Election outcomes and financial market returns in Canada

Stéphane Chrétien\textsuperscript{a,}\textsuperscript{*}, Frank Coggins\textsuperscript{b}

\textsuperscript{a} Faculty of Business Administration, Laval University and CIRPÉE, Pavillon Palasis-Prince, 2325, rue de la Terrasse, Quebec City, QC, Canada G1V 0A6
\textsuperscript{b} Faculté d’administration, Université de Sherbrooke and CIRPÉE, 2500 Boul.Université, Sherbrooke, QC, Canada J1K 2R1

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\textbf{Abstract}

This paper investigates the relationship between federal election outcomes and expected returns and volatilities in the Canadian money, bond, equity and currency markets from 1951 to 2006. There is little evidence that investment opportunities are different in minority versus majority parliaments and only money market returns differ in Conservative versus Liberal governments. The equity market performs better in the late part of the electoral cycle than in the first two years. Furthermore, the Canadian equity investment opportunities are better in Democratic versus Republican administrations and in the late versus early parts of the presidential electoral cycle. The Canadian dollar is also affected by American election outcomes. No apparent variation in risk or expected state of the economy accounts for the differences in returns.

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\section{Introduction}

Canadian political parties are eager to differentiate themselves by their policies. In particular, their economic policies are often sold as being the best for the country’s economy and financial markets. They furthermore argue that they are better equipped than the other parties to maintain strong relationships with Canada’s most important trading partner, the United States. To be able to operate efficiently and reduce their country’s economic uncertainty, they ask for ‘strong mandate’ during election campaigns. Political analysts and economists regularly comment on these important claims. They also analyze the influence of American politics on the Canadian economy. They finally discuss whether the ‘timing’ is

\* Corresponding author. Tel.: +1 418 656 2131x3380; fax: +1 418 656 2624.
E-mail address: stephane.chretien@fsa.ulaval.ca (S. Chrétien).

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right for the government to call an election or the opposition parties to force an election in a minority situation.

In a context where these issues are as relevant today as they were throughout history, this article explores the historical relationship between federal election outcomes and Canadian financial markets returns from 1951 until 2006. We are interested in four questions. First, are financial market returns different between majority and minority governments? Second, are financial market returns different between right-leaning Conservative and left-leaning Liberal governments? Third, are financial market returns different between the early part and the late part of the variable-term federal mandates? Fourth, are financial market returns influenced by American election outcomes?

To answer these questions, we estimate the expected returns and the standard deviation of returns conditional on election outcomes for ten monthly return series covering the money, bond, equity and currency markets. While the effect of election outcomes on the economy can potentially manifest itself in numerous ways, we focus on financial market returns as they are the easily measured outcome of the collective decisions of a large number of investors with strong economic incentives to act rationally. The competitive and generally efficient process of price determination in financial markets results in prices that adjust rapidly to new information so that realized returns over the long run should reflect the anticipations for risks and rewards conditional on election outcomes.

Apart from being motivated by the common rhetoric of political actors and pundits, our study contributes to a growing academic literature examining the relationship between election outcomes and returns. Hensel and Ziemba (1995), Chittenden, Johnson, and Jensen (1999), Santa-Clara and Valkanov (2003), Booth and Booth (2003) and Powell, Shi, Smith, and Whaley (2007) examine the relationship between the political ideology of the president and returns in the United States. Their results show that large and small–capitalisation equities yield higher returns under Democratic presidencies while U.S. Treasury bonds and bills produce higher returns under Republican presidencies, resulting in significantly higher equity and size premiums under left-leaning administrations.

Tufte (1978), Huang (1985), Hensel and Ziemba (1995), Chittenden et al. (1999), and Booth and Booth (2003) examine the returns in the early part and the late part of the United States presidential term. They find that large and small–capitalisation stocks give significantly higher returns and excess returns in the last two years of a term. For example, with data from 1926 to 1996, Booth and Booth (2003, Table 2) report annualized differences of 9.1% for large and 13.6% from small stock portfolios. This result can be interpreted as a sign of strategic election timing due to “policy timing” (e.g., Kayser, 2005; Nordhaus, 1975; Smith, 2004; Tufte, 1978) and is known as the presidential cycle effect. Bond returns are not statistically different between the first and second halves of the presidential mandate.

Tufte (1978) and Foerster and Schmitz (1997) examine whether the effects of the United States presidential election spill over into other economies. Tufte (1978, p.66) finds that “A presidential election in the United States is nearly as effective in producing accelerated economic growth in Canada, France, Germany, Japan and the United Kingdom as an election in the country itself.” Foerster and Schmitz (1997) find that the occurrence of a presidential election in the United States impacts international stock returns in 18 countries. Specifically, they document that the local currency stock returns are lower in the second year and higher in the first, third and fourth year of the United States presidential election cycle for most countries examined, including Canada. These findings, coupled with results from Mittoo (1992), Koutoulas and Kryzanowski (1994) and Normandin (2004) that the Canadian and American financial markets are partially integrated, suggest that Canada could experience the effect of the American election outcomes beyond the effect of its own federal election outcomes.


2 Powell et al. (2007) argue however that the statistical significance of some of these differences might be overstated.
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