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How Do Major World Event Affect the Stock Market

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Abstract – This paper seeks to examine how the stock markets around the world react to changes, whether gentle or turbulent, in the wake of any major event; political or as an act of terrorism in any particular country. It aims to connect the stock market movements in a particular country with the political winds blowing in that country, and will seek to infer whether the fluctuations in the market are caused as a direct result of any major political event, or whether the stock market is largely indifferent to any political scenario, current or potential.

Keywords: Stock Market, Crisis, Terrorism, Politics

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INTRODUCTION

The first stock market in the world was believed to be in Antwerp, the commercial centre of Belgium, although instead of dealing in stocks, it mostly managed the affairs of government, businesses, and individual debt.

The East India Company continues to be widely recognized as the world's first publicly traded company. The reason why it became so was only one: Risk. All voyages to East Indies for trade were very risky and carried a high chance of failure, and only a handful of them made it back home. As a result, in 1600, a unique corporation called "Governor and Company of Merchants of London trading with the East Indies". Hence the East India Company came into being, and was the first company to use a limited liability formula. An example of this is as follows: If a ship returning from East India had a 25% chance of drowning due to harsh weather conditions, then instead of investing in one voyage and risking losing all their money, the investors could invest in the shares of multiple companies and divide their risks.

The London Stock Exchange was the first stock exchange in the world. However, it was the creation of the New York Stock Exchange that was the turning point in the history of stock markets. The NYSE has traded stocks from Day 1, and soon became the focal point of all trading and commercial activity in the United States.

Today, pretty much every country around the world has its own stock market, and trading worth trillions of dollars happens daily on these stock exchanges around the world.

Throughout history, the stock markets around the world have seen lots of crashes, but the following are worthy of mention:-

Black Thursday of 1929, followed by Black Monday and Black Tuesday, which thereby heralded the start of the great depression

Stock Market Crash of 1973-1974

Black Monday of 1987

Dot-com Bubble of 2000

Stock Market Crash of 2008

All of the above mentioned crashes led to double digit percentage losses around the world.

STOCK MARKETS ACROSS THE GLOBE

In terms of Market capitalisation, the top 10 stock exchanges in the world are as follows:-

1. New York Stock Exchange
2. NASDAQ
3. Tokyo Stock Exchange
4. London Stock Exchange Group
5. Euronext

6. Hong Kong Stock Exchange

7. Shanghai Stock Exchange

8. Toronto Stock Exchange

9. Frankfurt Stock Exchange

10. Australian Securities Exchange

POLITICS AND STOCK MARKET MOVEMENTS

The question this paper seeks to answer is if the stock markets are affected by the political developments in a particular country or the world as a whole.

Over the years, the stock markets have reacted almost instantly to the occurrences, whether favourable or unfavourable, and also decisions of the governments, and the developments based on those decisions.

This paper will aim to provide a clearer understanding of the aforementioned phenomenon by listing several cases in the history of the world which showed a clear correlation between the political developments and the stock market.

LITERATURE REVIEW

Chen, A.H. and Siems (2004) have used the event study methodology to study the impact of terrorism on the stock market, in US and also at a global level. They examined 14 major terrorist / military attacks from 1915 onwards with special focus on two events, namely, Iraq's invasion of Kuwait in 1990 and the September 11, 2001 terrorist attacks. Based on their analysis, they arrived at the inference that contrary to belief, US capital markets recover rather soon vis-à-vis other global capital markets in case of terror attacks specifically. They have attributed this quick recovery partly to a stable banking / financial sector which provides sufficient liquidity and promotes stability in the time of panic.

Arin, Ciferri & Spagnolo (2008) have also studied the impact of terrorism on financial markets. They have focused their study on 6 different financial markets and the impact of terrorist attacks on each of them. Based on their analysis they arrived at the conclusion that such events do have an impact on the stock market and cause stock market volatility however the effect is felt more and is more long lasting in emerging markets as compared to developed markets.

Veronesi (1999) presented a rational expectations equilibrium model of asset prices. As per him when individuals react to any event, their reaction is what makes the stock market over react. He emphasised that the investors' willingness to hedge against changes in their own "uncertainty" on the true state makes stock prices overreact to bad news in good times and underreact to good news in bad times.

Santa-Clara & Valkanov (2003) have addressed the difference in the stock market volatility when the ruling party is Democrats vis-à-vis republicans. They found the excess return (approximately 9 percent for value weighted portfolio and 16 percent for equal weighted portfolios) in the stock market to be higher under Democratic than Republican presidencies. They found that difference came from higher real stock returns and lower real interest rates and found it statistically significant. The difference in returns was not explained by business-cycle variables related to expected returns, and was also not concentrated around election dates. Also, there was no difference in the riskiness of the stock market across presidencies that could justify a risk premium. Thus, in their conclusion they were not able to gauge what is the reason for the difference in returns through the political cycle and therefore called it a puzzle.

RESEARCH METHODOLOGY

In order to understand the impact of landmark turbulences on the stock market movements, we would be considering the case study method. As pointed by Bromley (1990), "a case study method is a systematic inquiry into an event or a set of related events which aim to describe and explain the phenomenon of interest."

Our approach is based on identification of an event in the past few years which has been etched in the memory of all as catastrophic and then examining the reaction of the stock market along with the time it has taken for it to stabilise.

Event → Stock market faces turmoil → Stability restored

ANALYSIS

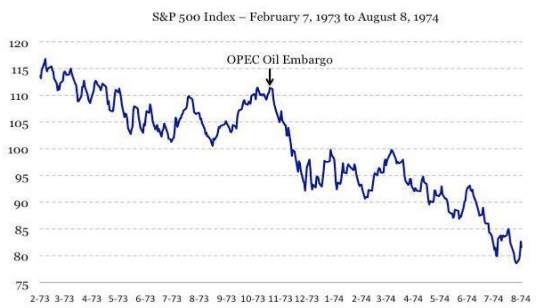
1. Event - Watergate Scandal - 17th July 1972, USA

The above scandal came about as a result of the failed burglary at the Democratic National Committee headquarters at the Watergate office complex, and the subsequent cover up by the Nixon administration that stretched over the next two years, and culminated with the resignation of President Nixon on August 8, 1974.

Impact

Although the name 'Watergate' has become synonymous with scandal worldwide, and the actual period was marked with major political uncertainty and turbulence, the subsequent impact on the stock market was minimalistic. The below graph depicts the movement of the S&P 500 Index for a period of a year and a half, starting from the date when the U.S senate first approved the select committee to investigate the Watergate scandal, and ending with the date on which Nixon resigned.

The Events Surrounding Watergate Did Not Move Markets



Source: Gerring Wealth Management, Yahoo Finance

On the face of it, the graph might lead one to believe that the Watergate event had a damning impact on the stock market, seeing as it had declined by over 28% during the above mentioned period. However, it is important to note that the markets at that time were getting weighed down by a lot of outside influences which were having a worldwide effect.

Apart from the Nixon event, the world economy also had to contend with the termination of the Bretton Woods agreement in 1971, but it was also plunging into a recession by 1973. The problem was compounded further by rising inflation, not least of which was caused by the OPEC oil embargo. In fact, when the announcement of the embargo was made by the Arab nations, the market reacted immediately, falling by over -16% within month. Thus, apropos the Watergate event, for lack of a better phrase, the stock market reacted just about matter of factly.

2. Event: 9/11 – September 11, 2001 - USA

Perhaps one of the most landmark terrorist strike in world history were the September 11 attacks in the United States where four coordinated terrorists attacks killed many and led to a loss of at least USD10 billion in property and infrastructure damage. Apart from having huge political ramifications, the event directly impacted the stock market in a big way.

Impact

As soon as the event occurred, the New York Stock Exchange (NYSE) and the Nasdaq closed down fearing a market meltdown, and remained closed till September 17. After opening, the NYSE suffered a fall of 684 points, a 7.1% decline, which holds the record for the *single biggest fall* in one trading day in the history of the exchange. At the close of the trading week on Friday, the Dow Jones was down by almost 1370 points, a decline of 14%. Overall, the market lost 1.4 trillion dollars in value in 5 days of trading.

Two domestic flights of American Airlines and United Airlines bound for California were hijacked by 19 Al –Qaeda terrorists and were forced to crash into the twin towers located in the World Business Centre in New York. The stocks that lost out the most, were thus predictably those of the American Airlines and United Airlines, tanking by 39% and 42% respectively. Other sectors to lose out were travel and tourism, hospitality, entertainment, financial services etc.

As opposed to this, the stocks of some technology and communication companies, as well as defence and weaponry companies rose substantially, in anticipation of the country's increased demand for weapons and associated equipment needed to wage a war on terror.

Bounce back

However, within a month, the Dow Jones, Nasdaq, and the S&P had regained their pre 9/11 price levels. By New Year's Eve, the S&P 500 had gained close to 20%. James B. Stack, president of InvesTech Research and Stack Financial Management, explains that the downward movement of the stock market and the recession at that time was less a consequence of the terrorist attack, and more of the technology bubble that burst in 2000 and was well and truly underway by then.

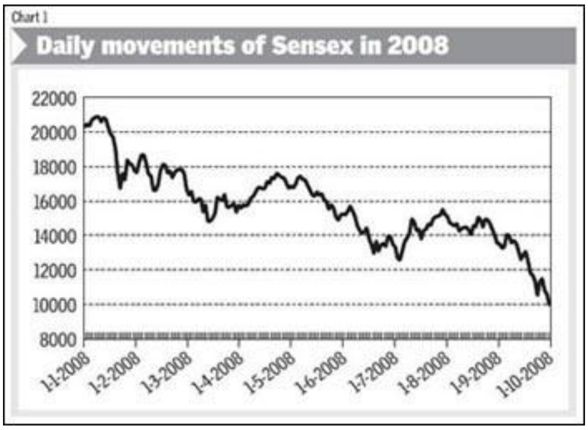
3. Event – Global financial crisis 2007-08 and its impact on India

The recent global financial crisis that started from United States, also more widely known as the global financial crisis is considered by many economists as the worst financial crisis since the Great Depression of the 1930s. The epicentre of the crisis was the sub-prime mortgage crisis, and then snowballed into a major global crisis of the banking sector which led to collapse of the Lehman Brothers. The crisis also led to the global economic downturn called The Great Recession. The sub-prime crisis affected the real and financial sectors all over the world, only that impact was less felt in some countries vis-à-vis others.

Impact

The volatility in portfolio flows were rather large during 2007 and 2008, the impact of global financial turmoil were felt on the Indian stock market. Largely owing to withdrawal of foreign institutional investors' (FIIs'). FIIs had invested over Rs 10,00,000 crore between January 2006 and January 2008, driving the Sensex 20,000 over the period. But from January, 2008 to

January, 2009, FIIs pulled out from the equity market due to mounting financial pressures back in their home country. These withdrawals drove the Sensex down from over 20,000 to less than 9,000 in a year. It seriously crippled the liquidity in the stock market. The stock prices tanked to more than 70 per cent from their peaks in January 2008 and some have even lost to around 90 per cent of their value.



Source: Mani, Kumar: Impact of Global Financial Crisis on Indian Economy

This left no safe haven for the investors both retail and institutional. The primary market got derailed and secondary market is in the deep abyss. Additionally, there was added impact owing to the heavy foreign exchange outflows and withdrawals from the country. Investors shifted from stocks and mutual funds to bank deposits and from private to public sector banks. Highly leveraged mutual funds and non-banking finance companies (NBFCs) were the worst affected.

Bounce back

However, India did bounce back inspite of the tremendous withdrawals by FIIs because of the fact that India as a country earns only 20% of its GDP from external trade and thus was never excessively dependent on foreign investment for growth. India has a large and robust internal sector which created growth and thus optimism leading to a smooth cycle even though many countries faced major setbacks.

4. Event: Demonetization – November 8, 2016, India

In India, one of the most recent events that evoked the interest of analysts was demonetization, whereby all notes of INR 500/- and INR 1000/- ceased to be identified as legal tender by the government. The move was the brain child of the Prime Minister Narendra Modi in order to curb black money, and was intended to promote a shift to a more cashless economy. This move essentially wiped out 86% of the currency notes in circulation in the economy at that time.

Impact

The impact on the stock market was immediate, but was a mixed bag. For instance, the real estate sector, which in India was heavily driven by black money, saw a major crash in the stock market, and tanked by about 25 % the day after demonetisation. Moreover, as a consequence the real estate sector itself seems to be staring at a correction of about 20-30% given the depressed consumer sentiment at present.

Bounce Back

At the same time, the stocks of sectors like infrastructure and banking held steady, and in fact improved after a month or so. The main reason for this was that given the plugging back of currency back into the formal banking system, there was expected to be more liquidity in the system, and also tackle the problem of the Non-Performing Assets (NPA's) that the banks were grappling with.

As regards infrastructure, the sector was expected to receive a huge stimulus from the government in the form of the excess cash being rolled back, in keeping with the governmental focus on structural reform in the economy through infrastructure creation.

While on one side the market sentiment was depressed owing to the expectation of lower GDP growth in the quarters to come, on the other side there was the hope of greater tax compliance due to more people coming under the tax net as a result of the tighter control imposed by the government as part of demonetisation.

CONCLUSION

To sum up, we conclude that the stock markets all over the world, have a certain pattern of reaction to political events happening within a particular country, or anywhere else in the world. While at first it may appear that the stock markets react instantaneously to the political events, at best these reactions can be qualified as knee jerk reactions, which do not last long, and have marginal impact on the overall position of the stock market. The potential investors in a stock market would be doing themselves a favour if they kept political events at arms' length while worrying about their affair with the stock market.

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