

From Washington to Wall Street: The Relationship Between National Politics and Stock Market Performance

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The question explored in this paper is the relationship between national politics and the stock market. There is an interesting relationship between Washington and Wall Street that has existed in the United States for decades that many citizens either do not know or do not understand. Government has had an increasingly influential role in the economy of the United States, particularly since the creation of the Federal Reserve. We seek to understand and explain the impact the balance of power in Washington and political activity can have on the performance of the stock market.

INTRODUCTION

Ever since its founding, the New York Stock Exchange has served as one of the most prominent leading indicators of economic conditions in American society (Hirt and Block, 2012). Throughout its history, this exchange and the broader stock market have reflected economic growth in the United States and around the world. It has provided opportunities for individual and institutional financial gain through risk taking in investments. Whether serving as an avenue of tremendous wealth accumulation or plainly as a supplemental retirement income source, the stock market has impacted the lives of the American people over time. Coinciding with the market's impact on society has been the role of the federal government and political establishments on the American people. Since the founding of the United States, free enterprise capitalism and democracy have shared a common bond of freedom (Friedman, 2002). These forces have arguably been the greatest two contributors of American affluence and exceptionalism, especially since the turn of the 20th century. It is clear that, over time, democratic principles in government pave the way for prosperity in the financial markets.

Political and economic interests, particularly financial interests, have consistently been intertwined in such a free and prosperous nation (Friedman, 2002). The question, then, becomes what is the best political power structure in American government for the stock market to thrive? Does the makeup of Democrats and Republicans in Washington have an impact on the performance of market indices such as the Dow Jones Industrial Average and the Standard & Poor's 500? Is there a particular balance of power between the White House and Congress that leads to higher investment returns? By examining historical data, we discover if there is a correlation between political party power and stock market performance.

This paper asserts that the balance of political power influences, or is directly related to, actions and events in Washington. These actions and events, carried out by elected officials in Congress and the White House, have a heavy impact on economic activity and development for the country. It is widely accepted that the stock market indices are a major leading indicator of the state of the economy in the country (Hirt and Block, 2012). Stock market performance on Wall Street fluctuates daily based on the latest economic and geopolitical news from anywhere and everywhere in the world. Politics and investments have something in common: they both directly impact the lives of millions of Americans. Are these two critical components of activity in the United States separate and impartial to each other, or is there a subtle or potentially deep relationship between the variables? How great of an influence does Washington have on the stock market? In other words, does political action have a cause-and-effect relationship with the stock market?

While many hold the belief that government and business (free enterprise) ought to be kept separate, it is evident that the federal government has played a continually increasing role in the nation's economy. One can look to the financial crisis of 2008 to see the role government played in the economy, and, therefore, the stock market. Following the collapse of the investment banks, Bear Stearns and Lehman Brothers, the financial markets went into turmoil (Paulson, 2010). Other large financial institutions such as AIG and Citigroup were on the verge of collapse as well and were in desperate need of assistance. These institutions were so large and heavily leveraged that other institutions were unable to come to their rescue financially. Only the federal government had the capital necessary to save such failing institutions deemed too big to fail (Sorkin, 2009). President Bush, advised by Federal Reserve Chair Ben Bernanke and then Secretary of Treasury Henry M. Paulson, Jr., was convinced that those institutions needed to be saved in order to prevent the rest of the economy from crashing as well (Paulson, 2010). The fear was that if the nation's largest financial institutions failed, they would bring down the rest of the economy possibly into levels not seen since the Great Depression or even worse. Paulson testified before Congress to convince the legislators that it was necessary to issue what became known as the TARP funds (Troubled Asset Relief Program) in the initial amount of \$700 billion to save firms like Citigroup, AIG, among other major financial institutions in the country.

In this circumstance, the government acted decisively in intervening in the economy. Many conservative politicians compromised their principles, which were based on the teachings of Adam Smith, of free market capitalism without government interference, for the good of the markets, the economy, and the country (Heilbroner, 1986). The balance of power in Congress had a significant influence on the Congressional willingness to proceed with the bailouts and the corresponding passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a result of this action, the stock market eventually stabilized after suffering significant losses. Proponents of the government bailouts and resulting legislation argued that the stock market would have collapsed even lower had the federal government not intervened.

This paper contends that political events impact the financial markets, positively and negatively, as part of an intertwined web of geopolitical and economic activity. It is reasonable to assume that the balance of political power in Washington has a large bearing on fiscal and even monetary policy, which, in turn, impact markets. Therefore, it is also reasonable to assert that politicians have a significant impact on the stock market. This leads to the question of whether the market has a preference for a certain political party or ideology. Does the stock market prefer Republicans in power, Democrats in power, or does it not matter?

BACKGROUND

Campaign Contributions from Wall Street

The relationship between Washington and Wall Street runs deep. When the New York Stock Exchange was founded in March of 1817, James Monroe was the fifth President of the United States. Almost 200 years later, Barack Obama is the nation's 44th President. One can argue that the power held by those in charge in Washington and Wall Street is the strongest, most concentrated amount of authority

and influence anywhere in the world. When these two forces work together, or are forced to work together in instances of crisis, the entire population of the United States may be affected for better or worse (Paulson, 2010).

Historically, Wall Street has been one of the most influential forces in political campaign funding. Despite various measures at campaign reform to protect the public from incredibly rich forces such as those on Wall Street, such forces remain as a powerful player in campaign funding. Wealthy donors and interest groups have become accustomed to using money to influence politics and are usually eager to find new ways to do so. The floodgates of unlimited funds were blown open in 2010 when “the Supreme Court issued a famous free-speech decision called Citizens United that allowed corporations and unions to spend unlimited amounts out of their own treasuries to voice their opinions in an election. Later, a separate court allowed groups to run campaign advertisements any time they wanted” (Mullins, 2012). While institutions cannot donate unlimited funds directly to candidates, they can donate unlimited amounts to political action committees (PACs) or to run their own campaigns for whatever candidate or political interest they desire to support. This influx of funding for campaigns led to what are known as super PACs. “Republican strategist Karl Rove, who was an adviser to President Bush, helped create two of the biggest super PACs, including a group called American Crossroads, which, along with a sister group, could raise and spend as much as \$300 million for Mitt Romney. President Obama’s backers responded with their own super PAC, called Priorities USA, which could raise as much as \$100 million for his re-election campaign”(Mullins, 2012). This trend is likely to continue and potentially increase in significance for one major reason: the winners of political campaigns write the rules. That is, elected representatives to Congress write the laws regarding campaign financing. Because this newfound source of funding is likely to continue to serve their benefit, they are very unlikely to change the status quo for it is the wealth from special interests and super PACs that help get them elected.

Wall Street executives give money to political candidates for one of two reasons: 1) they believe in that candidate’s policies and ideology that would benefit business or 2) they believe that candidate is likely to win and thus want to make sure they are on the winning side in the hope of getting preferential treatment from government and/or political favors. Wall Street embraced George W. Bush during both of his Presidential election bids. In 2000, he won the White House after collecting nearly \$4 million from the financial industry versus Democrat Al Gore’s \$1.4 million (Hook and Morain, 2008). In 2004, Bush received \$8.8 million, twice what Democratic Sen. John Kerry collected (Hook and Morain, 2008).

Due to their conservative, free market philosophy, it is reasonable to assume that Wall Street firms are more likely to donate money to candidates that represent their interests, i.e. Republican candidates. However, Wall Street has actually been a relatively positive supporter of President Obama, who received a heavy percentage of his top funding from Wall Street for his successful 2008 White House run. “In the entire 2008 cycle, bundlers in the finance sector accounted for about \$16 million of \$76.5 million brought in by top Obama fundraisers, the Center for Responsive Politics said. Obama raised a total of \$745 million in his first White House run” (Eggen, 2011). Wall Street viewed Obama as a fresh alternative to Bush’s policies, which fair or unfair, were in place during the financial crisis of 2008. Obama capitalized on his populist economic platform and was able to raise significantly more than Republican John McCain among Wall Street donors. Table 1 shows a breakdown of the top twenty institutional donations for the Presidential campaign of 2008. In total, Obama’s top twenty contributors gave \$13,382,825, while McCain’s gave \$4,034,622, meaning Obama had a \$9,348,203 advantage (Hicks, 2008).

The President also performed well with Wall Street in his 2012 reelection bid. “About a third of the money his top fundraisers have brought in this year has come from the financial sector, suggesting that strained relations with Wall Street have not hurt the President’s ability to attract donations there for his reelection campaign, according to data released Friday by the Center for Responsive Politics” (Eggen, 2011). During the campaign of 2012, Republicans sought to create a rift between Obama and Wall Street, highlighting a perceived desire of the President to increase taxes on high income earners, as well as on capital gains and dividends on investments. “Republicans have sought to take advantage of the rift by openly courting Wall Street donors. The top sources of corporate money for Presidential candidate Mitt Romney, who reported raising \$18.3 million, include contributions from employees of Morgan Stanley,

Bank of America, Goldman Sachs and other financial firms, according to Federal Election Commission data” (Eggen, 2011). Romney was successful in pulling many of Obama’s supporters on Wall Street away to his side, but clearly it was not enough to win the election. “Mitt Romney’s six largest campaign donors in 2011 were from Wall Street. Romney got \$1.8 million from Wall Street execs, according to the Center for Responsive Politics” (Drawbaugh, 2012). Thus, it can be seen that the nation’s largest financial firms play a significant role in national elections, particularly Presidential ones. “Even after the 2008 financial crisis and the 2010 passage of the Dodd-Frank laws that put new restrictions on the banks and markets, the power of Wall Street in Washington is unmitigated, said Richard Parker, a public policy lecturer at Harvard University’s Kennedy School of Government” (Drawbaugh, 2012). The significant wealth possessed by those on Wall Street gives them immense power and influence over politicians and political policy in Washington.

We can see, therefore, that Wall Street plays a critical role in political campaign funding, as it continually serves as one of the wealthiest sources upon which candidates rely for donations. In return for their patronage, the influential forces that exist from the nation’s largest banks and financial services firms expect positive (if not preferential) treatment from the political candidate whom they helped elect.

TABLE 1

2008 CAMPAIGN CONTRIBUTIONS			
DONOR	OBAMA	MCCAIN	
University of California	1,648,685		
Goldman Sachs	1,013,019	240,295	
Harvard University	864,654		
Microsoft	852,167		
Google	814,540		
JP Morgan Chase	808,799	343,505	
Citigroup	736,771	338,202	
Time-Warner	624,618		
Sidley Austin LLP	600,298		
Stanford University	595,716		
National Amusements, Inc.	563,798		
Wilmerhale LLP	550,168		
Skadden, Arps, et al	543,549		
Columbia University	541,002		
UBS AG	532,674	187,493	
IBM	532,372		
General Electric	529,855		
US Government	517,908	202,929	
Morgan Stanley	512,232	271,902	
Lehman Brothers	276,088	126,556	
Bank of America	274,493	167,826	
Merrill Lynch		375,895	
AT&T		201,938	
Wachovia		199,663	
Credit Suisse		184,153	
Pricewaterhouse Coopers		169,400	
US Army		169,020	
Gibson, Dunn, & Crutcher		160,346	
Blank Rome LLP		155,226	
Greenberg Traurig LLP		147,437	
US Department of Defense		146,356	
FedEx		131,974	
Ernst & Young		114,506	
TOTAL FROM TOP TWENTY	13,382,825	4,034,622	9,348,203
TOTAL SHARED	4,671,984	1,878,708	2,793,276

Source: Hicks (2008)

Government's Role in Ending the Financial Crisis of 2008

Government provides the legal and regulatory framework as well as stimulus, to promote market growth. It also plays an even more important role in providing a floor for equity markets. While the United States theoretically has a free market, the government has power to affect financial markets (Friedman, 2002). The economy is a set of interrelated parts, and government is, indeed, a crucial part of the equation. Further, the federal government is able to infuse cash into banking institutions, thus providing a floor against stock market crashes. The Federal Reserve, which receives its authority from Congress, can take various actions to either lower interest rates, increase the money supply in the economy, or lower bank reserve requirements, all of which are advantageous for economic growth (Rose and Hudgins, 2010).

One only has to look to the financial crisis of 2008 as an example of how the government, through its practically unlimited resources, can protect institutions and asset classes during times of great turmoil. In 2007, things began to look bleak in the American economy and stock market due to what became known as the subprime mortgage fallout in which there was a rampant amount of default on high risk loans made to borrowers with high credit risk (Sorkin, 2009). Many of these loans were made on terms of low initial interest rates and no down payment and were made to many people who could not afford them (McDonald and Robinson, 2009; Lowenstein, 2010; Morgenson and Rosner, 2011). Such subprime loans were then pooled together and sold as securities through financial engineering to various investment firms, securities companies, and hedge funds (Firms were able to once again combine commercial lending and investment practices when Congress replaced the previous stipulations of the Glass-Steagall Act). The magnitude of the defaults was amplified because the subprime loans had been sold as security products in the derivatives market, putting the entire financial industry at stake in a significantly intertwined and overly complicated housing bubble that led to the financial crisis of 2008 (Paulson, 2010).

The government took action to prevent a complete stock market crash that was pending as a result of the turmoil from the bursting of the housing bubble. "According to the free market theory, any institution with enough clout to sway the movement of the market -- like the government -- should stay out of the way and let nature take its course. While the U.S. government doesn't directly intervene in the stock market (say, by inflating the prices of stocks when they fall too low), it does have power to peripherally affect financial markets" (Clark, 2012). Government can serve as the most prominent source of liquidity to financial markets because it, theoretically, has unlimited capital potential since it has the ability to print money. In 2008, the U.S. government went to great monetary measures in an effort to keep the economy from plunging into a depression (Paulson, 2010; Sorkin, 2010; Morgenson and Rosner, 2011). First, it announced it would infuse money into the economy in the form of tax rebate checks in the amount of hundreds of dollars per taxpayer. The hope was that the money would spur Americans to spend on goods and services in America to help revive the economy.

Government can also guard the economy and protect against stock market crashes by providing liquidity to financial institutions. The federal government's main instrument for doing so is the Federal Reserve Bank. This is a network of government-related banks that serve as a standardization and regulatory force for commercial banks. The Fed also has the power to aid banks and took full advantage of this power in aiding distressed and failing banks during the financial crisis. In 2008, the Fed announced the creation of the new lending arm: the Term Securities Lending Facility (Paulson, 2010; Clark, 2012). The facility would offer \$200 billion in loans to non-deposit banks, thus aiding many of the investment banks that were in dire trouble (Clark, 2012). The Fed was even more hands-on when it guaranteed \$30 billion of debt when JP Morgan Chase bought Bear Stearns (Kelly, 2010; Clark, 2012). Since investment banks are such a driving force for injecting capital into the markets, the Federal Reserve, acting with support from Congress, took necessary actions to make sure that these large firms did not stop investing because that would have brought the entire financial system to a halt.

Congress also took direct action during the financial crisis of 2008 in creating the Troubled Asset Relief Program, commonly known as TARP (Members of the Federal Crisis Inquiry Commission, 2011: FRB TARP Program Information, 2011). This government program created the establishment and

management of a Treasury fund in an attempt to stop the financial crisis. Global credit markets had come to a near standstill as major financial institutions had gone under or were on the brink of going bankrupt. TARP gave the U.S. Treasury purchasing power of up to \$700 billion to buy mortgage-backed securities from institutions across the country in an attempt to reestablish liquidity in financial markets. Information from the Federal Reserve's website reads as follows:

“On October 14, 2008, the U.S. government announced a series of initiatives to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity. Treasury announced a voluntary Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Under the program, Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms. Treasury's Capital Purchase Program and the FDIC's Temporary Liquidity Guarantee Program complement one another. Through these programs, fresh capital and liquidity are available to foster new lending in our nation's communities.” (FRB TARP Information Program, 2011)

Critics of the Federal government's intervention into the American economy believe that markets would have corrected and recovered on their own without government action. They view the government's intervention more as interference than as an action of support. Critics say that government action can only prolong the problem in the free market and that the best course of action would have been to do nothing. While this idea can be debated one way or another, the fact is that the federal government did intervene in the marketplace in order to protect the nation's citizens and did what it felt was best for the well-being of the country.

Banking institutions have benefited from the government's actions. They have accumulated an increasingly large amount of liquidity since TARP was implemented. The Fed, with support and approval from Congress, has pumped billions of dollars into the financial system in an effort to strengthen financial institutions and increase liquidity in the market. In March of 2009, *The Washington Post* said that the Fed would “flood the financial system with an additional \$1.2 trillion” (Irwin, 2009). Such a move by the Fed was intended to stimulate the economy by lowering borrowing costs for home mortgages and other types of loans (Irwin, 2009). With this influx of capital, banks have been putting more money to work. “They do what they believe is prudent and in addition to buying treasuries they buy other assets that diversify their portfolios. The banks aren't necessarily acting illegally or corruptly. The banks are using their balance sheets to invest in assets that will increase their earnings. Based on their analysis, the assets they have been buying are “good” investments” (Business Insider, 2010). Results have been great for such institutions as shown in Figure 1.

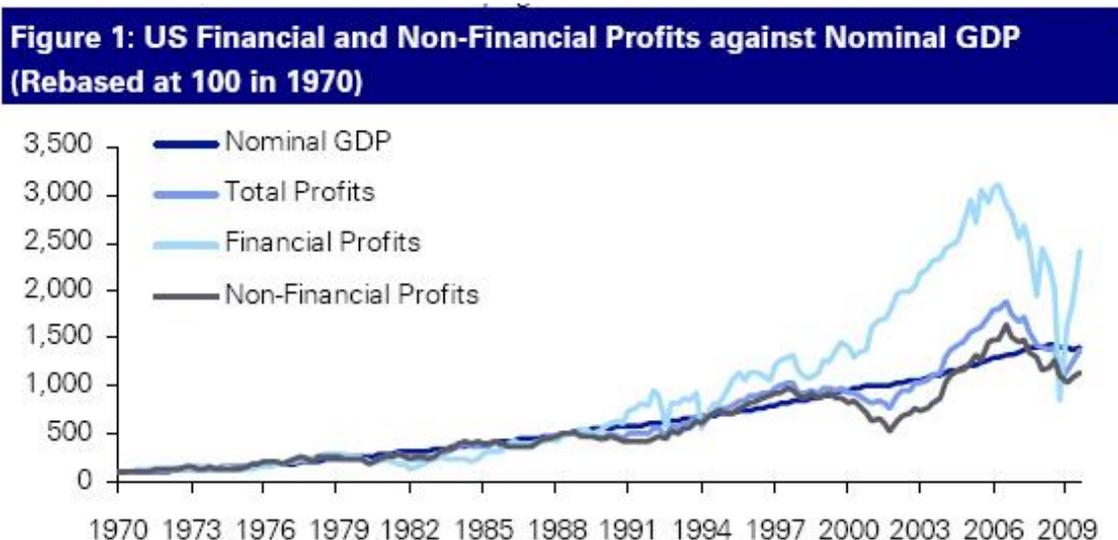
As Figure 1 indicates, U.S. financial profits rebounded quicker and increased at a much faster rate in 2009 than non-financial profits as the Treasury and Federal Reserve directly injected capital into the financial institutions amid the financial crisis in 2008.

In an environment of extremely low interest rates, markets are, theoretically, likely to flourish (Friedman, 2002). In such an environment, investors are likely to move money from less risky accounts with banks such as checking accounts, savings accounts, and certificates of deposit, to more aggressive accounts such as equity portfolios. Investors wish to get a sufficient return on their money, and when rates are extremely low (almost zero), they cannot get a sufficient return by just keeping their money in the bank. Theoretically, capital should flow from “risk off” accounts to “risk on” accounts i.e. the stock market. Essentially, through monetary policy, the Federal Reserve is encouraging investors to move capital out of cash and into securities (Rose and Hudgins, 2010).

The policy of the Fed has the greatest impact on the actions of institutions, since it has the largest amounts of capital. Large financial institutions, especially the investment banks such as Morgan Stanley and Goldman Sachs, have been increasingly putting more money to work in equity markets as a result of such a low interest rate environment. The Federal Reserve has a heavy influence on the activity of

investment firms. “Toxic assets get exchanged for cash and cash gets exchanged for whatever the banks feel like buying on a particular day. In this case, it’s approximately \$1.5T worth of firepower. The results have been “shock and awe” on steroids. \$1.5T certainly does wonders for an equity market, bond market or municipal bond market (all of which have rallied substantially in the last year)” (Business Insider, 2010). The Fed is considered independent. However, some critics argue that the Fed should be considered the fourth branch of the U.S. federal government due to its increasingly powerful role in injecting money into the country’s economy through its dealings with financial institutions. The Federal Reserve has been serving as the continuous support floor to prop up the struggling economy since the financial crisis in 2008. Its continued quantitative easing program has served as a buttress for financial markets. It is widely accepted in finance and accounting that a company’s cash flow is the most important element to successful growth in its business. By putting more cash into the financial system, the Fed has artificially inflated cash flows for financial institutions and the resulting businesses to which they lend. Research has shown that increased cash flows lead to higher earnings for companies, and these higher earnings are then reflected in the increases of company stock prices (Johnson and Zhao, 2012; Cheng, Warfield, and Ye, 2011; Bali, Demirtas, and Tehranian, 2008).

FIGURE 1



Source: Deutsche Bank, Bloomberg

Source: Deutche Bank, Bloomberg

Political Parties and the Stock Market: The Presidency

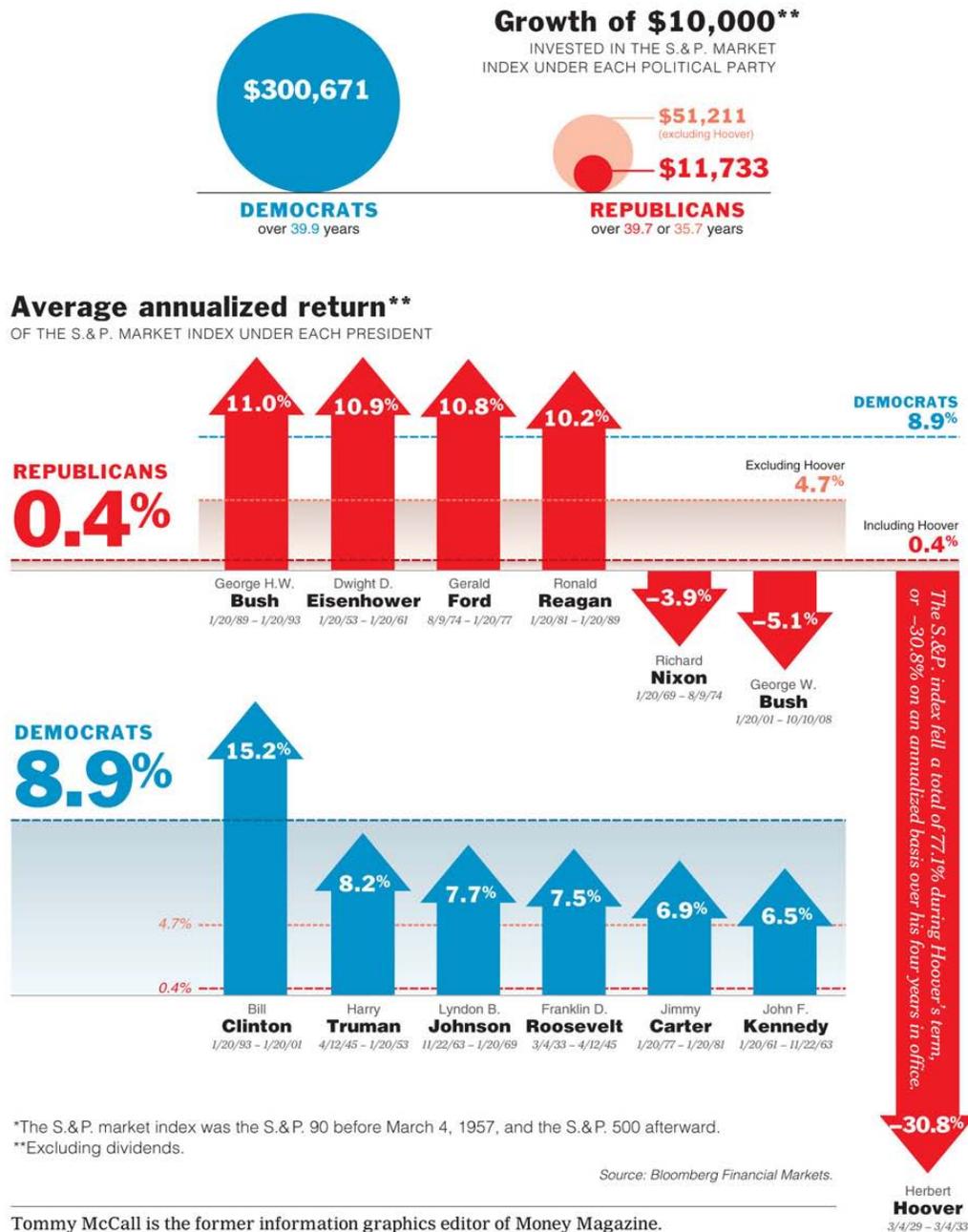
Since 1929, Republicans and Democrats have each controlled the Presidency for nearly 40 years. Because each party has controlled the White House for approximately the same period of time, it is possible to examine stock market performance under each President and do a comparison of market performance under a Republican administration versus a Democratic administration.

In 2008, *The New York Times* published an interesting illustration showing the growth of a \$10,000 investment in the S&P 500 index under Republican and Democratic administrations (McCall, 2008). One would think that the market would perform better under Republican administrations due to their tendency toward policies more favorable to business (lower taxes, less regulation) compared to their Democratic counterparts. However, surprisingly, the S&P 500 has performed better under Democratic Presidents over the long-term. The illustration suggests “a \$10,000 investment in the S & P stock market index would

have grown to \$11,733 if invested under Republican Presidents only, although that would be \$51,211 if we exclude Herbert Hoover's presidency during the Great Depression. Invested under Democratic Presidents only, \$10,000 would have grown to \$300,671 at a compound rate of 8.9 percent over nearly 40 years" (McCall, 2008). Figure 2 details that information.

Note: Information for President George W. Bush does not reflect full term because the article was published in October of 2008.

FIGURE 2



*The S.&P. market index was the S.&P. 90 before March 4, 1957, and the S.&P. 500 afterward.
 **Excluding dividends.

Source: Bloomberg Financial Markets.

Tommy McCall is the former information graphics editor of Money Magazine.

Source: The New York Times

The S&P 500 has had a positive return under every Democratic President since Franklin D. Roosevelt. There are, of course, potential outliers to consider in *The New York Times*' illustration. First is Herbert Hoover's presidency which the paper does cite. Hoover was President during the worst financial crisis in United States history: the Stock Market Crash of 1929 and the resulting Great Depression. A second, less obvious potential outlier to consider in this illustration is the Clinton presidency in which the market took off as a result of the technology bubble that resulted from tremendous developments in the industry and usage of the Internet during the 1990s. The housing market boomed during the Clinton years as well, resulting in a very rare occurrence where both the housing market and the stock market saw monumental gains. If the Clinton presidency is taken out as an outlier, the results of the illustration are much closer between the two parties. Also, if the Clinton presidency is discounted, the Democrats do not have a President that served during a double-digit percentage gain in the S&P 500 (10 percent or higher). The Republicans interestingly have four Presidents that saw double digit percentage gains in Eisenhower, Ford, Reagan, and George H.W. Bush. In solely examining this illustration, one can see that the market has been more consistent under Democratic Presidents and more volatile under Republican Presidents. However, this illustration does not suggest any potential causes or reasons for such results.

Another interesting study was conducted in 2003 regarding market return comparisons under Presidential administrations for each party. Pedro Santa-Clara and Rossen Valkanov published a study titled "The Presidential Puzzle: Political Cycles and the Stock Market," which was featured in *The Journal of Finance* in October of 2003. They analyzed market returns using the Center for Research in Security Prices indexes, including the value-weighted and equal-weighted portfolios. Such portfolios track major market indexes and are created in a systematic, unbiased manner for academic research purposes. Santa-Clara and Valkanov focused their study not on total return, but on excess return over the three-month Treasury bill. As shown in Figure 3, when a Republican held the office of the White House, both the value-weighted and equal-weighted portfolios yielded a much lower return over a Treasury bill than did the same portfolios under a Democratic President (Investopedia, 2010).

Further investigation reveals the results were generated by higher real returns and lower interest rates under Democratic administrations. Business cycle fluctuations did not show any correlation to the results, demonstrating statistically significant outperformance for the Democrats regardless of underlying economic conditions.

FIGURE 3
EXCESS RETURNS OF CRSP INDEXES OVER 3 MONTH TREASURY BILL
1927 – 1998

Portfolio	Returns Under Republican Administrations	Returns Under Democratic Administrations
Value Weighted	1.69%	10.69%
Equal Weighted	-0.01%	16.52%

Source: Investopedia

Value-weighted portfolios posted a steady 10% premium in favor of the Democrats, while equal-weighted portfolios came in at around 20% in the study. "Examination of additional business cycle variables revealed that expected returns (those anticipated by the markets) were 1.8% higher under the Republican administrations analyzed in the study, while unexpected returns were 10.8% higher when Democrats were in power, suggesting that stock market results may be driven by Democratic policies that surprise investors. Interestingly, the results do not show up in close proximity to election dates, but rather grow over time during the President's term" (Investopedia, 2010).

The authors of this study admit that the results may be inconclusive due to the small sample size, but they do believe the extensive testing of data suggests a legitimate connection between the data and the returns. In their own words, the authors acknowledge that "it might just be the case that we have stumbled upon a variable that tests significantly even when there is actually no underlying relation between the presidency and the stock market" (Investopedia, 2010). The study does not consider the impact of Congress on stock market returns.

Other articles, on the other hand, suggest the market can perform just as well under either Republican or Democratic Presidents. "Those who believe the markets perform best during Democratic presidencies can point to the 52 years from 1928 until 1980. That's when the Standard & Poor's 500 index had average annual gains of 12 percent compared with average gains of only 2.6 percent when Republicans were in the White House" (Deener, 2012). However, the tables were turned from 1952 through 1992 (does not include Clinton Presidency) when Republican Presidents presided over annual gains of 11.6 percent to the Democrats' 11.5 percent. (Deener, 2012).

James Stack, President of InvesTech Research, is a market historian who holds the opinion that the argument that Wall Street prefers one party's President to another can be made either way depending on the time period being analyzed, and he believes that the stock market can do well regardless of which party holds the White House and that the market conditions do not run coinciding with political cycles (Deener, 2012). When political parties take credit or blame another party for stock market performance, they fail to keep in mind that business cycles and political cycles are two completely separate things.

"Stock market and economic cycles don't fall neatly into Presidential terms. These are broad cycles that span several years, if not decades. For example, the seeds of the Internet bubble were sown well before Republican President George W. Bush took office in 2001 — and yet he is often blamed for the vicious bear market that ensued" (Deener, 2012). Sometimes, Presidents can be lucky or unlucky in terms of the economy they inherit upon entering the White House. For example, Herbert Hoover was President for less than eight months when the stock market crashed and the Great Depression began that had been years in the making. Stack says, "Market gains or losses are less dependent on which political party wins the White House and more reflective of economic conditions, trends and risks that are already in place prior to Election Day" (Deener, 2012).

It is understood that statistics can be deceptive and formulated to support either party's political cause. Politicians generally attempt to use such economic statistics to claim supremacy over the other party for self-serving interests. The data is inconclusive, suggesting that there is no real relationship between which party holds the White House and stock market return. Based on the data that has been cited, it is our conclusion that the political party holding the Presidency has little to no effect on the stock market.

Political Parties and the Stock Market: Congress

Many Americans credit or blame the President for the conditions of the markets and economy, but all legislation and regulatory authority that impacts economic activity resides in Congress. The federal legislature is responsible for creating the laws that impact tax policy and regulatory policy. Congress is responsible for the nation's fiscal policy which has a direct impact on the economy. Since the stock market is a reflection of the day-to-day fluctuations of the economy, Congressional activity and lawmaking can have a tremendous effect on stock market movements. Because it makes the laws that create fiscal policy, Congress is more important to economic stability and stock market success than is the President.

Is there any evidence suggesting better stock market performance under a certain type of Congress? Robert Schumacher of Van Kampen Investments examines the issue of political power on stock returns and found some interesting, perhaps telling results. He notes:

In every Presidential election year, voters and investors alike focus on the race for the White House, and rightfully so. You see, as shown in the accompanying chart from Ned Davis Research, the historical data depicts market returns that vary greatly under Republican or Democratic leadership. The same data also suggest that while Presidential races may dominate the statistical landscape, a more interesting

interaction between politics, the public and stock prices is likely to take shape. And it has very little to do with who wins or who loses (Schumacher, 2006).

Figure 4 is a study of market performance under various combinations of federal government, including different party combinations of Presidents and Congress working together. As Figure 4 demonstrates, the Dow Jones Industrial Average has historically performed best under a Democratic President and Republican Congress combination with the Dow returning 9.6%. While there is no guarantee of causation from these results, it is plausible for one to conclude that a Democratic President and Republican Congress would benefit the markets in that the two sides would serve as checks on each other and provide certainty to markets in that nothing too drastic is likely to be accomplished in the federal government under such split power. These results support the theory that political gridlock is good for equity markets.

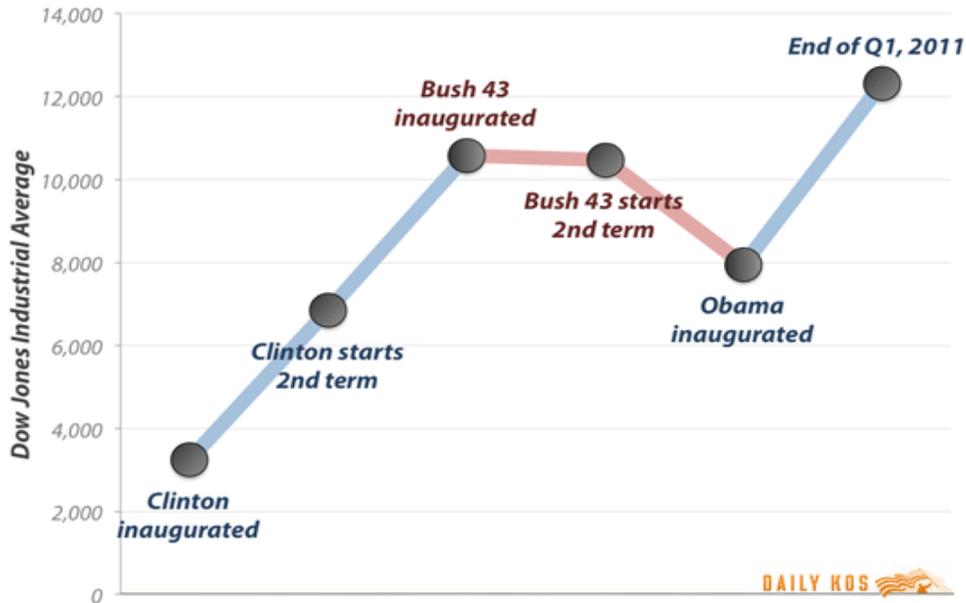
Statistically, the best combination for the stock market is a Democrat in the White House and Republican majorities in the both chambers of Congress. Republicans can constrain a Democratic President when they control both chambers of Congress, and both sides are forced to compromise if they wish to pass any new pieces of legislation. Evidence suggests that political gridlock is usually beneficial to the stock market for, when nothing in Washington changes, there is more certainty. Interestingly enough, the stock market performed very well during the Clinton Administration with a Republican House of Representatives and is also performing well under the Obama Administration and a Republican House of Representatives. Figure 5 shows price movements on the Dow Jones Industrial Average.

FIGURE 4
GAINS (%) FOR STOCKS BY PARTY OF THE PRESIDENT AND MAJORITY
PARTY IN CONGRESS
03/04/1901–10/23/2006

<u>Political Variable</u>	<u>Stocks</u> <u>(DJIA)</u>
Democratic President	7.19%
Republican President	3.85%
Democratic Congress	6.46%
Republican Congress	3.51%
Dem Pres, Dem Cong	6.53%
Dem Pres, Rep Cong	9.60%
Rep Pres, Rep Cong	1.54%
Rep Pres, Dem Cong	6.37%
All Periods Buy & Hold	5.34%

Sources: Van Kampen, Ned Davis Research

FIGURE 5

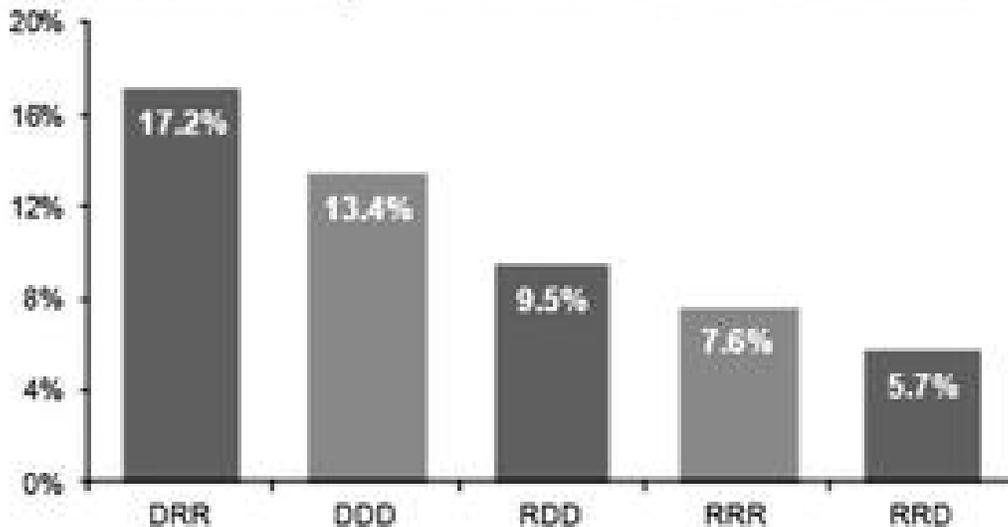


Source: Daily Kos

Again, it is important to keep in mind that Republicans controlled the House of Representatives (where legislation begins) in Congress for the majority of Clinton's presidency and have done so during the Obama presidency as well. This continues to illustrate two important considerations for stock performance: 1) the importance of Congress and 2) the impact of political gridlock on the market. Figure 6 shows S&P 500 returns from 1940 to 2008 based on political party control for the federal government.

FIGURE 6

Stock Market Returns by Political Party Control
Based on election dates, parties identified as President/Senate/House



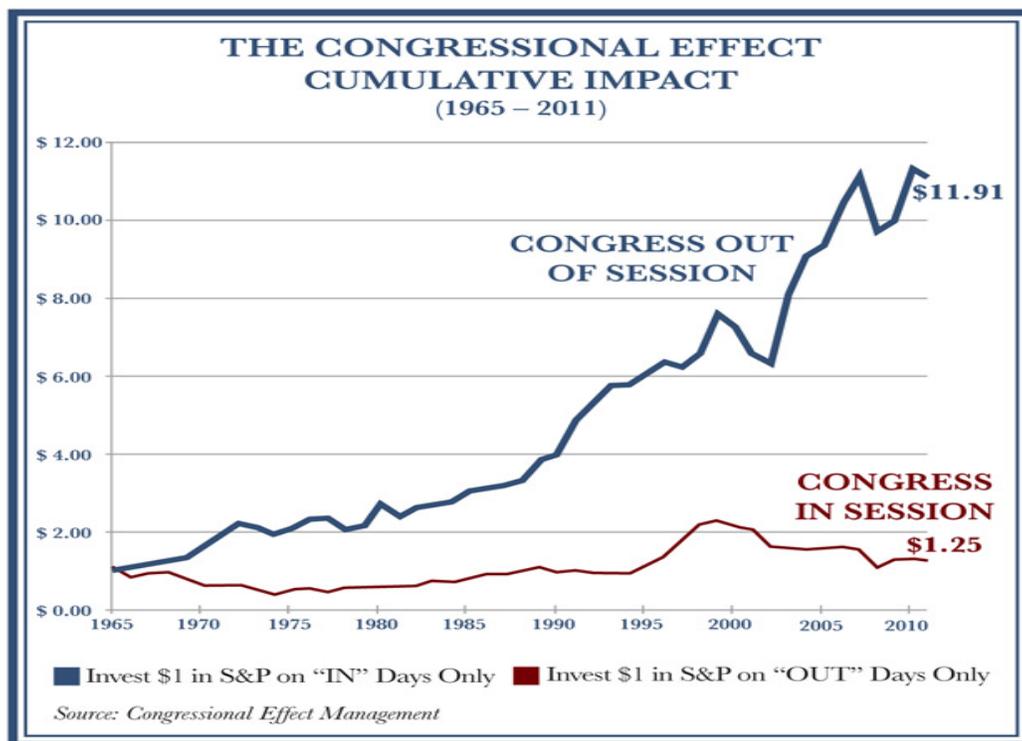
Note: R=Republican, D=Democrat

Source: Gallup Inc., Factset, J.P. Morgan Asset Management

Perhaps the most fascinating aspect of this study performed by Ned Davis Research and endorsed by Van Kampen Investments has to do not with political power but instead simply whether or not Congress is in session. "Using historical pricing on the Dow Jones Industrial Average (DJIA), the Standard and Poor's 500 Stock Index (S&P 500), the Center for Research in Security Prices (CRSP) Equal-Weighted Returns Index and Value-Weighted Returns Index, Ferguson and Witte find that, depending on the index, daily returns when Congress is in session range from 1 to 4 basis points per day. When Congress is out of session returns range from 5 to 15 basis points a day" (The Big Picture, 2006). The market is more likely to flourish under conditions of certainty, so once again, perhaps the market prefers the certainty that accompanies an out-of-session Congress. Figure 7 details the idea that a Congress out of session is more advantageous for the stock market.

Since 1965, the S&P 500 has historically performed much better on days when Congress is out of session. An interesting observation can be made from the above chart: starting in 1965, as the years go on, the two lines generally grow farther apart. The federal government has become larger in size and scope over time within the United States economy; it therefore has an increasingly powerful impact on stock market activity and performance. Daily activity (or inactivity) in Congress moves the stock market now more than ever before. Because markets prefer certainty, they prefer an out-of-session Congress.

FIGURE 7



Source: Congressional Effect Management

Investors have recognized this pattern of market outperformance while Congress is out of session. There has even been a mutual fund created on this premise. Launched in 2008, the fund invests on the premise that this relationship between the congressional calendar and stock market returns will continue in the future (Conrad, 2012). Based on data on the fund company's website, the annualized daily price gain of the Standard & Poor's 500 (S&P 500) from Jan. 1, 1965 through 2011 was 0.72 percent when Congress was in session and 16.60 percent when Congress was out of session (Conrad, 2012). Similar results have been experienced over the most recent ten years as well.

Does the Stock Market Determine Elections?

Data suggests that conditions and returns in the stock market can have a profound effect on elections, particularly Presidential elections. InvestTech Research, an investment firm based in Montana, has put together a model showing that the overwhelming majority of Presidential elections are decided by the Dow Jones Industrial Average. The firm claims that the stock market has been the most reliable indicator of who will win the presidency for more than a hundred years. Eric Vermulm, senior portfolio manager at the firm, says, “The election is a reaction to the stock market. If you see strength in the market, consumer sentiment and confidence among the voters is higher. If you see volatility, you are going to see investors take that out on the incumbent” (Fox, 2012). According to Vermulm, the math is simple: the incumbent party in the White House wins when the stock market increases the two months leading up to the Presidential election. When the stock market declines during the two months before the election, the incumbent party loses the White House (Fox, 2012). Since 1900, this has held true for approximately 90 percent of Presidential elections, the only exceptions being in 1958, 1968, and 2004 (Fox, 2012). Cathy Hetrick, a senior portfolio adviser at InvestTech and author of the study writes, “Wall Street typically worries about how politics might affect the stock market, perhaps, Presidential candidates should worry about how the stock market might affect their political outcome” (Fox, 2012).

Perhaps the stock market has just as a significant impact on national politics as national politics has on it. It is reasonable to believe this conclusion because the stock market is a reflection of economic conditions and consumer confidence. Politics and the stock market share in common the idea of perception being more important than reality. It is also reasonable to assume that when the stock market is doing well, Americans have more confidence in the economy and are more likely to re-elect their public officials. On the contrary, if the stock market is struggling, Americans may have less confidence and are more likely to elect new or different public officials.

HYPOTHESIS DEVELOPMENT

Based on previous research and literature, we know that there is long-lasting relationship between business people from Wall Street firms and politicians in Washington. We know that fiscal policy in the United States is established by Congress. We also know that monetary policy is established and carried out by the Federal Reserve and that its Chairman is nominated by the President, confirmed by the U.S. Senate, and can be called to testify before Congress. Together, these regulatory bodies and their corresponding policies help establish economic conditions for business activity in the country.

Both fiscal and monetary policy have a significant influence on the American economy. Fiscal policy entails the handling of conditions concerning factors such as taxes (individual, small business, and corporate), as well regulatory authority over various sectors and industries of the economy. Monetary policy most directly affects liquidity in the market and interest rates. Unemployment is a lagging indicator of economic growth since it is affected by decisions made regarding monetary policy and taxes. Changes in monetary policy can have drastic impacts on the level of liquidity in the economy and GDP, and these impacts are reflected in the stock market. Therefore, we hypothesize that:

- 1a) A change in monetary policy that lowers interest rates and increases the money supply causes gross domestic product to increase.*
- 1b) A change in monetary policy that raises interest rates and decreases the money supply causes gross domestic product to decrease.*
- 2a) As gross domestic product increases, the stock market will increase.*
- 2b) As gross domestic product decreases, the stock market will decrease.*

DATA AND METHODOLOGY

For this study, we are assuming that while there may be a correlation between political party power and stock market performance, there is no specific proof of causation. It is legislative laws that form fiscal

policy that enable such market returns over the long-run, not the political party itself. There is also an argument to be made that legislative policies do not have an immediate impact on the economy and the stock market but that they take a while, perhaps years, to go into full effect. Therefore, it is plausible that laws and regulations under a Republican Congress and President may go into full effect under a Democratic Congress and President, or vice versa. Overall, general fiscal policy from Washington has more of a long-term effect on the stock market in that it provides the framework for certainty and stability for the United States economy.

On the contrary, the Federal Reserve has the ability to take action more quickly. It can inject liquidity into the market through a process known as quantitative easing. We know that increased liquidity in the economy and low interest rates are advantageous to market growth. It is plausible to believe that more money in circulation in the economy means more money for institutions and individuals to invest in the stock market. Low interest rates are advantageous for individuals and companies to borrow and invest in their businesses. A larger money supply and lower interest rates, theoretically, should lead to more consumer spending in the economy. An increased money supply means more disposable income for people and more sales for companies which increase earnings and eventually stock prices. The Federal Reserve sets the guidelines for monetary policy which includes both interest rates and the amount of money in circulation. Such actions by the Fed influence the economy and coincidentally, the stock market. Therefore, secondly, we assume that the Federal Reserve and its Chairman have more of an immediate impact on the stock market. The Federal Reserve Chairman may be more important to positive stock market performance than is Congress or the President, at least in the short-term.

We also know that the stock market is reflective of projected GDP growth and how the economy is perceived by investors. It is important to keep in mind that the stock market is a reflection of future expectations than it is of past results. Therefore, growth projections and consumer confidence are two key metrics to the price of equities. The primary link between the stock market and the economy, in the aggregate, is that an increase in money and credit increase both GDP and the stock market simultaneously. A growing economy naturally produces more wealth. We also know that government can increase the money supply either through monetary policies carried out by the Federal Reserve or through the printing of money by the Treasury Department. If GDP is rising, either the money supply must be increasing, or the amount of products and services produced in the economy must be increasing, or both are occurring simultaneously.

Variables

For this study, there are a variety of variables to consider. We seek to determine whether market return in excess of GDP, known as Market Alpha, is a way to measure the political effect on the stock market. We include monetary changes by the Federal Reserve as part of this political effect. To do this, we will study the Standard & Poor's 500 index to gauge changes in the stock market using historic prices over a ten year period since 2003. The following are the variables that will be considered in the study:

1. Historical index averages as they relate to changes in monetary policy (interest rates and money supply).
2. Changes in GDP as related to changes in monetary policy. Stock market index changes as they relate to changes in GDP.
3. Stock market index changes as they relate to changes in GDP.

Figure 9 demonstrates the Standard and Poor's 500 index from 2003 to 2013. In comparing Figure 8 and Figure 9, we can see a trend of the stock market generally increasing when interest rates are lower and decreasing when interest rates are higher. It is interesting to note that, according to the charts showing the last ten years, both the Federal Funds rate and the S&P 500 reached their peaks in 2007, followed by severe declines. Both the Federal Funds rate and the S&P 500 then bottomed in 2009. Since 2009, the S&P 500 has seen its value double in price while the Federal Funds rate has remained below 1%. It is

plausible that both the bull runs in the S&P 500 from 2003-2008 and from 2009-2013 were either started by or aided from a low interest rate environment.

FIGURE 8

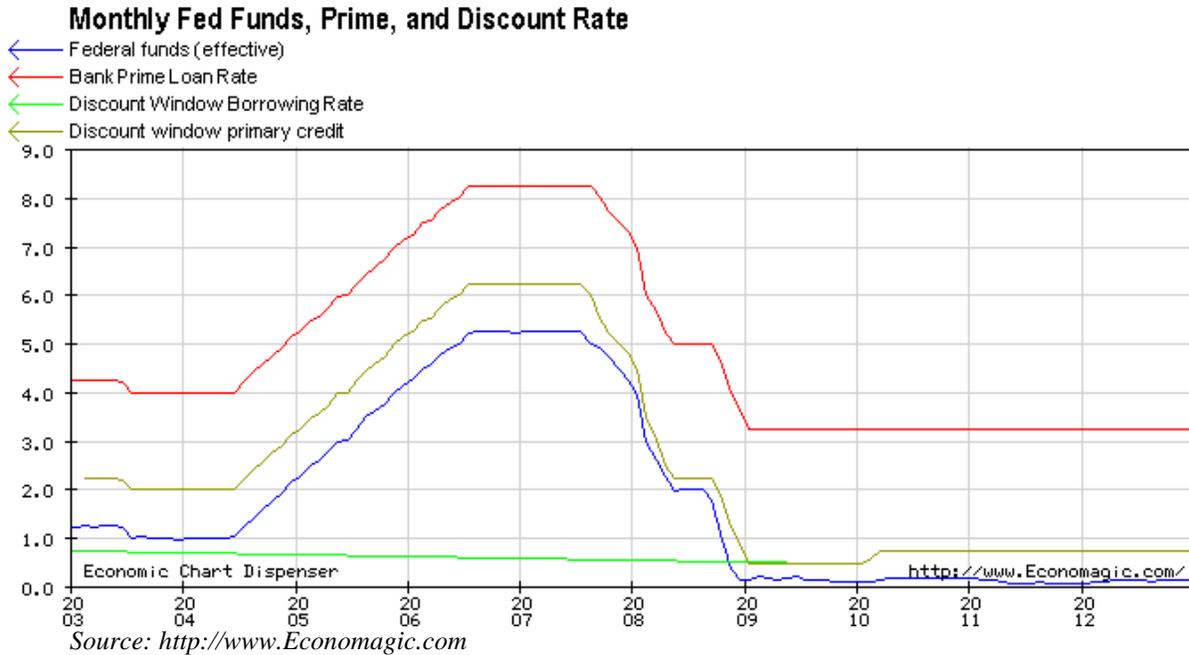
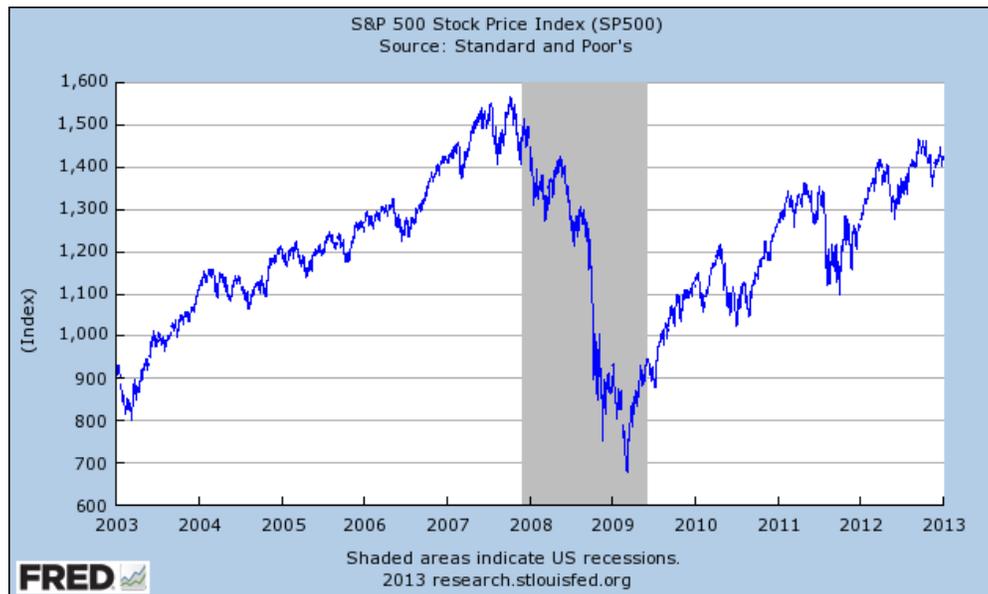


FIGURE 9

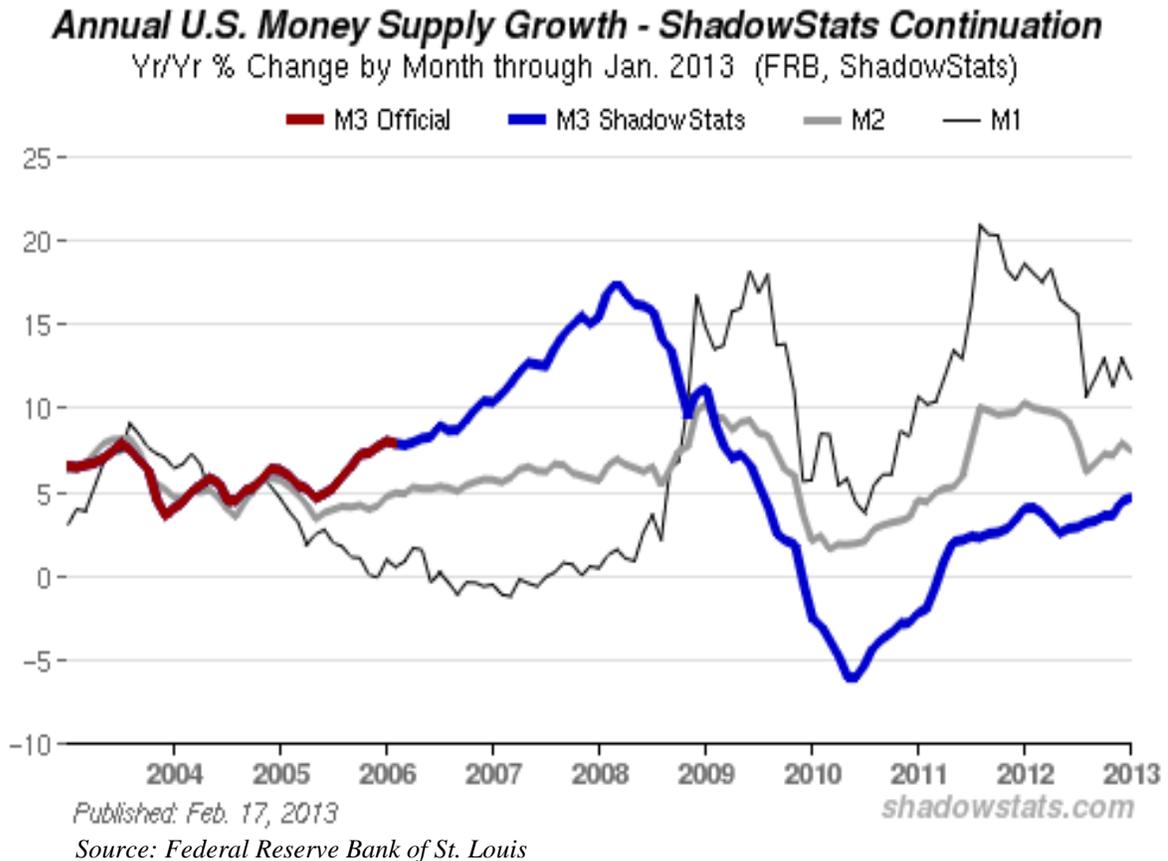


Source: Federal Reserve Bank of St. Louis

Monetary policy consists of two main parts: interest rates and money supply. We have illustrated how interest rates can affect the stock market, particularly how a low interest rate environment is conducive to

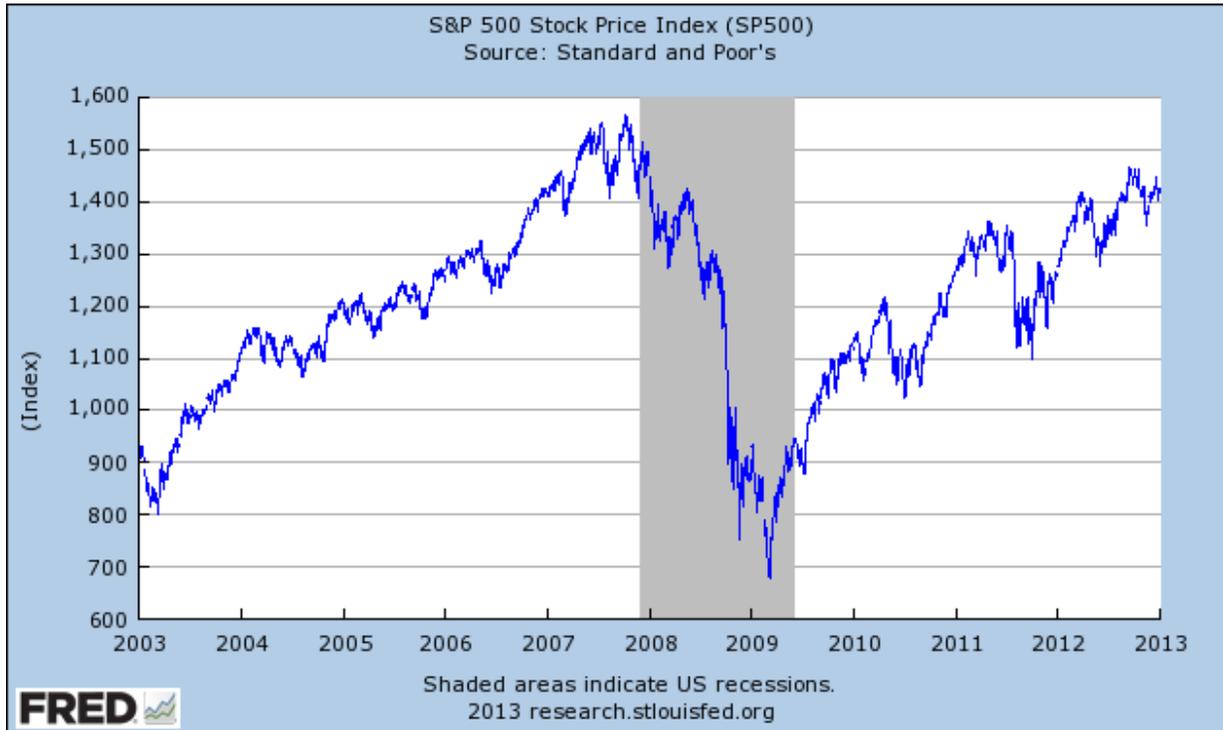
stock market gains. The other part of monetary policy, the money supply, has a significant impact on the economy as well, as more money in circulation means more liquidity in the financial system and more money that consumers can potentially spend in building the GDP of the nation. The question then becomes are there any noticeable trends between changes in the money supply and changes in the stock market's performance? Again, we examine the charts.

FIGURE 10



The Federal Reserve has characterized the money supply using the terms M1, M2, and M3. M1 refers to notes and coins in circulation, travelers' checks of non-bank issuers, demand deposits, and other checkable deposits. M2 consists of M1 plus saving deposits and time deposits less than \$100,000 and money-market deposit accounts for individuals. M3 consists of M1 and M2 plus large and long-term time deposits, including institutional money market funds. Since 2006, M3 is no longer tracked by the Federal Reserve. However, there are still estimates of M3 produced by various private institutions. Figure 10 presents annual U.S. money supply growth year over year percentage change by month from 2003 to 2013. The chart is followed by another chart of the S&P 500 over the same time period for comparative purposes.

FIGURE 11



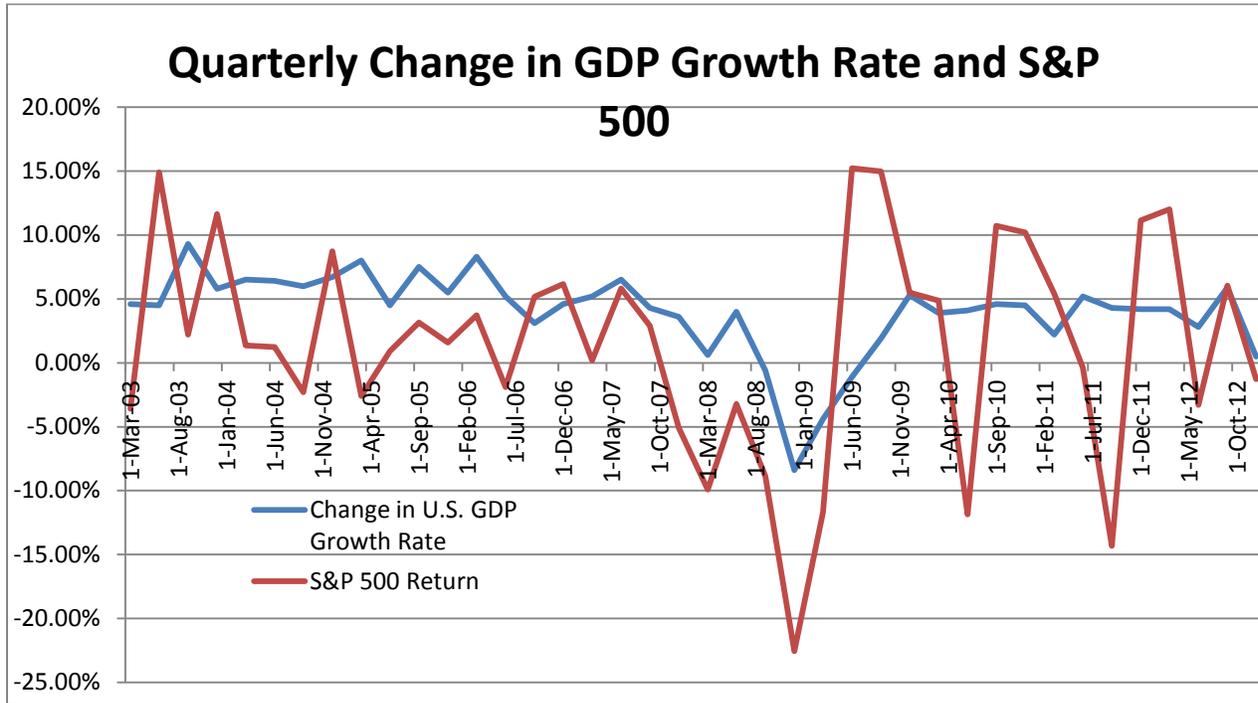
Source: Federal Reserve Bank of St. Louis

According to the figures, there appears to be about a one-year lag between percentage change in M3 and the performance of the S&P 500 as the market index bottomed in early 2009 whereas the chart for M3 shows its low point in early 2010. However, the general trends between the two variables appear to be similar. It is reasonable to believe that an increase in the money supply would drive the stock market higher as more money in circulation means more money that can potentially be spent or invested. From early 2010-2013, there has been a combination of low interest rates and a graduating percentage change in money supply. The total return for the S&P 500 was 15.1% in 2010, 2.1% in 2011, and 16.0% in 2012.

Ultimately, economic growth trends and expectations for economic growth are the primary reflections in the stock market. Figure 12 indicates the relationship between the quarterly change in GDP growth percentage in the United States and percentage change in the S&P500 index. Based on the chart, the two variables share a common trend as they appear to fluctuate in a similar pattern.

As the GDP growth rate fluctuates, the S&P 500 fluctuates even more. While the trend for both variables is approximately the same, the deviation of the S&P 500 variable is much greater than GDP growth. This implies what we call the “Market Alpha”, a term which represents excess return over GDP based on external economic and political conditions. While GDP plays a role in stock market returns, it is clearly not the only factor. The Market Alpha details market movement in excess of GDP in that it considers inflation, as well as fiscal policy actions put forth by Congress and monetary policy actions put forth by the Federal Reserve.

FIGURE 12



Source: Authors

DISCUSSION

Throughout this paper, we have attempted to demonstrate correlating relationships between external political decisions and events with the performance of the stock market. Of course, this does not mean that correlation implies causation. However, some interesting points and parallels can be taken away from the information presented. The stock market is so complex and is dependent on so many variables that it is impossible to guarantee its results. Analysts can forecast market conditions and make target price predictions, but they cannot guarantee outcomes of the future of the unknown.

First, we posited that political party power has significant influence on the stock market. It was reasonable to assume that due to its conservative, low tax, low regulatory tendencies, the Republican Party would be more favorable to the stock market. In examining historical data, data is inconclusive as to whether either the Republican Party or Democratic Party is more advantageous to the stock market. Based on the numbers, the stock market has performed better overall under Democratic Presidents. However, the market has also performed better overall under a Republican Congress. The best combination, according to historical information, is a Democratic President and a Republican Congress. The take-away from this is that the party in political power does not have a significant impact on the performance of the stock market. If anything, the market prefers political gridlock, such as a Democratic President and Republican Congress, because this increases the chances for stability in an uncertain economic environment. Political gridlock is beneficial in that it prevents substantial change from taking place in fiscal policy, something that the stock market embraces. According to the data presented, the stock market has actually performed better on days when Congress was out-of-session when compared to days in session, again suggesting the market prefers the certainty associated with a do-nothing Congress.

On the contrary, the political force that is the Federal Reserve can have a significant impact on the stock market. Since the financial crisis of 2008, the Fed has taken an aggressively active role in the economics of the United States. It's most aggressive programs, known as quantitative easing, have injected billions of dollars into the financial system through the consistent buying of mortgage-backed securities and other financial bond instruments. Led by Ben Bernanke, the Federal Reserve has actively pursued and maintained an environment of extremely low interest rates, the theory being that such a low interest rate environment is conducive to borrowing and spending in the economy (Paulson, 2010). This paper concluded that the combination of low interest rates and an increasing money supply is beneficial for the stock market's performance. Data and charts in the thesis suggest correlating relationships between changes in interest rates and changes in the money supply with changes in the stock market. In studying such an environment, it appears such conditions of continued low rates and increasing money supply are ideal for stock market gains for the following reasons:

- 1) Lower interest rates make it easier for borrowers to take loans which they then spend in the economy or on their own business, increasing gross domestic spending.
- 2) Increasing the money supply weakens the value of the dollar, thus increasing exporting as such action makes exporting cheaper for domestic companies.
- 3) Aggressive investors borrow at low interest rates to then invest in assets (real estate, precious metals, and financial instruments).
- 4) Record low treasury yields and bank account yields have forced many investors to reconsider where they put their money. Actions taken by the Federal Reserve encourage investors to move money out of cash and bond markets and into the stock market.

The stock market has clearly thrived in the low interest rate environment that has existed from 2009 through April, 2013. During this time the S&P 500 has gone from approximately 890 points to approximately 1,580 points, a return of approximately 78%. Both individuals and companies are more likely to borrow at such low levels of interest. This borrowed money can then be either spent, or invested, both of which produce a beneficial impact for the economy and GDP. Investors are also more likely to take on more risk in a low interest rate environment as they search for higher returns.

Lastly, we examined GDP and its impact on the stock market. Gross Domestic Product and Gross Domestic Product growth are often reviewed and referred to as the ultimate economic indicator by economists. It is important to keep in mind that GDP is factual data from the past, whereas the stock market is more of a reflection of projected earnings data for the future. When viewed from a long-term perspective, the relationship between GDP and the stock market has been positive. Over long periods of time (decades) in the United States, both GDP and the stock market have increased significantly. However, it is much more difficult to examine short-term fluctuations and how they correlate between the two variables. When we compared quarterly growth rates between GDP and the S&P 500, the S&P 500 fluctuated much more. This implied that fluctuations in the stock market are dependent on more than solely GDP growth rates.

CONCLUSION

In tying everything together, we confirm our hypothesis development. As demonstrated in the figures presented, a stable yet gridlocked political environment, combined with an aggressively easing monetary policy, makes for a very conducive environment for positive stock market performance. We consider political gridlock as a beneficial force for financial markets as gridlock decreases the chances of changes to fiscal policy. This increases the element of certainty, something the market prefers.

The Federal Reserve is a powerful political force in that its decisions and actions have a tremendous impact on U.S. financial institutions and markets. As stipulated by the Banking Act of 1935, the President appoints the members of the Board of Governors of the Federal Reserve System (Rose and Hudgins, 2010). The appointment of the Chairman of the Federal Reserve is subject to confirmation by the U.S.

Senate. If the Federal Reserve's policies are considered political, as we have contended, this current political environment can be considered the perfect storm for the stock market's continued advance. It is yet to be determined how effective the Federal Reserve's policies are on the actual economy. However, from an investment standpoint, quantitative easing has been stimulative to positive stock returns. The Federal Reserve has put out multiple statements that it intends to keep interest rates at record low rates for some time to come, possibly until 2015, when it projects the economy will be fully recovered with the unemployment rate substantially improved. However, until this time, one can expect continued low rates and measures of liquidity. If the stock market is a prediction of future economic conditions, we can project continued positive performance in domestic market indices at least until external political conditions change.

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