Rational speculative bubbles in the US stock market and political cycles

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\textbf{Abstract}

This paper tests the existence of rational speculative bubbles during Democratic and Republican presidential terms, which has not been systematically researched in existing studies. With monthly real returns on equally-weighted and value-weighted portfolios in the U.S. from January 1927 to December 2012, we find that there are rational speculative bubbles under Republican Presidents but not under Democratic Presidents. Our results are robust to different specifications.

\section{1. Introduction}

The term rational speculative bubbles is used to describe a persistent stock market overvaluation. Investors understand assets are sold at prices in excess of their fundamentals, which is the present value of all the asset's future cash flows (Lucas, 1978). However, they believe the bubble will continue
to expand and yield a high return, compensating them for the probability of a crash. There are a large
number of studies testing rational speculative bubbles internationally. Among them are Brooks and
Katsaris (2003) on London stock exchange, Gan et al. (2012) on Hong Kong stock market, Kizys and
Pierdzioch (2012) on stock markets in a cross section of countries, Watanapalachaikul and Islam

Research on asset prices in the U.S. stock market is also extensive. Some studies focus on rational
speculative bubbles in general. For example, with monthly returns between 1929 and 1991, McQueen
and Thorley (1994) find evidence supporting rational speculative bubbles in the U.S. stock market.
Lunde and Timmermann (2004) argue that the longer an expansion, the lower is its probability to
arrive at a termination and the longer a contraction, the higher is its probability to come to a ter-
mination. Other papers explore the relationship between stock market returns and political parties
in power. Johnson et al. (1999) find that the return differential between Democratic and Republican
presidencies is significant for small-cap stocks, but insignificant for large-cap stocks. In a seminal
study, Santa-Clara and Valkanov (2003) demonstrate that the stock market returns in the U.S. are
9% higher based on value-weighted and 16% higher based on equally-weighted portfolios under
Democratic than Republican presidencies over the period of 1927–1998, and they name this result
the “presidential puzzle”.

In this paper we apply the duration dependence test, proposed by McQueen and Thorley (1994), for
the existence of rational speculative bubbles in the U.S. stock market under different Presidents by
political affiliation, which has not been systematically researched in existing studies. With monthly
returns on equally-weighted and value-weighted portfolios in the U.S. from January 1927 to
December 2012, we find that rational speculative bubbles exist in the stock market in the U.S. in gen-
eral, echoing previous research. In addition, our empirical results show that rational bubbles exist
in the U.S. stock market under Republican Presidents but not Democratic Presidents. Various specifi-
cations are used and our results remain robust.

The remainder of the paper is organized as follows: Section 2 describes the duration dependence
test and Section 3 presents our empirical results. Section 4 concludes and discusses potential exten-
sion to this paper.

2. Duration dependence test

Previous research has adopted a number of methods to test for speculative bubbles in asset prices
such as tests for autocorrelation and kurtosis (Blanchard and Watson, 1982) and tests for skewness
(Evans, 1986). McQueen and Thorley (1994) propose a duration dependence test for rational spec-
culative bubbles, implying an inverse relationship between a run of positive abnormal returns and
the length of the run. The authors point out that this test is more unique to bubbles than attributes
including skewness, kurtosis, and autocorrelation which can result from other reasons, such as,
time-varying risk premiums or asymmetric fundamental news.

Duration dependence is a characteristic of hazard function for duration times. McQueen and
Thorley (1994) expect that the hazard function of a run of positive abnormal returns is an inverse
function of the length of the run. A run is defined as a sequence of abnormal returns \((ε_t)\) of the same
sign. Let \(f(t)\) represent the density function for duration times, and \(F(t)\) the corresponding distribution
function. The hazard function \(h(t)\) is the conditional density function for a run with duration of length
\(t\), given that it lasts at least until \(t\). Specifically:

\[
h(t) = \frac{f(t)}{1 - F(t)},
\]

If \(N_t\) and \(P_t\) represent the count of completed runs and partial runs, respectively, of length \(t\) in the sam-
ple, the density function version of the log likelihood for data consisting of a set \(S_T\) is as follows:

\[
L(θ|S_T) = \sum N_t \ln f_t + P_t \ln (1 - F_t),
\]

where \(θ\) is a vector of parameters. Following McQueen and Thorley (1994), the hazard function is writ-
ten as the log–logistic functional form:
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