

VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS



Politics and portfolios: What does the midterm election mean?

Conventional wisdom says that political gridlock is good for the economy because it minimizes economically unproductive government actions. It also says that the stock market will advance significantly in 2011, the third year of President Obama's presidency.

Then again, stocks have not followed long-standing trends recently: Stocks typically do poorly in September, but September 2010 turned the market around. For some perspective and analysis on politics, policy, and portfolios, FSI talked with Derek Young, the chief investment officer of the global asset allocation group for Fidelity Management & Research Company. We're grateful for the assistance of National Financial, a Fidelity Investments company and an FSI Premier Sponsor, for bringing Young's views to FSI members.

Q *What do two weeks of hindsight tell us about the 2010 midterm election?*

A We certainly realized what most people anticipated—a different political landscape in Washington. While we did go from uncertainty to certainty, there's still an absence of an overarching macroeconomic view from both the administration and the Congress. But the biggest question is: With a split Congress, will we end up with gridlock or with negotiated legislation? It's not obvious right now. We really need to keep our eyes open.

Q *What will the first signal be?*

A Clearly, it will be tax policy; specifically, whether the Bush-era tax cuts will be extended or not. This will be a huge issue as we head into the end of the year. This lame-duck Congress has the opportunity to address it, and it will be a very clear signal to the markets and a litmus test for how the split Congress will pursue its agenda. It's really quite unusual to have this big an issue and one this relevant to individuals and investors after a midterm election. If Congress doesn't address it before January, tax rates will be automatically reset and people will feel it in their withholding. Tax clarity will be very critical for the market.

Q *How do you see the election's results affecting consumer confidence?*

A Confidence is directly dependent on two important issues, tax clarity being one of them. The other is hiring and employment. In its most recent statement, the Federal Reserve was pretty blunt: "Employers remain reluctant to add

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—Derek Young

to payroll." Once businesses are more certain about taxes and about regulation, business confidence will pick up. Small business lending has been a big, missing part of the equation. When small businesses begin adding jobs, all types of confidence will increase. But ultimately, to get more consumer confidence, we need to see more hiring.

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Politics



Q *What comparisons are there between this election and others in the recent past?*

A The political situation today is very similar to the midterm election of President Clinton's first term. I was working at the Federal Reserve in Washington, right in the middle of it all, and it was fascinating to watch the president shift to a more centrist strategy and negotiate with a Republican-controlled House. But it's important to remember that the economy was in much better shape then than today. In addition, President Clinton had been a centrist governor in Arkansas. He knew how to pick his battles, and he was rewarded with a second term as president.

President Obama could, for example, soften his position on the income threshold for the tax cuts, moving upward from his earlier position of higher taxes for families earning \$250,000 and up. It would require modifying a personal bias and reaching out. This is why it's going to be a very interesting next couple of months—we get to watch this first data point and indication of style and strategy as they unfold.

Q *Was the Fed's recent announcement about buying \$600 billion in Treasury bonds in line with your expectations?*

A The economy is unquestionably weak and the Fed's recent announcement—stimulus called “quantitative easing”—indicates

a demonstrated willingness to continue stimulating the economy. They're trying to do two things—improve the employment picture and ensure the appropriate level of inflation. The Fed has historically liked to make up or down moves in small increments, such as 25 basis points. This has a similar feel, in that they're going to buy bonds every month until the middle of 2011, at a pace of about \$75 billion a month, and evaluate as they go. If they buy less, it will be a signal to the market that the economy is picking up faster than anticipated and they don't need to be as proactive. The Fed always likes to leave itself with as many options as possible, so this built-in flexibility on a monthly basis is exactly in line with their philosophy.

MIDTERM ELECTIONS

The market and midterm elections: What does history tell us?

Prior to 2010, among the last 17 midterm cycles—dating back to 1942—the president's party has lost an average of 3.4 Senate seats in each election. Similarly, the first midterm cycle for each president averages a loss of 3.1 senators.



There has been a clear trend for a president's party to do poorly in midterm cycles. In fact, the president's party has picked up senators in only 3 of the last 17 midterm cycles (1962, 1970, and 2002). Among the first midterm cycles for presidents, as well as the last 17 midterm cycles, the worst year for a president was 1946, when Truman lost 12 senators. Eisenhower also lost 12 senators in his second midterm cycle in 1958.* In 2010, Republicans picked up 6 Senate seats and 61 House seats. Of the 37 freshmen Democrats serving in the House, 20 lost their seats in the recent election.

The market has generally performed very well during the third year of a president's term. The S&P 500 has been positive on a total return basis during the last 17 presidential third years, with the last negative third year being 1939. Since the end of World War II, the DJIA has averaged +24.7 percent in the 12-month period including and just after a midterm election beginning in the fourth quarter of a president's second year.**

*Source: leftandrightnews.com **Source: MarketWatch



Derek Young, CFA®, is chief investment officer of the global asset allocation group for Fidelity Management & Research Company, the investment advisor for Fidelity's family of mutual funds. Young oversees the strategic investment direction of asset allocation portfolios, leads the firm's U.S. asset allocation committee, and represents North America on the global asset allocation committee. He joined Fidelity in 1996 from KPMG. Prior to that, he was a senior financial analyst with the Board of Governors of the Federal Reserve.

Q *What do you hear when you talk with CEOs? What are their concerns and points of optimism?*

A Their biggest measure of optimism right now is the financing cost advantage—they can borrow at very low rates and take advantage of global growth opportunities. For CEOs of larger corporations who are looking beyond our borders, they know that this is a terrific business opportunity. Just look at corporate balance sheets right now—our research tells us that there is about \$1.8 trillion in cash just sitting, earning nothing. They're ready to put this cash to work globally. Technology companies, for example, are currently seeing more than half of their revenue coming from outside the U.S. You don't have to go much beyond the front page of the newspaper to realize the

opportunities in, for example, China and India. But, and here's the rub, many CEOs say that their boards have been very cautious about putting the company's cash to work, simply because of this lack of clarity we talked about. If you aren't sure where the economy is going or what the regulatory and tax environment will be, it seems better to hang on to cash. It's really no different for individuals. But as we move forward, boards will become more confident about investing in growth. We know, and they do, too, that they're in a great position to start a new cycle of growth and hiring. Most of them do not expect a double dip recession.

Q *Give us an overview of expectations by major asset class.*

A In the equity asset classes, we have a slight overweight to U.S. and emerging market equities, and an underweight in non-U.S. developed countries' stocks. We still view Europe as a weak spot and are concerned about some of the sovereign debt issues there. Emerging market stocks are still the best long-term growth story. Many developing countries are beginning the shift from an export economy to a real domestic-growth economy. Emerging markets are probably the biggest beneficiary of the quantitative easing in the U.S. As the dollar declines and the Fed continues its purchase of Treasury bonds, commodities should pick up in price, which continues to boost emerging markets because of their focus on commodities.

Looking at bonds, we're underweight investment-grade bonds and overweight high-yield corporate bonds. We also like emerging market debt and real estate income investments. Currently, the spread

of high-yield bonds over Treasuries is about 6.5 percent; it's still around the long-term average and they could get much cheaper. In the last low-market cycle, the spread was less than 3 percent. When we look at high-yield bonds, we consider what's happening in the economy—as it begins to improve and the Fed continues to keep rates low to make sure the economy gets some traction, financing costs stay low. The biggest beneficiaries are the companies with the higher risk—by definition, they are higher-risk, high-yield companies. As financing costs come down, the balance sheet gets stronger, default rates get lower, and they get the edge over traditional corporate bonds. So we prefer to have our bond exposure tilted toward high-yield bonds rather than investment-grade bonds.

Q *What about the dollar?*

A The dollar is under significant pressure and will be as long as the Fed continues its buying program. It makes some international investments more attractive and also helps U.S. exporters. So we look closely at companies that have an export exposure; for example, those in the technology, consumer goods, and health care sectors. We're underweight cash in our asset allocation, essentially because you get no return on it right now. It's ironic that sometimes getting zero is a good thing—think about 2008. So when we think about “only” beating zero, we have to remind ourselves that we've recently had an environment where zero wasn't a bad number to have!

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Q Given what we do know post-election and what both history and data points are telling you, what is the main message for advisors and their clients?

A After 2008, a lot of “experts” debated whether diversification still mattered. We know that when correlations went to one, a lot of people lost a lot of money. But the clients who were most able to bear that risk were those who realized the importance of diversification and

sticking to a strategy—they rode out the cycle and started recovering once the market rebounded in 2009. You have to maintain confidence to stick to a strategy when times are tough in the market. Advisors who are constantly discussing a client’s risk profile—and holding their hands through downturns—are those picking up assets now. During some of the darkest days, we advised advisors to look at longer-term tactics, such as incorporating commodities and TIPS,

because those can stabilize risk and provide better protection against future inflation. In 2009, we also increased our recommended long-term allocation to international equities, going from 20 percent to 30 percent, as a percentage of their total equity fund exposure. But these tactics are all highly dependent on advisors really knowing the risk tolerance of their clients. That’s the most important message.

ADVOCACY AGENDA

The election and FSI’s advocacy agenda



With Republicans picking up 61 seats and now the majority in the House, committee chairs will change hands, thus giving Republicans the advantage in controlling the agenda.

Democrats retain control of the Senate, even with Republicans gaining six seats. Given a split Congress, we may experience an environment of legislative gridlock, particularly as the 2012 presidential campaign gets underway. FSI is not a partisan organization. We will continue to cultivate constructive working relationships with congressional leaders of both political parties. Based on our priority issues, we focus on work with a few key committees in Congress, including the House Committees on Financial Services, Ways and Means, and Education and Labor. In the Senate, we engage with key members of the Health, Education, Labor and Pensions (HELP), Banking, and Finance Committees.

We expect several issues to be on the forefront in the next congressional session. In 2011, FSI will focus on these priority issues:

- Impacting implementation of the Dodd-Frank Act’s financial regulatory restructuring, including a fiduciary duty of care. Republican House leaders are likely to engage in greater scrutiny of the SEC and other regulatory agencies as they write rules for implementing this sweeping law.
- Preserving the ability of independent broker-dealers to classify their registered representatives as independent contractors. If we can avoid the near-term danger of this being tacked onto a tax bill in the lame-duck session of Congress, the likelihood of action diminishes in the 112th Congress.
- Supporting legislative and regulatory initiatives that impact retirement savings and access to retirement planning advice. Gridlock will be the biggest impediment to action on these important issues,

which will require bipartisan agreement to move forward.

- Advocating for changes that benefit financial advisors as small businesses. We are joining active coalitions on small business relief issues and anticipate more congressional attention given the Republican gains.

Some of the changes in Congress as a result of the election could impact the voluminous rulemaking needed to implement the Dodd-Frank Act. Under Dodd-Frank, the SEC’s budget will be doubled to \$2.25 billion by 2015, but these are funds that need to be appropriated by Congress each year.

For more on the issues and our strategy, please visit the Advocacy Action Center on our website, financialservices.org.