The elections are over…now what?

Seems likes the midterm election results were largely known before the first vote was cast. As expected, the Republicans recaptured control of the House with a fairly commanding majority, while Democrats held on to the Senate with a narrow majority.

While results fell pretty much in line with projections, the midterm elections did feature some surprises along the way. “The failure to capture a majority of the three special election seats in the Senate, the inability to unseat Senate Majority Leader Harry Reid (D-NV) and the loss of the State House in California were disappointments for Republicans,” according to Mike Ryan, Head of Wealth Management–Americas (WMR). “And Democrats were unnerved by the extent of the losses in the House, where a number of long-serving senior lawmakers were voted out.”

With the election settled, now comes the really tricky part: trying to determine which issues the new Congress will work together on in this emotionally charged partisan atmosphere. “Republicans have made no secret of their disdain for healthcare reform and other initiatives, while Democrats have dug in their heels over legislation and programs they deem critical,” says Ryan. The likely result will be a challenging environment in which it will be hard to find a middle ground.

Election not a panacea for the economy

While results fell pretty much in line with projections, the midterm elections did feature some surprises along the way. “The failure to capture a majority of the three special election seats in the Senate, the inability to unseat Senate Majority Leader Harry Reid (D-NV) and the loss of the State House in California were disappointments for Republicans,” according to Mike Ryan, Head of Wealth Management–Americas (WMR). “And Democrats were unnerved by the extent of the losses in the House, where a number of long-serving senior lawmakers were voted out.”

While there is a wide ideological split between the two parties, there’s a risk that they may agree on things that are not good for the economy, such as protectionist measures. WMR analysts expect the trade imbalance and exchange rate with China to remain a bipartisan concern, although the House bill that facilitated specific tariffs against Chinese industry is still unlikely to pass the Senate. WMR doubts pro-trade legislation will make headway, despite increased Republican influence.
Decisions made in the new Congress will have important implications for asset class returns. Although it is difficult to draw definitive conclusions at this time, WMR's team of economists, strategists and analysts gives their take on potential implications the midterm elections and the election cycle may have on the major asset classes.

**Equities.** The typically stronger equity market returns in the second half of a president’s term are unlikely to occur. First, the 30% stock market returns in Obama’s first two years as president greatly trumps the 5% median historical gain. Second, strong average real GDP growth—4.0% and 3.8% in the third and fourth years, respectively, of the election cycle—typically forms the basis of that time period’s stock market strength, but WMR’s growth outlook for those two years is just 2.7%.

**Fixed income—Treasury yields and the debt ceiling.** Although WMR expects economic fundamentals and Fed policy to remain the key drivers of Treasury yields, a looming fight over the debt ceiling has the potential to inject headline risk into the bond market next year. With the $13.5 trillion debt inching up against the current ceiling of $14.3 trillion, WMR expects a lifting of the ceiling—but not without a heated battle from Republicans who are committed to deficit reduction. WMR believes an improving economy and structurally high fiscal deficits will support moderately higher bond yields over the next year (see chart), while expecting that headline risk—and thus volatility—may increase in the Treasury market.

**Agency securities.** The administration is set to release a plan in January 2011 for reforming the government-sponsored enterprises against a backdrop of a still-weak housing market. As reform discussions get under way in 2011, agency debentures and mortgage-backed securities will likely be subject to increased volatility. Nevertheless, WMR expects agency securities will be “money good”, despite being subject to headline risk, and continues to recommend investors underweight the agency sector. In WMR’s view, the credit-sensitive sectors offer better relative value, less headline risk and solid credit fundamentals.

**Preferred securities and taxation of dividend income.** Although prices of preferreds with coupon payments classified as qualified dividend income (QDI) could be the most affected by an increase in the dividend tax rate, WMR does not feel they will be materially impacted. In the beginning of the financial crisis, issuer’s credit risk and security ranking were dominant factors in causing QDI preferred yields to move higher. However, since their yields are not reflecting their favorable tax status, this should eliminate any negative price correction that could occur if their income distributions are taxed at a higher rate.

**Municipals.** Results of voter initiatives on state and local ballots were mixed—likely a reflection of local policy dynamics—but show an overall increased concern about the financial position of state and local governments. With a shift to a more conservative slate of governors, WMR anticipates a great deal of legislative scrutiny regarding state expenditures and public pension liabilities, and greater reluctance to rely on taxation as a solution. This bodes well for municipal credit in general.

**Let’s talk about it**

The above is based on WMR’s “US elections, Midterm 2010: The Wave Breaks,” (November 4, 2010). To obtain a copy of this report or discuss how its research insights might bear on your portfolio, please contact a UBS Financial Advisor.