FVCM

U.S. Market Report

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U.S. Election Impact

President Obama won a convincing reelection while the Democrats continue to control the Senate and Republicans the House of Representatives. This victory for Obama is different from 2008 when the Democrats took control of both the House and the Senate. At that time Obama was seen as a positive force for change and had considerable political leverage because of his popular support. However, this time is different. Although he won the presidency, he didn't get a big majority of voters and he also won without winning congress. Also the negative campaigning has left considerable ill-will on all sides. From our perspective, we are not optimistic that the two sides will happily sit down together to merely extend the status quo.

The primary economic issues, which have already been widely discussed, are the "fiscal cliff" on January 1, 2013, as well as the election's impact on monetary policy. As it looks now:

Fiscal Cliff – Effective on or around January 1, 2013, there will be many automatic changes to fiscal policy including the expiration of the "Bush tax cuts" of 2001 and 2003, other taxes related to Obama's healthcare plan will take effect including higher taxes on capital gains and an excise tax on medical device sales, and there will be automatic cuts to both defense spending and "discretionary spending," which is spending excluding Social Security and Medicare. Because of the very strained relations between the Democrats and Republicans, it is difficult to see how a compromise will be reached before sometime in early 2013. Obama is strongly in favor of raising tax rates and the Republicans will not agree to do so. Therefore, the chances of the automatic changes taking effect on January 1st appear quite high.

Monetary Policy – One of the issues effecting the markets over the past couple weeks was comments by Romney which indicated his desire to replace Bernanke as Chairman of the Federal Reserve, Romney was not in support of additional quantitative easing and was expected to lean toward "hard money." However, with Obama now in power for four more years, the current policy bias toward easy money is likely to remain.

The implications, as we see it, are the following:

1. Economic growth could slow or turn negative next year because of the changes brought by the fiscal cliff. While the budget deficit would fall to 4% of GDP, versus the current level of about 7%, the Congressional Budget Office has forecast that real growth would fall to minus 0.5% next year if all the changes take place and no compromise is reached.
2. Interest rates are expected to remain very low and QE3 is expected to continue indefinitely as the Fed attempts to stimulate spending and demand for labor.

3. Even though the deficit is likely to shrink next year because of higher taxes and lower spending, a the dollar is likely to trend toward weakness versus a trade weighted basket of currencies as well as against gold, because of ongoing monetary easing.
4. Earnings for the S&P 500 could fall to about 95 next year, from about 105 estimated for 2013, and then rebound in 2014.
5. Stocks have traded lower immediately after the election results and we would not be surprised to see further weakness in the near term because of the increased likelihood of the U.S. falling off the fiscal cliff. However, equities are trading at less than 15 times the low 2013 earnings estimate and remain very inexpensive versus bonds. As the political smoke begins to clear, the very substantial liquidity now parked in short-term instruments should start to flow into equities. Stocks are already down about 5% from the recent high and we would use further declines in prices as an opportunity to accumulate good companies.

There is one other interesting twist that has not been widely discussed. In a press release last week, the US Treasury noted that it may reach the "debt ceiling" before the end of 2012. The debt ceiling is the arbitrary maximum amount of debt the Treasury can sell and additional approval from the US Congress is required in order for it to be raised. While the treasury has options to manage cash and extend the period before the debt ceiling is raised, certainly by the 2013 first quarter legislative action will be necessary. You may recall that in August 2011 President Obama signed the law which led to the automatic spending cuts that will take effect in January 2013 as part of a political deal with Republicans to raise the debt ceiling. U.S. bond holders do not need to worry about being paid interest and principal—there is no chance of default—but parts of the U.S. government could be shut down in order to conserve cash if the political battle grows severe.

The good news is that both sides have an incentive to find a budget solution that enables the economy to continue to grow. A grand compromise could center around the following changes: a) tax reform--marginal tax rates above current levels but below the pre-Bush rates along with fewer tax loopholes; b) spending discipline – defense spending in particular is likely to remain under downward pressure; and c) entitlement reform – a major agreement that helps the solvency of the programs that aid the elderly, Medicare and Social Security. A significant reform package would help position the U.S. for a sustained expansion. However, the politics are dark and complicated and we expect a lot of verbal battles before both sides decide to move towards the center for a practical agreement.
