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Elections & Markets: An Outside Viewpoint

In April of this year, the CFA Society of Detroit invited Dr. Robert Johnson, CFA, Deputy CEO of the CFA Institute, to share his insights with members of the Society into the impact of US presidential elections on securities markets. Much of his work on this topic is the result of extensive empirical research conducted by himself and his two colleagues. We thought that our readers might find his observations and conclusions useful given that we are now in the midst of another quadrennial, presidential election cycle.

We have condensed, with permission, and reprinted below an article that Bob and his colleagues, Dr. Scott B. Beyer, CFA and Dr. Gerald R. Jensen, CFA, contributed to the Journal of Portfolio Management in 2004. His recent speech in Detroit, supported by additional research, indicates that the conclusions reached then still hold today.

For ease of reading, and due to space limitations, we are not reproducing the entire article, the tables summarizing the research, nor the endnotes. We are maintaining the actual footnotes in the body of the text and encourage readers to contact us if they would like either the entire article, or the endnote source information.

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Don't Worry About the Election
Just watch the Fed

It's a presidential election year. The papers are full of articles speculating on the relationship between security market returns and the outcome of the election. Is one political party better for the stock market? What about the influence of political gridlock on security returns? When Congress and the White House are controlled by different parties, does the market react? Movements in security prices are also routinely linked to the actions of the Federal Reserve. Is the Fed chairman the second-most powerful person on earth?

Many studies link the political landscape and monetary conditions to performance of the security markets. Oddly enough, politics and economic conditions have not been considered jointly in an examination of security returns. Our analysis considers two dimensions of the political landscape—the party of the president and political gridlock—along with Fed monetary policy in examining long-term security returns. The findings indicate that Fed policy dominates political considerations in determination of security returns. And, contrary to popular opinion, we find compelling evidence indicating that political gridlock is not beneficial to security market performance.

PREVIOUS EVIDENCE

There are strong arguments linking 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 research completes the link by showing a corresponding relationship between security returns and political and monetary conditions. Analysts scrutinize political and monetary conditions before making investment recommendations.

Fiscal policy and monetary policy represent fundamental variables believed to impact general business conditions, and thus security returns. While the two policies are set by independent bodies, they are frequently applied in a coordinated manner to achieve an economic objective. It is surprising the two variables have not been considered jointly in examination of security return patterns.

Many studies have investigated 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] and Smirlock and Yawitz [1985]). Such short-term studies are designed to capture the market's assessment of a change in political or monetary conditions. Our analysis focuses instead on the long-term implications of shifts in political and monetary conditions. The aim is to determine the relationship between security returns and the policies implemented by the political parties and the Fed. Long-term security return patterns are more likely to correspond with monetary and fiscal policies that are actually enacted.

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Some research shows that stock returns are higher during Democratic administrations than during Republican administrations. Santa-Clara and Valkanov [2003] report that excess stock returns (stock returns less the T-bill rate) are 9 percentage points per year higher during Democratic administrations. The excess return difference for small stocks is even greater, reaching 22 percentage points for the smallest size-decile.1

Santa-Clara and Valkanov note that the higher returns earned during Democratic administrations cannot be explained as compensation for higher risk, because the volatility of returns is actually higher during Republican administrations. Finally, they show that the return differences persist even after applying several robustness checks and controlling for changes in business conditions—a political cycle puzzle.

While the stock market has generally prospered during Democratic administrations, Johnson, Chittenden, and Jensen [1999] show that bond returns are much better for all maturities of bonds during Republican administrations. Bond returns are over twice as high in Republican administrations than Democratic administrations.

EXHIBIT 1
Annual Security Returns and Political Administrations

Panel A: Full Period
1926-2000

	S&P 500	**Small-Cap**	**Corp. Bonds**
Republican Adm. (n=420) a	10.78%	7.25%	8.22%
Democratic Adm. (n=480)	15.24%	26.70%	3.99%
(Democratic-Republican) b			
Mean	4.46%	19.45%	-4.23%
P-value	0.38	0.01	0.01

Political gridlock is another dimension of the political landscape frequently associated with economic conditions and security returns. The economic rationale is that fiscal policy intervention is more likely to occur in times of political harmony rather than in political gridlock.2

Popular press articles suggest gridlock is beneficial for the security markets. Shell [2001] quotes Tom McManus, chief equity strategist at Banc of America Securities, as saying "The stock market loves gridlock. Now that the Republicans no longer have the majority in both houses, gridlock is back." Before the 2000 election, Butler [2000] quoted Edward Yardeni, chief investment strategist at Deutsche Banc Securities: "Gridlock has been very good for the stock market." Just one day before that, Ip [2000] reviewed the political influences on the stock market, noting that "since 1982, the market has soared while government has been divided for all but two years."

The influence of Fed monetary policy on the security markets have been the subject of considerable analysis. Because we focus on long-term security returns associated with Fed policy actions, we do not detail the many studies of the announcement effect of Fed policy changes.3

Several studies identify systematic patterns in long-term security returns that are associated with prior changes in monetary policy. Specifically, stock returns in periods the Fed is following an expansive policy are shown to be better than returns in periods of restrictive Fed policy. See as examples Jensen, Mercer, and Johnson [1996], Patelis [1997], Thorbecke [1997], and Jensen, Johnson, and Mercer [1998]. The monetary policy-related return patterns identified in these studies exhibit two characteristics consistent with the political cycles puzzle: 1) the patterns are substantially stronger for small stocks, and 2) the patterns cannot be attributed to differences in volatility or business conditions proxies.

EXHIBIT 3
Annual Security Returns and Monetary Policy

Panel A: Full Period
1937-2000

	S&P 500	**Small-Cap**	**Corp. Bonds**
Expansive Policy (n=377)a	18.48%	28.26%	7.13%
Restrictive Policy (n=383)	8.10%	7.72%	4.48%
(Expansive-Restrictive)b			
Mean	10.38%	20.53%	2.65%
P-value	0.02	0.00	0.16

Our analysis extends this research in several ways. We believe we are the first to consider the political landscape and monetary conditions jointly in an examination of security return patterns. Monetary and fiscal policies are often structured in tandem to produce a desired result in the economy. The empirical similarities between the political cycles puzzle and the monetary policy-related return patterns provide further motivation for a joint examination of the two effects.

Second, while political gridlock has been debated in the popular press, the relationship between gridlock and security returns has not been subjected to rigorous academic study. Third, previous studies have focused almost exclusively on stock returns. We evaluate equity indexes, fixed-income indexes, and the rate of inflation.

Finally, we examine the relationship between security returns and political and monetary conditions over sub-periods to determine the consistency of the relationship over time.

CONCLUSIONS

We know monetary and fiscal policy are interdependent, and both variables have been linked to patterns in security returns. Our analysis examines their joint effects on long-term security returns.

The evidence is contrary to the popular opinion that the stock market benefits from political gridlock. Equity returns are found to be generally invariant to gridlock; if anything, equity markets perform more poorly under gridlock.

While earlier evidence suggests that equities, particularly small stocks, earn better returns during Democratic administrations, our evidence suggests the relationship is spurious. After controlling for monetary conditions and gridlock, equity returns are higher in early periods under Democratic presidents, but higher in later years under Republican administrations. The relationships between security returns and presidential administrations are statistically insignificant in both the early and the later period, though. Earlier evidence had suggested that fixed-income returns, both short- and long-term, are higher during Republican administrations. Our evidence identifies such a relationship for T-bills, but not long-term corporate bonds.

After controlling for shifts in the political landscape, we find strong evidence that shifts in Fed monetary policy has a significant relationship with security returns. The return patterns are particularly prominent during the last three decades, which is consistent with a contention that monetary policy was little used in the years following the Depression. The monetary policy-related return patterns, consistent with previous evidence, suggest that equity markets prosper when the Fed maintains an expansive policy stance. Expansive policy periods are also associated with significantly lower inflation, which indicates that real returns to investors are especially attractive during expansive periods.

Overall, the evidence is that equity investors have consistently benefited from an expansive rather than restrictive Fed monetary policy. There is no consistent evidence suggesting that shifts in the political landscape have been systematically related to security returns.

We'd say market participants should focus on the actions of the Federal Reserve when they consider investment, but treat election outcomes as a minor distraction.

The Economic and Market Environment

In Sum: Common stock prices declined materially during June and early July 2008 in a reflection of deteriorating global investor confidence. Government bond yields fell as investors bid the prices of the instruments higher, seeking to capture the security of these ultra safe investments. While some of the troublesome geopolitical issues that have caused consternation for investors in the recent past have moderated of late, economic concerns have overridden these generally positive developments. Central bankers are becoming increasingly worried about inflation pressures, and this mitigates some of the available options at their disposal to alleviate economic distress.

Geo-political: Iraq, North Korea, Iran, Israel, and Venezuela continue to dominate the headlines. In Iraq, an article in the July 13, 2008 issue of the New York Times suggests a reduction of US troops as early as this September as "...security in Iraq has improved vastly, as has the confidence of Iraq's government and military and police, raising the prospect of additional reductions that were barely conceivable a year ago." North Korea recently signaled further concessions in its nuclear arms program which led the Bush Administration to suggest it would remove that country from a list of terrorist sponsors. Iran continues to defy pressures to modify its nuclear program and as a result is losing support from former allies. Israeli Prime Minister Olmert recently met with the president of Palestine, Abbas, and stated that the two adversaries "Have never been as close to the possibility of an accord as we are today," according to the New York Times. Venezuelan president Chavez has seen his influence wane at home and in South America as economic conditions in his country worsen, causing him to reduce his public tirades directed at the United States.

Economic: Recent statistics indicate global economies continued to expand in the first quarter of 2008, albeit at a generalized slowing pace. With real and financial asset price declines spreading from the US to Europe and the far east, adversely affecting consumer and business sentiment, the outlook over near term economic prospects has clouded. One bright spot in the US has been employment, where the ranks of the employed dropped only modestly in June from May 2008 (155,000) and the unemployment rate remained unchanged according to the US Dept. of Labor.

Monetary: The Federal Reserve Board left interest rates unchanged following its June 25, 2008 meeting, citing heightened inflation concerns. Other central bankers, including the European Central Bank, have been sounding a similar refrain. This posture contrasts starkly with the general trend of interest rate decreases by central bankers over the past several months.

Fiscal Policy: The economic stimulus program recently passed by the US Congress and signed into law by President Bush did spur retail sales, but concerns are mounting that additional stimulus may be needed.

Equity Markets: Equity prices dropped precipitously in June 2008, following a strengthening in April and May. Virtually all sectors, and geographies, were impacted. The impetus was a worsening in the financial crisis that has resulted from residential real estate mortgage defaults. Past periods of weakness that were precipitated by financial crises have typically been resolved with material gains in the months following the crisis and we would expect this environment to follow a similar pattern.

Fixed Income Markets: Yields on US Treasury securities declined modestly during the past several weeks in a "flight to quality" from volatile equity markets. Short to medium term Investment grade corporate bond yields have declined more than longer maturities. Concerns about the US Governments' willingness to guarantee Fannie Mae and Freddie Mac (the government sponsored entities chartered to provide mortgage funding to home buyers) debt has proven unsettling to the fixed income markets, but the auction of new debt by Freddie Mac on July 14 was well received by investors.

Sigma Investment Counselors, Inc.
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26261 Evergreen • Suite 455 • Southfield, MI 48076 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com