Gridlock's Gone, Now What?

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Business publications and financial-market commentators frequently make reference to a connection between security-market returns and political gridlock. The conventional wisdom is that political gridlock, which exists when the party controlling Congress differs from the party of the President, is associated with favorable equitymarket performance.¹ The press, political analysts, and financial analysts alike generally suggest that gridlock is good for the equity markets. The rationale for this "gridlock is good" theory stems from the notion that gridlock reduces economic uncertainty due to the diminished chance for significant legislative change. Thus, the benefits of gridlock are generally attributed to the resulting political stalemate that blocks major legislative changes. For instance, Byrne (2004) reiterates the claim that gridlock is good for the equity market. She suggests that history supports this claim; and further, provides an economic rationale for the relationship, "…investors also like a government where power is more evenly split, because the chances of a legislative curveball are vastly reduced." While there is widespread acceptance of the "gridlock is good" tenet, there is no academic

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¹ Political harmony exists when the Presidency, the House and the Senate are controlled by the same political party. In contrast, if these three political institutions are not controlled by the same party, political gridlock exists.

research supporting such a claim. This study examines the relationship between political gridlock and security returns, thus addressing the void that exists in this area.

Political Gridlock and Economic Conditions

Economic theory details the significance of monetary and fiscal policy on economic conditions and security markets.² Other studies, outlined below, suggest a close relationship exists between political gridlock and the potential for enactment of legislation. Together these studies show why analysts closely track the political environment before disclosing investment recommendations.

Gridlock represents an important dimension of the political landscape and is often discussed as a critical variable in determining security returns. The economic theory that relates gridlock to the security markets is that fiscal policy actions are more likely to occur under political harmony than during political gridlock. For example, based on an evaluation of legislative action, Kelly (1993) concludes that the production of important legislation is more likely under unified government (political harmony). Coleman (1999) extends the analysis of legislative activity and finds that unified, relative to divided government, produces one to two more significant enactments per congressional session, blocks approximately ten fewer potentially significant bills, and significantly increases the percentage of important bills that become law.

Numerous popular press articles, a few of which are identified below, suggest that gridlock is beneficial for the security markets. Byrne (2004) claims that the "gridlock is good" view is supported by history and is consistent with the general notion that

² See Friedman and Schwartz (1963), Alesina, Roubini, and Cohen (1997) and Tavares and Valkanov (2003).

legislative changes are frequently harmful to business. Shell (2001) quotes Tom McManus, chief equity strategist at Banc of America Securities, as saying "The stock market loves gridlock. Now that the Republicans no longer have the majority in both houses, gridlock is back." Prior to the 2000 election, a *U.S. News & World Report* article by Butler (2000) quoted Edward Yardeni, chief investment strategist at Deutsche Banc Securities, "Gridlock has been very good for the stock market."

The Study

We evaluate monthly returns from 1949 through 2004 for ten equity indices, four fixed-income indices, and an inflation index. We limit the analysis to the most recent 56 years for several reasons. First, an earlier period would be heavily influenced by a war-time economy and a depression. Second, political and monetary policy is difficult to assess during periods prior to the 1950s.³ Third, the past 56 years is a more relevant period for investment analysis because it reflects more accurately the modern financial markets and political arena.

We use qualitative classifications to establish binary variables associated with the political environment. Specifically, the alternative binary classification is: divided government (gridlock) or unified government (harmony). All 672 months in the 56 year study period are classified into one of the two categories.

The monthly fixed-income returns are obtained from Ibbotson Associates (2004), while the equity indices are obtained from the Center for Research in Security Prices

³ Notable differences exist in the implementation of both monetary policy and fiscal policy in earlier periods. Details regarding monetary policy and fiscal policy implementation are discussed in Jensen Mercer and Johnson (1996) and Tavares and Valkanov (2003), respectively.

(CRSP). We evaluate returns for the following indices: long-term corporate bonds, longterm government bonds, intermediate-term government bonds, treasury bills, and valueweighted size (decile) portfolios.⁴ The examination of the alternative fixed-income indices is motivated by the studies identified above that show that political gridlock influences government spending, taxes, and trade policies, among other factors. These variables are likely to affect both credit and term spreads due to their potential influence on budget deficits and government borrowing. Motivation for examining the size deciles comes from previous studies (see Fama and French (1995) and Gertler and Gilchrist (1994)) that link firm size to financial distress and to the availability of financing. These studies suggest that gridlock, and its implications for fiscal policy, may have a differential impact across firms of various size. Specifically, if smaller firms are more financially distressed and have less access to financing sources, as suggested, they may be more sensitive to changes in taxation and government spending.

Finally, we examine indices' risk to determine whether security markets are more or less volatile during periods of gridlock. Based on the "gridlock is good" claim, one would expect that periods of political harmony would be associated with more volatile returns. In particular, if unified government increases the incidence of harmful legislation, then the volatility of security returns should be higher during periods of political harmony relative to gridlock.

The congressional and presidential calendar data is obtained from the *Congressional Directory*. Gridlock is determined based on each congressional period, which is measured as the two-year period from January to January corresponding to the

⁴ The CRSP return data is preformatted and readily available on the web page of Dr. Kenneth French.

congressional cycles.5

In examining the relationship between security returns and political gridlock, we conduct two broad types of statistical analysis. First, we examine security performance during periods of political gridlock versus periods of political harmony. The difference in returns is assessed with standard difference-in-means tests as well as Wilcoxon rank-sum tests. An *F*-test is used in assessing the difference in volatility of returns between the alternative periods.

Second, we estimate regressions, with monthly return as the dependent variable, and an independent qualitative variable corresponding to political harmony versus gridlock. In addition, the regression analysis allows us to control for monetary <u>policy</u> when examining the relationship between gridlock and returns. When estimating the regressions we use the Newey-West (HAC) matrix to augment regression results for heteroskedasticity.

Results

Table 1 reports general information about political gridlock and harmony during the 56-year study period. During this period, 270 months were associated with unified government (political harmony) and 402 months reflected divided government (gridlock). The average gridlock period was 80.4 months versus 49.0 months for political harmony. The longest period of consecutive gridlock was 144 months versus 96 months for political harmony. The shortest harmony period existed for five months, while the shortest period Deleted: changes in
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⁵ This approach is consistent with prior studies in this area (e.g. Santa-Clara and Valkanov (2003)). Some cycles are less than two years due to changes in party affiliation (e.g. on May 24, 2001 Senator Jeffords switched party affiliation, thereby, altering political conditions).

of gridlock was 18 months.

Table 2 presents annualized returns and standard deviations for the equity indices (Panel A) and fixed-income indices (Panel B) across the two alternative political environments. While our primary focus is comparing returns across political environments, there are a couple of interesting relationships that exist across the size deciles within each political environment. In particular, during gridlock periods, the small-firm premium is absent as the return to large firms exceeds the return to small firms (12.38% vs. 8.45%). Furthermore, during periods of political gridlock equity returns are relatively consistent across the size deciles, ranging from a low of 8.45% to a high of 12.80%. In contrast, the return difference across the size deciles is dramatic during periods of political harmony with small firms returning 31.98% versus 12.94% for large firms. This evidence indicates that the well-documented small-firm premium was produced during periods of political harmony, whereas during gridlock a large-firm premium prevailed.

The reported return differences (Harmony - Gridlock) allow us to consider the relationship between the political environment and equity returns, which is our primary focus. The return differences vary dramatically, ranging from a high of 23.53% for the smallest decile to a low of 0.56% for the largest decile. For each of the five smallest size deciles, the return differences exceed 10%, which is highly economically significant. The *t*-statistics from difference-in-means tests confirm that the return differences are statistically significant (at the 5% level) for the five smallest deciles as well.⁶

 $^{^{6}}$ In order to address potential problems with outliers, a Wilcoxon rank-sum test was also utilized. The results of the Wilcoxon test are consistent in all cases with the *t*-test. For conciseness purposes, the results of the Wilcoxon test are not reported.

The standard deviations indicate that equity returns were generally more volatile in gridlock periods relative to periods of political harmony. Standard deviations were approximately 3% to 4% higher during gridlock relative to harmony periods. The *F*-test results support the statistical significance of the volatility differences.

The results reported in Panel A of Table 2 run strongly counter to the view that equity markets prosper during periods of political gridlock as returns are both lower and more volatile during gridlock periods. Instead, it would appear that equities have thrived during periods of political harmony, and this is especially true for small-firm equities. This evidence contradicts the commonly advanced view that equity investors benefit from the lack of legislation enacted during periods of political gridlock. Rather, the findings are consistent with the view that the increased incidence of legislative action during periods of political harmony is advantageous to equities, and particularly small stocks.

The bond-return results reported in Panel B provide a much different story regarding the relative attractiveness of political harmony. Specifically, fixed-income returns are much higher during periods of political gridlock relative to periods of harmony.⁷ The return differences are economically large and statistically significant <u>at the 1% level</u>. The largest return difference (-7.90%) is reported for long-term government bonds, while the difference in corporate bond returns is -6.89%. This finding indicates that the return difference across political environments is due primarily to changes in the general level of interest rates rather than changes in credit spreads.

The evidence in Panel B is consistent with the view that the lack of legislative

⁷ We also examine real (inflation-adjusted) bond and equity returns and find results that are very similar to those reported. For conciseness purposes, only the results obtained from nominal returns are presented. The results with real returns are available upon request.

action during periods of political gridlock is beneficial for fixed-income securities. Bond markets may prosper during gridlock because the lack of legislative action dampens government spending, inflation, and deficits. According to this view, bonds thrive because interest rates are constrained due to a reduced demand for funds by the government (less competition for funds) and less concern about future inflationary pressures.

Surprisingly, even though T-bond returns are significantly different across political environments, the inflation rate is very similar across the two environments. This suggests that the differences in bond returns reported in Table 2 are driven largely by changes in inflation expectations rather than differences in the actual rate of inflation. Table 3 reports general *yield* data to provide additional information regarding inflation expectations. The yield data reported in Table 3 is obtained from Federal Reserve Statistical Releases and is calculated as the average yield for the first month of each environment. On average, tenyear bonds were yielding 6.86% at the beginning of gridlock periods and 5.37% when harmony periods began. Recognizing that the start of a political environment coincides approximately with the end of the previous environment, this indicates that long-term rates generally fell during gridlock periods (thus producing the higher bond returns). A similar, but more substantial difference in yields exists for one-year T-bonds.

The term premium represents the difference between the ten-year and one-year yields and indicates that, on average, the yield curve had a much steeper slope at the start of a harmony period. Thus, inflation expectations were much higher at the beginning of harmony periods relative to gridlock periods. This evidence is consistent with our previous conjecture that market participants expect political harmony to yield higher levels of government spending and expansion, which is viewed to have inflationary

consequences. Further, this evidence is consistent with political research that has established that unified government tends to be more legislatively active than divided government.

Table 3 also reports evidence regarding general credit spreads at the beginning of the two political environments. The default premium has been advocated by numerous researchers (e.g. Fama and French (1989)) as an indicator of the general level of uncertainty in business conditions (i.e. business conditions risk). On average, the default premium is higher at the initiation of harmony periods (2.28% vs. 1.71%) suggesting there is more uncertainty regarding business prospects at the beginning of a harmony period relative to a gridlock period. This evidence is consistent with <u>economic ansd</u> political <u>science</u> research that suggests that the prospects for major legislative action are more pronounced during unified government (harmony). Thus, the evidence is consistent with the view that the increased uncertainty associated with legislative activities corresponds with greater business conditions risk.

Because of the likely correlation between monetary and fiscal policies and the welldocumented impact monetary policy has on stock and bond returns (e.g. Conover, Jensen, Johnson, and Mercer (2005)), we estimate regressions to control for the effect of both monetary policy and political gridlock. Beyer, Jensen, and Johnson (2004) present evidence highlighting the importance of controlling for monetary conditions when examining the relationship between the political environment and security returns. In particular, the authors show that the "presidential puzzle" tends to disappear once you control for the Federal Reserve's monetary policy stance.

The multiple regressions contain monthly security returns as the dependent variable

and the independent variables are qualitative variables corresponding to the political environment and monetary conditions.⁸ The political gridlock variable assumes a value of zero during periods of political gridlock and one during periods of harmony. Following the methodology of Jensen, Mercer and Johnson (1996) and others, the monetary policy variable is based on changes in the Federal Reserve discount rate. Specifically, the first reduction in the discount rate initiates an expansive monetary policy, while the first increase in the rate initiates a restrictive environment. Rate changes tend to occur in clusters, so rate changes subsequent to the first change in a series extend the already established policy. Empirical evidence indicates that this methodology is effective in identifying fundamental shifts in monetary policy, which is our intention.⁹ The monetary policy variable assumes a value of zero if Fed policy is restrictive and one if Fed policy is expansive.

The regression results reported in Table 4, Panel A confirm the important role of the political environment for equity returns. After controlling for changes in monetary policy, we observe that the political landscape has a significant relationship with the six smallest size deciles. This finding supports our previous contention that equities, particularly small stocks, prosper during periods of political harmony. This conclusion is independent of the monetary policy actions of the Federal Reserve. Consistent with previous evidence, however, we find that monetary policy also has a systematic relationship with equity returns. For each of the ten deciles, equity returns are higher

⁸ The results are adjusted for correlation in the error terms and heteroskedasticity using the Newey and West (1987) general covariance matrix to determine the estimators and calculate the standard errors. The<u>se</u> results are robust with the unadjusted least squares estimates.

⁹ Jensen, Mercer and Johnson (1996) present evidence confirming that monetary and reserve aggregates differ significantly across monetary environments defined according to this methodology.

when the Federal Reserve is following an expansive monetary policy relative to a restrictive policy. Interestingly, the coefficients on the political gridlock and monetary policy variables are comparable in size and display a similar pattern as one proceeds from the smallest to largest decile of firms.

The results in Panel B indicate that the bond indices perform well during periods of political gridlock, even after controlling for differences in monetary conditions. Thus, gridlock is associated with favorable bond-market performance regardless of the policy stance of the Federal Reserve.

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Conclusions

We examine long-term security returns relative to shifts in the political landscape. Unlike past analyses, we perform a joint analysis to evaluate the relationship of security returns with both political and monetary conditions. A joint analysis of the variables is motivated by the widely-acknowledged interdependence of monetary and fiscal policy and the observation that both variables have been linked to patterns in security returns.

Our findings provide evidence on several issues that have been widely debated in the popular press and academic journals. First, we find evidence indicating that the "gridlock is good" tenet is a myth. Rather, our evidence indicates that equity returns tend to be higher and less volatile during periods of political harmony. The returns to small firms are especially attractive during political harmony suggesting that the increased incidence of legislative action during such periods is particularly beneficial to small firms. Therefore, our findings indicate that equity investors can stop lamenting the end of political gridlock. Second, we detail the impact of gridlock on fixed-income returns. Although equities generally suffer during gridlock, we find that fixed-income securities perform very well. Bond returns are consistently higher during periods of gridlock relative to harmony. Further, we present evidence suggesting that the higher fixed-income returns result from lower inflationary concerns during gridlock periods relative to harmony periods.

Third, we show that the small firm premium has only existed during periods of political harmony. Surprisingly, large firms have provided higher returns than small firms during gridlock periods.

Finally, we note that even after controlling for monetary conditions, equities perform poorly during periods of gridlock, while fixed-income securities prosper. Thus, we find strong support for an independent "gridlock effect" in security returns.

Overall, our evidence suggests that political conditions are an important consideration for both equity and fixed-income investors. Thus, our findings indicate that the attention that financial market participants and the media place on political conditions is warranted. Hopefully, our results will help to correct the misguided relationships that have been widely advanced in the popular press.

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				Political Envi	ronment			
			Grid	lock	Harmony		-	
Average Duration		80.4 months		49.0 months		-		
Shortest Duration Event		17 months 6/01 – 11/02		5 months 1/01 – 5/01				
Longest Duration Event		144 months 1/81 – 12/92		96 months 1/61 – 12/68				
Total Mo	nths		40	2	270			
From	То	Length	Gridlock	Congress	President	Senate	-	
Dec-02	Dec-04	25	Harmony	Republican	Republican			Formatted: Font color: Black
Jun-01	Nov-02	18	Gridlock	Split	Republican			Formatted: Font color: Black
Jan-01	May-01	5	Harmony	Republican	Republican			Formatted: Font color: Black
Jan-95	Dec-00	12 24	Harmony	Democrat	Democrat			Formatted: Font color: Black
Jan-81	Dec-92	144	Gridlock	Split	Republican			Formatted: Font color: Black
Jan-77	Dec-80	48	Harmony	Democrat	Democrat			Formatted: Font color: Black
Jan-69	Dec-76	96	Gridlock	Split	Republican			Formatted: Font color: Black
Jan-61	Dec-68	96	Harmony	Democrat	Democrat			Formatted: Font color: Black
Jan-55	Dec-60	72	Gridlock	Split	Republican			Formatted, Font color, Black
Jan-53	Dec-54	24	Harmony	Republican	Republican			Formatted: Font color: Black
Jan-49	Dec-52	48	Harmony	Democrat	Democrat		\sim	Formatted: Font color: Black
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Table 1. Political Gridlock and Harmony in the U.S., 1949 – 2004.

Note: Harmony is defined as any period in which the Presidency, House and Senate are controlled by the same party, while Gridlock exists if any of the three political institutions is controlled by a different party.

Panel A: Annual Equity Performance (Returns and Standard Deviations)										
	Dec 10 (Small)	Dec 9	Dec 8	Dec 7	Dec 6	Dec 5	Dec 4	Dec 3	Dec 2	Dec 1 (Large)
Returns ^a										
Gridlock	8.45%	10.57%	10.99%	11.13%	11.67%	11.58%	12.80%	12.75%	12.37%	12.38%
Harmony	31.98%	24.99%	25.06%	23.48%	22.65%	19.87%	19.22%	18.01%	16.87%	12.94%
(Harmony-Gridlock)										
Mean	23.53%	14.41%	14.06%	12.35%	10.98%	8.30%	6.42%	5.26%	4.49%	0.56%
P-value	0.00*	0.02**	0.02**	0.04**	0.05**	0.13	0.22	0.30	0.33	0.95
Standard Deviations ^b										
Gridlock	21.66%	21.52%	20.56%	19.95%	19.29%	18.25%	18.00%	17.69%	16.29%	15.47%
Harmony	18.70%	18.04%	17.24%	16.50%	15.68%	15.02%	14.31%	13.92%	12.56%	12.10%
(Harmony-Gridlock)										
Mean	-2.96%	-3.48%	-3.32%	-3.45%	-3.61%	-3.23%	-3.69%	-3.78%	-3.73%	-3.37%
P – value	0.02**	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*	0.00*

 Table 2. Security Returns and Political Environments, 1949-2004

Panel B: Annual Bond Performance (Returns and Standard Deviations)							
	Corp	LT Gov	Int. Gov	T-Bills	Inflation		
Returns							
Gridlock	9.53%	9.72%	8.73%	5.70%	3.89%		
Harmony	2.64%	1.82%	2.89%	3.67%	3.70%		
(Harmony – Gridlock) ^a							
Mean	-6.89%	-7.90%	-5.84%	-2.03%	-0.19%		
P-value	0.00*	0.00*	0.00*	0.00*	0.47		
Standard Deviations							
Gridlock	8.44%	9.69%	5.18%	0.78%	1.02%		
Harmony	6.90%	7.61%	4.59%	0.79%	1.34%		
(Harmony-Gridlock)							
Mean	-1.54%	-2.08%	-0.59%	0.01%	0.32%		
P – value	0.00*	0.00*	0.06	0.88	0.00*		

Note: Panel A lists the equity-index returns for periods of gridlock and harmony. Equity indices are obtained from the CRSP database and are value-weighted returns by size decile, decile 10 to decile 1(smallest to largest). Panel B lists the bond-index returns for periods of gridlock and harmony. The bond indices are taken from the Ibbotson Associates: Stocks, Bonds, Bills, and Inflation yearbook. The following bond indices were used: long-term corporate bonds (Corp), long-term government bonds (LT Gov.), intermediate-term government bonds (Int. Gov), US Treasury bills (T-Bills), and inflation.

^a - The difference in means test was performed on mean monthly returns. Therefore, the P-value indicates whether the mean monthly returns (assuming unequal variance) are different between periods of political gridlock versus harmony. Returns are annualized for expositional purposes and were calculated by compounding the mean monthly returns.

 b - F-tests were used to determine differences in volatility and were derived as the ratio of the variances of monthly returns. Annualized standard deviations are reported for expositional purposes and were calculated by multiplying the mean monthly standard deviation by the square root of 12.

	Political Environment			
Start of Period ^a	Gridlock	Harmony		
10-year T-bond Yield	6.86%	5.37%		
1-year T-bond Yield	6.49%	3.57%		
Term Premium	0.37%	1.80%		
Baa Yield ^b	8.57%	7.65%		
10-year T-bond Yield	6.86%	5.37%		
Default Premium	1.71%	2.28%		

Table 3. Political Environment and Yields

Note: All bond yields come from the Federal Reserve Statistical Release H.15 *Selected Interest Rates* ^a – Start of Period refers to the average bond yields for the start of all gridlock and harmony periods, respectively.

respectively. ^b – The Baa yield in Federal Reserve Statistical Release H.15 is taken directly from Moody's Investor Services.

Panel A: Regression Results with Equity Indices								
Index	Intercept	Political Gridlock	Monetary Policy	Adj. R ²				
Dec 10 (Small)	-0.0018 (.670)	0.0179 (0.00)*	0.0173 (0.00)*	0.0318				
Dec 9	0.0011 (.800)	0.0123 (0.01)*	0.0148 (0.00)*	0.0191				
Dec 8	0.0026 (.499)	0.0118 (0.01)*	0.0118 (0.01)*	0.0151				
Dec 7	0.0027 (.475)	0.0109 (0.02)**	0.0115 (0.01)*	0.0145				
Dec 6	0.0029 (.415)	0.0104 (0.02)**	0.0117 (0.01)*	0.0154				
Dec 5	0.0036 (.297)	0.0081 (0.05)**	0.0104 (0.01)*	0.0117				
Dec 4	0.0047 (.176)	0.0067 (0.09)	0.0098 (0.02)**	0.0096				
Dec 3	0.0056 (.086)	0.0056 (0.14)	0.0082 (0.03)**	0.0061				
Dec 2	0.0056 (.064)	0.0048 (0.17)	0.0076 (0.03)**	0.0060				
Dec 1 (Large)	0.0057 (.052)	0.0027 (0.41)	0.0069 (0.04)**	0.0042				
Panel B: Regression Results with Bond Indices								
Corp	0.0068 (.000)**	-0.0054 (0.00)*	0.0016 (0.40)	0.0133				
LT Gov	0.0076 (.000)**	-0.0065 (0.00)*	0.0000 (0.99)	0.0119				
IT Gov	0.0070 (.000)**	-0.0047 (0.00)*	0.0000 (0.99)	0.0221				
T-Bill	0.0051 (.000)**	-0.0018 (0.00)*	-0.0010 (0.01)*	0.1420				
Inflation	0.0038 (.000)**	-0.0004 (.475)	-0.0013 (0.01)*	0.0322				

 Table 4.
 Security Returns and the Influence of Political and Monetary Conditions, 1949-2004

Note: Regression results are reported as coefficients with p-values in parentheses. The regressions are estimated with mean monthly index return as the dependent variable and two qualitative independent variables: gridlock = 0, harmony = 1; and restrictive Fed policy stance=0, expansive Fed policy stance=1.

 $\ast, \ast\ast$ Identify statistically significant coefficients at the 1% and 5% levels, respectively.