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POLITICAL ORIENTATION OF GOVERNMENT AND STOCK MARKET RETURNS

ABSTRACT

Prior research documented that U.S. stock prices tend to grow faster during Democratic administrations than during Republican administrations. This letter examines whether stock returns in other countries also depend on the political orientation of the incumbents. An analysis of 24 stock markets and 173 different governments reveals that there are no statistically significant differences in returns between left-wing and right-wing executives. Consequently, international investment strategies based on the political orientation of countries' leadership are likely to be futile.

JEL classification: G11; G14; G15

Keywords: Stock Market Returns, Politics, Presidential Puzzle

I. INTRODUCTION

An important question faced by every voter on the Election Day is which of the parties is best equipped to foster the development of economy and capital markets. In the pursuit of their own political agenda, the winning party or coalition can fine-tune the fiscal policy and significantly impact on the future economic outcomes. Depending on their political orientation, the objectives of different camps can be quite disparate. As suggested by the partisan theory of Hibbs (1977), left-wing governments tend to cater for the well-being of their working class electorate by targeting unemployment. Right-wing governments, on the other hand, prioritize reduction in inflation feared by the higher income and occupational status groups.

Several earlier papers focused specifically on the relationship between political orientation of the executive branch of the government and the stock market performance. Johnson et al. (1999) and Santa-Clara and Valkanov (2003) report that U.S. stock market returns were higher under Democratic than Republican presidencies, with the difference being particularly large for small stock portfolios. This anomaly can not be explained away by variations in business cycle proxies. Huang (1985) and Hansel and Ziemba (1995) look at whether presidential trading strategies are able to improve investors' risk-return trade-off.

Our paper adds to the presidential puzzle literature by extending the empirical analysis beyond the U.S. stock market. The dataset compiled for this study covers 24 OECD countries and 173 different governments. Since elections are relatively infrequent, a multi-country approach allows increasing the number of observations and the power of statistical tests. Furthermore, it provides useful insights to international investors who wonder whether the conclusions obtained from the U.S. data can be generalized in a global context.

The remainder of this letter is organized as follows. The next section describes data sources and sample characteristics. Section III investigates the behavior of stock market indexes around the Election Day and throughout the tenure of different administrations. The implications for investors and conclusions are contained in the last section.

II. DATA

In order to investigate the nexus between political variables and stock returns the authors attempted to construct a comprehensive dataset including all OECD countries. Regrettably, Iceland, Ireland, Luxembourg, Slovakia, South Korea, and Switzerland had to be excluded from the analysis because either MSCI did not provide data on stock market indexes for these capital markets, or there was not a single change in the orientation of the government throughout the period for which the index was available. The returns for the remaining 24 countries were computed using the U.S. dollar denominated, value-weighted, and dividend-adjusted MSCI Country Indices spanning a period from January 1980 through December 2005. Whenever daily data on MSCI index was not available from January 1980, the sample period was adjusted accordingly. The stock market data was sourced from Thomson Financial DataStream. This dataset has been previously used in Bialkowski et al. (2006).

The prevailing political system in a given country (presidential or parliamentary) determines the relevant type of election that will be examined. Election dates as well as the exact start and end dates of each government’s term in office were obtained from Banks et al. (2004), Caramani (2000), Lane et al. (1991), Laver and Schofield (1998), and Müller and Strøm (2000). The classification of governments into left- and right-leaning administrations was taken from Alesina and Roubini (1992), Alt (1985), and Banks et al. (2004). Coalition governments were attributed to the political camp they are conventionally associated with. Table 1 describes the characteristics of the political and financial variables used in this letter.

Country	MSCI index starting date	Number of left-wing governmen ts	Number of right-wing government s	Number of days left-wing government in office	Number of days right-wing government in office
Australia	*1-Jan-80*	*5*	*6*	*4749*	*4382*
Austria	*1-Jan-80*	*6*	*2*	*7339*	*1792*
Belgium	*1-Jan-80*	*2*	*6*	*1999*	*7132*
Canada	*1-Jan-80*	*5*	*3*	*5734*	*3397*
Czech Republic	*30-Dec-94*	*2*	*2*	*2359*	*1295*
Denmark	*1-Jan-80*	*5*	*6*	*4211*	*4920*
Finland	*1-Jan-87*	*5*	*1*	*5126*	*1448*
France	*1-Jan-80*	*4*	*4*	*5346*	*3785*
Germany	*1-Jan-80*	*4*	*5*	*3261*	*5870*
Greece	*1-Jun-01*	*1*	*1*	*1013*	*296*
Hungary	*2-Jan-95*	*2*	*1*	*2230*	*1421*
Italy	*1-Jan-80*	*6*	*3*	*7487*	*1644*
Japan	*2-Jan-80*	*1*	*9*	*885*	*8245*
Mexico	*1-Jan-88*	*3*	*1*	*4718*	*1491*
Netherlands	*1-Jan-80*	*2*	*7*	*2891*	*6240*
New Zealand	*2-Jan-87*	*4*	*3*	*3248*	*3325*
Norway	*1-Jan-80*	*5*	*5*	*5029*	*4102*
Poland	*1-Jan-93*	*2*	*2*	*2635*	*1747*
Portugal	*4-Jan-88*	*2*	*3*	*2350*	*3856*
Spain	*1-Jan-80*	*5*	*3*	*5161*	*3970*
Sweden	*1-Jan-80*	*6*	*2*	*7021*	*2110*
Turkey	*4-Jan-88*	*2*	*4*	*1407*	*4799*
United Kingdom	*1-Jan-80*	*3*	*4*	*2800*	*6331*
United States	*1-Jan-80*	*3*	*5*	*3307*	*5824*
Overall		*85*	*88*	*92306*	*89422*

Table 1: Sample Description

Note: The first column lists all of the 24 OECD countries included in the sample. The dates from which daily stock prices for the respective MSCI Country Indices became available in DataStream are shown in the second column. For any given country, the number of left-wing and right-wing governments that were in office between the index start date and the end of 2005 are indicated, as well as the overall number of days corresponding to the tenures of either political camp.

Over 60% of countries had daily MSCI index data available from January 1980, whereas in the remaining cases the index starts at a later date. Among the 24 nations, Denmark and Australia had the highest number of governments included and Greece had the lowest due to short index availability. The dataset covers a comparable number of 85 left-wing and 88 right-wing governments. Although the number of right-wing administrations was slightly higher, the left-wing governments had tenures that were on average 70 days longer. This translates into a longer overall term in office for the left camp.

III. RESULTS

Abnormal Returns around the Election Day

One of the features of political systems is that elections do not necessarily coincide with an immediate change in the executive. For instance, the U.S. elections are always held on Tuesday following the first Monday of November, whereas the presidential term starts on the 20th of January the following year. This study investigates the relationship between politics and stock market by focusing both on the entire term of office and on the day on which voters cast their ballots.

It is conceivable, that in the face of political changes investors adjust their required risk premium on assets. If they attribute greater uncertainty to the left of the political spectrum, the stock market will be expected to offer higher returns under left-wing governments. These higher returns would be a form of compensation for the increased risk. In this scenario, however, stock prices on the Election Day are likely to plummet. This is an immediate consequence of the increased discount rate and the resultant lower present value of future cash flows of all firms. The story of changing risk premium is consistent with the previously discussed presidential puzzle and Riley and Luksetich (1980) findings showing the existence of negative returns around the Election Day for Democratic victories and positive returns for Republican wins.

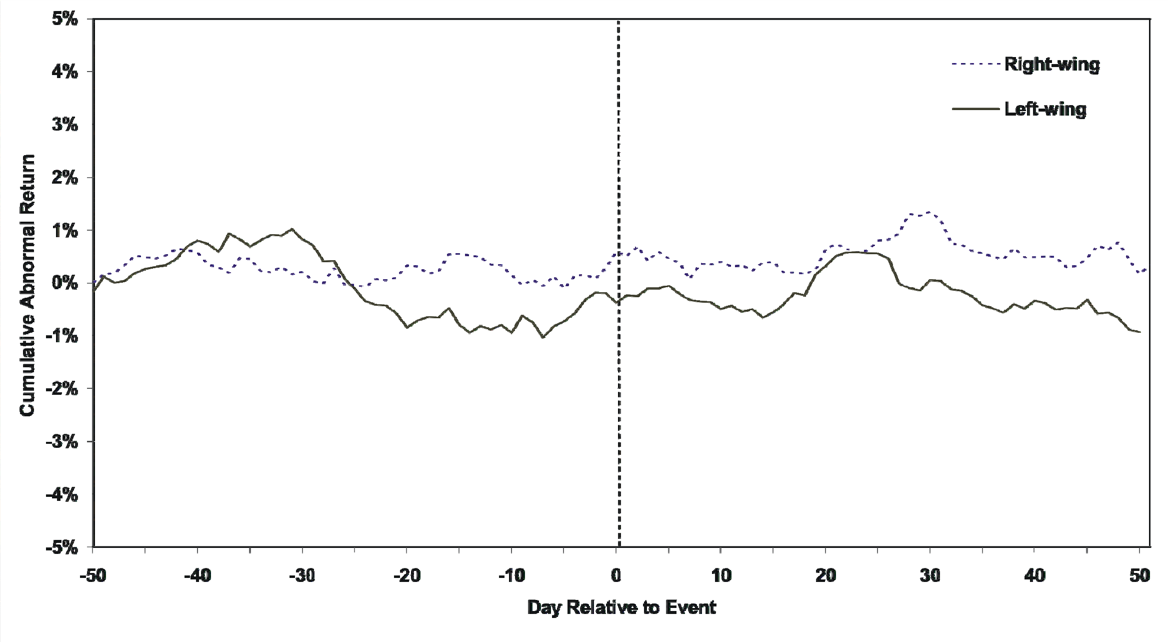

Figure 1: Cumulative Abnormal Returns around the Election Day

Note: This figure depicts cumulative abnormal returns around the Election Day (Day 0) for right-wing and left-wing government wins. In instances where elections took place during the weekend Day 0 is defined as the first day of trading after the elections. The abnormal returns are calculated as the difference between the return on the MSCI Country Index and the MSCI World Index. The abnormal returns were subsequently averaged across all relevant events and cumulated over time to obtain the cumulative abnormal return.

In its first step, this analysis examines international stock market patterns around Election Day using a simple event-study. The abnormal returns are defined as the difference between the returns on the MSCI Country Index and the MSCI World Index. Figure 1 depicts the cumulative abnormal returns separated by orientation of the election winner. The plots show no apparent market reaction around the day when the uncertainty about future political leadership is resolved. The cumulative abnormal returns for the right-wing and left-wing election winners oscillate within a narrow range and fail to reach statistical significance. Consequently, the conclusion that investors re-adjust their discount rates in response to election results is not supported by our data. It is also unlikely that highly profitable trading strategies based on the predictions of election outcomes can be designed.

Returns during the Term of Office

Having established that the announcement effect around elections is negligible, our focus turns to measuring stock market performance throughout different incumbencies. Table 2 presents the dollar-denominated annualized returns corresponding to calendar years of tenure. The second column shows mean returns under left-wing rules and is juxtaposed with the third column which reports similar statistics for the right-wing governments. A bootstrap test based on 1,000 replications is used to verify whether the difference between these two columns is equal to zero.

Country	Returns [%]			
	Left-Wing	Right-Wing	Difference	Bootstrap *p*-value
Australia	11.0897	2.0911	8.9986	0.1140
Austria	4.5204	19.4968	-14.9764	0.0490**
Belgium	2.3024	9.8324	-7.5300	0.2060
Canada	5.6661	7.7861	-2.1200	0.3680
Czech Republic	18.1543	-3.9685	22.1228	0.0730*
Denmark	-0.8029	13.3258	-14.1287	0.1090
Finland	9.9560	12.9370	-2.9810	0.4440
France	13.4530	1.5492	11.9038	0.0690*
Germany	-4.1297	14.1892	-18.3189	0.0160**
Greece	3.1633	31.0425	-27.8792	0.1480
Hungary	33.4150	-5.9310	39.3460	0.0190**
Italy	10.9697	2.9079	8.0618	0.2260
Japan	0.43515	7.9392	-7.5041	0.2690
Mexico	20.1139	13.8611	6.2528	0.3610
Netherlands	4.9962	11.1087	-6.1125	0.2330
New Zealand	-3.9651	3.0679	-7.0330	0.2460
Norway	3.3169	9.9913	-6.6744	0.2020
Poland	8.0489	28.1800	-20.1311	0.1690
Portugal	4.5779	0.3350	4.2429	0.3320
Spain	12.4139	3.0942	9.3197	0.1270
Sweden	15.0895	9.7092	5.3803	0.3030
Turkey	0.9501	8.2212	-7.2711	0.3670
United Kingdom	3.1467	10.6031	-7.4564	0.1490
United States	13.9556	6.2568	7.6988	0.1230
Overall	8.6992	8.3588	0.3404	0.5580

Table 2: Political Orientation of Government and Stock Market Returns

Note: The first column lists all of the 24 countries included in our sample. The next two columns report annualized dollar-denominated average stock market returns during the tenure of left-wing and right-wing governments. Column 4 shows the difference between the two estimates. The last column lists the bootstrap *p*-values for the null hypotheses that the differences in column 4 equal zero. The bootstrap procedure was performed as follows. For a single bootstrap sample returns were drawn at random with replacement to match the number of days in office for the left-wing and right-wing governments in our original sample. Subsequently, the annualized average returns for both camps were computed and the difference was recorded. This procedure was repeated 1000 times to develop an empirical distribution for the difference under the null and the *p*-value was extracted from this distribution.

According to Table 2 the Democrat premium in the U.S. is around 7.7% per annum, which is in line with the findings of previous studies using value-weighted index (see Huang (1985), Johnson et al. (1999) and Santa-Clara and Valkanov (2003)). The U.S. experience does not, however, generalize in the global context. A closer inspection reveals that 14 out of the 24 considered stock markets actually offered a right-wing government premium. Out of the 5 cases with bootstrap *p*-value below 10%, 2 favored right-wing governments and 3 favored the political left. Overall, the stock market returns were 34 basis points higher when the left-wing administrations were in power, but this result is not statistically significant. In light of these findings, international investors should exercise a great deal of caution whenever speculating on the orientation of the executive.

IV. CONCLUSIONS

Several earlier papers noted that U.S. stock prices tend to grow faster when Democrats are in office. This anomaly persisted for almost a century and opportunities to exploit it in security trading were present. Since political orientation of the incumbent president is common knowledge, this result may *prima facie* appear to refute the Efficient Market Hypothesis. Alternatively, it may be interpreted as an increased risk premium accruing to investors who decide to hold stocks throughout the tenure of left-wing administrations. If the latter explanation was correct, one would expect high returns during left-wing rules not only in the U.S., but also in other countries.

To verify the abovementioned hypothesis, this study used a comprehensive database covering 24 OECD countries and 173 different governments. The results based on the international sample indicate that there are no statistically significant differences in returns between left-wing and right-wing governments neither in the election period nor throughout the tenure. The anomaly observed in the U.S. appears to be country-specific and investors who diversify their portfolios internationally should be wary of allocating their money based solely on the political orientation of the countries' leadership.

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