

## **The Mid-Term Elections: Key to the Market's Performance**

At this point the stock market is essentially where it was on January 1 of this year. By the indexes one would not be out anything by not being invested the first seven months of 2010. Going forward the market dynamics are slated to change as rising profitability and international demand pull the country out of its economic decline.

Indeed one can make the case that the recession ended last year. Economic activity has been more robust as industries such as transportation see profits leap from incremental demand. To the person on the street this does not feel like an economic expansion. This is the result of three factors.

First is the TARP funding which took place in the fall of 2008. While all the TARP funds have been repaid, with interest, the average person does not know this. Added to the confusion is the fact that several of the institutions that received TARP funds paid extravagant salaries and benefits to their key executives. This was considered something of a slap in the face to the employed and particularly the unemployed.

The second point of public confusion is the stimulus program. Not all stimulus funds have been spent and the program is a key reason for the current level of Federal deficits. A good portion of the stimulus funds went to provide tax cuts for lower income people, while less was deployed in public works which was the focal point of stimulus spending in the past. There was also extensive spending on alternative energy such as battery factories for cars. This did help economic demand, but not in the manner most voters are used to seeing.

Because of the confusion over the use and effectiveness of the stimulus spending, there is now a backlash against further spending by the Government. This backlash concerns those who agree in principle the deficits need to be reduced but now is not the time to do so. The risk to reducing deficits at this time is that the economy will fall back to a level of slow or no growth. The precedent for this concern is the economy of 1930-32. During that time Herbert Hoover cut spending and raised taxes to keep the Federal Budget balanced. By doing so he took a faltering economy and robbed it of the demand necessary to turn itself around. Not until World War II did the Government generate the demand necessary to pull the country out of its funk.

The third factor is the activist position taken by the Obama administration upon taking office. Clearly the agenda was health care reform and environmental concerns. The economy was initially a distraction to these goals. Thus matters of the economy and finance were delegated to others who had more background in the matter. Because of the association of some of the administration appointees to Wall Street, the perception was created that reforms and economic issues have not been pursued with the same priority as health care and the environment.

The bottom line of these factors is an administration that is falling in terms of public support. This is not a small thing. In the mid-term elections, the popularity of the President tends to dictate the success his or her party has in gaining, keeping or losing seats. The rule of thumb is that if a President's poll ratings approach and go below 50 percent, the associated party tends to lose an increasing number of seats.

At this time Democrats hold a 39-seat edge in the House of Representatives and a 10-seat edge in the Senate (this assumes independent members vote with the Democrats, which they often do). Current estimates are for the Republicans to pick up at least 30 seats in the House and eight in the Senate. While such numbers will not change control of either chamber, it would greatly reduce the ability of the majority to assemble and pass legislation. Also, as this is late July the estimates are subject to revision as we approach November.

Thus there will be either divided government if either chamber changes hands or reduced government if the Democrat majorities are reduced. Either way it would appear that the activist approach of the White House will come to an end due to the lack of political clout to carry objectives to fruition. As Bill Clinton and George Bush learned it will also require a new approach by the administration to the legislative branch. For a President who has been quoted as saying he would rather serve one term than not carry out his agenda this may be a wrenching change. It may not be a possible one.

For the stock market, divided government is the best environment. When government is divided there is less chance of drastic change. This permits a sense of being able to plan that a changing environment does not afford. Since businesses require a sense of the future as a continuation of the past in order to invest, the prospect of a divided government between the legislative and executive branches should be welcome news for investors going forward.

## **The Economy**

One of the best contemporary indicators of economic activity is the demand for freight transportation services. The movement of goods is something that happens only when goods are produced or sold. Unlike the production of goods themselves, transportation services are not inventoried. They are either used or they are not.

On this basis the economic recovery is picking up steam. Utilization of railroads, ships, and truck transport is up double digits from this time last year. Such data would challenge the talk of another economic downturn. At this time it would not appear such a downturn is in the cards. We look for a continuation of economic growth, although it may not be robust enough to create significant numbers of new jobs. However, if the economy keeps growing the job creation will come with time.

## **Interest Rates**

After months of flat interest rates, it appears that the yields on Government bonds are beginning to go up. The ten-year bond is now just over three percent while the 30-year bond is approaching four percent.

Such a pattern of steepening yields over time suggests that economic activity is beginning to increase. It also implies that with the increase in economic activity will come an increase in interest rates. As stated previously, the most risky investment to hold at the present time is a US Treasury bond of any appreciable time frame to maturity.

## **Inflation**

Inflation is still a matter of discussion as opposed to actual fact. Much has been said of the current deficits leading to inflation or some other apocalyptic scenario.

While a heedless use of deficits on an ongoing basis will certainly result in catastrophe, the lack of deficits at this stage of the economic cycle could be equally dire. Removing the demand represented by the deficits could result in a sudden decline in economic activity. If collectively embraced by the general population, the lack of demand would cause a spiral of economic contraction. In fact, one economist has estimated that had the Government stimulus program not been enacted the current unemployment rate would be between 13 and 14 percent instead of less than ten percent at present. There will come a time to reduce the deficit. Now is not that time.

### **The Stock Market**

After being down double digits in the second quarter, the market has rallied to get back to where it was the first of the year.

Given the political landscape described above, the economic momentum noted, and the degree of skepticism that greets anyone who advocates stocks at this time, it would appear that we are now in a good environment for investing. As interest rates rise the appeal of low-yielding Government bonds will lose their allure, no matter what their safety. Real estate is still perhaps too early as an investment concept. Gold owners will feel wanting as the income on cash and debt show up the inability of gold to provide the same.

Warren M. Barnett, CFA  
July 28, 2010

© 2010 Barnett & Company