DBS Wealth

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Focus: US Elections

Wednesday, 07 November 2012

Obama Returns to an Unchanged Washington

SUMMARY

- Beyond confirmation for President Obama, markets will shift attention to the "fiscal cliff"
- Obama weakened by a slimmer majority of the popular vote, a divided electorate
- Republican-controlled House of Representatives will be emboldened to play hardball with President Obama over the "fiscal cliff"
- Stocks could weaken again; US Dollar index could rise on headline-driven fear
- But a compromise will eventually be reached, even if only in January 2013

Get ready for nasty haggling over the "fiscal cliff"

In the end, the results were as the market had expected. Barack Obama has won another term as President of the United States but he did so only on Electoral College votes, not with a popular vote majority but one that barely beat challenger Mitt Romney. Meanwhile, the Republicans retained control of the House of Representatives and Democrats kept control of the Senate. In short, this was the expected outcome – status quo. A Romney victory would have been more positive for equities than an Obama Administration negotiating with a hostile Republican House of Representatives over the "fiscal cliff'. Now attention will shift to the coming negotiations over scheduled tax hikes and spending cuts that could bite into the economy in 2013. For equities and currencies, this will be a volatile time.

Equities market reaction – a story likely to be told in three chapters

The market reactions are likely to unfold in three distinct chapters. Near-term, US equities may maintain the Election Day bounce for a little while. There has been a tendency for the US equities market to bounce after closely contested Presidential elections. The rationale is that they remove political uncertainties. This time it is different – the political uncertainties will continue long after the elections. After the initial euphoria is over, President Obama will have to deal with a hostile Republican House, meaning chapter two of the "play" then unfolds with renewed political uncertainties over how the key power players in Washington manoeuvre the US economy over the "fiscal cliff". That's when stocks could weaken again. But there is a third part in this political play. That is when stocks rebound again, on either a compromise deal to ease the US economy gently over the "fiscal cliff" or, more likely, a decision to defer the final reckoning by a few months to buy time.

US dollar – near-term risk appetite factor and longer-term policy implications

The US Dollar index, the DXY, was down on the results. This can be interpreted in two ways. 1) The scenario of equities bouncing very near-term could support a weaker US Dollar as markets go into moderate risk-on mode. 2) President Obama would likely appoint another policy dove to replace Ben Bernanke when he steps down as Chairman of the Federal Reserve at the end of his term in 2014. That means continued accommodative monetary policies and long-term weakening of the US Dollar. The first factor – risk appetite/sentiment – is likely to be very volatile over coming days and weeks. When President Obama starts haggling with House Republicans over the "fiscal cliff", the mood could take a turn for the worse. That is, the reality of an ugly round of brinksmanship is likely to unnerve markets. Risk-on could very quickly turn into risk-off. Then equities weaken and the US Dollar gains. But longer-term, beyond the "fiscal cliff" negotiations, the US will continue to suffer large budget deficits and the Federal Reserve will continue to enlarge its balance sheet – meaning print money. The logic of US fiscal and monetary policies suggests persistent US dollar weakness.

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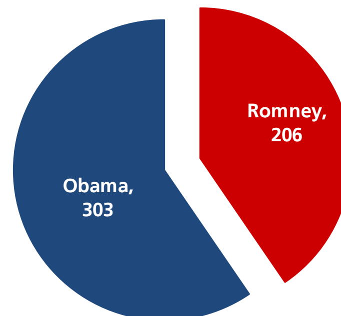
Electoral College

- The President is voted in via an indirect Electoral College system
- Votes are carried out by electors who determine the winner in each state
- Each state carries a different weight, with California having the most votes with 55
- At least 270 votes are needed for a win

Electoral College Votes



**Obama declared winner with 29 to be decided*

Popular Vote

Obama: 50%
Romney: 48%

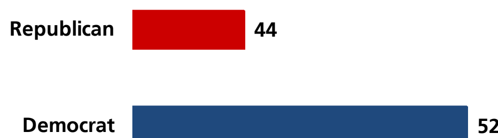
House of Representatives

All 435 seats contested

**Republicans retain control of House as of 7 November 2012, 7pm Singapore time*

Senate

33 of 100 seats contested



**Democrats retain control of Senate; 1 independent and 3 undecided as of 7 November 2012, 7pm Singapore time.*

Why isn't the market panicking over the new reality of a weakened Obama Presidency?

If markets were panicking and into risk-off mode, the US dollar index should have spiked and not gone down. Part of the answer is that notwithstanding the media headlines of the "race too close to call", this was a widely anticipated outcome. The betting outfits had been pricing between 67% and 75% probability of an Obama victory. And most analysts had been expecting that even with an Obama victory, he might lose the popular vote. There was also little chance of anything other than a Republican-controlled House of Representatives. In short, gridlock was expected. Indeed, in our latest weekly "Investment Insights", we wrote that markets may have gone some way towards pricing in such an outcome.

But there can always be more downside as the haggling goes to the brink and possibly beyond

Obama's thinning popular vote (he secured 53% in 2008) means House Republicans could be emboldened to play bare knuckle politics over the "fiscal cliff" issue. That is, an early resolution during the "lame duck" session of Congress late this year is unlikely. Indeed, there is a risk that the negotiations could take the economy metaphorically "over" the "fiscal cliff". That is, they could go into January 2013 before they either cobble together a fiscal compromise that would see a more moderate contractionary outcome or a deal to postpone the day of reckoning by three to six months for more haggling.

Should investors sell on the risk of a fall over that "cliff"?

Theoretically, if all the tax cuts and fiscal spending measures were allowed to expire, the US economy would gradually slide into a recession. But it is difficult to imagine US lawmakers doing nothing and allow the US economy to slide into recession. Republicans will risk being blamed for a recession that Americans arguably did not need to have. So the risk is not of a fiscal cliff-driven economic disaster. The real risk is headline-driven fear. As negotiations turn nasty – as they may– the headlines will exaggerate the risk and exacerbate fear. But a meltdown in risk asset markets is probably unlikely. This is a fine judgment call but the market has seen this before during the debt ceiling negotiations. Then, the situation was similar. The institutional gridlock was the same. Indeed, the key political players were the same. The outcomes are likely to be the same. Or so the reasoning should go. The players will negotiate to the brink and possibly beyond and eventually come out with a compromise that prevents a fiscal meltdown.

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