The 2012 Election and Fiscal Cliff

Ironically, despite historic levels of dissatisfaction with our Washington leadership, the election caused virtually no change in the composition of the federal government. However, the status quo election led to a market reaction that was anything but status quo. In the seven trading days following the election, the S&P 500 sold off over 5% as some speculated that continued polarization in Washington increases the odds of going over the "fiscal cliff" in 2013. While these concerns are warranted given the recent track record of Congress (i.e. the debt ceiling debacle), we do believe there will be a deal this time around to avoid the full impact of the cliff; albeit in a temporary extension rather than a more substantial long-term solution. In this month's MAInsights, we will discuss the implications of the election and the "fiscal cliff" and how we are positioning portfolios for the current investment environment.

How do the election results affect the fiscal cliff debate?

In a presidential election that was anticipated to be so close that it would take days to determine the winner, President Obama won every swing state except North Carolina and ran away with the electoral votes, winning 332-206 in a surprisingly decisive victory over challenger Mitt Romney. As expected, Democrats also retained their majority in the Senate (gaining two extra seats) and Republicans maintained their majority in the House despite losing seats to the Democrats. Following the election, investors wasted no time in turning their focus to the next source of uncertainty for the markets - the quickly-approaching "fiscal cliff". The fiscal cliff represents a combination of higher taxes and spending cuts which would subtract over 4% from real GDP in 2013 if Congress does nothing to soften the blow. Fortunately, we believe the stakes are too high this time around and Congress will come to an agreement that reduces the cliff to roughly 1-2% of real GDP when all is said and done. This has been our view since our first Insights piece on the fiscal cliff in May, but following the election, we believe Democrats now have more leverage to require higher taxes on the wealthy to be part of the compromise and Republicans have less leverage to fight against it. At this point, it seems the most pressing debates for the market will center on what income levels will see higher taxes (incomes over $250, $500, $750k?) and how much to increase taxes on dividends and capital gains (our base case is for 23.8% tax rate on both which includes the 3.8% "Obamacare" tax). Taking into account the likelihood of these higher taxes, we believe the GDP impact will now be closer to 2% than 1%, which means we can expect a more sluggish economy next year.

What is our outlook for the next twelve months?

Although we anticipate some medicine to be taken in 2013, it appears that the majority of the cliff will be extended in order to buy time for a long-term package of entitlement and tax reform. We believe that this type of "grand deal" would be a huge positive for the markets, but we are skeptical that it will be possible given the divisive Congress that we have today. In our view, reactive, short-term fixes and extensions are more likely than a long-term solution, and as a result, persistent uncertainty could cause corporations and investors to continue to sit on their hands and economic activity to slow further. The offset to this headwind is that President Obama fully supports an accommodative Federal Reserve which portends extremely low interest rates and aggressive quantitative easing for the foreseeable future. As a result of these opposing forces, we see the equity market as having limited upside due to our meager growth outlook but also limited downside thanks to easy monetary policy.

How are we investing in this post-election environment?

Considering our outlook for a range-bound equity market, low interest rates, and higher tax rates, we are emphasizing strategies that offer defensive characteristics, above-market income potential, uncorrelated returns and/or tax advantages. Under this framework, within equities we are favoring lower beta, dividend-paying companies; within fixed income we are finding relative value in municipal bonds whose interest payments are tax-free at the federal level; and within alternatives we continue to like Energy MLPs that offer above-market, tax-deferred distributions (4-6% average yields), global bonds with attractive yields, and gold which should have the wind at its back in a world of aggressive money printing.

At the margin, we have become incrementally more cautious on the outlook for next year, but also believe that pent-up demand could make for a sharp rebound in the economy and markets going into 2014. For this reason, we believe it is prudent to stay invested but also have some downside protection in place, so where appropriate, we are employing structured notes in portfolios to provide this type of hedged exposure. In addition, we continue to advocate broadly diversified portfolios that balance the risk and return objectives of the client and allow for both protection and participation in a variety of market environments.

Source:

1. Strategas Research Partners, November 7, 2012