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Special Report

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Government and Financial Markets

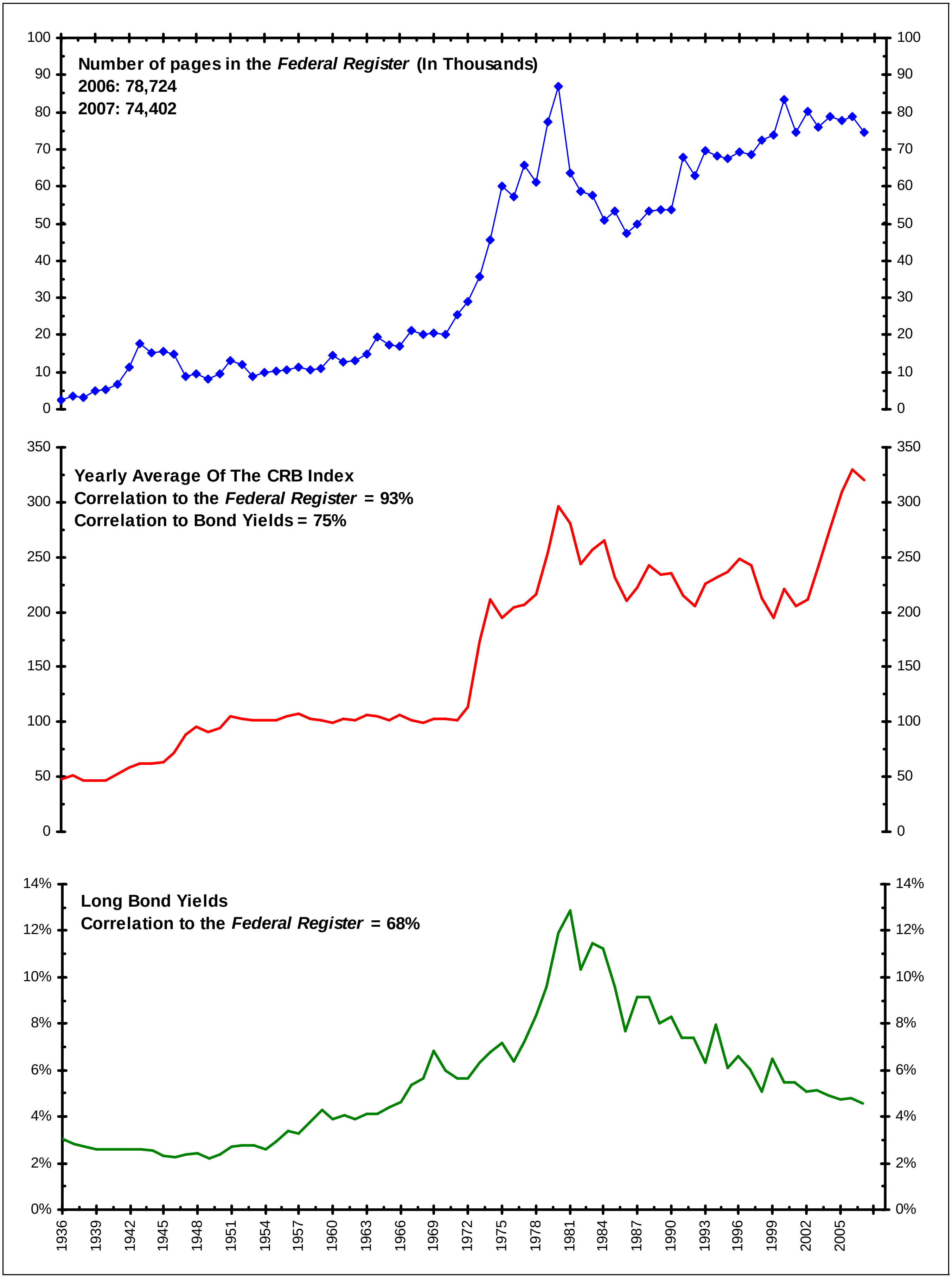
April 15 was be the last day for U.S. citizens to do their civic duty and pay, or at least file, their taxes. At this point of the year, the popularity of the government is at its lowest. This may account for the fact the Election Day has been placed six months away.

Because of this event, we tend to think of the government in terms of cost. The size of the budget deficit, the amount of government spending, and the total revenue take of the government are the typical measures. However, one measure of governmental cost that is often overlooked is the regulatory burden the government places on all of us and the markets.

Measuring the Rule Book

To measure the effect the government has on financial markets through regulations, we look at the amount of regulation imposed by the Federal Government by tracking the number of pages in the *Federal Register* (the *Federal Register*, or the "rule book," is a log of all Federal regulatory activity). In 2007, the *Federal Register* finished the year with 74,402 pages. The chart below shows the number of pages in the *Federal Register* and the movements of the CRB index. Note that the correlation between the CRB and the number of pages in the *Federal Register* is "highly significant" at 93%. The second chart adds long-term interest rates. While interest rates have recently diverged from the *Federal Register*, their correlation is still "significant" at 68%.

Government regulatory activity has long focused on commodity prices (especially agricultural and gasoline prices), so it is not surprising to find a high degree of correlation between commodity prices and federal regulatory activity.


Number of pages in the *Federal Register* (In Thousands)
2006: 78,724
2007: 74,402
Yearly Average Of The CRB Index
Correlation to the *Federal Register* = 93%
Correlation to Bond Yields = 75%
Long Bond Yields
Correlation to the *Federal Register* = 68%

Regulation, Political Alignment and The Financial Markets

The table below shows how political alignment impacts the pace of regulatory growth and therefore the financial markets.

When the Federal Government is divided, as it currently is, history shows us that regulatory growth nearly grinds to a halt. (Divided means control of the House, Senate, and Presidency is split between the two parties.) The bond market does well in this environment, and its returns are over twice the average of all periods. Stocks favor divided government as well (more on this later).

When the Federal Government is unified, as it was during the previous Congressional session, regulatory growth averages a pace that is almost 2 times faster than all periods. (Unified means the same political party controls both houses of Congress and the Presidency). In this environment, bond returns have been poor. **In fact, since 1950, bonds have underperformed 3-month bills (cash) when the government was unified in all cases except 1953 - 1955, which was the only other time in the post-WW II period that Republicans were the unified party.**

Interestingly, the unified, Republican Congress of 1953 - 1955 shrank the *Federal Register* by 8.35% per annum. So, while it was technically a unified government, functionally, they acted like a divided government and financial market returns resembled the returns found in divided government years.

Subtracting this period from all unified government periods, **we find that whenever the Democrats have been in complete control, bond investors have always been big losers. For more detail, see appendix A.**

Regulatory Growth and Market Performance Based on Political Alignment

Two-Year Annualized Growth Rates
1937 to 2007 by Congressional Session

	Change in the *Federal Register*	Congressional Session	Long Bond Total Return	Congressional Session	S&P 500 Total Return	Congressional Session
Median Gain Per Annum: All Periods	3.12%		5.18%		17.36%	
All **Unified** Governments 17 Sessions	4.12%		2.83%		17.36%	
All **Divided** Governments 18 Sessions	1.54%		9.97%		17.51%	
Unified Gov't: Biggest **Gain** Session	54.90%	1941 - 1943	10.97%	2003 - 2005	36.68%	2003 - 2005
Unified Gov't: Largest **Loss** Session	-8.35%	1953 - 1955	-4.83%	1967 - 1969	-7.69%	1937 - 1939
Divided Gov't: Biggest **Gain** Session	28.52%	1973 - 1975	27.75%	1997 - 1999	57.93%	1997 - 1999
Divided Gov't: Largest **Loss** Session	-17.40%	1947 - 1949	-3.46%	1955 - 1957	-33.51%	2001 - 2003
109th Congress - 2005 to 2007	-0.08%		9.43%		19.99%	

Data Sources: The *Federal Register* , Marvin Zonis and Associates, Ibbotson and Associates

Why Political Alignment Matters

Political alignment and regulatory growth seem to have a great impact on the bond market. We believe the bond market does not like increased regulation since it acts like another form of inflation. Whenever the government imposes restrictions, supposedly in the name of the public good, costs rise. (Liberals argue this is necessary to "level the playing field" while conservatives argue that restrictions hurt everybody, no matter how well-intentioned they are.) This is why we believe both commodity prices (the most sensitive measure of inflation) and bond yields are highly correlated to the *Federal Register*.

Divided government restrains the expansion of government regulations, which in turn is bullish for stocks and bonds.

What about Stocks?

As we alluded to above, the stock market does not seem to care if the government is divided or unified. However, if we change our study's starting time from 1937 to 1964, then the fortunes of the stock market dramatically reverse. Regulatory growth and the bond market's returns hold the same under either starting date.

Regulatory Growth and Market Performance Based on Political Alignment
Two-Year Annualized Growth Rates
1964-2007 by Congressional Session

Returns	Change in the *Federal Register*	Long-Bond Total Return	S&P 500 Total Return
All Congressional Sessions			
Median	3.12%	5.18%	17.36%
Average	6.70%	7.34%	16.01%
Std Dev	14.33%	8.66%	18.88%
Divided Government Sessions			
Median	1.54%	12.45%	26.30%
Average	4.37%	14.19%	20.35%
Std Dev	11.45%	9.21%	26.45%
Unified Government Sessions			
Median	3.89%	2.26%	18.48%
Average	6.75%	3.25%	16.32%
Std Dev	10.48%	6.02%	12.38%

Data Sources: The *Federal Register* , Marvin Zonis and Associates, Ibbotson and Associates

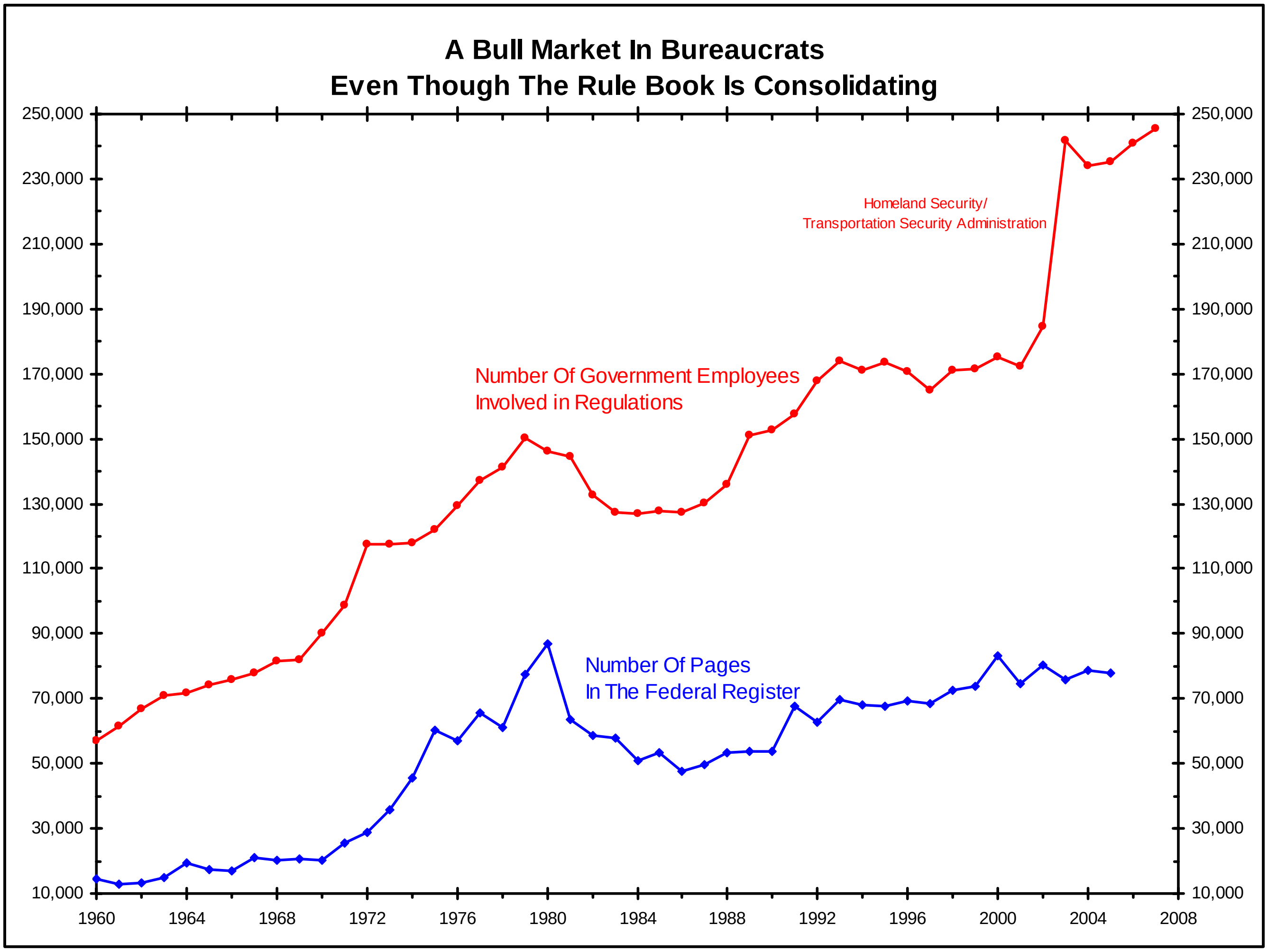
We elected to show these market returns separately to illustrate how unstable the relationship between political alignment and the stock market has been.

Change the starting date, and the return profile for stocks between divided and unified government radically changes. This suggests that the relationship between stocks and regulation is somewhat unstable.

Government Employees and Regulation

The chart below shows a disturbing trend. The number of government employees involved in overseeing government regulation is at an all-time high, even though the rulebook (the *Federal Register*) has held steady. The Federal Government currently has about 3.03 workers per *Federal Register* page – up from 1.68 in 1980. While these employees cannot create laws, having more employees to enforce regulations could suggest stricter compliance with existing regulations. This might have the same effect as Congress passing additional laws.

(The number of employees involved in regulations can be found in the paper "Moderating Regulatory Growth: An Analysis of the U.S. Budget for Fiscal Years 2006 and 2007" by Melinda Warren. It was published by the Mercatus Center at George Mason University.



The Current Congressional Session

The current Congressional session (110th) started in January 2007 and ends in January 2009, bringing an end to the past couple sessions which were unified under Republican control. In fact, the 108th and 109th sessions were the first unified Congress under Republican control since 1953 – 1955.

(In 2001 the 107 congress started off unified under Republican control until Senator Jim Jeffords of Vermont switched parties and became an Independent, but voting with the Democrats, on May 24, 2001. From that point forward, this Congressional session was divided.)

Conclusion

Political gridlock is bullish, but the government has the power to undo this bullish event by increasing regulations, or the number of bureaucrats enforcing those regulations.

Unfortunately, we do have examples of this occurring. From 1973 to 1975 (the 93rd Congress), we had a divided government, yet the *Federal Register* ballooned at an annualized pace of 28.52%. Returns during this time period suffered with stocks down at an annualized rate of minus 20.78% and bonds only up an annualized 1.59%.

Whether the Federal Government is divided or unified is important. However, the key statistic to watch is the pace of regulatory growth. Divided government has often meant slower regulatory growth. As long as this precedent holds, it is bullish for the financial markets. Should the current divided government allow the pace of regulatory growth to increase, all financial markets could continue to be at risk.

Appendix A

Congressional Session		Annualized change			Unified Government Only			Divided Government Only		
Number	Years	Change in *Federal Register*	S&P 500 Total Return	Long Bond Total Return	Change in *Federal Register*	S&P 500 Total Return	Long Bond Total Return	Change in *Federal Register*	S&P 500 Total Return	Long Bond Total Return
75	37 to 39	10.95%	-7.69%	2.83%	10.95%	-7.69%	2.83%			
76	39 to 41	33.08%	-5.22%	6.02%	33.08%	-5.22%	6.02%			
77	41 to 43	54.90%	3.15%	2.07%	54.90%	3.15%	2.07%			
78	43 to 45	18.23%	22.78%	2.44%	18.23%	22.78%	2.44%			
79	45 to 47	-1.51%	11.98%	5.18%	-1.51%	11.98%	5.18%			
80	47 to 49	-17.40%	5.60%	0.33%				-17.40%	5.60%	0.33%
81	49 to 51	-0.24%	25.10%	3.20%	-0.24%	25.10%	3.20%			
82	51 to 53	12.20%	21.15%	-1.42%	12.20%	21.15%	-1.42%			
83	53 to 55	-8.35%	22.94%	5.39%	-8.35%	22.94%	5.39%			
84	55 to 57	3.12%	18.39%	-3.46%				3.12%	18.39%	-3.46%
85	57 to 59	0.24%	13.09%	0.45%				0.24%	13.09%	0.45%
86	59 to 61	18.43%	6.06%	5.45%				18.43%	6.06%	5.45%
87	61 to 63	-4.33%	7.62%	3.88%	-4.33%	7.62%	3.88%			
88	63 to 65	22.98%	19.60%	2.36%	22.98%	19.60%	2.36%			
89	65 to 67	-6.36%	0.58%	2.16%	-6.36%	0.58%	2.16%			
90	67 to 69	9.56%	17.36%	-4.83%	9.56%	17.36%	-4.83%			
91	69 to 71	-0.09%	-2.43%	3.16%				-0.09%	-2.43%	3.16%
92	71 to 73	22.18%	16.62%	9.39%				22.18%	16.62%	9.39%
93	73 to 75	28.52%	-20.78%	1.59%				28.52%	-20.78%	1.59%
94	75 to 77	12.82%	30.36%	12.91%				12.82%	30.36%	12.91%
95	77 to 79	3.67%	-0.54%	-0.91%	3.67%	-0.54%	-0.91%			
96	79 to 81	21.02%	25.22%	-2.59%	21.02%	25.22%	-2.59%			
97	81 to 83	-16.39%	7.45%	19.57%				-16.39%	7.45%	19.57%
98	83 to 85	-6.41%	27.88%	7.86%				-6.41%	27.88%	7.86%
99	85 to 87	-3.51%	47.43%	27.66%				-3.51%	47.43%	27.66%
100	87 to 89	6.28%	25.82%	3.30%				6.28%	25.82%	3.30%
101	89 to 91	0.23%	26.77%	11.99%				0.23%	26.77%	11.99%
102	91 to 93	8.68%	35.63%	14.23%				8.68%	35.63%	14.23%
103	93 to 95	4.12%	11.63%	9.38%	4.12%	11.63%	9.38%			
104	95 to 97	0.93%	53.84%	27.56%				0.93%	53.84%	27.56%
105	97 to 99	2.15%	57.93%	27.75%				2.15%	57.93%	27.75%
106	99 to 01	7.56%	11.85%	10.55%				7.56%	11.85%	10.55%
107	01 to 03	-1.78%	-33.51%	21.08%				-1.78%	-33.51%	21.08%
108	03 to 05	-0.92%	36.68%	10.97%	-0.92%	36.68%	10.97%			
109	05 to 07	-0.08%	19.99%	9.43%	-0.08%	19.99%	9.43%			
110	*07 to 09*	*???*	*???*	*???*						
Median		3.12%	17.36%	5.18%	4.12%	17.36%	2.83%	1.54%	17.51%	9.97%
Average		6.70%	16.01%	7.34%	9.94%	13.67%	3.27%	3.64%	18.22%	11.19%
Std Dev		14.33%	18.88%	8.66%	16.31%	12.37%	4.29%	11.85%	23.63%	10.03%
Best		54.90%	57.93%	27.75%	54.90%	36.68%	10.97%	28.52%	57.93%	27.75%
Worst		-17.40%	-33.51%	-4.83%	-8.35%	-7.69%	-4.83%	-17.40%	-33.51%	-3.46%
Pct. Pos		62.86%	82.86%	85.71%	58.82%	82.35%	76.47%	66.67%	83.33%	94.44%
Pct. Neg		37.14%	17.14%	14.29%	41.18%	17.65%	23.53%	33.33%	16.67%	5.56%
Number		35	35	35	17	17	17	18	18	18

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