
Invited Editorial

A perspective on US regime change and the global financial crisis

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As the US and global equity markets strive to recover in the aftermath of substantial and protracted decline, at what point does the media, the public and investors at large¹ consider that the 35–38 per cent decline in US and global equity prices from 2 September 2008 to 10 February 2009 may be partly because of US regime change as reflected in the market's apparent response to the *prospective* election of Barack Obama – with a Democratic-controlled Congress – and the *reality* of that election result?² Although the effects of lingering sub-prime issues and the Lehman collapse are important, the author's view of regime change as the 'third rail' of global stock market weakness is presented in Figures 1–3.³

Figure 1 shows that from 2 September to 5 November – the first full trading day after the 2008 US Presidential Election – the US stock market, as measured by the S&P 500, declined by a whopping 22 per cent.⁴ Meanwhile, as US equities were falling in the September – 4 November period, the IOWA electronic political futures market was reporting that the futures price (probability) of a US\$1 payoff on the November 2008 Democratic Presidential Election contract was rising sharply, to a value of unity as of 5 November 2008, indicating

widespread expectation that Barack Obama would be elected president.

While several other factors⁵ certainly have played a role in the market downturn over the past 6 months, it is plausible that the stock market was also reacting negatively to the prospective election of Barack Obama. Fears (whether justified or not) that Obama would, if elected, pursue massive increases in federal spending, resulting in concomitantly large budget deficits, expand governmental regulation and oversight of business and markets, pursue labor-friendly policies and reverse Bush-era tax cuts for upper-income earners may have been priced into equity markets by institutional and high-net-worth investors. If correct, then an 'Obama wealth effect' along with other reasons of global stock market weakness has been punishing on individual investors, notably workers and retirees in defined contribution (as compared with defined benefit) retirement savings programs.

Confirmation of the 'prospective' implications of regime change should be supported by actual results. In this context, Figure 2 reinforces the view that the stock market reacted negatively not only to the prospective election of Barack Obama, but

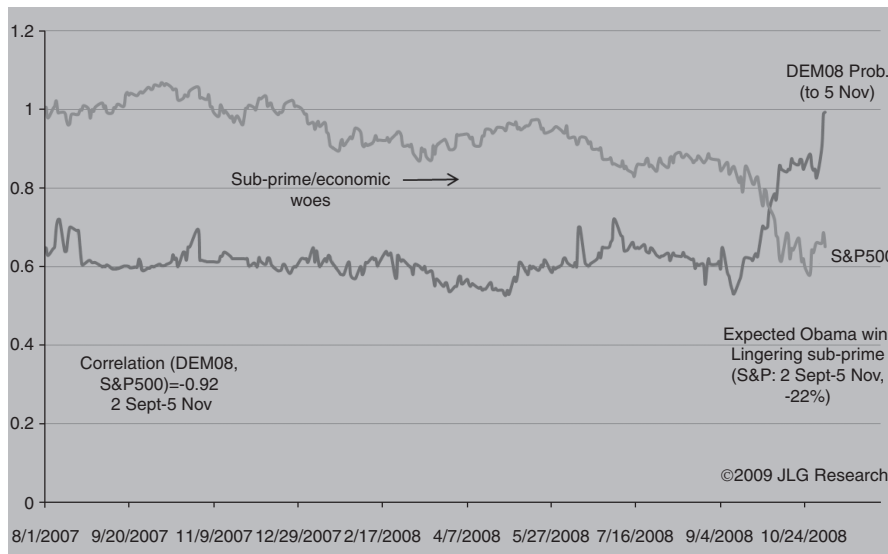


Figure 1: US Regime change and stock prices: A prospective view S&P500 versus DEM2008 probability IOWA electronic market.

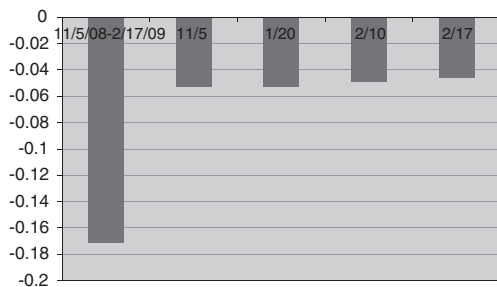


Figure 2: US Regime change and stock prices (S&P500): 2008 election, inauguration, senate approval of 'stimulus', Obama signing.

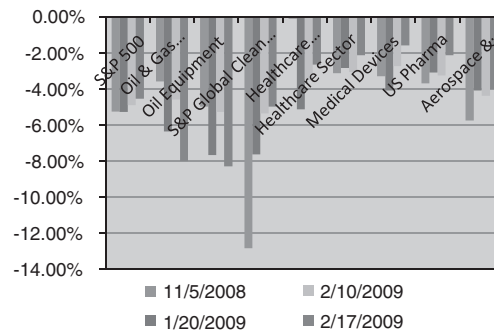


Figure 3: US Regime change and selected sector performance.

also to the reality of that event. The exhibit shows that the US stock market declined by 5 per cent on 5 November, the first full trading day after the election; the market declined another 5 per cent on 20 January 2009, the day that Barack Obama was inaugurated as the 44th President of the United States.⁶ The stock market declined 5 per cent on 10 February 2009, the day of first US Senate approval of the president's economic 'stimulus plan', and the market declined yet again by some 4.5 per cent on the day that President Obama signed the plan into law.

As noted, the market may perceive Barack Obama as on the one hand unfriendly to Corporate America and overly friendly to

labor unions and special interest groups on the other hand. Although that might be palatable for the President's Democratic supporters, it is troublesome for all investors – regardless of political stripes – because a significant portion of their retirement accounts are invested, either directly or indirectly, in US large-capitalization stocks. Moreover, the substantial decline in investor wealth that we have witnessed over the past 6 months is troublesome for the US and global economy as investors as consumers base their planned consumption decisions on both expected future income (wages) and wealth.

A more fundamental reason why US equity prices may have fallen so far and fast

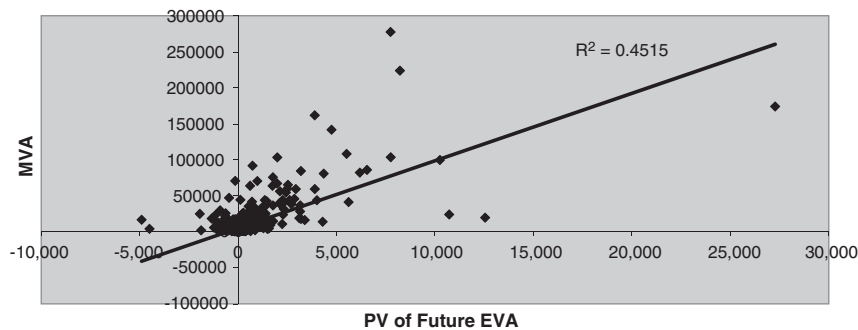


Figure 4: Look ahead 1 year: MVA 2005 versus PV of EVA 2006 all 1000 companies.

over the past six months has to do with the markets' perception that Barack Obama has limited understanding of or appreciation for the way in which wealth is created in the private sector. 'Real' wealth is created in an environment in which companies and enterprises have the opportunity to *rationalize* (as opposed to ration!) capital in the context of generating after-tax returns that exceed the opportunity cost of capital (WACC). Consider President Obama's economic 'stimulus plan'. Not surprisingly, a large portion of the allocated funds will go to state governments, local governments and non-profit organizations: entities that have no market-driven test of whether they are creating or destroying value via the rationalization of invested capital.⁷

Consider too that the proposed funding for infrastructure or 'shovel-ready' projects to maintain roads and bridges does not create any new wealth, nor does federal money allocated to wealth-destroying, private sector industries with low capital returns, such as autos and rails. These 'investments' merely perpetuate extreme inefficiencies, propping up stale companies and by inference, their unions, whose members largely vote Democratic. Moreover, the market may perceive that Barack Obama is not truly supportive of the defense industry, the energy sector (other than alternatives), or for-profit health-care companies. Consider the big pharmaceuticals: with the prospect of US socialized medicine on the horizon – as masked in 'universal health care' – one

would naturally expect health-care stocks to decline in anticipation of profit margin and multiples compression. Along these lines, Figure 3 shows selected sector and industry performance for key event dates including and around the 2008 US Presidential election.⁸

President Obama has commented that the stock market is 'impatient' for not seeing the presumed benefits of his economic 'stimulus plan'. Unfortunately, this inexperienced view of the market is tantamount to saying that investors do not know how to properly compute discounted present values. Consider Figure 4, lest there be uncertainty as to whether investors know how to discount economic realities. The exhibit shows the statistical relationship between the market value added (MVA) at 2005 and the present value of the *actual* economic earnings (EVA⁹) at year-end 2006 for 1000 companies in the Stern Stewart Performance Universe. With an R^2 (percentage of MVA variation explained) of 45 per cent, the exhibit shows a strong positive relationship between MVA and the discounted value of EVA, in this case, the one-step-ahead actual economic earnings.¹⁰

Moreover, research by the author shows that that stock market serves as a prism to distinguish between wealth-creating and wealth-destroying companies.¹¹ On this score, investors reward the 'value creators' with higher stock prices, while they punish the value destroyers with lower prices, even though the leadership of such risky, troubled

companies may be working earnestly to reinvigorate these firms. In effect, the market prices up the stocks of companies that can consistently rationalize capital, while it prices down the stocks of troubled companies that irrationalize capital. Such empirical findings support the well-established finance view that the stock market not only discounts future economic outcomes (events), but also serves as a mechanism to reward or penalize companies that create or destroy shareholder value.

With quasi-governmental ownership now in the banking sector, it is easy to see why ‘fallen angel’ companies in this sector are now truly challenged and unlikely to turn around anytime soon. With limited opportunities for bank capital to flow to its most efficient use, the reality of private sector management with quasi-governmental-run banks – managed directly *or* indirectly by politicians – seems hardly a recipe for creating shareholder value. With the prospect of significant equity dilution via government ownership, the market sees the currently depressed financial services sector as truly challenged; banks now have doubly constrained turnaround prospects for generating economic value.

Going forward, there are competing views about the recent uptick in stock prices since the early March lows.¹² One could argue that the rebound over the past month in US and global equities is short-lived, more of what is known among analysts and market watchers as a ‘dead cat bounce’. On a more positive note, it is possible that the recent turnaround in stock prices may be because the realization that ‘regime change’ from the 2008 US Presidential election is not so dramatic after all, as the actual policies of President Obama (expansion of TARP, Fed repurchases and so on) may not be as bad for business and economic activity as was originally feared. Also, the recent market turn may be because of more effective opposition from Republicans in Congress than had been initially expected.

Moreover, as a ‘bottoms-up’ perspective on when US and global equities will turn on a consistent basis, hedge-fund director, James Abate (2008), tells clients, ‘ignore the headlines, and instead, focus on the bottom-up cases for recovery’. He argues that investors should ignore the bailout plans of former President George Bush and President-elect Barack Obama, as the market recovery will come at the depths of the economy. In this view, the market turn will be sustainable when the benefit of a massive internal restructuring of Corporate America gets priced into the capital market. In Abate’s view, US and global stock market recoveries will be largely driven by companies and enterprises that fully understand the ‘bottom-up’ fundamentals of wealth creation in the context of capital rationalization.

To sum up, Figures 1 and 2 reveal that (1) the US stock market fell by 22 per cent during the 2 months leading up to the election of Barack Obama; (2) the stock market fell by 5 per cent on 5 November, the first full day of trading when election results were known; (3) the stock market fell by 5 per cent on the inauguration of President-elect Obama; (4) the stock market fell 5 per cent on the first Senate approval of the ‘stimulus plan’; and (5) the stock market fell again by 4.5 per cent on the day that President Obama signed the economic ‘stimulus plan’ into law. Along with the sector findings in Figure 3, it seems reasonable to conclude that investors have offered up a negative signal to US regime change, namely, the election of Barack Obama with a Democratic-controlled Congress. As further support for this perspective, Figure 4 shows that the stock market *is* a forward-discounting mechanism, while empirical research (available upon request) reveals that the stock market has confidence in the economic prospects of wealth creators, while it has little-to-no confidence in the economic profit prospects of risky challenged companies.

Finally, let the record books show that two US presidents – namely former President George Bush *and* President-elect Barack Obama – presided over the stock market collapses of 2008 and early 2009 that at the time of this writing were second only to the Great Depression. In fairness to President Obama, markets sometimes react negatively to regime changes, as evinced by the 25 per cent market decline¹³ in the year that George Bush arrived in office as a presumed ‘fiscal conservative’. Moreover, the author realizes that there are other valid explanations of stock market happenings around presidential elections – including the 2008 US Presidential election – and that it is often difficult to make reliable connections between political events, the real economy and the stock market.

NOTES

1. Presumably individual investors, as institutional investors with TAA models have reduced their equity allocations.
2. While US equities fell 35 per cent from 2 September 2008 to 10 February 2009, EAFE iShares plummeted by 38 per cent. Also, the S&P 500 declined 38.5 per cent from 2 September to 17 February 2009, the day that Barack Obama signed the economic ‘stimulus plan.’ Moreover, in recent years, the correlation between US and international equity markets has been high, around 0.8 (Bandopadhyaya *et al* (2009)), suggesting that global investors have had *no* place to hide in the presence of US initiated events including the sub-prime mortgage crisis and the Obama wealth effect (or contagion from the international perspective) on stock prices as argued in this article.
3. Lest the reader think that this article is a partisan view, the author is equally concerned about the negative stock market implications of *both* the Bush ‘financial rescue plan’ and the Obama ‘economic stimulus plan’. Neither of these plans recognizes the importance of wealth creation in terms of the ability of companies and enterprises to rationalize capital. Moreover, in the discussion that follows, it should be understood that references to President-elect Obama are also references to the Democratic-controlled Congress.
4. The author is aware of the fall of Lehman in mid-September, and the buyout of Merrill Lynch because of known and lingering economic and sub-prime troubles.
5. For example, in noisy capital markets one can argue that investors were pricing uncertainty about huge losses in yet-to-be announced asset portfolios, and/or concerns about sizeable impairment of commercial real estate. One can also argue that an endogenous variables problem may be present – which we are investigating.
6. Obama was shown in as the 44th US President of the United States at 1200 on 20 January 2009.
7. Fortunately, not-for-profits must (at least) satisfy the credit markets via their existing and prospective debt obligations.
8. iShares were used to measure selected industry and sector performance. The energy ‘bars’ include Oil & Gas Exploration (IEO), Oil Equipment (IEZ) and Alternative Energy [S&P Global Clean Energy (ICLN)]; health-care bars include health-care providers (IHF), health-care sector (IYH), Medical Devices (IHI) and US Pharma (IHE); defense includes US Aerospace and Defense (ITA). Interestingly, global clean energy (ICLN) was down some 13 per cent on 5 November 2008, likely because alternative energy ventures faced a dearth of private equity investors.
9. EVA[®] is a registered trademark of Stern Stewart & Co. See Grant (2003) or Stewart (1991) for a detailed explanation of EVA as a measure of economic profit.
10. Our valuation results are consistent over several years, including MVA and the present value of EVA in the years 2000–2005.
11. See Grant (1996, 2003).
12. The S&P 500 has risen some 20 per cent since the early March lows; interesting too, the US treasury bond market has not sold off.
13. On a more comparative basis, the market (S&P 500) declined by 13 per cent from August to November 2000, while the market dropped 18 per cent through February 2001. From August 2000 to August 2001, the stock market declined by 25 per cent, inclusive of a recession.

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