

As we approach a historic election this fall, political polarization is extremely high. At the same time, we see a shift in the dialogue toward more substantial and long-term issues. The coming year will feature a critical debate about the future of government, its size, and the role it plays in the life of every American. As we move past the election, the so-called fiscal cliff issues could serve as a catalyst for real tax

abstract

and fiscal reform. If no bipartisan solution transpires, however, we think market forces could push change. Make no mistake, the election is only the beginning of what will be a politically vicious and stressful year for investors. The odds for a recession next year are rising and we are watching signs closely. We encourage readers to engage in this debate, study the facts, avoid sound bites, and make up their own minds. Nothing less than the future direction of our great republic is at stake.

A HISTORIC ELECTION DRAWS NEAR

A SIGNATUREFD WHITEPAPER



The 2012 Presidential election cycle began in earnest on August 5, 2011. That was the day that Standard & Poor's Rating Service downgraded the venerable sovereign credit rating of the U.S. from AAA to AA+. Pages of commentary could be written both about the relevance of Standard & Poor's (especially after the sub-prime mortgage crisis), and the validity of its arguments for downgrading the U.S. credit rating (especially after the Treasury Department identified a \$2 trillion mistake in S&P's math). However, those details obfuscate the real issue, which is that many Americans feel that the American Dream, along with its visions of opportunity and financial independence, is slipping away. There is a fear that the system is rigged in favor of the powerful and connected, and politicians are letting it happen.



AS THE 2012 ELECTION MAKES THE TURN TOWARD THE FINAL STRAIGHTAWAY, WE'LL SEE A BATTLE OVER HOW TO FIX THE COUNTRY'S ECONOMIC CHALLENGES AND REVIVE THE AMERICAN DREAM.

At a time when Americans are scared and in need of positive leadership, politics seems to be degenerating into a state of dysfunction. The lack of progress stems at least partially from the fact that political polarization is at extreme levels. In recent analysis, JP Morgan found that in both the Senate and the House, votes are more than 90% along party lines.¹ This level of polarization hasn't been seen since the early years of the twentieth century. Several factors have created current divisiveness, including campaign finance laws, gerrymandered congressional districts, and a new world of online media that thrives on arguments rather than solutions.

The month-long battle in July 2011 over the debt ceiling ended in a draw, with both parties bloodied and an American public that was all the more cynical about policymakers' ability to help fix our current ills. Moreover, the failure to find common ground during this debate hardened the lines between the White House and Congress and set the tone for everything that has happened since. As the 2012 election makes the turn toward the final straightaway, we'll see a battle over how to fix the country's economic challenges and revive the American Dream.

We encourage our readers to look at the current deadlock through a new context: *maybe it is a good thing*. Political commentator George Will recently said, "There is nothing wrong with partisan politics and extended bickering about issues where the disagreements are so deep. That is what the founding fathers intended." In the end, the voters will decide, and we encourage you to participate in the process, understand the issues, and cast your vote for the candidate that you feel will put America ahead of politics and secure the future of our great republic for all generations to come.

THE ELEPHANT IN THE ROOM

In the third part of this white paper series, we referenced several studies that focus on the unsustainability of the current fiscal situation, and specifically the elephant in the room: entitlement spending. In an upcoming white paper (to be released at the end of September), we will touch on some solutions to these problems. Recently, Alan Greenspan summed up the situation nicely, saying, "We have created a level of entitlements that will require a greater share of real resources ... than the economy seems likely to be able to supply."² Summarized simply, the bill is coming due.



THE MOST PROFITABLE PERIODS OF STOCK MARKET INVESTING HAVE OCCURRED WHEN THERE WAS A DEMOCRATIC WHITE HOUSE AND A REPUBLICAN-CONTROLLED CONGRESS.

The silver lining in the messy debt ceiling fight was the fact that the debate was happening at all. As we've written previously, "The first step in solving a problem is admitting that you have a problem." In its 2010 Financial Report of the United States Government, the Government Accountability Office concluded, "[t]he projections in this Report indicate that the trajectory of current policies are not sustainable...[c]losing the gap between spending and receipts over the next 75 years is estimated to require some combination of spending reductions and revenue increases that amount to 2.4% of GDP over the period."³ The 2.4% figure doesn't seem overwhelming at first glance, but in reality, it translates into more than \$4 trillion of adjustments over a decade and likely more than \$20 trillion over a 30-year period. Keep in mind, these figures are designed to stabilize the current debt situation, not reverse it. Up until last summer, these warnings fell on deaf ears, but no longer.

During last summer's debt ceiling debate, we often reflected on the feeling of invincibility that our country held just over a decade ago. In the late 1990s, when tax receipts were booming and the country was operating with a material surplus, Alan Greenspan gave a speech about the difficulties of monetary policy in a world where the stock of treasury debt was significantly reduced. It is hard to fathom how much has changed in just over a decade. In early 2001, the Congressional Budget Office released its annual 10-year budget forecast. That year, as tax receipts were continuing to boom and before 9/11 and that year's recession led to increased expenditure, the CBO projected a \$5.6 trillion surplus over the coming decade. It further projected that federal debt outstanding would drop to just 4.8% of GDP by 2011. In reality, the actual cumulative deficit ended up being \$6.2 trillion over that period, a forecasting error of \$11.8 trillion.⁴

The debate over the next 10 weeks (and throughout the next year as the new administration and the 113th Congress are seated) will not be over the question of the viability of the system; it seems both parties have now acknowledged that change is needed. The larger debate will be over the solutions that will put us back on the right track. This is where things get more complicated. Both parties seem to be dug into their ideological corners and are showing no sign of compromise. Our hope is that after the election, both Democrats and Republicans will be able to set polarized policies aside and deal with the issues at hand. For this bipartisan environment to take hold we believe a majority of decision makers must agree to two things. First, it will take some combination of spending cuts and revenue increases to close the gap between spending and revenue. Second, our leaders will need to address the real structural challenges of Medicare, Medicaid and Social Security; simply trying to close the gap via surface-level spending won't solve the problem.

The bottom line is that markets and business don't care about parties and politics, they care about money. *As an interesting aside, the most profitable periods of stock market investing have occurred when there was a Democratic White House and a Republican-controlled Congress.* For now, business is clearly on a "capital strike" and has reduced investment and hiring as a result of a lack of perceived opportunities and uncertainty over future policy. The headwinds to growth that come from

a natural deleveraging, combined with political, tax and regulatory uncertainty, will take time to ease even after the political debate is settled. But if politicians actually acknowledge and address the elephant in the room, the future could begin to look brighter and business and the markets would respond rapidly to a new environment.

A HOUSE DIVIDED

In 1858, Abraham Lincoln, referencing a biblical passage, said, "A house divided against itself cannot stand." Of course, he was referring to the schism between the North and the South, principally on slavery. Clearly, today's issues cannot compare to the conflict of that era, but the general feeling within the country is that the political process is broken, to the point of being ineffective. The President has an approval rating below 50%, Congress now has approval ratings as low as 9%. A cynic would ask what those 9% are thinking!

As we touched on in the beginning of this paper, we believe that current rhetoric and passionate debate is historically normal given the level of change occurring in society, both economically and geopolitically. In periods of peace and prosperity, politics are petty, civil and frankly somewhat irrelevant. But when we reach inflection points, such as we are in now, politics becomes the battlefield where ideas are debated and challenges ultimately confronted. The beauty of our system is that every citizen has an equal say in the future of our republic.

Until politicians find a balance that fulfills the desires of the electorate, we are likely to remain in a volatile state, with the potential for mass turnover every two years.

In the second part of this white paper series, we put forth the idea that what began as an economic crisis has now morphed into a political one. In that paper, we summarized the importance of this issue as follows:

"If one believes we are living through a political crisis rather than an economic crisis, the length of time to full recovery in confidence will be longer than expected, and eventually the focus of change will be on the political system rather than on the markets, business, or banks. This will occur because the populace believes they can't directly control the economic and business elite, but they can have a direct impact on the political elite."⁵

Our elementary school U.S. history books often see the past through the lens of romanticism, and this is clearly evident in our beliefs about the Founding Fathers. Just as with today's politicians, the Founding Fathers were human beings with significant flaws and emotions. History has painted a collegial and peaceful picture of our leaders working together during the years of the Revolutionary War and through the ratification of the U.S. Constitution. Yet the years after 1787, during Washington's presidency, were some of the most volatile and personally vicious of any period in our history. The utopian dream of a non-partisan United States

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was quickly erased as the division between Alexander Hamilton, the Secretary of Treasury, and Thomas Jefferson, the Secretary of State, solidified and resulted in the Federalist and Republican parties. The personal attacks during this period were beyond anything we have today. At one point, Washington, taking Hamilton aside, was quoted as pleading that, “liberal allowances will be made for the political opinions of one another... Without these I do not see how the reins of government are to be managed, or how the union of the states can be much longer preserved.”⁶

Finally, as we recognized in our previous white paper, much of the need for common ground comes down to what Niall Ferguson called the “clash of generations.” In *Reflections on the Revolution in France* (1790), Edmund Burke wrote that the real social contract is not Jean-Jacques Rousseau’s contract between the sovereign and the people or “general will,” but the “partnership” between the generations. He wrote, “*Society* is indeed a contract ... The state ... is ... a partnership not only between those who are living, but between those who are living, those who are dead, and those who are to be born.” In the enormous intergenerational transfers implied by current fiscal policies we see a shocking and perhaps unparalleled breach of precisely that partnership, so brilliantly described by Burke. It is this division that has to be reconciled by our next President. Without a fix, the economic foundation of the proverbial American house will be seriously weakened.

It is too soon to make predictions about the coming elections, but we believe that much is riding on the decision of the American people. Our hope is for a clearer and more convincing message from the people and a set of leaders who appreciate history and understand the vision for America. We further desire an atmosphere of compromise. It is clearly appropriate to stand on principle with regard to strategy and vision, but much of what are presented today as principles are really just roadblocks to compromise. Without a willingness to give some ground on the details or tactics, we are left to wonder how difficult problems will ever be solved.



NOVEMBER 6, 2012

So with such voter anguish, what do the tea leaves say about the upcoming election? This paper is being finalized on August 28, which is the first day of the Republican convention and one week before the Democratic convention. Intrade data is showing the odds of President Obama winning reelection at 56%. Many pundits are putting the odds at closer to 50/50, but we aren't going to venture a guess. However, we will point out scenarios under which each candidate can win. Further, we will outline the implications for year-end and the legislative season in early 2013. The one thing that is certain is that this will likely be the roughest, most vicious and personal campaign we have seen in generations.

Governor Romney has selected Wisconsin Representative Paul Ryan as his vice presidential nominee. This was a bold and potentially risky move, but provides some insight into Romney's strategy. He is going to make this election about a clash of ideas—a vision for the future of America, if you will. During the last several months, Romney has been trying to win over independents with limited success. Though Obama does not have high favorability ratings, Romney has been unable to gain traction, which puts the incumbent in a good position.

Dan Clifton at Strategas has a differing view of current trends. In reviewing the data, he feels that currently Romney is doing better than Intrade data would suggest. His argument rests on three points. First, voter enthusiasm is in favor of the Republicans. Registered Republicans are excited about the upcoming election, though it is more of an anti-Obama enthusiasm than a pro-Romney enthusiasm. Second, the favorability ratings for Obama are not high enough, since they correlate closely with certain economic metrics, including consumer sentiment, unemployment and wage growth. Clifton believes that material positive momentum in these economic numbers is necessary for Obama to be re-elected. Finally, he believes that national, and especially state-level, polling is of limited value at this stage of the campaign. This is especially relevant as polling in key swing states shows a slight edge in favor of President Obama. The undecided voter, however, is not likely to decide until two or three weeks before the election. Essentially, the race could be very close up until the very end, and then break decisively in one direction or the other. The Electoral College clearly favors the Democrats, with several of the largest states safely in the Obama camp. However, there are enough swing states that could move together and allow for a Romney win.

So can the Romney-Ryan ticket win the clash of ideas? As one political strategist has said, candidates must focus on just two or three ideas in a campaign or risk losing the focus of the American electorate. This is only our two cents, but if we were advising Romney, we would tell him to continually discuss three things: jobs, energy prices, and the amount of federal debt held outside our country. These three critical issues can be wrapped up in the debate over domestic energy. As we will discuss in the future, technology developments have opened up vast new sources of energy in the United States in recent years. Regulated but aggressive expansion of these resources would reduce the cost of our energy, thus expanding jobs directly and through a growing manufacturing base. Finally, it would reduce our nation's trade deficit, which would automatically close the gap in share of our debts purchased by foreigners. This is a crisp and clear message with which

many independent voters would sympathize. It also avoids a confusing and potentially negative discussion about entitlement reforms.

So there is a clear path to Republican victory, but is it likely? In our opinion, there are legitimate reasons the conventional wisdom is that Obama will be re-elected. Starting again with the Electoral College, the Romney-Ryan ticket needs two thirds of the electoral votes in the most critical swing states. Second, if President Obama wins Florida, then he is probably only one or two states away from securing the 270 votes needed. With the Republicans pushing a campaign of ideas, the Democrats will retaliate with threats of coming cuts to entitlement programs. This will certainly be the strategy in Florida. Though it won't get many committed Republicans to switch their votes, it could increase turnout among Democrats and also attract independent voters. If we were to give advice to the Obama campaign, it would be to focus on three themes. First, argue that the Republicans want to take the

country in a significantly different, and therefore risky, direction with regard to entitlements. Second, confuse the Romney-Ryan message by constant reference to many of the apparently contradictory positions taken by both Romney and Ryan during their political careers as well as the bold and divisive proposals that Ryan has made and endorsed. In other words, put them on the defensive and keep them from focusing on a crisp and clean message. Finally, though not a strong argument on its own, focus on the message that we have made progress toward recovery and though not there yet, four more years are needed to fully turn the U.S. economy around.

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At this stage, it is clearly too early to make a call on the presidential race. Is it any easier to project what will happens in Congress? Again starting with Intrade data, it would appear it is. Intrade projects an 89% chance of the Republicans maintaining control of the House and a 75% chance of outright Republican control or a tie in the Senate (53% chance of outright control and 22% chance of a tie). Of course, an Obama win and a tie in the Senate would mean the Vice President has the tie-breaking vote, leaving control of the Senate a near toss-up. If Romney wins, it would appear his administration would have a fairly strong mandate for significant change, but would still be lacking decisive control of the Senate (i.e., fewer than 60 seats.) That said, if President Obama wins, he would probably face a divided government, with Republicans controlling the House and a Republican-controlled or split Senate. Thus, it is likely that neither party will have a mandate to push through its entire agenda without debate. In our opinion, this isn't necessarily a bad outcome, as long as both parties can come to the table with a willingness to compromise. Though recent history doesn't suggest the odds are good that this will happen, it appears that the best possible window for that occurring involves a second-term President and two years until the next congressional elections.



WE BELIEVE THE MARKET WOULD BEGIN TO DECLINE IF THE COMPROMISE TALKS COLLAPSE AND BOTH PARTIES WITHDRAW FROM NEGOTIATIONS.

AFTER NOVEMBER 6

What are the implications for the so-called fiscal cliff and the longer-term deficit challenges as we move into the days and months after the election? First, something will need to be done before year-end. The fiscal cliff refers to the automatic cuts and tax increases that will occur without legislative action before December 31. Because of the combination of expiring Bush tax-cuts, the automatic sequestration passed as part of the debt ceiling debate, and the natural rolling off of stimulus from the 2009 act, the total drag could be as large as 3.6% of GDP in 2013. To put this figure into context, it is more than twice as large as the largest post-WWII government contraction, which occurred in 1968, and was at least partially responsible for starting a recession that year.⁷ Because of the sheer scale of this fiscal gap, we must assume that it would be political suicide for either party to allow it to happen. As a result, compromise to extend a majority or all of the provisions into next year seems likely. The delicate part of this equation is that the debt ceiling will also need to be raised again, and the credit reporting agencies will be closely watching the negotiations.

In January 2013, the next Presidential term and the 113th Congress will begin. We continue to hope that this will create a window for real fiscal compromise to occur. Something along the lines of Bowles Simpson that addresses both tax reform and entitlement would be the ideal model, and could lead to a dramatic increase in confidence and economic certainty once all the provisions are finalized and analyzed. A tax package that broadens the base, reduces marginal rates and closes special interest benefits, combined with a sturdier entitlement system, would remove a huge weight of uncertainty from the economy and the investing public. But the old cliché that things are likely to get worse before they get better seems appropriate. This type of compromise is not likely to happen without a lot of nail-biting moments and last-minute threats.

If a compromise fails, is all hope lost? Certainly this would not be the ideal scenario, as we believe the market would begin to decline if the compromise talks collapse and both parties withdraw from negotiations. The uncertainty surrounding the discussions may be enough to push us toward a mild recession, and a complete failure to pass a solution would almost certainly get us there. The stock market would then drop as earnings fall and interest rates could spike as bond investors are confronted with the continuing unsustainable deficit spending into the foreseeable future. The silver lining in this dark cloud would be the fact



that politicians would be forced back to the table. At that point, they would likely come to some type of compromise. Either way, we continue to believe that major changes are coming next year; it just comes down to timing and whether it will be done proactively or as a reaction to market forces.

WATCHING AND WAITING

The lesson to be learned from our experiences over the past decade, and even back to the founding of our country, is that it is much easier to squander strength than to rebuild confidence. America is, and will remain, the greatest country in the history of the world. Yet our collective stamina is likely to be tested in the years immediately ahead as we repair our image and the foundations that make us great. The coming year will feature a critical debate about the future of government, and its size and the role it plays in the life of every American. We encourage you to engage in this debate, study the facts, avoid sound bites, and most important, make up your own mind. We have no doubt that our current challenges are completely solvable and a clarified vision for the future is just around the corner.

In a recent *Financial Times* commentary, Francis Fukuyama was asked to suggest a way that the modern conservative movement could regain the political authority it held in earlier times. The core of his prescription is that, “The Republican party has lost sight of the difference between limited government and weak government.”⁸ Fukuyama further holds out Alexander Hamilton and Theodore Roosevelt as models who current conservatives should look to, and he says they both, “saw national power as a tool to achieve their ends, something to be nurtured and built rather than demonized.”⁹ Although Fukuyama is a conservative thinker and writer, we believe party politics don’t need to apply to this logic. The brilliance of his analysis is that it hits squarely on the key aspect of the current environment that we have focused on throughout this white paper series: confidence. Without a return of confidence there won’t be a return to a normal and healthy economy or investment markets. By reasserting its role as a strong, fair and objective referee, the government can once again provide confidence to the American people that the system is designed to support the *wealth of the nation*, not just the politically connected.

As we move toward an election where two extremes seem to be pitted against each other, one must ask if the desires of the middle are going to be heeded. Even more important, after inauguration day, no matter who is in power, will an environment of bipartisanship exist? We hope for the best, and believe this could be the last proactive opportunity to create long-term and sustainable changes in the fiscal situation. Yet we fear for the worst and recognize that recent history gives little reason to believe that constructive solutions will be forthcoming. The outcome of the elections on November 6 and the political posturing in the first six months of 2013 will no doubt tell us a lot about what lies ahead. History is likely to look back on 2013 as an inflection point, but from this vantage point we can’t yet say what that history will be. Stay tuned.

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