The U.S. Presidential Election—Does it Matter for the Economy & Markets?

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The biggest story of the week will clearly be tomorrow's US Presidential election. But does it really matter as much as some like to think?

Assessing the Outcome and Likely Impacts

With less than 30 hours to go before the next US President is determined, investors and citizens are still fairly uncertain about the potential outcome. But online prediction markets have Obama ahead by a healthy margin:

- **Intrade odds of Obama win: 68%**
- **Iowa Electronic Markets odds of Obama win: 72%**

Also of note is the US House of Representatives and Senate. As of now, it's looking like the House will remain in Republican hands and the Senate will remain in Democratic hands. That means no party has any chance of holding all three branches following tomorrow's elections. This could be important.

If President Obama wins we're likely to see a continuation of many of the policies that have characterized his first four years. That means large budget deficits, accommodative Fed policy and a Congress that can't get much done. We find it hard to believe that President Obama's second term would resemble anything like the Clinton second term when he worked with Republicans to get quite a bit done. Instead, we believe the divide between President Obama's policies and the Republicans has grown to a point where there are irreconcilable differences. So, the good news in the case of an Obama victory is that we will continue to see some

Long story short—There's still no recession in the USA. The same cannot be said for the rest of the world.

policy stability in terms of continuing what is currently in place. But the downside is we're also likely to see very little getting done in his second term. From the equity market's perspective, investors are likely to breath a sigh of relief if Obama is re-elected. Why? Because Romney has stated very loudly that he does not approve of the Fed's QE policies and would seek to immediately influence the way the Fed is behaving. That could create enormous uncertainty for investors who feel that QE is helping to support the equity markets through the Bernanke Put. A Romney victory would introduce a very uncertain future around Fed policy whereas an Obama win is likely to mean a continuation of what's already in place.

A Romney win also has the potential to introduce substantial fiscal policy uncertainty. So far, Romney and Ryan have played to their party by stating they're in favor of balancing the budget and cutting government spending. Although we actually believe Romney is a closet Keynesian (given his policies as governor of Massachusetts) the markets are likely to respond with uncertainty because Governor Romney has stated no clear plan of action on fiscal policy aside from vague comments about excessive spending and a need to balance the budget. In attacking the Fed and failing to clarify a specific fiscal plan, Governor Romney has become the candidate of uncertainty. Markets hate uncertainty.

Unfortunately, given the gridlock in the Congress, President Obama is unlikely to get much done in his second term. This is fairly positive in continuing past policies and creating some certainty in the near-term, but any relief rally over an Obama victory is likely to be very short-lived. As we've discussed in recent notes, the market is likely to turn to the matters of investment tax treatment and the fiscal cliff as soon as the elections results are digested. Goldman Sachs estimates that the capital gains tax rate is likely to increase to 23.8% under both candidates. And the fiscal cliff is unlikely to be settled before early December when Congress comes back from recess. These are market negatives and will persist through November regardless of who wins tomorrow night.

The Likely Outcome

We believe Obama is likely to win tomorrow. As such, we don't think the Presidential election is likely to have a huge impact on the future direction of the economy or markets. An Obama victory is essentially a "steady as she goes" result. No big changes in Fed policy will result. And no huge changes in fiscal policy will result. Although we believe the fiscal cliff is likely to have a marginal impact on 2013 GDP an Obama victory might give him increased negotiating room in the final months of the year. Our estimate for the total impact of the fiscal cliff is cuts of $100B or about 0.5% of GDP. We think an Obama win will validate our theory that the "fiscal cliff" is more likely to look like a "fiscal bump". But that won't be settled for many weeks. And while the election might reduce some near-term uncertainty, the fiscal cliff is a far larger issue for 2013 than the Presidential election. And the markets will immediately begin to focus on that outcome come Wednesday morning. In short, the winner here might matter a lot less than most people presume….

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