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Leaning Left – Hope and Change Part II

"Much of the social history of the Western World, over the past three decades, has been a history of replacing what worked with what sounded good."
U.S. Economist, Writer Thomas Sowell

As everyone knows, President Obama won a second term by about 4% of the popular vote, while sweeping the battleground states and winning the Electoral College. The Democrats gained two Senate seats while the Republicans held on to a comfortable majority in the House.

For investors, party politics, personalities and affiliations really do not matter. What matters is the direction of policy. What this election ensured, is that big government is here to stay for a while in the USA. With government that big and interfering, the economy is not going to suddenly find a switch to a higher gear, so odds are we will continue to plod along, even though equities appear to be undervalued.

US Federal spending to GDP – which peaked at a post-World War II high of 25.2% under President Obama, and is still at approximately 23%, does not appear that it will fall under 20% anytime soon, which is where it was consistently before 2008-2009.

Policy wise, the President's victory means his health care reform package better known as "Obamacare," will remain in place. High income earners will face tax increases on interest, dividends and capital gains, and an additional 1% or so Medicare tax on regular income. The President says he doesn't want to cut military spending, but it's a big chunk of annual spending.

It seems to me, many Americans went to the polls without much enthusiasm for either candidate. The majority seemed to be saying to the President, "you didn't get it right the first time, but we are going to give you another chance." In a way, they voted for hope and change" again. A country with nearly 8% unemployment preferred to give the President a second chance rather than give Mitt Romney a first one.

Up first, are negotiations between the President and the lame-duck Congress on averting the so called "fiscal cliff" – the crux of which is approximately $600 Billion of tax increases and spending cuts that are scheduled to take effect in 2013 unless action is taken to avert them. The combined impact could be as much as 4% of GDP, which given the fragile state of the US economy, may be enough to trigger another recession.

The US is expected to reach its $16.394 Trillion borrowing limit late this year. The 2011 debt ceiling debate led to significant market volatility followed by an S&P downgrade of the U.S. long term debt. The 2012 debate could have similar implications with Moody's having already threatened a downgrade if the debt ceiling is not raised in an organized manor.

Given the complexity of the issues and the lack of time (about 45 days as I write), we may see an agreement to extend everything for one year, which would give Congress and the President more time to work on a larger, all encompassing package.

US fiscal policy is on an unsustainable path. Five years ago the debt-to-GDP ratio was 36.5% (which is roughly the average for the previous 40 years). Now that ratio has doubled to about 72%, the highest percentage since World War II.

This effort is going to have to involve a combination of both revenue increases and huge spending cuts. It is not achievable with just one or another, and raising taxes on the wealthy won't be enough. The Democrats want taxes to rise but don't want to touch Medicare. The Republicans don't want tax increases, but want much smaller government.

Neither of these positions will get the USA to where they need to be. Democrats and Republicans will have no choice but to meet in the middle.

With the President's re-election, expect continued higher regulations, especially for financial institutions. Monetary policy will remain highly accommodative, and even if Fed Chairman Ben Bernanke steps down when his term expires in January of 2014, expect the President to replace him with someone who will continue the dovish approach and remain accommodative, which raises the risk of higher inflation. The Obama victory is less bullish for equities, because Romney promised to take <u>ALL</u> of the tax bite out of the fiscal cliff, Obama did not.

The US electorate has voted to make a sharp move to the left, following the President's lead. They've chosen big government and increased taxes on the "wealthy" as the way to prosperity.

It seems to me the President prefers to have a legacy that speaks to progressives. This would come at the expense of destroying centers of wealth. While President Obama has won the election, he could still lose the war, big time.

Let's hope they all do the best thing for the USA, which would help global markets as well.

Stay tuned,

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