Effect of the U.S. Presidential Election on Stock Market Performance.

*Empirical study on effects of election results on stock market*

The U.S presidential elections are a major event that takes place every 4 years and affects economies all over the world. Election results may influence corporate performance by changes in government policies such as spending and tax changes. Further, specific sectors might gain or suffer from sector-specific governmental policies. Stock market participants incorporate their expectations about political changes into prices just before an election and adjust it according to the actual decisions made following the election. In this paper, we will discuss studies on the likely effects of U.S political changes on the economy, if there are any effects at all, and then move on to a more recent analysis of what would likely happen after Obama had won the latest 2012 election.

In a study by Oehler, Walker, and Wendt – 2011, evidence from U.S. presidential elections from 1976 to 2008 with focus on party-specific favoritism are used to explain abnormality in stock prices. The results demonstrate statistically significant (positive or negative) cumulative abnormal price returns for most industries. Most effects appear to be related to the individual presidents and changes in political decision making per se irrespective of the underlying political ideology.

Two parties dominate the U.S. political system: the Democrats and the Republicans. Republicans typically pursue laisser-faire capitalism, favouring low taxes and deregulation, whereas Democrats employ a more Keynesian approach, leveraging the government as the catalyst for socioeconomic progress.

Academic literature that has been studied in the past have shown that there is not much significant impact on industry specific performance whenever the party in power changes, but there is always an abnormal stock price movement across the market whenever the President changes, signaling a change in political policies affecting the economy. More often than not, this abnormal movement is positive rather than negative when the ruling party changes, suggesting that the market expects positive effects from changes in policies
irrespective of the direction of these changes – an effect that is in line with the fact that most reform takes place at the beginning of a presidential term.

The study by Wendt used corporate leverage, calculated as the ratio of book value of debt to market capitalization, and the ratio of net income to total assets to capture pre-election corporate performance independent of the stock market. In order to determine the stock market reaction to changes in the political landscape they used event study methodology. Within the four weeks after being elected, the new president typically outlines his plans for the coming months. This includes explicitly outlining major goals and priorities for the new administration – the first opportunity to reinforce or invalidate current market assumptions (Snowberg, Wolfers, and Zitzewitz 2007a).

The results show that all U.S. presidents, regardless of party, cause abnormal company and sector returns following their elections. However, the effects tend to be more evident in the longer post-election time frame probably because the market remains uncertain (and does not adjust) until the president’s political priorities are clear; or the market struggles to reconcile the effects of political changes. Overall, the results support the hypothesis that, following a presidential election, the market corrects and thus reflects changes in the underlying governing philosophy (Republican or Democrat). This is shown through abnormal returns, the distribution of which varies in direction and magnitude. However, despite some identifiable distinctions between the political profiles of the Republican and Democratic Party it appears that change in the president himself rather than any consistent and permanent difference in political decision making between parties influence stock and industry performance.

**Background on the 2012 election**

As mentioned above, historically U.S. presidential election years have been associated with positive equity returns (abnormal positive stock price movements). Equities often underperform during the first two years of a president’s term and outperform during the last two. According to Strategas Research Partners, the average quarterly total return of the Standard & Poor’s 500 Index in the presidents fourth year in his term was 6.2% during the third quarter, and 3.0% during the fourth quarter since 1926(Exhibit 1).
So far this year, stocks have been following the election-year upward trend: the S&P 500 has gained roughly 12% from January 17 through September 18.

As explained earlier, each of the 2012 presidential candidates has his own vision for the country’s future, depending on whether he’s a democrat or a republican.
For tax rates, Romney’s proposal would pursue reduction in taxes for both personal income taxes and on capital gains and dividends. If approved, these cuts could be a great benefit to personal income and investments. Obama’s proposal is the opposite, increasing taxes for both personal income and capital gains and dividends. This could possibly mean that was Romney to be elected; the stock market would experience a positive reaction whereas Obama’s re-election would mean a negative reaction in the market.

On corporate taxes, both candidates propose tax rate reductions, although Romney’s proposed rate would be lower and would also eliminate tax on foreign earnings.

Another key difference between the Romney and Obama proposals involves the Dodd-Frank Wall Street Reform and Consumer Protection legislation. Romney wants to discard it, potentially eliminating a major regulatory overhang on the Financials sector. Obama wants to leave Dodd-Frank essentially intact, which might sustain negative sentiment on Financials.

**Effect on market depending on the outcome**

The typical rally that follows a close election generally favours domestic cyclicals. However, depending on the outcome, the election could provoke an assortment of reactions in the U.S. equity market. If the Democrats win and hold on to both the White House and a Senate majority, the market could sell off a bit as investors adjust to more gridlock and continued regulatory pressure on Health Care, Energy and Financials.

If the Republicans gain the White House, this could lead to a market stimulus. Investors generally favour a Republican president, as they view the Republicans as more pro-growth and business-friendly than the Democrats.

If the Republicans only gain a Senate majority, the initial market reaction might be muted, as investors would not be surprised to see Obama hold on to the White House as he is generally favoured to win. However, historically, the S&P 500’s average annual return under an all-Republican Congress is 13.3%, compared with 5.8% for a divided Congress, according to Strategas. That could prove to be a decent longer-term market stimulus.
If the Republicans gain both the White House and a Senate majority, Health Care, Energy and Financials could rally on a Republican victory, as these industries stand to benefit from lower regulatory scrutiny.

**Other factors that intertwine with the elections**

The outcome of the U.S. election will definitely impact the direction of the market, but it is just one of many critical issues for investors to consider. As of now, the U.S. economy is growing quite slowly. In 2011, nominal growth in gross domestic product was just 3.8%, a level usually associated with past recessions.

Another important consideration is the “fiscal cliff,” the coming $537 billion potential drag on the U.S. economy in 2013 if Congress makes no decisions to avoid it. Policymakers are in agreement in their desire to reduce the effect of the drag and are likely to reach some agreement. Thus, in the short time between Election Day and New Year’s, Congress will be left with the gargantuan task of coming up with a solution in a “lame-duck” session to avoid an immediate estimated 3.5% blow to the GDP.

Slowdown in a significant number of the world’s economies is also an important thing to consider. China’s slowing economy is of concern, as the country’s high 10% to 12% annual growth rate had been an engine of economic expansion throughout developed and emerging markets.

The debt crisis in Europe and overall recessionary conditions continue to weigh down investors. Markets responded positively to European Central Bank President Mario Draghi’s announcement that the bank would purchase bonds issued by Spain, Italy and other eurozone countries. Although this is definitely a positive announcement, it is only one step in a complicated economic recovery process.

**Post-election effects**

The eventual winner of the elections was President Obama, which probably meant a short-term negative market sentiment. One day after the re-election of President Obama, stocks ended sharply lower. The Dow Jones industrial average closed down about 313 points, or 2.4%.
Investor reaction is markedly negative over the loss of the more pro-business Mitt Romney and the continued gridlock in Congress that makes it tough for lawmakers to avert a fiscal policy crisis by year-end.

The S&P 500 index and Nasdaq composite index ended down 2.3% and 2.5% respectively, with stocks in nearly every industry lower.

The negative sentiment was amplified after Mario Draghi expressed concerns ahead of the U.S. market open about the outlook for Europe's economies, especially Germany.

Investors are focusing on what Obama and Congress will do to avert the looming "fiscal cliff." The biggest fear is Washington's inability to compromise in a lame-duck session over a host of mandated budget cuts and tax cut expirations set to kick in Jan. 1. Fears are that lack of a deal will derail the economic recovery.

In morning trading on Nov. 7 2012, the Dow had been down 369 points, raising fears that it would take its biggest one-day point drop in a year. The index lost 389.24 points on Nov. 9, 2011, on Eurozone debt fears. The blue-chip average's day-after drop so far puts it on pace for its fifth-worst one-day decline following a Presidential Election Day, according to Bespoke Investment Group. The worst fall was after Obama's first White House win in November 2008, when stocks ended more than 5% lower.

The general perception on Wall Street was that a Romney victory would have been better for markets. People will have a lot of concerns about the fiscal cliff (getting resolved) and will again question the economic policies and fiscal prudence of the Obama administration.

**Conclusion**

In conclusion, it can be seen that elections do affect stock markets in a certain direction, depending on both the individual president's themselves as well as the general policies the winning parties will undertake and the possible effect of those policies on market reactions and sentiments. In addition to this, we must look at the other economic factors in the environment at the particular time and place in order to make a good assessment of the market direction. Effects of post elections must also be taken into account, such as the so-called fiscal cliff for the 2012 elections.