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Election 2012: A Time of Polarizing Politics & Heightened Uncertainty

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"Next Tuesday all of you will go to the polls, will stand there in the polling place and make a decision. I think when you make that decision, it might be well if you would ask yourself, are you better off than you were four years ago?"

— Ronald Reagan, October 28, 1980

2008 TO 2012: A REVIEW

Reagan's question to the American public resonates well in any presidential election cycle, and especially in today's uncertain environment. In 1980, Reagan faced off against President Jimmy Carter, who at the time was considered to be a particularly weak incumbent. According to polls late in the election cycle, the race was close until the last week or so. In fact, momentum didn't truly swing Reagan's way until after the campaign's one and only debate when Reagan capitalized on Carter's perceived flaws on the economy and the Iran hostage crisis. In 2012, we see some parallels to the 1980 election as Republican candidate Mitt Romney looks to the debates as a means to cast darker shadows around a president plagued by a fledgling economy and high unemployment. On the heels of one of the most challenging economic periods American investors have ever known, the US economy has made some progress over the last four years. However, questions about the robustness of the recovery linger. In fact, with real growth failing to materialize, some analysts projected the potential for a double dip recession in consecutive years: first in 2010 and then again in 2011. While markets have been performing well as of late in 2012, they remain haunted by the specter of extreme performance volatility which has recently given way to an environment characterized by extreme uncertainty of future direction.

FIGURE 1: DOES HIGH UNEMPLOYMENT OFFSET LOW INFLATION IN 2012?

	OCTOBER 2008	MOST RECENT 2012
US Unemployment Rate (%)	6.50	8.10
Average Duration of US Unemployment (Weeks)	20.00	38.80
US Real GDP (% Change Y/Y)	-3.32	2.26
US Consumer Price Index (% Change Y/Y)	3.66	1.69
US 10-Year Treasury Yield (%)	3.97	1.55
US 30-Year Fixed Mortgage Rate (%)	6.46	3.59
US Total Student Loan Debt (Trillions of $)	0.61	0.91
S&P 500® Index	969	1,407

Source: FactSet, The Conference Board, US Bureau of Economic Analysis, US Bureau of Labor Statistics, US Department of Labor, US Department of the Treasury, US Federal Reserve, SSgA, as of August 31, 2012.

It's amid this layered backdrop that we all wonder: will the country's electorate make a referendum on the policies of President Obama or will a Romney campaign reenergized by Tea Party favorite Paul Ryan fall short in an election marked by tough decisions and big ideas.

"It is not possible both to keep taxes at their historical average share of gross domestic product (GDP) and to keep the laws unchanged for Social Security, Medicare and Medicaid."

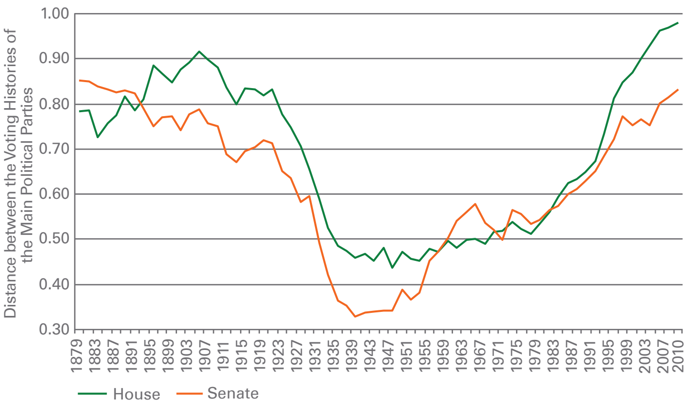
— Douglas W. Elmendorf, Director, Congressional Budget Office, June 6, 2012

WHAT MATTERS TO VOTERS & INVESTORS IN 2012

In 2012, politicians have presented voters with a predicament that can't be solved. After all, there is seemingly no way to cut the deficit, sustain social benefit programs and keep taxes at current rates for all Americans. Yet, polarizing politicians are presenting cut and dried solutions to the nation's problems. For Americans, it comes down to two options that are fundamentally and philosophically at odds with one another. President Obama represents a vote to sustain social programs and reduce the bulging deficit through increased tax revenue directed at the wealthy while a vote for Romney reflects a desire to reduce the deficit through modifications to social programs and certain tax eliminations and reductions targeted at individuals and businesses.

The uncertainty surrounding the 2012 election decision will have sweeping implications that transcend the fundamental and philosophical differences each party represents. Therefore, it is wise to understand what a victory for either party may bring. Unfortunately, it seems unlikely that significant changes will be undertaken post the election. One of the impediments to change is the fact that politicians in Washington are the most divided they have been since after the Civil War. In other words, the voting patterns of the two main political parties in the US are extremely far apart, with Democrats voting closely with other Democrats and Republicans voting with other Republicans. This makes passing legislation difficult and impacts the willingness to cross party lines and compromise on important issues.

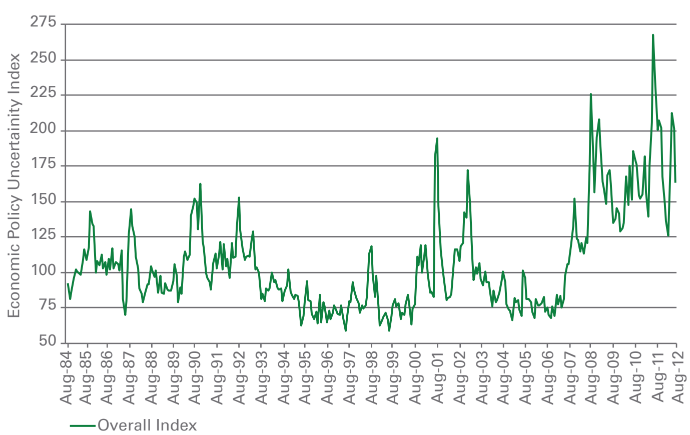
FIGURE 2: POLITICAL POLARIZATION IS GREATER THAN AFTER THE CIVIL WAR



Source: http://www.voteview.com, SSgA, as of December 31, 2010.

With the legislative body seemingly unwilling to come together and work out the imperative issues that impact the well-being of individuals and corporations alike, the level of economic policy uncertainty is on the rise. According to work by economic researchers, Baker, Bloom and Davis, economic policy uncertainty can be measured by the newspaper coverage of policy-related uncertainty, the disagreement among economic forecasters and the number of federal tax code provisions set to expire.[1] It has been suggested that uncertainty and its impact on decision making could play a large role in determining future business prospects. As this level of uncertainty increases, companies may be less willing to invest in large scale projects because they are unsure as to the implications of their decisions. This can lead to a state of paralysis that perpetuates for some time. This can also reverberate to consumers, who are less willing to spend if they are unsure about what state they'll find their personal finances in going forward.

FIGURE 3: THE UNCERTAINITY OF ECONOMIC POLICY REMAINS AT ELEVATED LEVELS

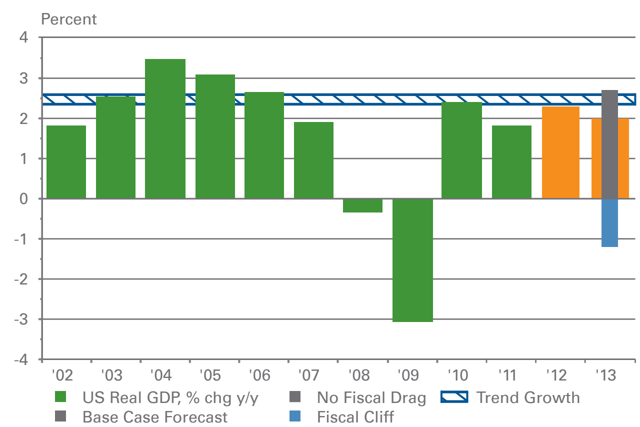


Source: http://www.policyuncertainty.com, SSgA, as of August 31, 2012.

One of the largest sources of uncertainty impacting today's marketplace is the "fiscal cliff." This term refers to the eventuality that without resolution, a number of major tax policies will come into place at the start of 2013. These include the expiration of a number of policies, including the Bush-era tax cuts, payroll tax cut, patches for the Alternative Minimum Tax, taxes associated with the new Patient Protection and Affordable Care Act, and a few others. In addition, because lawmakers didn't take decisive action when raising the debt ceiling last August, it will also include the first round of sequesters on defense and nondefense spending. It is based on these scenarios that, as their base case, the State Street Global Advisors (SSgA) Economics Team estimates that US GDP in 2013 will register at 2.0%. Further, SSgA's worst case scenario forecasts that GDP would fall to -1.2% should the full impact of the fiscal cliff be felt. Finally, in the best case scenario which assumes that no fiscal drag occurs, GDP could post a comparatively strong 2.7%. Clearly, the fiscal cliff will play a significant role in potential growth scenarios for the world's largest economy.

FIGURE 4: THE FISCAL CLIFF HAS THE POTENTIAL FOR SERIOUS ECONOMIC IMPACT

US GDP GROWTH



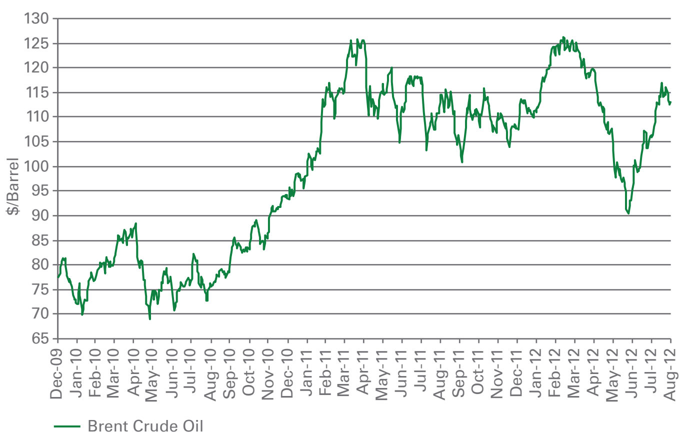
Source: US BEA, Federal Reserve, SSgA Economics Team, as of June 30, 2012. History as of 2011.

Politicians have a choice. They can allow the tax increases and spending cuts to come to fruition on January 3, which would most likely push the US into recession. On the other hand, they could defer all or some of the tax increases and spending cuts, which would further worsen the deficit and increase the rising debt to GDP ratio. In general, Republicans would prefer cuts in spending with no tax increases, while Democrats have a greater appetite for tax increases with minor cuts. Most likely, there will be some element of comprise; however, anything truly impactful will be hard to push forward because of the extreme levels of polarization. With hopes of a so-called "grand bargain" far from the dialogue in which Democrats and Republicans are currently engaging, it seems that addressing all of the issues with one mechanism will be challenging.

Outside of the US, it is hard to quantify the numerous geopolitical risks around the globe. However, in today's environment the price of oil may very well serve as a representative benchmark. An example of this seems to be the renewed fears of tensions between Israel and Iran. Based off of the numerous acts of terrorism undertaken, it could be argued that a covert war is already underway. It is very difficult to speculate when a conflict would start, but the impact on oil is being felt and may not be completely priced in among other markets.

From a timing standpoint, pressure seems to be mounting for a possible escalation by the Netanyahu administration in Israel to disarm a potential Iranian nuclear threat before the inauguration in January. They may be compelled to do so because the Obama administration would be less likely to oppose an Israeli attack during his campaign since this could have an impact on the sensitivities of the American electorate and be pounced on by Romney's camp.

FIGURE 5: OIL PRICES HAVE BEEN ON THE RISE RECENTLY



Source: FactSet, SSgA, as of August 31, 2012.

Even with the amount of uncertainty at home and abroad, markets have recovered quite a bit from last year's selloff following the debt ceiling debate and this year's deteriorating European debt crisis. Some of this growth can be attributed to the idea that the Federal Reserve, and other central banks, are willing to consider undertaking additional monetary stimulus should they feel that the recovery changes course and begins to lose its momentum. One of the key tenants for additional action in the US will be upcoming job reports. While some have commented that the Fed will be reluctant to make further moves close to an election, it's worth bearing in mind that the Fed's current composition is extremely dovish and Chairman Bernanke's term isn't up until 2014, thus he may not feel pressured by politics.

An additional boost can be attributed to the fact that, for now, fears of Europe completely unraveling have abated. However, such a sigh of relief could prove to be the calm before the storm as the growth trajectory of European countries continue to worsen and fears that Greece and other countries may ultimately exit the Euro continue to persist. In fact, more and more countries are slowing or entering a recession, with Greece edging closer to a depression. In addition, with ongoing concerns about how deep China's slowdown may be, investors certainly have a lot to contend with this fall. It's within this context that investors can benefit from exploring a range of investment scenarios associated with the candidate who wins the election.

ELECTION SCENARIOS & INVESTMENT IMPLICATIONS

WHAT HAPPENS IF ROMNEY WINS

In Romney's Day One, Job One plan he notes that should he emerge victorious in November, he would immediately take action. He'd start by introducing bills to reduce the corporate income tax rate to 25.0%. He'd also facilitate the negotiation of new trade agreements, invigorate options for domestic energy solutions, move retraining programs to the states and cut non-security discretionary spending by 5.0%. In addition, his executive orders would ensure that the each state was essentially given the authority to end Obamacare. Additional orders would serve to remove Obama-era regulations, rapidly issue permits for drilling in pre-approved areas, ask the Treasury to label China as a currency manipulator and move to be more pro-business at the expense of organized labor.

In addition, Romney's past comments on the Fed hint of his views on the role and moves of the Federal Reserve. Romney recently remarked, "A QE3 would do the same thing [as QE2], but the potential threat down the road is inflation and that's something which we have to be aware of, and the last QE2, the last monetary stimulus, did not put Americans back to work, did not raise our home values, did not bring jobs back to this country or encourage small businesses to open their doors."[2] As the calendar moves closer to the election, Romney may tone down his aggressive rhetoric because politicizing the Fed may not do him much benefit. Most likely, a President Romney would take a more even-keeled approach to addressing monetary policy issues. However, the addition of Paul Ryan to the ticket makes Romney, at least by association, appear more hawkish.

In general, should Romney take the White House some of the uncertainty that has been permeating of late would be reduced. However, much of this will depend on the fate of his fellow Republicans in the House and the Senate. Many of Romney's proposals would directly benefit dividend-paying investments due to favorable tax treatment and may encourage more companies to initiate or raise dividend payments. Therefore, in addition to stocks generating a high yield, stocks that generate strong, sustainable cash flow could be next in line for a boost. Based on his plans for domestic energy production, the energy sector and many sub-sectors would benefit. An improved regulatory environment could also boost industries that have recently taken heat, such as chemicals, for-profit education and transportation. Lastly, while not as pro national defense as other Republican administrations, Romney would likely be favorable to aerospace and defense.

WHAT HAPPENS IF OBAMA WINS

With an Obama victory in 2013, it will be difficult for a big deficit reduction to occur because the Republican-controlled House has no appetite for tax hikes without spending cuts. Any reduction that does move forward will be modest at best. Based on the present situation, Obama won't do much until the financial markets potentially impel him to act. At present, the bond market is indifferent unlike the situation in the mid-1990s, in which bond investors protested potential inflationary policies with a sell-off that drove government borrowing costs higher. Allowing Romney to begin defining the issues, Obama has kept his message for new ideas very vague.

Even so, should President Obama be reelected, it would most likely be the case that taxes will increase for at least a portion of the population. While there has been some debate on reducing the benefits of municipal bonds, there doesn't appear to be a credible assault in place. Doing away with this type of tax break will be hard to stomach, thus they may be left untouched. Investors should probably be most concerned about the dividend tax changes. If the Bush era tax cuts aren't extended, dividends, for those in the highest tax bracket, will revert to the ordinary income rate of 39.6%. In addition, because of the healthcare bill, capital gain taxes are already going up by 3.8%. At the end of the day, dividends most likely will not be raised to ordinary income, but the possibility that taxes on dividends could increase has left investors cautious. In fact, clarity may not exist until the end of the first quarter. With the increased uncertainty around taxes, it might be very hard to be bullish into year-end because investors might sell in order to lock in the lower gains because future tax consequences will be unclear.

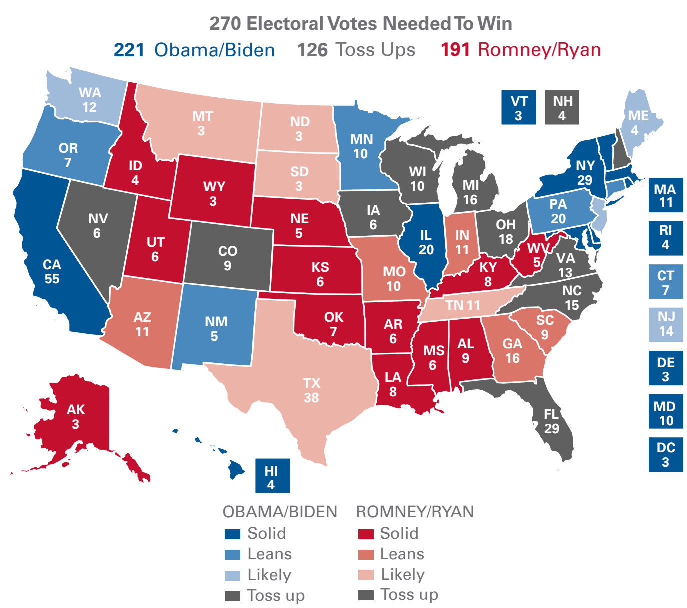
Thus under the President's second term, taxable investors may find comfort in municipal bonds due to their still favorable tax treatment. Should tax changes be implemented, REITs could become more attractive relative to other income-producing assets. In addition, the President seems committed to boosting the nation's infrastructure investment, thus stocks in that industry may stand to benefit. Of course, all investors may seek to exploit the impact of Obamacare on most of the healthcare sector, especially those companies with the most direct exposure to Medicaid. While clean energy remains a priority, the efforts surrounding solar energy will most likely be tempered in the wake of the recent issues with Solyndra.

THE CURRENT STATE OF THE ELECTION

Based on various polling data, Romney has experienced some fits and starts in his relative position, but by most accounts he is the underdog in what will likely be, at least by popular vote, a closely contested race. However, when looking at electoral votes, we see that Obama begins to distance himself from Romney with the current breakdown of the Electoral College tilting toward President Obama, with many states still up for grabs.

In fact, with Romney's choice of Ryan as his running mate, the election will no longer simply be a referendum on Obama and his record as President. More likely, the election will serve as a referendum on entitlement programs and Ryan's proposed budget plans. However, the Romney camp is skillfully playing a balancing act—distancing themselves from certain elements of Ryan's ideas while strongly cementing Ryan as the ideal vice presidential candidate and a powerful advocate for change. Finding the right balance will be tricky and Ryan's message will likely come across as threatening for many seniors who could view major Medicare reform as a direct attack. This would cause serious issues in states that carry a large number of Electoral College votes, such as Florida with 29 votes. Like Reagan, Romney, after having already proved he can hold his own during the Republican primary contests, must do well in the upcoming debates. A strong performance could push some of the toss-up states his way. In any event, Congress will most likely get more conservative, especially the House of Representatives. In the Senate, the Republicans have the chance to pick up a few more seats to be close to or above parity with the Democrats.

FIGURE 6: CURRENT ELECTORAL COLLEGE PROJECTIONS FAVOR PRESIDENT OBAMA



Source: http://www.realclearpolitics.com, as of August 31, 2012.

ELECTION 2012: HOW TO RESPOND

While it seems that every election has the feeling of being the most important to a generation, the 2012 election may actually be able to claim this title. With polarized political parties and a great amount of uncertainty surrounding the direction of economic policy, investors should consider the investment opportunities that exist with a victory by Republican candidate Mitt Romney relative to a reelection of President Obama. In addition, it may be worth understanding the long-term challenges that face the US and what investments may be best suited for strength should a decisive political environment remain in place. With the benefits of efficiency, transparency and flexibility that ETFs offer, financial advisors and institutions can make shifts to position portfolios for these outcomes now.

INVESTMENT IMPLICATIONS FOR A ROMNEY VICTORY

Due to the potential for favorable tax treatment, those companies that pay dividends or have the potential to initiate programs may perform strongly should Romney win. In addition, high yielding equities offer investors attractive income opportunities in the continued low-rate environment.

Under a Republican victory, there are also several sectors and industries that may benefit. Given Romney's interest in increasing domestic energy production, the energy sector may see positive performance on a relative basis. The metals and mining sector could also see a boost with less regulation that allows for companies to pursue more projects. In addition, due to the potential for a less restrictive tax environment, the transportation industry could have a leg up. Further, given the potential for limited defense cuts, the aerospace and defense industry may also benefit.

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– SPDR S&P® Dividend ETF (SDY)
– Utilities Select Sector SPDR Fund (XLU)
– SPDR S&P Telecom ETF (XTL)
– Energy Select Sector SPDR Fund (XLE)
– SPDR S&P Oil & Gas Exploration & Production ETF (XOP)
– SPDR S&P Metals and Mining ETF (XME)
– SPDR S&P Transportation ETF (XTN)
– SPDR S&P Aerospace & Defense ETF (XAR)

INVESTMENT IMPLICATIONS FOR AN OBAMA REELECTION

With the potential for higher taxes, municipals bonds can offer after-tax benefits to investors in higher tax brackets. With a persistent low-yield environment and the potential for rising interest rates a seemingly longer term concern, investors may find the options of various segments of the municipal market advantageous. For those seeking income, REITs could be an interesting option because of the potential changes to dividend-paying equities that would make them less attractive than they are at present. In addition, Obama's predilection to increase spending to boost the nation's infrastructure may result in an infrastructure rally.

Lastly, with the introduction of Obamacare, most companies in the healthcare sector will react favorably to the reelection of the current President.

SPDR ETFS TO CONSIDER

– SPDR Nuveen Barclays Capital Short Term Municipal Bond ETF (SHM)
– SPDR Nuveen Barclays Capital Municipal Bond ETF (TFI)
– SPDR Nuveen S&P High Yield Municipal Bond ETF (HYMB)
– SPDR Dow Jones REIT ETF (RWR)
– SPDR FTSE/Macquarie Global Infrastructure 100 ETF (GII)
– Health Care Select Sector SPDR Fund (XLV)
– SPDR S&P Health Care Services ETF (XHS)
– SPDR S&P Biotech ETF (XBI)

INVESTMENT IMPLICATIONS FOR POLITICAL PARALYSIS

If politicians in Washington continue to lack the appetite necessary to make large scale changes to the US fiscal situation, non-dollar denominated assets as well as those that have no to low correlations to dollar-denominated assets may become more attractive. Thus, over the longer term investors may look to diversify away from US-denominated assets to those denominated in local currencies, especially in the high growth emerging markets. Outside of the relative value attractiveness, adding non-US fixed income exposure to a portfolio may offer diversification benefits.

In addition, should the US face another debt crisis or should lawmakers make a renewed commitment to aggressively reduce spending, gold could benefit from investor anxiety. In the face of countries willing to debase their currencies in order to boost exports, investors who believe that the asset class could emerge as the gold standard of currency may find new growth ahead. Lastly, with the potential for a long-term inflationary environment due to large-scale government spending, investors may find a safe haven in assets tilted toward a real return.

SPDR ETFS TO CONSIDER

– SPDR Barclays Capital Emerging Markets Local Bond ETF (EBND)
– SPDR Gold Trust (GLD)
– SPDR SSgA Multi-Asset Real Return ETF (RLY)

CONCLUSION

Once the fiscal cliff reaches some degree of resolution, it may be easier to get more optimistic on either the short-term or the long-term prospects for the US economy and markets. Recent data has shown that the housing market seems to be a bright spot. Increasing home values will certainly help with the wealth effect and potentially drive an increase in consumer confidence.

While corporate cash balances are at historically high levels, many have been reluctant to spend because of the uncertain business and investment climate in the coming months and years. Given the perception that markets would prefer a Romney victory and Obama seems to be more willing to kick the can down the road, there will be uncertainty throughout the lame duck session. If Obama is willing to work on cutting a deal, there will be a sense of relief on the corporate side as well.

In some respects, the election may serve as a catalyst that unites Washington into taking decisive action in either direction. More likely, the election will be so close that both camps will become further ingrained in their positions. At the end of August, Obama's approval rating continues to drift lower, which doesn't bode well for his reelection chances. With market participants embracing the attempts of central banks to bolster the lack of action on the fiscal side, investors may witness further gains over the coming months. However, with either candidate, investors may need to wait until the early spring for clarity on many of the larger issues. This will further exacerbate an uncertain environment, and the need for investors to stay focused on the long-term while identifying shorter-term opportunities where they arise.

FIGURE 7: PRESIDENT OBAMA'S APPROVAL RATING HAS BEEN SLOWLY DRIFTING LOWER

Source: http://www.gallup.com, SSgA, as of September 2, 2012.

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[1] http://www.policyuncertainty.com/media/BakerBloomDavis.pdf
[2] http://www.bloomberg.com/news/2012-06-17/third-fed-stimulus-won-t-be-better-than-qe2-romney-says.html

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