

The Presidential Term

Is the third year the charm?

Scott B. Beyer, Gerald R. Jensen, and Robert R. Johnson

SCOTT B. BEYER

is an assistant professor of finance in the College of Business at the University of Wisconsin, Oshkosh.
beyers@uwosh.edu

GERALD R. JENSEN

is a professor of finance in the College of Business at Northern Illinois University in Dekalb.
gjensen@niu.edu

ROBERT R. JOHNSON

is deputy CEO and a managing director of the CFA Institute in Charlottesville, VA.
bob.johnson@cfainstitute.org

The relation between security returns and elections has been a favorite topic of Wall Street observers for years. Throughout history, all sorts of election characteristics have been cited as connected with the performance of the security markets.

One prominent relation noted by business publications and financial market commentators is the third-year effect or the presidential cycle, which refers to the positive stock market performance observed during the second half of a presidential term. In a March 2004 *Time* article, Zweig notes "stocks have gained an average of 14.5% in year three of a presidency and 7.7% in year four vs. less than 6% in year one and year two." In a 2004 *US News* article, Pethokoukis suggests that "a pre-election year is a sure bet."

Investment newsletters indicate investment professionals have also recognized a presidential cycle in stock returns. In 2003, *US Global Investors* issued a special report devoted to the presidential election cycle. Northern Trust, in its *Market Signals* monthly report, June 2004, notes that stock returns are appreciably higher in the last two years of a presidential term. In its January 8, 2003, *News & Views*, Smith Barney's Richie Freeman states "in terms of the presidential cycle, the third year of a presidential term is historically the strongest for the stock market."

A rationale advanced for the presidential cycle effect is that the return patterns are created by systematic variation in fiscal policy across a president's term. For example, in a January 2, 2006, *Barron's* article, Abelson [2006] claims that presidents are "keen on getting the ugly stuff out of the way early in their tenure so they can act expansively the rest of the way." He argues that, in the latter part of their terms, presidents opportunistically strive to pump up the market with "every means, fair or foul, at their disposal."

Sanford [2005] advocates a similar rationale, and also provides a possible monetary policy dimension. He quotes Robert German, vice president of managed investment solutions at TD Bank Financial Group, as indicating that the Fed does not want "to be seen as getting in the way of politics during the election cycle." German claims that if the Fed is "going to pull up rates" it will happen early in a president's term.

Stovall [1992] provides an alternative explanation for the presidential cycle that is unrelated to macroeconomic considerations: that investors become more optimistic in the latter part of a presidential term as it becomes more apparent a popular president will be reelected or an unpopular president will be replaced.

We examine security returns relative to the presidential cycle to determine the size of the return patterns and their consistency over

time. In addition, we investigate the contention that the return patterns are affiliated with systematic changes in monetary and fiscal policy across the presidential term.

The results indicate prominent patterns in equity returns that relate to the presidential cycle. Stock returns are higher on average in the second half of a president's term, and especially during the third year of a term. Small-cap equities display a much more prominent return pattern than large-cap equities. Interestingly, bond returns are generally lower during the third year of a presidential term, but the return differences for bonds are not statistically significant.

We find evidence that the patterns in equity returns are comparable in the first and second half of our sample period, indicating the results are robust across time. There is also support for the contention that the presidential cycle in equity returns corresponds with comparable patterns in monetary policy measures. That is, Fed policy is systematically most accommodative when equity returns are highest, the third year of the presidential term.

RELATED RESEARCH

A substantial body of research examines the relation between the political party of the president and stock market performance. Riley and Luksetich [1980] examine short-term returns around presidential elections, and identify negative stock returns associated with presidential elections won by a Democrat and positive stock returns associated with elections won by a Republican. Subsequent studies by Huang [1985], Johnson, Chittenden, and Jensen [1999], and Santa-Clara and Valkanov [2003] examine long-term stock returns following presidential elections, and report evidence supporting the contention that Democratic presidents are better for long-term equity returns than Republican presidents.

In Beyer, Jensen, and Johnson [2004], however, we find that after controlling for monetary policy, party of the president is not significant in explaining equity returns. We conclude that other studies failed to control for changes in monetary policy, and thus, the identified relation between party of the president and stock returns was spurious. Cooper, McConnell, and Ovtchinnikov [2006] also confirm there is not a robust relation between party of the president and stock returns.

Allvine and O'Neill [1980], Huang [1985], Stovall [1992], and Booth and Booth [2003] identify a presidential cycle in stock returns. They all find equity returns tend

to be higher during the final two years of a presidential term than in the first two years.

Booth and Booth [2003] investigate whether the observed presidential cycle can be attributed to systematic changes in business conditions across the presidential term, but conclude that the presidential cycle remains even after controlling for changing business conditions. Thus, their evidence suggests the return patterns are independent of variations in general business conditions.

While most proposed explanations for the presidential cycle are based on hypothesized changes in economic conditions, Stovall [1992] suggests that the return patterns displayed across the presidential term are created through a "pendulum pattern" in the popularity of the president. He attributes the strong market performance in the third and fourth years to an increased likelihood that a popular president will be reelected, while an unpopular president will be turned out.

We contribute evidence relevant to several aspects of the relationship between the presidential term and security returns. First, while other authors have focused exclusively on the returns to a broad equity index, we examine returns for several equity and fixed-income indexes over the presidential term. We segment the fixed-income market in terms of maturity and credit risk, and divide the equity market into large-cap and small-cap equities.¹ Given the strong link between interest rates and fiscal and monetary policy, we believe there is strong justification for evaluating fixed-income returns along with both small- and large-cap equity returns. Clearly, if the actions of politicians and the Federal Reserve governors create a presidential cycle in a broad equity index, a more thorough analysis of alternative index is likely to identify more compelling patterns.

Second, to examine the robustness, and recent relevance, of the presidential cycle, we divide the sample period into an earlier and later subperiod. We examine returns through the most recent full presidential term, 2004.

Finally, we investigate the relation between the presidential cycle and monetary and fiscal policy developments. This final analysis allows us to determine the extent to which the presidential cycle is consistent with monetary and fiscal policy actions.

SAMPLE AND METHODOLOGY

We evaluate quarterly returns from 1957 through 2004 for two equity indexes, three fixed-income indexes, and an inflation index.² Given the evidence linking market capitalization with temporal security return patterns, we

evaluate both a small-cap and a large-cap equity index. The fixed-income indexes include long-term government and corporate bond indexes and a Treasury bill index. Thus, comparisons across the fixed-income indexes allow for consideration of changes in credit and maturity spreads across the presidential term. Finally, we report inflation data to allow the reader to assess real returns in addition to the nominal returns that are reported in the exhibits.

We evaluate quarterly returns for each index relative to the four years of a presidential term. To evaluate the robustness of our findings, we consider two alternative subperiods, 1957 through 1980 and 1981 through 2004.³

In order to assess monetary policy relative to the presidential cycle, we select prominent measures that have been widely used to identify variations in monetary policy. We use the federal funds premium to depict monetary conditions in the short-term market, and the most recent change in the fed discount rate to depict the Fed's broad policy stance.

Ho and Saunders [1985], Laurent [1988], and Bernanke and Blinder [1992] support use of the federal funds premium as a measure that accurately identifies the stringency of Fed monetary policy based on interest rates in the short-term market. Similarly, Jensen, Mercer, and Johnson [1996] and Conover et al. [2005] among others use directional changes in the discount rate to identify broad shifts in Fed policy.

Patelis [1997] contends that policy-induced changes in short-term interest rates impact equity risk premiums differently in policy periods that are generally restrictive versus expansive. Thus, to assess the relation between Fed monetary policy and security returns, it is necessary to consider both a measure of policy stringency and a broad policy measure. We include both types of monetary policy measures in this analysis.

The primary mechanisms by which the Federal government provides stimulus to the economy are its spending and tax policies. In order to gauge the amount of stimulus provided by government actions, our fiscal policy variables are measured as the percentage of change in Federal government spending and the percentage of change in federal tax receipts.⁴

There is a well-established relation between macroeconomic state variables and security returns (Fama [1990], Cochrane [1996], and Campbell [1999]), and between fiscal policy variables and macroeconomic variables (Ramey and Shapiro [1997], Blanchard and Perotti [1999]). It is therefore logical to expect security returns may be linked

to changes in fiscal policy, particularly since elected officials have significant influence over fiscal policy actions.

We evaluate security returns along with fiscal and monetary policy measures over the presidential term to determine whether there are systematic patterns. Difference in means tests and the chi-square test are used to test for statistically significant patterns in security returns and monetary and fiscal policy measures. We extend the statistical analysis by estimating a regression to examine the relation between the presidential cycle and monetary and fiscal policy. The regression allows us to consider how much the presidential cycle in security returns is explained by changes in our monetary and fiscal policy measures.

RESULTS

Exhibit 1 reports average equity performance for each year of the presidential term over the 48-year study period. We follow the widely adopted approach of reporting performance data for both large-cap and small-cap equities. (Gertler and Gilchrist [1994] and Beyer, Jensen, and Johnson [2006]) suggest that small-caps are more sensitive than large-caps to changes in political and monetary conditions, thus motivating a separate examination of the two equity indexes.

The mean returns reported in Panel A indicate a prominent pattern in returns relative to the presidential term. Our findings are consistent with previous claims in that the reported returns in the latter half of a presidential term (years 3 and 4) are noticeably higher than returns during the first two years. A year-by-year analysis of the results, however, clearly indicates that the return pattern can be primarily attributed to the very prominent returns reported in year 3. Specifically, year 3 returns (23.8% for large firms and 38.0% for small firms) dominate the returns in the other three years. The extreme year 3 return reported for the small-cap index is consistent with the contention that small-cap equities are more sensitive to the underlying factors that produce the return pattern.

While a presidential cycle in equity returns seems apparent, we employ difference in means tests to confirm that the return pattern is statistically significant. The hypotheses tested and the resulting p-values associated with the t-tests are reported at the end of Exhibit 1.⁵

T-tests confirm that year 3 returns are significantly higher (at the 1%) level than returns in the other three years for both the large-cap and small-cap index. Tests of equity returns for two alternative time periods, 1957-1980 and 1981-2004, indicate similar equity return patterns for sub-

EXHIBIT 1

Equity Returns over Presidential Terms: 1957-2004

	Year 1	Year 2	Year 3	Year 4	Overall
Panel A. Mean Annual Returns					
Large-Cap	6.87%	4.89%	23.84%	13.27%	12.04%
Small-Cap	12.07%	3.39%	38.02%	20.82%	17.93%
Panel B. Annual Standard Deviation of Returns					
Large-Cap	14.40%	21.15%	15.34%	10.31%	16.01%
Small-Cap	22.27%	26.07%	25.05%	22.46%	24.47%

Significant Difference in Means Tests:

Large-Cap: $H_0: R_1 = R_2, R_3, \text{ and } R_4$; $P\text{-value} = 0.009$

Small-Cap: $H_0: R_1 = R_2, R_3, \text{ and } R_4$; $P\text{-value} = 0.008$

where R_t = mean quarterly return in year t .

periods. Returns for large-cap equities across the four-year presidential term are -0.68%, 1.82%, 22.08%, and 17.49% in the first subperiod, and 14.84%, 8.02%, 25.61%, and 9.16% in the second. As expected, small-cap equities exhibit the same pattern in each subperiod, but results are more pronounced. Given the similarity in findings across subperiods, the full results for the subperiods are not reported, but are available from the authors upon request.

Additional t-tests on the large- and small-cap index confirm that none of the other years' returns are consistently significantly different (at the 5% level) from the other three years. Thus, our findings strongly support the view that the presidential cycle is more accurately a *third-year effect*.⁶

Exhibit 1, Panel B, indicates that while year 3 returns dominate the returns reported for the other three years, the variation in returns in year 3 is about average. Clearly, the higher returns earned in year 3 are not compensation for a higher level of risk. Interestingly, year 2 reveals a below-average return and an above-average level of risk, so on a return per unit of risk basis, year 2 has clearly been a laggard.

Exhibit 2 reports the performance data for the fixed-income indexes, including the inflation index. Panel A presents the mean returns and shows that, in contrast to the equity returns, fixed-income returns are below average in the third year of a presidential term. T-tests, however,

indicate that there are no years in which bond returns differ significantly (at the 5% level) from the other years. The standard deviations (in Panel B) indicate comparable volatility in fixed-income returns across the four years of the presidential term. Finally, the inflation index indicates a fairly constant average inflation rate across the four years of the term, so the nominal return pattern reported for the equity indexes is very similar to the pattern in real returns.

Exhibit 3 reports monetary and fiscal policy data across the presidential term. The monetary policy measures reported in Panel A include both a measure of general Fed policy stance (expansive quarters) and a measure of the degree of monetary policy stringency (mean federal funds premium). As indicated earlier, the policy stance measure follows a well-established past precedent and is based on directional changes in the Fed discount rate.

Specifically, a quarter is classified as subject to an expansive (restrictive) monetary policy if the most recent change in the Fed discount rate was a reduction (increase). The reported value indicates the number of quarters in each year in which the Fed maintained an expansive stance. Since the study period covers 48 years, each of the four years of the presidential term are represented by 12 years or 48 quarters.

Our second monetary policy measure, the federal funds premium, is included to indicate the degree of stringency of Fed policy. The premium is measured as the federal funds rate less the three-month T-bill rate.⁷

The monetary policy measures display patterns that fairly closely match the equity return patterns identified so far. That is, both the broad measure of Fed policy stance and the measure of monetary stringency suggest that Fed policy has generally been most expansive during the third year of a presidential term. That is, while the Fed's general policy stance was expansive in 23 of 48 quarters (48% of the time) during years 1, 2, and 4, it was expansive in 31 of 48 quarters (65% of the time) during year 3. Chi-square test results, reported in Exhibit 3, confirm that the number of expansive quarters in year 3 is significantly different from that in the other three years ($p\text{-value} = 0.046$).

Furthermore, the average federal funds premium in year 3 is less than half its value in years 1 and 2, which suggests that the degree of monetary stringency is far more relaxed in year 3 than to the first two years. A difference in

EXHIBIT 2

Fixed-Income Returns over Presidential Terms: 1957-2004

	Year 1	Year 2	Year 3	Year 4	Overall
Panel A. Mean Annual Returns					
Long-Term Corporate Bond	7.43%	9.07%	5.58%	8.74%	7.70%
Long-Term T-Bond	7.58%	9.39%	4.14%	8.61%	7.42%
T-Bill	5.85%	5.45%	5.15%	5.27%	5.43%
Inflation	4.20%	4.20%	3.99%	4.08%	4.12%
Panel B. Annual Standard Deviation of Returns					
Long-Term Corporate Bond	8.70%	9.94%	8.10%	11.04%	9.46%
Long-Term T-Bond	9.75%	11.24%	8.65%	11.93%	10.43%
T-Bill	1.59%	1.33%	1.18%	1.37%	1.37%
Inflation	1.59%	1.88%	1.70%	1.59%	1.68%

means test confirms that the fed funds premium in year 3 differs significantly from that in the other three years (p -value = 0.020).

Overall, the evidence in Exhibit 3 indicates that the Fed has traditionally assumed its most expansive policy during the third year of a presidential term.

The fiscal policy measures are reported in Panel B of Exhibit 3. Unlike the monetary policy measures results, variations in the fiscal policy measures do not clearly align with the equity return patterns identified. On average, government spending has generally increased at a slower rate in the final two years of a presidential term than the first two years, which may indicate some desire to portray fiscal restraint prior to an election. The percentage change in tax receipts is considerably lower in year 3 than in the other three years, which provides some support for the contention that, through tax policy, the federal government provides a fiscal policy stimulus in year 3.

Statistical tests on the fiscal policy measures, however, identify no years for which there is statistical support for the claim that the measures in a specific year are unique from the other three years. Thus, we are unable to find evidence supporting the view that the presidential cycle in

stock returns corresponds with detectable changes in fiscal policy.

Of course, measuring policy stimulus is very difficult for a variety of reasons. First, policy stimuli frequently rely on the interaction of several alternative national and international factors. Second, policy stimuli frequently work with considerable lag in influencing the economy. Third, correctly gauging the extent of a stimulus is difficult. For example, a tax reduction (a positive stimulus) may result in an increase in aggregate tax receipts as taxpayers take advantage of the tax benefit.

Finally, the government may shift priorities to provide a stimulus that targets a sector that will have the greatest effect on the economy. For example, by reallocating spending, the government may be able to provide an effective policy stimulus without changing aggregate spending.

Overall, one needs to recognize that any monetary or fiscal policy proxy variable is unlikely to completely capture the economic influence of Federal Reserve and Federal government policy changes.

In order to better assess the contribution of monetary and fiscal policy measures in explaining the presidential cycle, we report in Exhibit 4 the results of two separate regressions. The dependent variable in the first regression is quarterly return, and the independent variable is the year 3 dummy variable. The results confirm the significant year 3 effect in equity returns identified in Exhibit 1. Specifically, the year 3 dummy variable is significant (at the 1% level) for both the large- and small-cap index. Further, consistent with Exhibit 2 values, the year 3 dummy is insignificant for the fixed-income indexes.

The objective of the second regression is to determine how much of the third-year effect is explained by the variation in monetary and fiscal policy measures. To examine this issue, we perform a two-step regression process. The first step removes the influence of the monetary and fiscal policy measures on quarterly stock returns, while the second step investigates the prominence of the remaining third-year effect. Specifically, the procedure involves a first-step regression that includes quarterly returns as the dependent variable and the two monetary and two fiscal policy measures as independent variables. The residuals from this preliminary regression are then

EXHIBIT 3

Monetary and Fiscal Policy Measures over Presidential Terms: 1957-2004

	Year 1	Year 2	Year 3	Year 4	Overall
Panel A. Monetary Policy Measures					
Expansive Quarters	23	23	31	23	100
Mean Federal Funds Premium	0.68	0.66	0.32	0.44	0.52
Panel B. Fiscal Policy Measures					
Change in Current Spending (in %)	1.91%	2.08%	1.80%	1.73%	1.88%
Change in Tax Receipts (in %)	2.10%	1.25%	1.07%	2.52%	1.73%

Significant Chi-Square Test

Expansive Quarters: $H_0: NE_1 = NE_2 = NE_3$; P -value = 0.046

Significant Difference-in-Means Test

Fed Funds Premium: $H_0: FFP_1 = FFP_2 = FFP_3 = FFP_4$; P -value = 0.020

where NE_t = number of expansive quarters in year t and FFP_t = average fed funds premium in year t .

EXHIBIT 4

Regression Results 1957-2004

Index	Dependent Variable Nominal Returns		Dependent Variable Model Residuals	
	Intercept	Year 3 Dummy	Intercept	Year 3 Dummy
Large-Cap	0.0201 (0.004)	0.0348 (0.003)	-0.0071 (0.268)	0.0285 (0.027)
Small-Cap	0.0282 (0.002)	0.0557 (0.005)	-0.0115 (0.243)	0.0461 (0.020)
Long-Term Corporate Bond	0.0204 (0.000)	-0.0067 (0.384)	0.0018 (0.626)	-0.0073 (0.330)
Long-Term Govt. Bond	0.0207 (0.000)	-0.0105 (0.238)	0.0024 (0.553)	-0.0098 (0.237)
T-Bill	0.0135 (0.000)	-0.0009 (0.578)	-0.0003 (0.677)	0.0011 (0.321)

P-values are in parentheses.

These results indicate that monetary and fiscal policy account for a considerable amount of the third-year effect. After removing the influence of the monetary and fiscal policy measures, the year 3 dummy coefficients drop substantially (from 0.0348 to 0.0285 for the large-cap index and from 0.0557 to 0.0461 for the small-cap index). Clearly, however, a significant third-year effect still remains after removing the influence of our monetary and fiscal policy measures.⁸

Overall, our findings support the conjecture that monetary and fiscal policy actions contribute to the third-year effect. A significant effect, however, remains even after eliminating the influence of monetary and fiscal policy measures on returns. In interpreting these findings, our caveat regarding monetary and fiscal policy proxy variables is relevant. That is, fiscal and monetary policy proxy variables should be viewed as rough indicators of the actions of the Federal Reserve and the federal government.

Our identification of systematic patterns in Fed monetary policy that correspond with the third-year effect provides a policy-based explanation for a pattern that has so far gone unexplained. Further research may indicate whether alternative measures of monetary and fiscal policy might explain more of the effect.

SUMMARY AND CONCLUSIONS

We evaluate quarterly returns from 1957 through 2004 and confirm a prominent presidential term-year cycle in equity returns. The evidence indicates equity returns are significantly higher in the final two years of a presidential term than in the first two years. Returns are shown to be especially pronounced during the third year of a presidential term, when small-cap stocks generated an average annual return that exceeds 38%. While equities are shown to prosper during the last half of the presidential term on average, bond returns are higher (but not statistically higher) during the first two years of the

included in the second (reported) regression as the dependent variable, and the independent variable is the year 3 dummy variable.

generated an average annual return that exceeds 38%. While equities are shown to prosper during the last half of the presidential term on average, bond returns are higher (but not statistically higher) during the first two years of the

presidential term. Further analysis indicates that equity returns during the third year of the presidential term are evident in a divided sample period, which supports the temporal robustness of the effect.

To shed light on possible explanations for the presidential cycle, we evaluate fiscal and monetary policy measures during the presidential term. Our evidence indicates that the presidential cycle is strongly aligned with movements in Federal Reserve monetary policy variables. Thus, we provide support for the contention that policy changes are instrumental in the identified security return patterns. A multivariate regression analysis confirms that much of the presidential cycle can be explained by changes in our monetary and fiscal policy proxy variables.

Overall, our evidence confirms the view that for an effective portfolio strategy investors must carefully monitor both monetary and fiscal policy developments. Investors could most effectively capitalize on the pattern by examining the actions of policymakers.

ENDNOTES

¹In Beyer, Jensen, and Johnson [2006], we show that the relation between stock returns and political gridlock varies noticeably across stocks of various market capitalizations, while Conover et al. [2005] find that the relation between monetary conditions and stock returns depends on market capitalization.

²The quarterly equity and fixed-income returns are obtained from Ibbotson Associates. Indexes are value-weighted and taken directly from the Ibbotson and Associates *Stocks, Bonds, Bills, and Inflation* yearbook.

³The presidential calendar data are obtained from the *Congressional Quarterly Almanac* [2005].

⁴The monetary policy data are obtained from the *Federal Reserve Statistical Release H.15, Selected Interest Rates*, while the fiscal policy data come from the 2006 DRI Basic Economics database. Federal funds data are available starting in 1954, which restricts our sample start date to the subsequent first full presidential term.

⁵When relevant, t-tests were performed with a difference in variance adjustment. For expositional purposes, the hypotheses and test results are reported only when statistical significance is confirmed.

⁶In spite of the rather high mean returns reported in year 4, t-tests indicate that year 4 returns are not significantly different (at the 5% level) from the returns in years 1 and 2.

⁷More exactly, the quarterly values for the federal funds premium are derived as the average monthly premium for each quarter in the sample.

⁸The model used in the first-step regression (to obtain the residuals) includes quarterly return as the dependent variable and four independent variables (the two monetary policy variables and the two fiscal policy variables). In the first-step regression,

the two monetary policy measures are significant (at the 5% level) for both equity indexes, but the two fiscal policy variables are insignificant.

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