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Washington meets Wall Street: A closer examination of the presidential cycle puzzle☆

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A B S T R A C T

We show that the annual excess return of the S&P 500 is almost 10 percent higher during the last two years of the presidential cycle than during the first two years. This pattern cannot be explained by business-cycle variables capturing time-varying risk premia, differences in risk levels, or by consumer and investor sentiment. We formally test the presidential election cycle (PEC) hypothesis as an alternative to explain the presidential cycle anomaly. The PEC states that incumbent parties and presidents have an incentive to manipulate the economy (via budget expansions and taxes) to remain in power. We formulate eight testable propositions relating to the fiscal, monetary, tax, unexpected inflation and political implications of the PEC hypothesis. We do not find statistically significant evidence confirming the PEC hypothesis as a plausible explanation for the presidential cycle effect. The presidential cycle effect in U.S. financial markets thus remains a puzzle that cannot be easily explained by politicians employing their economic influence to remain in power, as is often believed.

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1. Introduction

"On average, stocks have risen just 2.6% in the first year of a presidential term, nearly 8 percentage points less than the 10.4% returns enjoyed in the third year of the term, which historically has been the best. That underperformance tends to occur because the incumbent president and party in power tend to prime the pump in the final two years to get the economy running on all cylinders in hopes of getting re-elected."

(USA Today, 16 February 2009).

The presidential cycle effect in U.S. stock market returns consists of higher stock market returns during the second half of a presidential term compared to the first. This phenomenon first appeared in Hirsch's Stock Trader's Almanac in 1967 and has returned in the yearly *Almanac* ever since. The first academic interest dates from at least the 1980s. Huang (1985) reports that trading strategies based on the presidential cycle effect produce returns superior to a traditional buy-and-hold strategy. Foerster and Schmitz (1997) examine each year of the presidential cycle individually and conclude that U.S. stock market returns are significantly lower in the second year of the presidential term, compared to the other three years.

The question why there is a relation between the presidential cycle and stock market returns has puzzled academics for years. Several market efficiency explanations have been put forward. First, the presidential cycle might merely proxy for variations in expected returns due to business cycle fluctuations. Booth and Booth (2003), however, find that this is not the case. Second, the relationship between the presidential cycle and stock market returns could be concentrated around and limited to election dates. However, Santa-Clara and Valkanov (2003) find no significant evidence of stock price changes immediately before, during, or immediately after presidential elections. Third, the difference in returns during the presidential cycle might be a compensation for risk. Market volatility could simply be higher in the second half of the cycle, thereby explaining the higher returns. Campbell and Li (2004), however, indicate that the differences in returns cannot be explained by differences in market volatility. Finally, the presidential cycle effect might be driven by the impact of outliers. Gärtner and Wellershoff (1995) as well as Foerster and Schmitz (1997) find that the effect is not driven by individual outliers in the data, such as the October 1987 stock market crash.

Since most rational explanations fail to provide an adequate answer, we formulate a testable framework of the presidential election cycle theory as an alternative. We label this framework the presidential election cycle (PEC) hypothesis. It is based on the macroeconomic political business cycle (PBC) theory by Nordhaus (1975) and MacRae (1977) and states that political parties that try to win elections often manipulate business conditions. Nordhaus (1975) argues that presidential administrations have an incentive to stimulate the economy prior to the elections in order to increase the probability of their electoral success. Fair (1982), who develops a model for voting behavior, indicates that voters do not look back more than a year or two in judging the economic performance of an administration. His result might give presidents an incentive to manipulate the economy prior to the elections, since the myopic electorate only judges the administration on its last years. Rogoff (1990) provides rational underpinnings for the PBC hypothesis by introducing the assumption of information asymmetry whereby policy makers are better informed than voters about their competence. The significant interactions between macroeconomic outcomes and presidential administrations are also confirmed by Chappell and Keech (1986) and Alesina and Sachs (1988), while Tufte (1978), Grier (1987) and Haynes and Stone (1988) find empirical evidence in favor of an American PBC.

Under the PBC theory, an incumbent president would impose stimulative economic measures and corporate friendly policies to create a favorable voting environment close to elections. In order to create this PBC, some economic policy instruments must be manipulated. For electorally-inspired policy making to have macroeconomic consequences, incumbent presidents must either manipulate fiscal or monetary policy. However, the independence of the Federal Reserve System should guard against political pressures, and little empirical evidence for the existence of a political monetary cycle has been

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