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What happens next in politics?

This November 6th, President Obama will come up for re-election, as will the entire House of Representatives and one-third of the Senate. While sitting Presidents are generally favored to win a second term, there is no clear-cut leader yet in this election. Recent polls have shown President Obama and the presumed Republican candidate, former governor Mitt Romney, to be in a near tie. But there will be significant differences in policy, including taxation, spending, business regulation and international trade, depending on the victor, and the markets are watching closely.

President Obama is opposed to another extension to the Bush tax cuts, which are set to expire on January 1, 2013, especially for the wealthy. This would mean that the top income tax rate would rise from 35% to 39.6% and capital gains taxes will rise from 15% to approximately 25%. Besides higher taxes, Obama also favors higher government spending. For example, most Americans get their health insurance from their employer, while Medicare is government health insurance for the elderly and Medicaid is government healthcare for those in poverty. Obama's healthcare legislation intended to help those people who fell through the cracks. Such people include students just out of school in an entry level job that does not provide health insurance but who make too much money to qualify for Medicaid. Similarly, as for retirement spending, Obama has said he opposes any increase in the retirement age from the current range of 62 to 67 and supports higher taxes, especially on the wealthy. So under Obama, social spending would likely continue to increase while the costs would be partly offset with higher taxes.

In terms of business regulations, President Obama signed a law which puts significant restrictions on banks, hedge funds and other financial activities. Obama has also been behind a large number of new environmental regulations including many designed to reduce carbon emissions. The use of coal in the U.S. has been falling sharply due to the high cost of complying with new restrictions at electric power plants. Obama has also supported many other new regulations that cover labor activities, healthcare, transportation and other segments of the economy. As for trade, Obama has been very reluctant to support new trade agreements and, only after a three year delay, signed the free trade pact that Bush negotiated with Columbia. Whereas eleven new free trade agreements had been negotiated under Bush, Obama has put trade on the sidelines likely due to pressure from unions, which wish to avoid competition from foreign labor.

Mr. Romney's philosophy leans toward creating the conditions so that the U.S. will return to the 3.3% average growth rate it experienced in the postwar years. Romney would not only support continuing the Bush tax cuts, he has proposed reducing tax rates even further, including a reduction in the corporate tax from 35% to 25%. Romney points to the fact that high tax rates smother work effort, innovation and capital spending. In terms of spending, Romney and the Republicans believe there is a large amount of wasteful spending that can be cut. Under Obama, Federal spending has been running at nearly 25% of

GDP. Romney has proposed that spending should be capped at 20% of GDP, which was about the historical average before Obama. As for healthcare spending, Romney opposes the new Obama health plan and believes it would be more efficient to provide new tax benefits, for example, so that people can buy private insurance. And in terms of reforming, Social Security and Medicare, Romney supports gradually raising the retirement age as people live longer, as well as limiting benefits to wealthier people. For example, Warren Buffet is entitled to the same Social Security payments as a retired person living in a rented apartment with no assets. This would change under Romney.

As for regulations, Romney has pointed to a federal government estimate that regulations are a "hidden tax" that cost the economy $1.75 trillion annually. Romney has proposed to reduce or repeal many costly financial regulations and give industry a longer time period to phase in changes in environmental laws. Again, Romney has emphasized that conditions have to be made fertile for growth so that more jobs can be created. Similarly, Romney believes that international trade will lead to greater freedom and growth and he has pledged to return to a policy of pursuing new agreements, specifically with the emerging Asian partners.

Two Scenarios, both Positive

The equity markets should benefit regardless of whether Obama or Romney wins the election. There have been many polls and other studies that have shown that one of the primary reasons why businesses have been reluctant to expand and hire new workers is because of uncertainty. Corporate profits in the U.S. are at record highs and yet capital spending has remained depressed. With tax, spending, regulatory, trade and other policies soon to be changed, it is difficult for businesses to make longer term plans and, at a minimum, the election will provide clarity.

If Obama wins, we will certainly see tax rates rise next year. At the same time, social spending is likely to continue to increase. On the whole, economic growth should continue to move along at the current modest pace of perhaps 2% annually, and the federal budget deficit should continue to decline at a moderate pace. Major reform of the entitlement programs would be more difficult because the House of Representatives will most likely remain in Republican control. Under this scenario, equity prices would move higher thanks to greater certainty on government policy, but the gains would likely be modest. In contrast, if he wins in November, Romney would still not take the oath of office until January 20th and, therefore, the Bush tax cuts would automatically expire in January regardless. However, it seems likely to us that Romney would sign a law would that retroactively reduced tax rates to the beginning of the year. The emphasis on growth through lower taxes, spending and regulations, along with more open trade, suggests more profits and jobs. We could envision real growth of 4% in the first year of a Romney presidency. Equity prices would likely increase more sharply under a Romney presidency