



The 2016 U.S. presidential election and the Stock, FX and VIX markets



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ABSTRACT

The U.S. presidential election is one of the global political events that have the profound effects on the Global Financial Markets (GFM). The aim of the study is to examine Stock, FX and VIX markets under the U.S. presidential election 2016. The findings strongly suggest that 'U.S. presidential election effects' hold in equity and FX markets across the GFM. The empirical outcome signifies that markets are inefficient in the short-run (election year) and allows the opportunity to make abnormal gains from the market. The 'Republican president elect' has shown negative effects on the Nifty50, S&P500, and IPC equity markets while FTSE100, DJIA, Top40, EuroStoxx50 and Nikkei225 have reported positive returns. The Trumps' proposal on international trade has caused major loss in the global currency market against the U.S. dollar. The investors' sentiment to be measured extremely low on the poll announcement day but VXJ and AXVI based market participants have shown very high degree of concern. The Bearish-run election effects to be observed during the election period while post election period has shown Bull-run effects (Asia-Pacific markets).

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1. Introduction

There is no reason to believe that policies and regulations imposed by the president and administration do have significant effects on the economy and general sense of well-being of the citizen. The performance of the financial market is linked to the performance of the economy, and performance of the economy influenced by the political uncertainty. Those government policies and actions lead to positive effects on the economy, lead to positive effect on the stock market. The macroeconomic fundamentals such as lower general price level, low interest rate, and low taxes contributes more money supply in the system, and which results in strong economic growth, business gain and growing economy. These positive trends give positive shock to the stock market and strong optimism among the investors. At this point, one can say that elections and stock market are closely associated; as the presidential election approaches-market enters into temporarily turbulence phase.

The presidential election of U.S. 2016 holds special importance for the domestic and global investor community, and those who deal in the Stock, FX, and volatility as an asset class. The starting month 'January' of the election year starts with dominant uncertainty, 'Who will be the next president elect'? There is general wisdom, more the uncertainty about president elect, results in poor performance of the market during election period. Once the winner is declared typically stock market enters in the positive direction. Indeed, the election year generally exhibit a bullish rally in the stock market. It has been

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observed over the last 28 presidential election years, the stock market rallied during September and October 16-times, and slumped 12 –times (e.g. see, early evidences [Niederhoffer, Gibbs, & Bullock, 1970](#) and [Nordhaus, 1975](#)). This explains that stock market closely follows the outcomes and debates of presidential election years. The financial dailies report that markets are outperforming under Democratic presidents ([WSJ., 2016](#); [WSJ, 2016](#)). The S&P 500 yielded 12.18% positive returns under Obamas' presidentialship 2012, but during May 2015 to May 2016 market has reported negative returns with –2.79%.

There is a lack of theoretical guidance in explaining the casual relationship between financial markets and political uncertainty. For example, [Pástor and Veronesi \(2012, 2013\)](#) attempt to explain political uncertainty and stock market behavior. Moreover, [Baker, Bloom, and Davis \(2016\)](#) construct the economic policy uncertainty index (EPU Index) which measures the policy related economic uncertainty and they examine employment, investment, stock price volatility etc. [Pástor and Veronesi \(2013\)](#) build general equilibrium model by taking into account the political uncertainty and show that equity risk premium is commanded by governments' policy uncertainty. They document that stock volatility and correlation remain higher under weak economic conditions. They describe that assets prices are effected by three types of shocks: Capital Shocks, Impact Shocks and Political Shocks. The first two shocks are due to aggregate capital shocks also known as fundamental economic shock. The third one is political shock due to uncertainty of future plan of government and are orthogonal to economic shocks. In a nutshell, the equity risk premium mainly consists of these three components as discussed above. The demand for excess equity risk premium purely determined by debates (presidential election debates) and negotiations of the future government. More specifically, risk premium is considered as political risk premiums associated with agents' belief about the new government policy. It is believed that political risk premium remains lower when economic conditions are stronger. The present study documents the presidential election debates (PEDs) to analyze the effects of political debates and negotiations on the investors' sentiment.

The equity risk premium and political uncertainty are strongly associated. The weak economic conditions not only influence the risk premium but also the assets' returns and volatility. The assets' volatility will be higher when potential new government proposals are perceived as more heterogeneous a priori. The empirical findings support the high volatility and increased level of expected stock market volatility (implied volatility) during the political debates and negotiations.

In order to derive robust empirical outcomes, the study incorporates the policy uncertainty index also known as economic policy uncertainty index (EPU) as developed by [Baker et al. \(2016\)](#). The EPU index and presidential election year 2016 has been considered to examine the global financial markets in terms of Stock, FX and volatility index (VIX). It is believed that when future policy is uncertain and economy is weak it leads to higher degree of political uncertainty (i.e. spikes in EPU index), and also adversely affecting on financial assets. Moreover, it commands the equity risk premium. The findings are consistent with these statements.

There is a dearth of studies (e.g. [Allvine & O'Neill, 1980](#); [Bowen, Castanias, & Daley, 1983](#); [Herbst & Slinkman, 1984](#); [Hill & Schneeweis, 1983](#); [Hobbs & Riley, 1984](#); [Huang, 1985](#); [Zivney & Marcus, 1989](#); [Homaifar, Randolph, Helms, and Haddad, 1988](#)) explore, the stock market returns, stock price Intra-Industry effects, U.S. Treasury market and Defense stock following the presidential election cycle. The abovementioned studies have well documented the effects of U.S. presidential elections on the stock and treasury market. Moreover, [Foerster and Schmitz \(1997\)](#), [Browning \(2000\)](#), [Pantazis, Stangeland, and Turtle \(2000\)](#) and [Nippani, Liu, and Schulman \(2001\)](#) describes how uncertainty of election polls effects on the domestic and global stock market in stipulations of stock returns and Treasury defaults.

[Nippani and Medlin \(2002\)](#) and [Nippani and Arize \(2005\)](#) report that delay in the declaration of presidential candidate after the election, adversely effected the stock market. The above early evidences clearly speak that presidential elections of U.S. affects stock market returns. Some of the interesting attempts e.g. [Nordhaus \(1975\)](#) and [MacRae \(1977\)](#), [Allivne and O'Neil \(1980\)](#) and [Herbst et al. \(1984\)](#) has first time addressed the economic consequences of presidential elections, and stock prices and elections cycles.

[Herbst and Slinkman \(1984\)](#) examine the stock market and U.S. presidential elections for the period 1926–1977. The study observed the existence of both two and four-year election cycles. The political economic cycle affects the stock market returns in 48-month cycle. [Huang \(1985\)](#) describes the U.S. equity market under the regime of Republican and Democrat and present the evidences on Four-year cycle and cycle based strategies. By extending the work of [Allvine and O'Neill \(1980\)](#) [Huang \(1985\)](#) also confirmed the existence of political cycle in the stock market. Findings reveal that investor take lower risk through a switching strategy rather than in-stock strategy.

Not only the election stock markets there are some studies e.g. [Herron, Lavin, Cram, and Silver \(1999\)](#) and [Henry \(2000\)](#) describes the effects of presidential elections on American economic sectors, defense policy, environmental issues, FII's, stock market liberalization and cost of equity capital. The empirical results present adequate evidences that presidential elections influenced the above areas. [Hansen, Schmidt, and Strobel \(2004\)](#) explores the manipulation in the political stock markets using the Berlin 1999 election data and conclude Political Stock Market is subject to manipulation. To control the manipulation, market imperfection should be reduced and filtering of the prognosis advised. Moreover, [Brüggelambert \(2004\)](#) examines the political stock market in terms of information and market efficiency and it hold good in U.S. but did not performs as well in the German market.

The studies for the Canadian, Mexican, and Brazilian stock market on election stock market (ESM) e.g. [Nippani and Arize \(2005\)](#) and [Jensen and Schmith \(2005\)](#). The studies document the impact of delay in the declaration of president after the election and the information contained in the elections campaign and its impact on the Canadian, Mexican and Brazilian economy.

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