate fixed-income securities experienced superior performance during Republican administrations.[[8]](#footnote-8) The return differences are highly economically and statistically significant, suggesting that policy actions during Republican administrations were more conducive to stable or decreasing interest rates. Interestingly, the real returns (returns less inflation) earned by investors in corporate bonds were substantial during Republican administrations, but were actually negative during Democratic administrations. The inflation index suggests that fiscal policy actions during Democratic administrations were more likely to spur inflation.

Panel B shows the mean annualized returns for the five asset classes during periods of political gridlock and political harmony. Large caps performed almost identically during each of the two environments. The Small Cap index, however, performed significantly stronger during periods of political harmony, (29.89% versus 8.67%). The return difference for the Small Cap index is both sizeable and statistically significant. These findings are contrary to the popular belief that the equity market prefers political gridlock. On the other hand, the return differences for the long-term corporate bond index provide evidence that the bond market prospers during periods of political gridlock. Perhaps the inability to enact significant legislation during such periods serves to maintain a stable or decreasing interest rate environment. Interestingly, gridlock appears advantageous for the fixed-income market, and gridlock corresponds with periods of lower inflation.

Panel C shows the mean annualized returns for the five asset classes during the third year of the Presidential term cycle versus the other three term years. The equity return differences are staggering in size, and they are highly statistically significant. The S&P 500 return is 16.98% higher during the third year of the term cycle and the small index returns are 26.87% higher. It’s unclear here as to why the equity returns are so much greater during the third year, but Beyer, Jensen and Johnson [2008] note that the third year of a Presidential term has more often benefited from relatively easy monetary policy.

Panel D presents the mean annualized returns for the five asset classes during periods of expansive and restrictive Fed monetary policy. The difference in the equity returns in the two monetary policy regimes is also quite striking. The S&P 500 is 11.70% higher (*p*-value = 0.03) and the U.S. Small Cap index is 25.63% higher (*p*-value = 0.00) during expansive periods as opposed to restrictive periods.[[9]](#footnote-9)  Clearly, the equity markets have prospered during periods when the Fed has maintained an expansive monetary policy stance.

Exhibit 1 Panel D also shows higher returns for corporate bonds during expansive relative to restrictive monetary periods. However, this result is not statistically significant at traditional levels. In contrast to the equity and long-term bond indices, the T-bill and inflation index indicate that short-term interest rates and the inflation rate are significantly higher during restrictive monetary periods. This observation is consistent with expectations as the Fed is generally considered to follow a restrictive monetary policy during periods when inflation is a more prominent investor concern.

The prominence of the return patterns in Panel D for the equity and long-term bond index are accentuated by an evaluation of the real returns (nominal return less the inflation rate). The S&P 500 and Small Cap index produced weak real returns of -0.76% (4.92% - 5.68%) and 1.63% (7.31% – 5.68%), respectively, during periods when the Fed was following a restrictive policy stance. In contrast, during expansive policy periods, the corresponding real returns for the two indices were an ample 13.65% (16.62% - 2.97%) and 29.97% (32.94% - 2.97%). Interestingly, the real return to the corporate bond index during restrictive monetary periods was a negative 15 basis points, which indicates that, on average, corporate bond investments were losing propositions during such periods. These findings provide compelling evidence that capital market investors have achieved superior returns during periods when the Fed maintained an expansive policy stance. While variation in returns is not reported, expansive policy periods were also characterized as periods with lower volatility, further supporting the attractiveness of these periods.

Exhibit 2 considers the joint influence of the political variables and Fed monetary policy. If, as many have argued, these factors are interdependent and relevant for security-market performance then the analyses presented in Figures 1 through 4, or Exhibit 1, are likely to be misleading. Failure to consider instrumental variables can result in either an understatement or overstatement of the true strength of a relationship between variables. Consistent with the previous exhibits, the analyses in Exhibit 2 are run over the same sample period from 1965 through 2008.

To jointly examine the relationships, we estimate multiple regressions that contain, as independent variables, the qualitative variables described earlier.[[10]](#footnote-10)

Consistent with Jensen and Moorman [2012], we capture the monetary policy effects using a detailed qualitative classification that combines the separate policy measures. Monthly data is tabulated as expansive monetary policy, restrictive monetary policy, and periods in which the monetary policy stance is indeterminate. In order to observe each classification’s impact, we create binary variables for expansive (1) or not expansive (0) and restrictive (1) or not restrictive (0) periods, with the indeterminate classification serving as the omitted case. Political variables are represented with binary variables that reflect a simple qualitative distinction. The presidential party variable takes a value of 1 if the president is a Republican and a value of 0 for a Democratic president. The political gridlock variable assumes a value of 1 if gridlock is present and 0 if there is no gridlock. Finally, the term year variable is 1 if the return is in the third year of a Presidential cycle and 0 if the returns are from any other year of the term cycle.

The multiple regression results are reported in Exhibit 2. These results confirm the dominant role of monetary conditions for security returns. After controlling for the political landscape, monetary policy has a significant relationship with the small stock equity index and is also significantly related to T-bill returns and the inflation rate. In contrast, the party of the president is not significantly related to any of the indexes studied. Interestingly, political gridlock is significantly related to the small stock index, corporate bond returns and T-bill returns. The Presidential term dummy is significantly related to both the large and small equity indexes

Overall, the results of the regression analysis suggest that the security-return patterns that previous studies have attributed to the party of the president are more likely the result of monetary or fiscal policy developments. Our results present compelling evidence that shifts in monetary policy and the state of political gridlock are systematically related to long-term security returns. Furthermore, the evidence indicates that the third year of a presidential term, on average, offers equity investors a significant return premium.

## CONCLUSIONS

This study conducts a comprehensive evaluation of the relationship between security return patterns and both political events and shifts in Fed monetary policy over the period from 1965 through 2008. Our research offers three fundamental improvements on previous research: First, we consider the relationship between security returns and political and monetary policy developments jointly, rather than independently; Second, we use a more valid measure of monetary policy that considers Fed policy stance (long-term strategy) and stringency (short-term actions); and finally, we consider real and nominal returns for both equities and fixed-income securities.

We find prominent security return patterns associated with political gridlock, the presidential term and shifts in Fed monetary policy. As expected, the patterns are especially pronounced for small firm equities, which is consistent with the strong influence that fiscal and monetary policy actions have on the most vulnerable firms. Our findings also identify considerable divergence in the patterns across asset classes; this divergence has several implications for the asset allocation decisions of investors (see Exhibit 3). In contrast to past research, we find no significant relationship between the president’s party affiliation and the returns to either equity or fixed-income securities.

Overall, our empirical evidence is consistent with the following contentions. 1) Equity investors, especially those that target small-cap stocks, would be wise to monitor Fed policy actions, while paying limited attention to the party of the president. Investors should be particularly wary of a shift to a restrictive Fed monetary policy. 2) Contrary to the conventional view, equity investors should welcome political harmony; however, debt investors should prefer continued political gridlock. 3) Fed policy shifts should be reviewed as potential signals of coming inflationary pressures. A shift to a restrictive policy stance should alert investors to higher future inflation and support a re-allocation to securities that offer more inflation protection (e.g., commodities and TIPS). 4) Regardless of the political outcome in November, it appears that equity investors will have to wait until the third year of the next presidential term before reaping the benefits of the election season.

**Figure 1: Equity Returns under Democratic and Republican Presidencies 1965-2008.**

**Figure 2: Equity Returns under Harmony and Political Gridlock  
1965-2008.**

**Figure 3: Equity Returns during the Third Year of the Presidential Cycle 1965-2008.**

**Figure 4: Equity Returns during Expansive and Restrictive Monetary Policy 1965- 2008.**

**Exhibit 1 Nominal Annualized Returns of Ibbotson and Associate’s SBBI Indexes**

Nominal (inflation unadjusted) annualized means of monthly return observations for Ibbotson Stocks, Bonds, Bills, and Inflation Market Report. The data spans from January 1965 through December 2008. The results are given for Democratic and Republican Presidencies, for periods of political harmony and gridlock, for the 3rd year of the Presidential term and the other term years and for expansive, restrictive and indeterminate monetary periods. *p*-values are for the difference-in-means tests.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **SBBI Nominal Returns 1965 through 2008** | | | | | |
|  | **Large** | **Small** | **Corp** | **T-bill** | **Inflation** |
| **Panel A. Presidential Party Influence** |  |  |  |  |  |
| Democrat (n = 192 months) | 14.61% | 26.18% | 3.52% | 5.62% | 4.65% |
| Republican (n = 336 months) | 7.73% | 9.45% | 10.75% | 5.81% | 4.33% |
| Democrat-Republican | 6.87% | 16.73% | -7.23% | 0.19% | 0.32% |
| *t*-stat Probability | 0.08 | 0.02 | 0.01 | 0.22 | 0.21 |
|  |  |  |  |  |  |
| **Panel B. Political Gridlock Influence** |
| Gridlock (n = 354 months) | 10.12% | 8.67% | 10.97% | 6.18% | 4.17% |
| Harmony (n = 174 months) | 10.33% | 29.89% | 2.38% | 4.87% | 5.01% |
| Gridlock-Harmony | -0.21% | -21.22% | 8.59% | 1.31% | -0.84% |
| *t*-stat Probability | 0.48 | 0.00 | 0.00 | 0.00 | 0.03 |
|  |  |  |  |  |  |
| **Panel C. Presidential Term Year Influence** |
| Year 3 (n = 132 months) | 23.14% | 35.93% | 6.28% | 5.49% | 4.47% |
| Other Years (n = 396 months) | 6.16% | 9.06% | 8.67% | 5.83% | 4.44% |
| Year 3-Other Years | 16.98% | 26.87% | -2.39% | 0.34% | 0.03% |
| *t*-stat Probability | 0.00 | 0.00 | 0.24 | 0.09 | 0.47 |
|  |  |  |  |  |  |
| **Panel D. Monetary Policy Influence** |
| Expansive (n = 161 months) | 16.62% | 32.94% | 8.59% | 4.67% | 2.97% |
| Indeterminate (n = 186 months) | 10.01% | 9.14% | 10.14% | 6.01% | 4.54% |
| Restrictive (n = 181 months) | 4.92% | 7.31% | 5.53% | 6.43% | 5.68% |
| Expansive-Restrictive. | 11.70% | 25.63% | 3.06% | -1.76% | -2.72% |
| *t*-stat Probability | 0.03 | 0.00 | 0.22 | 0.00 | 0.00 |

a – The number of months in each administration during the respective sample period is identified by "n".

b - The difference in means test was performed on mean monthly returns. Therefore, the *p*-value indicates whether the mean monthly returns are different between Republican and Democratic administrations. Annual returns are reported for expositional purposes and are calculated by compounding the mean monthly returns.

**Exhibit 2**

**Security Returns and the Combined Influence of Political and Monetary Conditions**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | | **Regression Results, (1965 – 2008)** | | | | | |
| **Index** | **Intercept** | | **Presidential Administration** | **Political Gridlock** | **Presidential Term Year Three** | **Expansive Monetary Policy** | **Restrictive Monetary Policy** |
| Large | 0.0091  (0.035)\*\* | | -0.0068  (0.058) | 0.00038  (0.919) | 0.0112  (0.011)\*\* | 0.0048  (0.34) | -0.0035  (0.43) |
| Small | 0.021  (0.000)\* | | -0.0077  (0.17) | -0.017  (0.003)\* | 0.017  (0.011)\*\* | 0.017  (0.018)\*\* | -0.0063  (0.27) |
| Corp | 0.0027  (0.297) | | 0.0033  (0.157) | 0.0049  (0.045)\*\* | -0.0023  (0.359) | -0.0015  (0.605) | -0.0018  (0.523) |
| T-Bill | 0.0038  (0.000)\* | | -0.00031  (0.433) | 0.0017  (0.000)\* | 0.0001  (0.781) | -0.0011  (0.000)\* | 0.0008  (0.011)\*\* |
| Inflation | 0.0037  (0.000)\* | | 0.00024  (0.640) | -0.00029  (0.615) | 0.00038  (0.511) | -0.0013  (0.004)\* | 0.00089  (0.035)\*\* |

Regression results are reported as coefficients with *p*-values in parentheses. The regressions are estimated with mean monthly index return as the dependent variable and five qualitative variables for independent variables. The qualitative variables are defined as follows: Republican administration=1, Democratic administration=0; gridlock present=1, gridlock absent=0; and expansive Fed policy=1, non-expansive Fed policy=0. Restrictive Fed policy =1, non-restrictive Fed policy=0, Presidential term year three =1, all other term years =0.

\*, \*\* Identify statistically significant coefficients at the 1% and 5% levels, respectively.

#### Exhibit 3: Historical Outcomes for the Ibbotson and Associate’s SBBI Indexes.

#### This Table evaluates nominal returns during periods when the following political environments (Gridlock or Harmony), Fed Policy (Restrictive or Expansive) and party in control of the Presidency have been observed and compares them against the asset class historical averages. The periods when returns are greater than historical averages represent an opportunity to “overweight” an investor’s portfolio in that asset class and the periods when returns are lower than historical averages represents an opportunity to “underweight” an investor’s portfolio in that asset class.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **Republican President** | | | | |
| **Monetary Policy** | **Political Environment** | **Large** | **Small** | **Corp** | **T-bill** | **Inflation** |
| EXPANSIVE | *Gridlock* | Overweight | Overweight | Overweight | Underweight | Underweight |
|  | *Harmony* | Underweight | Overweight | Underweight | Underweight | Underweight |
|  |  |  |  |  |  |  |
| RESTRICTIVE | *Gridlock* | Underweight | Underweight | Underweight | Overweight | Overweight |
|  | *Harmony* | Overweight | Underweight | Underweight | Underweight | Underweight |
|  |  | **Democratic President** | | | | |
|  |  | **Large** | **Small** | **Corp** | **T-bill** | **Inflation** |
| EXPANSIVE | *Gridlock* | Overweight | Underweight | Underweight | Underweight | Underweight |
|  | *Harmony* | Underweight | Overweight | Underweight | Underweight | Overweight |
|  |  |  |  |  |  |  |
| RESTRICTIVE | *Gridlock* | Overweight | Overweight | Overweight | Underweight | Underweight |
|  | *Harmony* | Underweight | Overweight | Underweight | Overweight | Overweight |

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1. For instance, in a recent review article by Foster (2012), the broad question, “Does the U.S. Presidential Election Impact the Stock Market?” is posed. [↑](#footnote-ref-1)
2. The superior performance of the stock market during Democratic administrations is also identified by Huang [1985], Johnson, Chittenden and Jensen [1999] and Sy and Zaman [2011]. [↑](#footnote-ref-2)
3. See for example, Coleman [1999] for details on the theoretical rationale. [↑](#footnote-ref-3)
4. For examples of announcement period studies, see Waud [1970], Smirlock and Yawitz [1985] and Pearce and Roley [1985]. These studies show that stock markets generally react positively to announcements of Fed easing and negatively to announcements of Fed tightening. [↑](#footnote-ref-4)
5. This is consistent with prior studies in this area. In particular, see Santa-Clara and Valkanov [2003] and Beyer, Jensen and Johnson [2004]. [↑](#footnote-ref-5)
6. Note, some political periods ran shorter than the full election term due to death, resignation, or change in party affiliation, which changed the balance of power. [↑](#footnote-ref-6)
7. For a more thorough discussion of the monetary policy measure see Jensen, Johnson and Mercer [2000]. [↑](#footnote-ref-7)
8. This result was also identified by Johnson, Chittenden and Jensen [1999] and Beyer, Jensen and Johnson [2004]. [↑](#footnote-ref-8)
9. These findings are consistent with Jensen, Johnson and Mercer [1998]. [↑](#footnote-ref-9)
10. The results are adjusted for correlation in the error terms and heteroskedasticity using the Newey and West [1987] general covariance matrix to determine the estimators and calculate the standard errors. The results are robust with the unadjusted least squares estimates. [↑](#footnote-ref-10)