Commentary
October 31, 2013

It has become more than tiresome to continue commenting on the circus that is Washington, D.C. Unfortunately, it remains a driving force in financial markets, and therefore must be considered and addressed. The Republican party misplayed its hand badly (weak as it was) and Obama and the Democrats pressed the issues of a government shutdown and an increased debt ceiling, and won the day. The Republicans chose to attempt to delay the individual mandate of the Affordable Care Act (Obamacare), but the President refused to negotiate. Ironically, enrolling members is such a mess that Obama himself may have to delay implementation. Nevertheless, the Republican caucus misjudged its chance for success and the consequence was a terrible battering at the polls. The final compromise on the budget and debt problems only provided a short-term fix, with 3 to 4 months for the two parties to reach a more meaningful solution. There are reasons to believe that the negotiations in next year's first quarter will not be as acrimonious and debilitating as those just concluded. The Republicans, after taking such a severe drubbing, will be less than obstinate in their demands, and Democrats will not want to risk losing their hard won advantage. With an election looming in November, neither side will want to lose votes by seeming to be obstructionists. The continuation of the "sequester" will be a topic to be resolved but since it will have a much smaller fiscal drag effect in 2014 than it did this year we believe a compromise will be worked out. If we are correct in the assessment that a resolution will be enacted to carry the government through the next election, it bodes well for the U.S. stock markets in the near term.

The Federal Reserve Board continues to inject liquidity into the U.S. economy. After the Fed surprised the markets by not beginning to taper in September, the new game is to guess when tapering will begin. The consensus estimate is March, 2014 and that is as good a guess, as we can come up with. The Fed has repeatedly said the move to start tapering is "data dependent". Since no data was available during the government shutdown and new data will be tainted by the effect of the shutdown, waiting until 2014 would seem appropriate. By that time Janet Yellen will be the new Chairperson. She is considered a "dove" and therefore should be market friendly. We are watching carefully for signs of an earlier (or later) start date. If there is no change in the rate at which the Fed is purchasing securities, by mid 2014 its balance sheet will reach $5 trillion. We believe that is not a number the Board would find comfortable and it will make every effort not to get there.

There is no significant news to change our economic outlook. The U.S. continues on a path of modest growth. Europe is improving, but at a very slow pace. Most emerging economies continue to struggle. Canada, as our new Bank of Governor Poloz said in his most recent statement, is in a "temporary" setback that is "more demanding than normal", and he lowered estimates of economic growth. Lower prices for most commodities currently differentiates the outlooks for Canada and the U.S. as they are negative for Canada's revenues and trade balance, but act like a tax cut for U.S. consumers.

China, the world's second largest economy, must be closely watched. A new regime has been in power since March of this year, but there already appears to be a significant change in approach. Gone are the days of double digit GDP growth that supported higher commodity prices and rest-of-the-world growth. Most importantly this government seems to be prepared to pay more than lip service to moving from a mostly investment and export driven economy to one more focused on the consumer and internal growth. Notably, more efforts are being made to control inflation and excess credit creation at the risk of slower growth. China's leadership recognizes the difficulties in enacting these reforms, but are slowly moving forward. Recently the authorities have reigned in liquidity to the banking system and pushed banks to write off more bad loans. With 124 countries counting China as their largest trading partner, the success of these shifts in policy will have global implications. In addition China is opening up free trade zones and reforming its foreign exchange policies, in an attempt to make the Yuan a major settlement and investment currency. This will not happen overnight, but China wants the Yuan to someday be a regional, if not international, reserve currency. That opportunity may come at the expense of the U.S., if Washington can't get its house in order.

Considering all of the above, we continue to favor the U.S. markets. Chris Verrone of Strategas Research noted that as of October 28th, 451 of the S&P 500 stocks are up for the year. While some market watchers are concerned this represents over exuberance, in fact such broad-based participation has historically been followed by continued upside.