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summaries

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Election 2010: The Two Year Opportunity

With the completion of the 2010 mid-term elections, Sigma has taken a look at what might be politically feasible in the current environment. We recognize that only the House has a Republican majority whereas the Senate and White House remain firmly in the hands of the Democratic Party. Thus, it will be up to the Republican Party leadership in the House, Harry Reid, and President Obama to determine whether we, the citizens/taxpayers of the U.S., can expect compromise and attention to the "people's business," or gridlock as our leaders begin posturing for 2012.

At the same time, Republicans should not delude themselves into thinking that their victory in the House represents a sudden enrapture with the GOP. We believe that Americans want the new Congress to focus on economic growth and private sector jobs. That should be doable if both parties understand that neither has a mandate to govern from the left or the right.

Informing our judgment was a well conceived and written Op-Ed article by Senator Evan Bayh (D-Indiana) in the New York Times on November 2, 2010, titled "Where Do Democrats Go Next?" Since many at Sigma generally see fiscal policy through a "center-right" lens, we thought Bayh offered many acceptable solutions to the problems confronting the United States.

We are well aware that the real elephant in the room, how to control long-term entitlement spending, may have to wait given the current political climate. Nevertheless, we believe there are a number of other issues that aren't as controversial such that even in a bipartisan Congress, compromises can be found that both parties find acceptable to pass the appropriate legislation.

For example, the calendar dictates a prompt decision on the soon-to-expire Bush tax rate reductions. If there is no extension on the tax rate reduction, capital gains and dividend income will be taxed at higher rates. This will likely hurt the financial markets as the net after-tax value of these sources of income would be reduced. Soak-The-Rich tax policies might have political appeal but history suggests that they are not good revenue producers and the majority of voters are not currently in favor. Witness a proposal on the State of Washington's ballot to introduce a 5% income tax on "wealthy individuals" that lost overwhelmingly, 65%-35%, leaving Washington as one of only nine states without an income tax.

While nothing is a given in politics, compromises should be relatively easier to achieve with respect to the Alternative Minimum Tax (AMT) and the Estate Tax. These two issues are pressing and hopefully will be resolved quickly. We would anticipate an extension of the AMT tax fix from 2009 and Estate Tax legislation that looks like the law that existed in 2009.

Another urgent, but more difficult matter, is public sector wages and benefits. While this is a complex issue with considerable differences of opinion, it appears to be reasonably evident that public sector total compensation is now considerably higher than in the private sector. In the not too distant past, public sector compensation, in exchange for greater job security, was less than private sector compensation. It remains to be seen whether our elected officials have the stamina and courage to tackle this contentious issue despite the fact that the outcome of the debate will have a significant impact on both state and federal budgets. One of the central issues that will need to be addressed is whether government workers should be treated as if they are part of a privileged class and immune from the economic realities faced by those employed in the private sector. Other issues that may be too contentious for near-term resolution include, but are not limited to, Cap and Trade, Immigration, Card Check and Trade.

There are some other areas that may not require legislation but could benefit from a greater working relationship between the Democrats and Republicans. For example, earmarks and pork barrel legislation have become a symbol of a broken Washington, and an entire lobbying industry has been created around them. While a complete elimination of both may not be feasible or desirable, greater transparency and disclosure may help to limit the frequency and magnitude of their use and reduce the amount of waste in our budgets.

Let the games begin!

The Economic and Market Environment

In Sum: We recognize that there are significant risks that could undermine the economic recovery in the U.S. and abroad. As the economy continues to improve, albeit at a slow rate, we believe that President Obama and our elected officials are being awakened to the demands of the electorate to reduce spending, get our deficit under control, and embrace policies that promote job creation and economic growth. If Washington can show such leadership, not only does this bode well for the capital markets, it should also go a long way in supporting our dollar and credibility with our trading partners.

Geo-Political: The G20, a collection of Finance Ministers and Central Bank Governors from 20 industrialized and developing economies, recently held a summit in Seoul to discuss currency and trade disputes, as well as reducing the gaps between nations with large trade surplus and others with large and growing deficits. Unfortunately, it appears as if the United States has waning influences at these meetings and in fact, was widely criticized for our growing budget deficit and decision to proceed with QE2. Moreover, President Obama was not successful in his attempt to reach a free-trade agreement with South Korea, perhaps another indication of our standing amidst our trading partners.

Economic: The fragile U.S. economy appears to be showing signs of life based on the current read of retail sales, industrial production, consumer confidence, labor statistics, and other leading economic indicators.

We remain cautiously optimistic that the consumer will continue to spend during the Christmas holiday season and into 2011 and that the private sector will increase its pace of hiring thereby reducing the need for additional stimulus spending in the not too distant future.

Monetary: The Federal Reserve intends to purchase an additional $600 billion in long-term Treasuries in an effort to keep interest rates low and provide added stimulus to the U.S. economy. This initiative, known as QE2, has been widely criticized, both domestically and abroad, claiming that this is simply a back-door means of reducing our dollar to improve our exports. Many also believe that with interest rates near historic lows, there are more productive ways to encourage businesses and consumers alike to open their wallets and spend.

Fiscal Policy: Longer-term, the U.S. must find the political willpower to control entitlement spending and reduce our budget deficit. Whether sound or not, this suggests that taxes are going higher in the future. However, in the short-run, Congress will likely extend many of the Bush tax rate reductions that will otherwise expire at the end of this year. Failure to address this issue, as well as legislation impacting both the Alternative Minimum Tax and Estate Tax would be a major disappointment.

Equity markets: The U.S. stock market, as measured by the S&P 500 Index, bottomed on March 16, 2009 with a closing value of $753.89. Since then, the market has staged an impressive recovery with the index trading above $1,200 at the time this commentary was being drafted. This nearly 60% rebound off the bottom is indeed encouraging, yet we are still substantially below the peak of $1,565 reached on October 9, 2007. We remain hopeful that as the global economic landscape continues to improve, equity markets will continue to climb back towards its former peak although we would expect a fair amount of volatility along the way.

Fixed income markets: It seems plausible that interest rates will remain low in the near term. However, we believe interest rates will begin to migrate back to the mean at some point over the next 12 to 24 months. Assuming rates don't rise materially above historical averages, we believe this would be a positive development and not punitive to economic activity or the equity markets. It may, however, temporarily suppress the prices for many fixed income oriented securities.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

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