President Obama’s re-election resolves a major element of uncertainty that has hung over the political landscape. But what kind of impact will his victory have on the economy and the markets, especially with the House still in Republican control? We posed that question to a roundtable of five investment professionals from Eaton Vance Management, Hexavest and Richard Bernstein Advisors.

Let’s start with the “fiscal cliff” of automatic spending cuts and expiring tax cuts, since those are looming at year-end. Are we any closer to pulling back from the ledge?

Shively: Unfortunately, I don’t believe so. We still face a significant cliff that will be difficult for the U.S. economy to endure, especially with the economic weakness overseas. There are estimates that anywhere from 1.5% to 3% could be cut off of annual growth in U.S. gross domestic product (GDP). I believe the markets are not totally discounting a significant fiscal cliff at this point, despite the warnings.

Stein: With Obama’s re-election, one certainty is that we are going to have a 3.8% tax increase to fund the Patient Protection and Affordable Care Act, better known as Obamacare, which is set to go into effect on January 1, 2013. It’s guaranteed to happen. With that hike and the Social Security payroll tax reduction expiring, we already have guaranteed tax increases built in. There’s uncertainty over which of the other tax cuts will be extended, which will likely lead to volatility. I can’t see how this is a positive at all. It’s negative for growth.

Metzold: I’m pessimistic that our elected officials will properly address the fiscal cliff before the end of the year. U.S. policymakers have had enough time leading up to this point to strike a deal. We have heard the warnings that Moody’s will downgrade the U.S. credit rating due to policymakers’ inability to act. Even though the fiscal cliff event could help shrink the budget
deficit, this could very well put the U.S. back into a mild recession. If the fiscal cliff is not addressed until after the inauguration but results in the issues being addressed in a more thoughtful way, it could end up being a positive. Hopefully the delay increases the likelihood that Congress chooses to address the issues in a more thoughtful way by taking up comprehensive tax reform in 2013.

What Obama decisions are likely to have the biggest impact?

Stein: U.S. Treasury Secretary Timothy Geithner will mostly likely leave in January 2013 and Federal Reserve Chairman Ben Bernanke will likely leave when his term is over in January 2014. For the Fed position, Obama will likely nominate someone who thinks like Bernanke, who focuses on the demand side, and who wants to boost asset prices, like Janet Yellen, Bill Dudley or Roger Ferguson. However, if Obama selects someone like Erskine Bowles as Treasury Secretary, there is a higher likelihood of a grand deficit reduction bargain along the lines of the Simpson-Bowles deficit commission recommendations. That could include major tax reform lower marginal rates, a broader tax base, and fewer deductions—as well as entitlement reform. This would allow for both long-term growth and for deficit/debt reduction. If Obama appoints someone more partisan, more of an ideologue, a deal like that is less likely.

Adam: If Eric is right and we do get a new Fed Chairman who is as dovish as Bernanke, it would likely be bearish for the U.S. dollar and bullish for gold prices. You’ll likely see more quantitative easing and less-aggressive deficit cutting compared with someone Romney might have appointed. It is important to remember that even with President Obama’s re-election, the U.S. still has a divided government. We expect about $150 billion to $200 billion of austerity in the U.S. next year. When you have (GDP) growing less than 2% annually with a 9% deficit, the U.S. may be close to recession next year. That view doesn’t change with the election results.

Metzold: President Obama’s fiscal 2013 budget proposal seeks to pare back the tax break for municipal bond interest to 28% for those making more than $250,000 a year – something that will likely face stiff resistance from state and local governments who benefit from the lower cost of tax-exempt financing. However, the potential for higher taxes under a second Obama term could offset that by increasing the value of tax-exempt income. Obama’s second term may also lead to a reintroduction of the taxable, subsidized Build America Bonds (BABs) program created in the 2009 economic stimulus plan. The BABs program would likely be a positive for the muni market, as a large amount of tax-exempt supply would not come to market.

Are there ways in which the president’s re-election is likely to have little impact?

Bernstein: The election results do not impact my overall investment view that the U.S. industrial sector will gain global market share over the next decade. No matter who is in office, I
believe the groundwork has already been completed for the U.S. economy to ramp up. The idea of the “American Industrial Renaissance” continues to be one of our favorite investment themes. It is unlikely that the U.S. will again be the manufacturing powerhouse that it was during the 1950s and 1960s, but many factors are suggesting that the U.S. industrial sector will likely gain market share over the coming decade.

In addition, early-cycle sectors are starting to improve and that’s what is important to markets. Housing, autos and retail are early-cycle industries that are starting to show signs of life, which argues that 2013 and 2014 economies might be stronger than consensus estimates. Even if you don’t like the result of the elections, I think there will be more certainty in the markets going forward, which is a positive in the short term.

Shively: I would agree with Rich’s point. The U.S. has done more to improve its relative competitiveness. Europe hasn’t done enough to fix the competitiveness imbalances between the core and peripheral countries. However, my view is that investors are not getting compensated fairly in any financial asset for market, or beta, risk. I prefer absolute return strategies to beta risk in the short run unless valuations change.

“Even though we are not bullish on the U.S. economy, we do agree that it’s better than elsewhere.” Jean-Rene Adam, CFA

Adam: Even though we are not bullish on the U.S. economy, we do agree that it’s better than elsewhere. We also believe in the U.S. manufacturing renaissance and we don’t think the elections will change that. Consumer deleveraging is also progressing in the U.S. What we don’t like about the U.S., however, is valuation and sentiment. We feel being overweight U.S. equities is the most consensual trade. At Hexavest, we prefer to take the contrarian view. We also think that valuations of the U.S. stock market are too high. We believe earnings expectations are too elevated for 2013 at projections of 10% to 15% earnings growth. Right now, we are seeing profit margins shrinking at the same time sales are contracting.

Metzold: The re-election doesn’t end the uncertainty of rising taxes or potential changes to tax law affecting the municipal bond market. With the lame-duck session of Congress, much of this likely won’t change. If you believe gridlock in Congress is going to occur, you should consider assets that are expected to provide the most income. Regardless of what happens, I still believe municipal bonds will remain the most attractive fixed-income alternative on an after-tax basis.

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.
Do the U.S. elections results have any effect on the fiscal challenges facing Europe?

Shively: No, I don’t believe so. I’m still pessimistic on the idea that the eurozone stays intact. Those economies continue to weaken as social pressures, particularly in the peripheral economies, continue to build. The longer this situation goes on, the more social pressure we’re likely going to see on both sides: the debtors and the creditors. This could work against the political efforts to keep the eurozone together.

Stein: I find it somewhat surprising the eurozone stayed intact this long. European Central Bank (ECB) President Mario Draghi has bought a lot of time with massive intervention by the ECB. However, the ECB’s injections are only providing liquidity. The interventions are not dealing with the solvency issues or the competitiveness issues of troubled eurozone countries. Policymakers will likely do enough to keep the eurozone from crumbling apart, but they are never going to solve their philosophical differences. If Germany leaves the euro currency, the whole project could come to an end. That said, I do not see Germany leaving the euro currency any time soon. Even though there is significant public discontent about recent developments, there is not yet a credible political party that wants to leave the euro.

Adam: The ECB’s actions certainly remove the risk of a breakup of the euro in the short term, but nothing has changed over the medium and long term. If Spain or Italy needs help and asks for aid, they will be forced to enact more austerity measures and the economies could end up in even worse shape. We realize now that the core countries like France and Germany are being impacted by the debt crisis. For that reason, I am very bearish on the eurozone.

Bernstein: European stocks appear to be cheap, but they’ve appeared that way for three years now while the fundamentals continue to erode. The definition of a value trap is a situation where things look undervalued but the fundamentals keep getting worse. We could be seeing that with European stocks today. We want to see the profit dynamics improve and that is simply not happening. We’ve been very wary of Europe because of that. If the profit dynamics begin to stabilize, that would be encouraging for European equities.

What is the investment outlook for emerging economies like China following the U.S. elections?

Shively: People may have been expecting a rosier scenario in China than what may actually play out. I think China is going to have a much more difficult time transitioning to a more domestic-led economy from their current export-driven model.

Stein: I agree. Structurally, China’s growth has slowed and it will likely continue to slow for the long-term. The transition to new leadership will occur over the next six months, and it will be important to see the amount of pain they are willing to absorb in the
short term in order to get China’s economy on more sustainable footing. China is trying to clamp down on property prices and hasn’t announced a truly massive stimulus—both are steps in the right direction. That said, China’s path will have investment implications. While China’s domestic demand will likely continue to be a source of growth, China’s usage of industrial commodities will likely slow.

“The re-election doesn’t end the uncertainty of rising taxes or potential changes to tax law affecting the municipal bond market.” Tom Metzold, CFA

Bernstein: I agree with Eric’s view that China has very much been an infrastructure story. However, it’s important to remember that the amount of capital spending like we saw in China over the past decade always has to be financed. In my estimation, China has a credit bubble that makes the U.S. look like amateurs. It’s going to be hard to get financing for the level of capital financing we’ve seen in the past 10 years. That has important implications abroad, especially for countries like Australia that rely on metals and mining.

About Risk: Investments in equity securities are sensitive to stock market volatility. An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. As interest rates rise, the value of certain income investments is likely to decline. The ability of municipalities to issue Build America Bonds expired on December 31, 2010 and there can be no certainty as to whether future legislation will be enacted that would again permit such issuance. Given the limited issuance of Build America Bonds they may not be actively traded. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging or frontier countries, these risks may be more significant. Absolute return strategies benchmark their performance primarily against short-term cash instruments, adjusting to compensate for the amount of investment risk assumed. Relative return strategies, by contrast, seek to outperform a designated stock, bond or other market index, and measure their performance primarily in relation to such benchmark. Over time, the investment performance of absolute return strategies typically is substantially independent of longer term movements in the stock and bond market.

Jean-René Adam, M.Sc., CFA is Assistant Chief Investment Officer & Vice President of Hexavest covering North American Markets. Eaton Vance Corp. acquired a 49% interest in Hexavest in August 2012. Richard Bernstein is chief executive officer of Richard Bernstein Advisors LLC, a multimarket equity strategy advisor and subadvisor to certain Eaton Vance sponsored investment companies. Neither Mr. Adam or Mr. Bernstein is providing legal or tax advice as to the matters discussed herein.

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.
This material is being provided for educational and informational purposes only and should not be considered investment advice, a recommendation to buy or sell any particular security or to adopt any particular investment strategy. The discussion herein is meant to be general in nature. There is no guarantee as to its accuracy or completeness. It is not intended as legal or tax advice and individuals may not rely upon it (including for purposes of avoiding tax penalties imposed by the IRS or state and local tax authorities). Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, retirement or insurance arrangement.

The views expressed in this material are those of the respective speaker identified, are current only through November 7, 2012 and are not meant to reflect those of Eaton Vance as a firm. These views are subject to change at any time without notice based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. Different views may be expressed based on different investment styles, objectives, opinions or philosophies. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of Eaton Vance. This Commentary may contain statements that are not historical facts, referred to as forward-looking statements. Future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions.

Eaton Vance does not provide specific tax or legal advice. Investing entails risks and there can be no assurance that Eaton Vance, or its affiliates, will achieve profits or avoid incurring losses. Past performance does not predict future results.

About Eaton Vance

Eaton Vance Corp. (NYSE: EV) is one of the oldest investment management firms in the United States, with a history dating to 1924. Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit: http://www.advisorperspectives.com/subscribers/subscribe.php