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Investment Publications Highlights

US Presidential Politics and the Asset Allocation Decisions of Individual Investors

Carlos A. Colón-De-Armas and Javier Rodríguez, *The Journal of Wealth Management*, vol.19, no. 2 (Fall 2016): 68–72

The authors share evidence that individual investors take the political environment into account when making asset allocation decisions.

Various studies over several decades have looked at the relationship between politics and markets. Some of the more well-known analyses look at returns by administration and the influence of the presidential cycle on asset returns. These studies present evidence that stock returns are higher during Democratic presidential administrations[1] and during the last two years of a presidential administration, regardless of the party.[2,3] Do individual investors act in a way that suggests they believe these findings of return regularities related to politics? The authors seek to answer this question using data from the American Association of Individual Investors (AAII).

Since 1987, AAII has surveyed a subset of its members, considered to be "small, well-informed investors," on their current stock, bond, and cash holdings on a monthly basis.[4] From 1988 to 2012, the average allocation of respondents was 60% to stocks, 16% to bonds, and 24% to cash. Over this same period there were six different presidential administrations (three from each party) in the United States.

The authors test for significant differences in the average asset class allocations of these individual investors during the six presidential administrations. The survey data show that the average allocation to stocks during Democratic and Republican administrations is 63.6% and 57.3%, respectively, a difference that is statistically significant. In addition, for five of the six administrations, individual investors allocated more to stocks during the last two years of a president's term, and four of these differences are statistically significant.

The authors suggest that these findings indicate that individual investors take politically-induced return regularities into account when making investment decisions.

[1] See, for example, Victor Niederhoffer, Steven Gibbs, and Jim Bullock, "Presidential Elections and the Stock Market," *Financial Analysts Journal*, vol. 26, no. 2 (March–April 1970): 111–113.

[2] See, for example, Fred Allvine and Daniel O'Neill, "Stock Market Returns and the Presidential Election Cycle: Implications for Market Efficiency," *Financial Analysts Journal*, vol. 36, no. 5 (September–October 1980): 49–56.

[3] For our take on this type of analysis see Eric Winig, "The Presidential Cycle: Less Than Meets the Eye," Cambridge Associates Research Brief, August 15, 2016.

[4] According to the authors, the AAII survey is sent to 600 members, and the response rate is near 30%.

US Presidential Elections and Implied Volatility: The Role of Political Uncertainty

John W. Goodell and Sami Vähämaa, *Journal of Banking & Finance,* vol. 37, no. 3 (March 2013): 1108–1117

The authors examine the impact of uncertainty during US presidential election cycles on implied stock market volatility, finding that a positive relationship exists between an increase in the election probability of the eventual winner and the implied volatility of the S&P 500 Index. That is, volatility increases as voters become less uncertain about the eventual election winner.

The authors put forth two alternative hypotheses—the election uncertainty hypothesis (EUH) and the political uncertainty hypothesis (PUH)—to study the association between stock market volatility and presidential elections. The EUH postulates that volatility will decrease as it becomes clear one candidate will win, while an equal probability of either candidate winning maximizes uncertainty. The PUH predicts the opposite relationship, suggesting volatility spikes as one candidate's election becomes more likely because investors focus on the unknown impact of his or her macroeconomic policies.

To evaluate these hypotheses, the authors establish a monthly measure of election uncertainty, using presidential contract data from the Iowa Electronic Markets (IEM) over five elections from 1992 through 2008. Their regression results indicate that a 1% change in the election probability of the eventual winner leads to about 0.6% increase in CBOE's Volatility Index (VIX), while an examination of the election uncertainty variable in their model is statistically insignificant. This suggests election uncertainty (not knowing which candidate will win) plays a lesser role than political uncertainty (not knowing the impact of the winning candidate's policies) in causing market anxiety.

The authors conduct additional robustness tests and observe that other economic variables (such as changes in unemployment, inflation, and consumer confidence) have no significant relationship with implied stock market volatility during election cycles, nor does the party affiliation of the eventual winner.

The Outlook for Post-Election Fiscal Policy

Jan Hatzius et al., *US Economics Analyst*, Goldman Sachs, August 5, 2016

Infrastructure spending and business taxation are likely to be the most important fiscal policy issues in the US over the next two years. The authors examine the difference in policy proposals between the two presidential candidates, analyze the likelihood of different proposals becoming policy, and predict how such policies would affect government spending.

Despite their differences, Hillary Clinton and Donald Trump are both promoting expansionary fiscal policies on the campaign trail, with boosting infrastructure spending as one area of common ground. Clinton has proposed paying for these spending increases by changing taxes paid by US corporations on sales made abroad, while Trump has indicated he would increase borrowing. Both have also made corporate tax reform a priority.

The easiest path for expansionary fiscal policy to be enacted is for one party to win the White House and both houses of Congress. Since 1961, single-party controlled US governments have expanded spending through fiscal policy by an average 0.9% of GDP in the first year of a new administration; in contrast, divided US governments have tightened fiscal policy by an average of 0.8%. Prediction markets show the likelihood of a single-party US government in this election cycle is 40%, about evenly split between a Democrat-controlled and Republican-controlled outcome.

The more likely scenario, based on prediction markets today, is a divided government—but that wouldn't necessarily mean deadlock. Even in the divided political climate of the past few years, several pieces of fiscal legislation have been enacted. The authors estimate a 50% likelihood of a deal on Clinton's infrastructure and tax reform priorities if she is elected and Congress remains divided. If Trump is elected, coinciding with Republican majorities in Congress, the authors think a deal on his infrastructure and tax reform priorities has a 75% chance.

In all, the authors believe 2017 fiscal policy spending is likely to be flat, as the 2017 budget was essentially determined in 2015's budget deal. The authors do see fiscal spending increasing by 1.5% in 2018. They also expect state and local government spending to increase because of infrastructure needs. Regardless of who wins, fiscal policy spending is expected to increase as a result. ■