Research in International Business and Finance 33 (2015) 59–74

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Better the devil you know: The influence of political incumbency on Australian financial market uncertainty

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A R T I C L E I N F O

Article history:
Received 27 September 2013
Received in revised form 18 June 2014
Accepted 20 June 2014
Available online 18 July 2014

JEL classification:
C22
C23
G1
G10
G15
G18
H3

Keywords:
Political uncertainty
Investor sentiment
Financial market uncertainty
Implied volatility
Exchange traded options
Stock markets

A B S T R A C T

The Australian federal election cycle, which occurs approximately every 3 years, causes much media attention and invokes indecision regarding investment decisions in both the real economy and financial markets. This paper constructs measures of political uncertainty and formally explores their relationship with market uncertainty, as measured by implied volatility. The empirical evidence suggests that increasing (decreasing) levels of uncertainty around the election result induce higher (lower) levels of market uncertainty. In a case of the market preferring the devil it knows, an increasing (decreasing) likelihood of the incumbent party, whose economic policies are well-known, winning the election, reduces market uncertainty. The results remain significant even after controlling for a number of macroeconomic variables, and when an alternative GARCH framework is considered.

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http://dx.doi.org/10.1016/j.ribaf.2014.06.002
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1. Introduction

The September 2013 federal elections in Australia brought to an end months of media commentary and speculation as to the likely winner, and the prospective future direction of fiscal and economic policy should a particular party win. Existing literature indicates that such political factors influence both the returns and risk levels of financial assets. Hibbs (1986) suggests that economic policies are conditioned by political forces, and party differences in policy have the potential to move the economy along different time paths and manifest in different returns to both stock- and bond-holders. Julio and Yook (2012) provide evidence connecting political uncertainty to changes in fundamentals of the real economy as firms reduce expenditures during times of political uncertainty.

Prior studies have found substantial evidence for the influence of political outcomes on the stock market with the substantive finding that market uncertainty tends to rise as the election approaches and uncertainty about the result increases. Li and Born (2006) find that whilst the mean daily stock return rises in the 3-month period prior to U.S. elections when the outcome is uncertain, it is indistinguishable from the non-election period when the incumbent party is assured of re-election. Goodell and Vähämaa (2013) utilize data from the Iowa Electronic Market, a betting market for the U.S. Presidential election, and find support for the political uncertainty hypothesis which presumes that information regarding the probability of a particular election winner reflects information about future macroeconomic policy.

Three studies have considered the international influence of political uncertainty: Gemmill (1992) discovers a close relationship between U.K. polling and the FTSE Stock Index, with some evidence of ill-informed option speculators creating a bubble in the week prior to the election. Pantzalis et al. (2000) report that the connection between political uncertainty and the stock market differs in countries of varying political, economic and press freedom. Bialkowski et al. (2008) investigate a sample of 27 OECD countries and find that investors are often surprised by the election outcome with stock market return variance doubling during the week around the election. Importantly, the margin of victory and changes in political orientation of government are key factors in explaining the magnitude of the election shock.

In terms of the impact that elections have on the macro-economy of a nation, this study fits within the more general field of research into the impact of news announcements and their effect on market uncertainty and implied volatility. The general result is that an upcoming scheduled news event induces an increase in market uncertainty that quickly dissipates once the announcement is made. Nikkinen and Sahlström (2004), Ederington and Lee (1996) and Smales (2013) report a rise in the volatility of financial asset prices as an approaching macroeconomic announcement creates uncertainty and then falls quickly when the data is released.

Vähämaa et al. (2005) investigate how option-implied return distributions change in bond futures in-light of macroeconomic news announcements, and report that expected volatility increases in response to higher than expected inflation and unemployment announcements. Nikkinen and Sahlström (2004), Chen and Clements (2007) and Vähämaa and Äijö (2011) examine the behaviour of implied volatility around FOMC monetary policy decisions and document that, having risen prior, implied volatility falls following the decision as uncertainty is resolved. Donders and Vorst (1996) utilize a similar methodology to examine the implied volatility behaviour of call options around scheduled firm-specific news announcements and report a substantial increase in implied volatility in the pre-event period and a sharp drop after the news release. To-date, there has been little empirical work concerning implied volatility indices in the Australian context. However, Frijns et al. (2010) construct an implied volatility index for the Australian equity market and observe a significant and asymmetric relationship between the volatility index and stock returns; echoing prior findings in U.S. markets.

French and Porteba (1991) note that investors have a significant home bias and predominantly hold domestic assets, thus they will have a significant amount of country-specific political risk within their portfolios. For such risk-averse investors it is essential to gain a full and proper understanding of the relationship between political uncertainty and market uncertainty. In seeking to investigate

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