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# The US election

EDITION 34 – 17 OCTOBER 2012


## Key points

- The November 6 US Presidential election has more significance than usual given the policy differences between the two candidates and urgent need to reduce the "fiscal cliff" that will be reached on January 1.
- Ultimately the "fiscal cliff" is likely to be averted, helping a continuation of the rising trend in shares, but uncertainty around it and the approaching debt ceiling could contribute to some nervousness over the next few months.
- Mitt Romney's business-friendly policies would seem to be more positive for the share market, but bear in mind that historically US shares have performed better under Democrats and Romney's commitment to not reappoint US Federal Reserve Chairman Bernanke in 2014 is a possible negative.

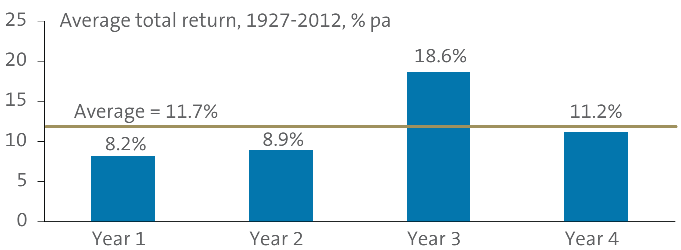
## Introduction

The November 6 US election is looming as a potentially significant event for investment markets. In contrast to past US elections there seems to be more at stake this time with the looming fiscal cliff and the threat of more sovereign ratings downgrades if the US does not come up with a long term plan to address its budget deficit and debt.

## The election and the share market

First let's look at the facts. The election year, or Year 4, in the 4 year presidential cycle is normally an okay year for US shares. Year 4 has been well above average when Democrats have been returned as President, with such election years generating an average return of 14.8% per annum (pa) compared to an 11.2% pa average return for all Year 4's since 1927.

**US sharemarket returns through the presidential cycle**




Source: Bloomberg, AMP Capital

Historically US shares have actually done better under Democrat presidents with an average return of 15.1% pa since 1945 to date compared to an average return over the same period under Republican presidents of 10.2% pa. This has certainly been the case in recent years with good returns under President's Obama and Clinton but terrible returns under President G W Bush.

US elections themselves show little sign of having a major impact on share markets as depicted in the following chart. The share market around the 2008 election was dominated by the global financial crisis.

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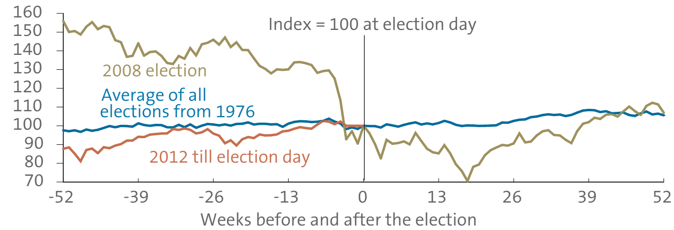
**US equity market around election days**




Source: Thomson Financial, AMP Capital

This election is threatening as more significant for markets given the significant policy differences between President Obama & Republican candidate Romney and looming fiscal issues.

## Key policy differences

The key policy differences relate to:

**Taxation**: whereas Obama has committed to continuing the Bush era tax cuts –except for those earning more than $US250,000– Romney is committed to extending them for all income earners and cutting company tax.

**Spending on entitlements:** a Republican administration would seek to deal with America's long term deficit problems via a sharp scaling back of spending, particularly on entitlements –social welfare and health– whereas an Obama Administration would favour a combination of spending cuts (more focussed on defence) and tax increases.

**Regulation:** Romney would favour less regulation, particularly for financial services, energy & the environment.

**Health:** Romney is committed to repealing President Obama's health care reforms.

**China:** Romney has said he will name China a "currency manipulator", which could lead to more tensions with China.

**The US Federal Reserve (Fed):** Romney has indicated he will not reappoint Chairman Bernanke when his term expires in January 2014. This would likely see a less dovish/less activist Fed Chairman appointed.

All up, the business friendly stance of a Romney government may be good for shares and so a Romney victory may be greeted positively by investors, but we would caution against getting carried away given the history of better share gains under Democrats and the possibility of a less proactive Fed.

## Clean sweep or more of the same

Whether Obama or Romney will be able to implement their program depends on the outcome in Congress which invariably acts as a brake on the US governments. The outcome of the Presidential election has become a close call recently, but there are three main scenarios.

**Status quo** – Obama retains the Presidency, Republicans retain the House and Democrats retain the Senate. Hence continuation of a divided Government. A Democrat loss of the Senate majority would make life even tougher for Obama.

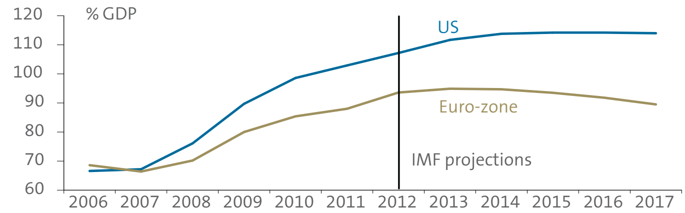
**Romney victory but divided Government** – Romney gains the Presidency and Republicans increase their majority in the House but Democrats retain the Senate.

**A Republican sweep** – Romney gains the Presidency and takes both houses of Congress. This scenario would lead to the greatest policy certainty. (A Democrat sweep is unlikely.)

## The approaching fiscal cliff & debt ceiling

The so-called "fiscal cliff" will be reached January 1 next year, followed soon after by the need to raise America's debt ceiling again and the need to come up with a long term plan to reduce America's budget deficit to head off more ratings downgrades. America has a bigger public debt problem than Europe in aggregate but as yet it hasn't really dealt with it.

**US and Euro-zone Gross Public Debt**




Source: IMF, AMP Capital

While the major ratings agencies have retained their sovereign ratings for the US this year, they have warned of downgrades if it doesn't bring its debt under better control. The US needs a long term plan to reduce its budget deficit. The trouble is that the fiscal cutback, scheduled to occur in 2013 under current law, will occur too quickly.

The main measures that will drive the "fiscal cliff" are; the expiration of the Bush era tax cuts, the expiration of the payroll tax cuts and extended unemployment benefits that were part of President Obama's stimulus measures and cuts to health and defence that flowed from last year's debt ceiling agreement (referred to as a "sequester").

### The US Fiscal Cliff - Fiscal Drag in 2013

| Country | US$ billion saving 2013 | % GDP in 2013 |
|---|---|---|
| Bush tax cuts for wealthy | 45 | 0.3 |
| Bush tax cuts for middle income | 150 | 0.9 |
| Payroll tax cut | 116 | 0.7 |
| Unemployment benefits | 25 | 0.2 |
| Budget Control Act 2011 | 85 | 0.5 |
| Payment rate for physicians | 20 | 0.2 |
| Other items | 229 | 1.5 |
| **Total** | **670** | **4.3** |

Source: Congressional Budget Office

Taken together, these measures will result in a fiscal drag of over 4% of gross domestic product (GDP) in 2013. With GDP growth running around 2% it would likely plunge the US economy into recession.

The other problem is that America's debt ceiling will also be reached again early next year. Any negotiation regarding the debt ceiling is likely to go hand-in-hand with negotiations over a long term plan to reduce the deficit as occurred in 2011.

The fiscal cliff has been well known for over a year now – so much so that it's starting to feel a bit like the year 2000 – but both sides of politics have been reluctant to make the compromises to address it ahead of the November elections.

American politicians are more than aware that not reducing the "fiscal cliff" will cause a huge fall in disposable household income which in turn will likely drive a recession, both of which will drive a huge backlash from voters. They are also aware that not coming up with a long term plan to reduce the budget deficit will likely result in more ratings downgrades.

With US politicians not wanting to be blamed for a recession or another rating downgrade, ultimately these issues will be addressed. The most likely outcome is that the "fiscal cliff" will be cut to around 1.5 to 2% of GDP with the Bush tax cuts likely to be extended along with some other measures along with some agreement on long term budget deficit reduction measures next year in return for raising the debt ceiling.

The smallest drag, of 1.3% of GDP, is likely to occur if the Republicans gain the presidency and both houses of Congress. Under Obama and a Republican House the drag is likely to be reduced to around 2% with a likely compromise being that the Bush tax cuts continue except for those earning US$1 million or more.

The question is how long it will take to reach agreement. Memories are still fresh from the dysfunctional debt ceiling negotiations of 2011, which dragged on and ultimately saw America lose its AAA rating from Standard and Poors.

How the fiscal issues are addressed will in large part depend on the election outcome. The neatest scenario would be a clean sweep by Obama and the Democrats (unlikely) or by Romney and the Republicans (possible). In the case of a clean sweep by Romney and the Republicans, they would be seen as having a broad mandate and the Democrats would not want to stand accused of tipping the US into recession. This would likely result in a solution or a temporary fix during the lame duck session (before the inauguration of the new President in January) or if agreement is not reached then there would be a very high level of confidence that it would be once the new President takes over in January. In other words, America could temporarily fall off the cliff before current laws are reversed. The resolution of the fiscal cliff would likely also include agreement to reach a long-term plan to cut the deficit during the first half of next year. This would all be taken positively by investment markets.

A continuation of the current status quo or a Romney Presidency with continued Democrat control of the Senate would lead to greater uncertainty. Ultimately a deal would likely be struck as the losers would not want the stigma of causing a recession but it may entail a greater risk of a re-run of the 2011 debt ceiling imbroglio. Similarly the debt ceiling negotiations would likely drag on longer in 2013.

Either way, there could be a period of uncertainty for the US over the next few months, which may pose a risk for share markets in the short term. Ultimately though, given the awareness that inaction will cause huge damage to the US economy the most likely scenario is that the fiscal cliff will be reduced in size. This –combined with continuing quantitative easing stimulus from the Fed– should enable the gradual US recovery and rising share market trend to continue.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## Contact us

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