Obama Wins: What's Next?

Perspectives on the outcome of the U.S. election

U.S. President Barack Obama has been re-elected for another four years, while Democrats will continue to control the Senate and Republicans the House of Representatives. We believe this outcome was largely anticipated by the markets before Election Day. However, U.S. Treasury markets likely will gain and risk assets could decline as investors remain concerned about sluggish economic growth, the impact of the impending "fiscal cliff" and the effects of continued Federal Reserve (Fed) intervention.

Status quo preserved

In general, investors seem to have prepared for this result. Both equity and U.S. Treasury markets held relatively steady in the weeks leading up to Election Day, as many polls reflected a narrow lead for Obama. However, concern that we will see slow economic improvement in the next four years—based on the lackluster growth seen in the previous four years under this leadership—could spur gains in Treasury markets and softness in risk assets.

In our opinion, both equity and Treasury markets will tread water until Congress reconvenes in a lame-duck session beginning on November 13. Attention then will turn to the impending "fiscal cliff," when automatic federal government spending cuts are scheduled to begin on January 1, just as long-term unemployment benefits, the payroll tax holiday and Bush era tax rates expire.

U.S. economic growth hangs on the fiscal cliff

How Congress handles the fiscal cliff will be key to both economic and market performance in coming months. If Congress were to extend tax breaks, postpone spending cuts and raise the federal debt ceiling with minimal drama (a "bull case" scenario we believe has a roughly 15% chance of occurring), U.S. gross domestic product (GDP) could grow 2% in 2013. Although below potential, this would outpace 2012 growth, which is running between 1.5% and 1.8%. This would not solve the country's fundamental fiscal problems and likely would prompt ratings agencies to downgrade U.S. sovereign debt, an important but longer-term story. In our view, this would be the most conducive scenario for 2013 growth.

However, we expect a divided Congress to kick the can down the road at the 11th hour, patching together a deal that postpones resolution of major issues. Mechanisms already are in place to delay federal spending cuts until May 1. Washington will reach the debt ceiling again soon, probably between December and January, but emergency funding can be used to keep the government running into March, at least, and possibly into May. Our "base case" scenario (estimated probability 55%) assumes some element of compromise, possibly a one-year extension of the Bush tax cuts for all but the wealthiest taxpayers, an extension of long-term unemployment benefits and a reconfiguring of the automatic

KEY POINTS

- **Obama's re-election may prompt a moderate rally in Treasury markets and decline in risk assets, as investors remain concerned about the fiscal cliff and continued Fed intervention.**
- **We expect Congress to find ways to kick the "fiscal cliff" can down the road, postponing resolution of major issues for six to 12 months.**
- **Obama's re-election paves the way for the Fed to continue its accommodative monetary policy.**
- **Our base case is for 2013 GDP growth of between 1.5% and 1.7%, roughly the same pace as in 2012.**

spending cuts. Under this scenario, we would expect some degree of fiscal drag in the first half of the year, followed by improvement in the second half. This would result in 2013 GDP growth of between 1.5% and 1.8%, similar to the pace we are currently running in 2012. The question remains what growth would look like in 2014.

The election result also leaves current accommodative monetary policy on the table, with the Fed likely maintaining near-zero short-term interest rates into 2015 and continuing to pump money into the system via its latest quantitative easing program (QE3) until the U.S. unemployment rate falls closer to 7.25%. Had Republican challenger Mitt Romney won the White House, we might have seen some change in the trajectory of QE3 buying, particularly if Fed Chairman Ben Bernanke were to resign or step down when his term ends in January 2014. Republicans in general have been more concerned about the potential inflationary impact of current Fed policy, and Romney would have been expected to appoint more hawkish Fed leaders. The issue around the chairman's role at the Fed remains in question. The media has raised questions around Bernanke's interest in maintaining his role past the end of his term, putting another risk factor for markets on the horizon.

Meanwhile, our "bear case" scenario (estimated likelihood 30%) is that Congress does nothing, allowing the country to go over the fiscal cliff in January. The combined effect of these spending cuts and tax increases could siphon up to 5% from 2013 GDP growth spread over the first six months of the year, likely pushing the U.S. into recession. However, we believe a recession in the first half would force Congress and the White House to compromise quickly, allowing for a recovery in the second half of the year. Under this worst-case scenario U.S. GDP would contract by 0.5% in 2013, in our opinion.

Below-potential growth until 2014

No matter who is in the White House, we see little chance of U.S. economic growth picking up significantly before 2014. The headwinds are too strong and the economic ship simply doesn't turn very quickly.

However, it's important to bear in mind that the economy is growing, albeit slowly, and we don't expect Congress to fumble badly enough to send the country back into recession. As of October, nonfarm payroll growth was averaging 157,000 jobs per month, slightly above the 153,000 average for 2011, while the unemployment rate was 7.9%. Absent a major shock, progress is likely to continue throughout 2013, setting the economy up for a possible return to potential (above 2%) growth rates in 2014.