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Political climate, optimism, and investment decisions*

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Abstract – We show that people’s optimism towards financial markets and the macroeconomy is dynamically influenced by their political affiliation and the current political climate. Individuals become more optimistic and perceive markets to be less risky and more undervalued when their preferred party is in power. Accordingly, investors increase allocations to risky assets and exhibit a stronger preference for high market beta, small-cap, and value stocks, and a weaker preference for local stocks. The differences in optimism and portfolio choice across political regimes are not explained by shifts in economic conditions or differential response to economic conditions by Democrat and Republican investors.

Keywords: Portfolio choice, optimism, politics, sentiment, behavioral finance

JEL Classifications: G11, G02

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