Now what? Post-election analysis

Expect volatility as Washington grapples with fiscal reforms. Stay focused on your goals.

All the waiting and wondering about the presidential election may be over, but investors continue to face a lot of uncertainty. The balance of power in Washington looks much the same as it did before the election. President Obama has been re-elected to a second term, and the Congress remains divided with Democrats retaining control of the Senate and Republicans retaining control of the House. Soon the really big battle will begin over the country’s ever-burgeoning debt, now $16 trillion and growing, and a host of tax, budget, and regulatory issues.

Up first, negotiations between President Obama and the lame-duck Congress on averting the so-called “fiscal cliff”—approximately $600 billion of tax increases and spending cuts that are scheduled to take effect in 2013 unless action is taken to avert them. Then other priorities, such as raising the debt ceiling, monetary policy, regulation, and appointments at key posts are expected to take center stage.

What does it all mean for investors? Prepare for the potential of increased short-term market volatility. As always, keep a long-term investment perspective front of mind and maintain a diversified portfolio that can weather short-term market swings. Says Fidelity fund manager Joanna Bewick, “A rigorous investment plan transcends current events.” And if we do experience a stock market pullback, consider rebalancing your asset mix and improving the quality of your holdings for the long run.

Here, a roundtable of Fidelity veterans discuss their views on:

- The fiscal cliff
- The debt ceiling
- Long-term fiscal issues
- Regulations
- Monetary policy
- Investor implications

Immediate priorities

The fiscal cliff

Without Congressional action, approximately $600 billion of expiring tax cuts, new taxes, and automatic spending cuts are scheduled to take effect in 2013. The combined impact could be as much as 4% of GDP. Will President Obama and Congress prevent us from falling off the cliff? And what will this mean for the markets?

Shahira Knight, Vice President of Government Relations:
Expiration of the 2001 and 2003 Bush-era tax cuts is one of the more controversial components of the fiscal cliff. A central theme of President Obama’s platform is to allow these tax cuts to expire for individuals making more than $200,000 and married couples making more than $250,000—roughly, taxpayers in the top two tax brackets. We can expect President Obama will insist on this position during the lame-duck negotiations. However, he has to contend with a Republican majority in the House that has consistently opposed such tax increases as potentially detrimental to small businesses and the economy. Some level of compromise will be needed from both sides to avert the full impact of the fiscal cliff.

If a compromise isn’t reached, all the tax cuts will expire at the end of the year for taxpayers at all income levels, and new spending cuts will begin to take effect. Some of the tax cuts and spending may be restored next year, but it’s hard to see how the political dynamics will change in January since the new Congress and White House will look a lot like the old Congress and White House. If nothing is done this year, the debt limit will likely be the event that forces some type of action in 2013.

Bill Irving, Portfolio Manager, Fidelity® Government Income Fund:
If we were to drive off the fiscal cliff—that is, if all the scheduled policy changes were to go into effect—the resulting fiscal contraction would undoubtedly push the economy back into recession. Neither party wants that. So my base case would be that we go only partially over the cliff, with the 2% payroll tax cut expiring, the income taxes to finance the Affordable Care Act implemented on schedule, and some of the sequestration budget cuts going into effect. Those things together would cause 1.25% of GDP contraction.

Post-election landscape

What to watch for:
- Heightened market volatility
- Potential tax increases for wealthier individuals
- Continued implementation of new regulations
- Accommodative monetary policy

Strategies to consider:
- Stay diversified and focused on long-term goals
- Think about income as well as potential price appreciation
- Keep taxes in mind
Analyzing the election

If we were to fully go over the cliff, even for a short time, I think that would lead to more market volatility and lower Treasury yields. On the other hand, if it became clear that policymakers were coalescing around some kind of a grand bargain, I think that could be very good for risk assets like stocks and high-yield bonds and would lead to higher Treasury yields.

Dirk Hofschire, Senior Vice President, Asset Allocation Research:

I am concerned that investors are complacent about the ramifications of failing to address the fiscal cliff, and that the post-election debate might set the stage for increasing volatility as the year comes to a close.

Stock market volatility, as measured by the VIX Index, is at a five-year low and shows little investor concern about the next few months. But that could change quickly if political rancor escalates, as it did in mid-2011. The probability that Congress may not reach a compromise before year-end is likely higher than what the markets are pricing in, implying the potential for a significant blow to sentiment if the dialogue does not result in a temporary fix.

Such a scenario may have economic influences as well. For example, consumers may experience a negative sentiment shock during the crucial holiday spending season. Business investment has already dropped in recent months to its lowest growth rate since the first quarter of 2011, and firms may delay additional spending plans due to fiscal-cliff uncertainty.

The debt ceiling

The United States is expected to reach its $16.394 trillion borrowing limit late this year or early next. The 2011 debt ceiling debate led to significant market volatility followed by an S&P downgrade of the U.S. long-term debt. The tenor of the 2012 debate could have similar implications, with Moody's having already threatened a downgrade if the debt ceiling is not raised in a timely or organized manner. What is likely to happen?

Karthik Ramanathan, Senior Vice President and Director of Bonds:

The Treasury is likely to resort to some extraordinary tools to give them about $250 billion in additional borrowing capability. That would take us to approximately early February, soon after the inauguration.

Just employing those extraordinary tools may increase the risk that Moody's and Fitch downgrade U.S. debt. That may lead to some market volatility, but, in my view, is not likely to cause a sell-off of Treasuries. It may even lead to a rally in the Treasury market, as investors become more worried about the economy and the outlook for risk assets.

Knight: President Obama may want to raise the debt ceiling this year so that he doesn't have to contend with a debt ceiling crisis early in his second term. As a result, the debt ceiling may be debated during the lame-duck session.

As we learned from the 2011 experience, debt ceiling debates can be highly contentious, and it's reasonable to assume that Republicans will want to extract budgetary savings and/or reforms before they agree to another debt limit hike. It's too soon to predict whether the debt limit will be raised this year or if the debate is pushed into 2013.

Long-term fiscal issues

Taxes and spending

Taxes and the federal debt were both major factors in the political campaign. The first major debate will be about the expiration of tax cuts scheduled for December 31, 2012. Beyond that, significant changes to both business and individual taxes may be considered. On the spending side of the ledger, reduced spending now could impede short-term economic growth, but increasing levels of debt in the future could lead the United States down the path of countries like Greece and Spain. How will this play out?

Knight: Republicans and Democrats both support deficit reduction. However, they disagree on the specific policies that should be implemented to reduce the debt and the relative mix of spending cuts and revenue increases needed to put the country on a more sustainable fiscal path. President Obama has proposed raising income, capital gains, and dividend taxes on taxpayers with incomes above $200,000 ($250,000 for joint filers). He has also proposed reducing the value of most itemized deductions and tax benefits for the same group of taxpayers.

Republicans have generally opposed higher tax rates on income and investment. However, they may be open to other types of revenue increases, such as eliminating targeted tax breaks, as long as those changes are accompanied by meaningful spending reforms.

In addition to deficit reduction, I think momentum is building for comprehensive tax reform and we're likely to see a lively debate in 2013. It remains to be seen whether these ambitious reforms can be achieved in a divided Congress with narrow majorities in the House and Senate. Any major reforms will require some level of bipartisan support and compromise.

Ramanathan: If President Obama claims he has a mandate and is able to win sufficient Congressional support to implement higher taxes on the wealthiest individuals in this country, including higher capital-gains and dividend taxes, that could lead to the equity market's selling off toward the end of the year to lock in gains, because it has been an strong year for stocks. On the other hand, investors might take a wait-and-see attitude into the new year.

Joanna Bewick, Portfolio Manager, Fidelity® Strategic Funds: The conventional wisdom suggests that Obama's win could lead to higher taxes on dividends, and that might create more
of a headwind for dividend-paying equities. But there are some factors that mitigate this. First, about half of all assets that hold dividend-paying equities are already in tax-advantaged vehicles, so they’re indifferent to tax policy. Second, historical data around dividend-paying stocks’ performance when tax policies change is inconclusive: These assets have tended to outperform non-dividend-paying stocks, regardless of changes to dividend tax rates. This tells me that tax policy in a vacuum has only a slight influence over asset prices, compared with the overarching factors of the economic cycle and corporate profits.

Irving: Fiscal policy is on an unsustainable path. Five years ago the debt-to-GDP ratio was around 36.5%, which was roughly the average for the previous 40 years. Now that ratio has doubled to about 72%, the highest percentage since shortly after World War II. To stabilize the debt-to-GDP ratio at the current level, I think we need to steadily move the current budget deficit of 7.2% of GDP to a surplus of 3% within the next decade.

I think this effort is going to have to involve a combination of both revenue increases and spending cuts. I don’t think it’s achievable with just one or the other. The Republican Party doesn’t want tax rate increases, but wants much smaller government. The Democratic Party doesn’t want to touch Medicare, but wants taxes to rise. Neither of these positions is going to get us where we need to go; Democrats and Republicans have to meet in the middle.

I’m still optimistic—and I think the markets are still optimistic—that over the next ten years we can stabilize our debt to GDP. The United States has the resources to get the job done.

Regulations

Obama’s first term saw significant regulation of financial institutions in the wake of the 2008 financial crisis. What is in store for a second term?

Knight: I think we will continue to see an aggressive regulatory agenda for the financial services industry in President Obama’s second term. The regulators have completed only 40% of the regulations mandated by the Dodd-Frank Act, which means they have a lot more work to do to implement the entire law. In addition, there are several regulations in the pipeline that were not mandated by the Dodd-Frank Act. Many of them had been put on the back burner temporarily, but they may now move forward. For example, the Department of Labor has indicated it intends to reissue a proposed regulation that could significantly limit the retirement guidance provided to investors.

Ramanathan: Treasury Secretary Timothy Geithner has said he plans to leave at the end of the year, but Obama is likely to put in place another Treasury secretary with similar views regarding the markets, regulation, and the banking sector. He also may put in an even stronger force in the SEC to push regulatory reform.

Monetary policy

The markets have been supported by low federal lending rates and quantitative easing. Do you expect that to continue?

Irving: Ben Bernanke’s term as Federal Reserve chairman ends in January of 2014. I don’t know if Bernanke even wants another term; if he doesn’t, or if he isn’t offered another term, many believe that Obama would nominate Janet Yellen as the chair of the Federal Reserve.

Both Ben Bernanke and Janet Yellen are more dovish than hawkish in their views on monetary policy. So in our view, Obama’s reelection means the Fed is likely to stay highly accommodative, which raises the risk of higher inflation. This would imply that the yield curve may remain relatively steep, with accommodative monetary policy anchoring low rates at the front end and an inflation premium causing higher rates at the long end.

Investor implications

With such large issues on the horizon, how should investors react to this election and this period of uncertainty?

Geoff Stein, Portfolio Manager, Fidelity Asset Manager® Funds:

It’s very hard to correlate specific investment outcomes to election results and party control. The data are not very predictive.

Instead, I consider the economic environment. While asset allocation is fairly neutral in my funds, I currently favor U.S. assets over foreign assets based on more favorable relative economic and earnings outlooks. Despite all our failings, the United States still enjoys safe haven status compared with much of the world.

Hofschire: I think the U.S. economy is in a middle phase of the business cycle. Generally, that’s an expansionary phase that is pretty good for stocks and other risky asset categories. So in ordinary circumstances, you might overweight equities and underweight fixed income, and overweight high-yield bonds relative to Treasury bonds.

But when you introduce the fiscal cliff and the prospect that we might get pushed back into recession, that’s a significant enough risk that it causes us to be a little more cautious on a near-term, tactical basis. Over the next year, however, we expect the environment to be favorable to reach an agreement that improves the medium-term sustainability of our fiscal outlook. That could be a very positive development for stocks and other riskier assets over the intermediate term.
Irving: Interest rates are very low, and I think a number of factors will keep them low for the foreseeable future. Those headwinds include the fiscal cliff, the still-high unemployment rate, and the fact that the Federal Reserve’s monetary policy is keeping downward pressure on rates. Overseas, you have questions about how Europe deals with its sovereign debt and banking crisis, and tensions in the Middle East.

We are managing our portfolios consistent with our mandates. I think people own government bonds for diversification—they want something that can do well in a flight to quality, when equities perform poorly. So I don’t want to underweight long-duration Treasuries, because I think in a flight to quality scenario, that’s the one asset that can still go up in price. I don’t think they’re cheap, but I do think they can go up in price if there’s a shock to the economy.

Bewick: Historically, the economic cycle and corporate profits have been more important drivers of financial asset returns than has the political cycle. The influence of U.S. presidents over economic growth is quite slight, in my opinion, compared with the natural recuperative powers of the economy, the international climate, and the pace of innovation.

I remain cautious, but that caution is related less to the election than to other issues like corporate profits. Margins have likely peaked. We’re looking at a slowdown in China. Europe remains highly uncertain. The eventual impact of the fiscal cliff is quite uncertain as well. On the other hand, monetary policy is very accommodative, which tends to be inflating for risk assets, and I don’t want to fight the Fed. Taking all these factors into account, I have been holding neutral allocations in my funds.

At the same time, I am favoring income-producing assets. Total return has two components: price and income. When you have an uncertain economic environment, or the certainty of some drag on the economy, price appreciation is likely to be more difficult to come by, so income should provide a greater portion of total return.

There is the potential for volatility, so it’s understandable if investor anxiety is on the rise. But we manage risk all the time. It’s endemic to the capital markets, and the key to weathering these kinds of environments is preparation. You need a sound investment plan that focuses on building a well-diversified portfolio that balances unique time horizons, risk tolerance, capital appreciation, and income needs across a variety of market environments. A rigorous investment plan transcends current events.

Before investing, consider the funds’ investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

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The CBOE Volatility Index (VIX) is based on the prices of eight S&P 500® Index put and call options.

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