Palmetto Wealth Management

Game On!

John Gustafson – 8 October 2012

"The reports of my death have been greatly exaggerated." – Mark Twain

Last week, Willard "Mitt" Romney took the consensus standing eight-count and delivered a shot across the Presidential bow that almost nobody saw coming. He finally delivered the performance his supporters were hoping for: prepared, friendly, funny & most importantly, folksy & personable – in stark contrast to a surprisingly unprepared and unpolished President Obama. Do I now believe he's sure to win next month? No, it's still not a popularity contest, it's an electoral one and the bully pulpit of the incumbent is still a very large obstacle. Do I think he has a better chance than a month or so ago? Absolutely…

However, I would like to jump away from that line and discuss a bit as to why it doesn't matter as much as everyone is expounding regarding the markets. Can Willard help us? (and by "us," I narrowly mean investors – that is the point of these notes, not general political speculation or advocacy) Sure, but that's not the only combination for continued prosperity in the markets; regardless of what the screaming masses on Fox News or MSNBC would lead you to believe.

As has been outlined in these missives over the past couple of years, we need *balance*, in the form of reasonable adults across both the Executive and Legislative branches, to compromise and stop with all the extreme policies which net/net accomplish nothing. Politicians across the globe currently all seem to have the same fatal flaw: "liberals" can't stomach any cuts whatsoever & "conservatives" believe we will all morph into Spain or Greece if we don't violently hit the brakes immediately. Both extremes, as with most things in life, are likely incorrect.

Let's take a look at what we've seen of late… The U.S. market has continued to rise in the face of every pessimistic short term prediction from the technicians, the media and even some of the fundamentalists. Please remember that every "professional" appearing in the media in this business is talking his or her book – as am I – just keep that in mind when you see or hear comments or "advice" in any public forum.

I do try to be a little more balanced in these notes because my primary audience is much narrower - i.e. current clients who can easily see what I'm actually doing, making the act of advocating a theory where I'm not in a position to benefit doesn't make much sense. I do try to take you through the thought process as to how I arrive at these conclusions, so you will better understand what's going on in the portfolios.

This year, the old market saw that we hear in the media annually, "Sell in May and go away," has cost anyone following that track a considerable amount of money. I know my caution with new money coming in over the past few months has certainly held things back a little, but as always, opportunities are recovered more easily than losses – with the corollary that it's not how much you make, but how much you keep that counts in the long term. All that said, this continued strength has surprised me a little, but it is far from irrational and has also served to rebuild the constant bubble of pessimism we've experienced over the past several years. We've gone from small pockets of cautious optimism a few months ago, back to almost bearish lockstep across the board.

It is part of the reason why money continues to flood into bonds for "safety" (which I think is anything but, at this point) as the public has simply stayed away from equities. It will be interesting to see if the election outcome changes the public's view of investing at all. Joe & Jane Sixpack do comprise the outlier bullish case because of that virtual lack of movement back to stocks since the '08 crisis. There is an awful lot of buying firepower sitting there in retail bonds and cash. We shall see…

Another one of the grand bearish arguments that is truly becoming tiresome is from the long-cycle folks who in one breath complain about the Central bank manipulations around the globe and in the next one describe why, based on the current picture of a past pattern, (presumably without artificial manipulation back then – wink, wink) you should bail out immediately or face disaster.

My thoughts are, if the level of intervention is historically unprecedented and the markets are far more global now than they have ever been, then why would patterns from completely different environments apply here? Again, I'm not trying to whistle past the graveyard just to be a contrarian, but you can't continually try to find market "pictures" to overlay now while complaining of historical levels of Fed meddling – it almost seems to be arguing both sides at once. I won't stand on the generally ridiculous bull argument always trotted out, "it's different this time," but to paraphrase Mr. Twain once again, those two historical items don't even seem to rhyme.

At this point, I'd like to get out my political crystal ball – but I'm going to be a good economist / lawyer and hedge my bets on several sides.

Up first, the "fiscal cliff." As I mentioned in an earlier note, what we've learned about the behavior of our current crop of ineffective national legislators is that they will NOT take any action with political ramifications interpreted (by them) to be the slightest bit detrimental to their reelection potential before the eleventh hour. (Confirmed fact: the least productive Congress in history.) However, they will make whatever concessions are necessary at the last possible second, of course without complete thought or vetting, to mitigate disaster. That is what I see here as the most likely scenario.

Congress will do nothing before the election because they see no upside, or perceive more upside to the "other" team - equally as distasteful for this selfish cabal - only downside from their financial benefactors across the country. However, I do think there is a good chance that something in the lame duck session will be cobbled together shortly after the election, especially if there is a good deal of turnover. They all need to go back home to lucrative consulting jobs and would like a final "win" to point to on the résumé. I still think all of these folks are too dumb to do anything truly productive and useful, but disaster will be averted. My best guess is another "can-kicking" to at least mid-year.

Remember, the "cliff" is not merely the GOP's sworn enemy of an enormous tax increase, it also hits at the heart of the Democrats in the form of draconian spending cuts across the board. The last debt ceiling deal was a milquetoast disaster, but at least they added a poison pill that should compel some action before the clock strikes twelve.

From an investment standpoint, I think trying to trade your way around it may be foolhardy as it will be more emotional and speculative daily until the very end. The road will certainly be bumpy if they let it go too long, but my feeling is that a globally diverse portfolio should make it to the other side relatively dry. Also, trying to "hide" in bonds at this point just seems foolhardy. There is absolutely no fear in bonds at this point and as mentioned above, money continues to flood into that bucket. It is the very definition of a "crowded trade." (But it's different this time, right? :) Again a conundrum for the same people who continually rail against the Fed's actions, always stating that Bernanke "can't keep this up," while merrily shoveling money into a pile that will get absolutely obliterated if they are correct.

And one more comment on the Fed… As I've said in these notes numerous times and continue to believe – if it weren't for Bernanke, we would all be in pretty hot water at this point. Politicians and pundits like to continually bemoan the disaster of the "dual mandate" and all this other nonsense, but the Fed's real job is *stability* and they are doing the only thing they can in the face of *gross* mismanagement by the President and Congress these past few years. The politicians don't need to take over the Fed, (another moment that would require two-handed selling and a new job for me) they need to do their own jobs properly so the Fed doesn't have to continually break the emergency glass and grab their economic fire extinguisher.

Not wanting to continue to spend pages and pages on politics, though it's difficult this year so close to the elections and with the constant influence (effluent? ;) Capitol Hill has unleashed on the investment world for the past several years, (rules that would not have prevented a thing that went wrong - but that's another verbose discussion) I'll merely give a few scenarios as to how I feel things will play out.

1. Obama wins, GOP takes Senate reasonably, but does not reach 60, and maintains the House, however with a few less extremists who proved they are willing to let their home (America) burn to the ground on "principle" in the last debt fight. *This may be one of the best outcomes for investors – both sides will have a legitimate dog in the legislative fight and neither will have any excuse not to at least pass something and push for compromise, rather than deadlock with nothing actually getting done*.

2. Romney wins with the same Senate / House scenario outlined above. *Because Willard is probably more moderate than the left is willing to admit and the right has shown to prefer, this will probably work just as well as scenario #1 from an economic / investment scenario.*

3. The first "bad" scenario – status quo. All this money, shouting and time wasted and we basically come back with the same cast of selfish, thieving liars we have now. *Not great, they have shown that nothing substantive can be accomplished over the past few years; I would not hold out hope for any change. This would make me very cautious if not outright bearish going forward. The current doomsday extrapolations may actually come true as both sides go back to obstructing to try and simply make it to the next election.*

4. Romney wins; general Congressional makeup remains the same. *This also appears negative to me. Although I think he is enough of a leader to at least get his party to put forward some of his ideas in the House and perhaps pass something – although the past actions of that group lead me to believe that language unpalatable to the more austere Senate will be baked*

into that cake at the 11th hour. Putting everything right back to where we are now – nothing getting done and both sides fiddling while Rome burns.

There could be one or two more scenarios of course; a total sweep by the Democrats, but that seems very unlikely in the current environment. Romney winning and dominating in the Senate to grab over 60 - also a stretch currently and not something that would be healthy. One-party rule in a two-party system has only served to grow huge deficits and pass programs most people hate.

To be clear, from an investment standpoint, I would be happy with #1 or #2, but either #3 or #4 would make me very uneasy and I think would truly bring us more into the grips of the unending European scenario. Right now I think the EU problems have become short-term, emotional background noise, almost like potential terrorism. It's something of a "known unknown."

However, if our period of non-leadership continues in the U.S., especially with a slowing China, that cooks up an unappetizing global meal. Bob Woodward's recent book certainly outlined the current group in Washington's unbelievable lack of understanding, urgency and general ability outside of media sound bites and talking points. The best, but also unlikely scenario may be 'Trow da bums out! (I know, pure fantasy...)

Finally, the worst case in the short term is something in the back of my mind; the Bush / Gore fiasco of 2000 – where all of this recent vitriolic, partisanship really seems to have been born and taken hold. In other words, the outcome shows no clear winner and both sides head to court. That absolutely killed the markets a decade ago and I have no doubt, being in a much weaker economic position currently, the same would occur now. If you wake up on November 7th with no declared winner or concession speech replays and begin to hear breathless reporters running toward the courthouse uttering the words, "hanging chads" or other such nonsense, we will be selling that day for sure.

At this point, I have probably droned on long enough and will save my further Baby Boomer bashing for another update (though *The Economist* has finally picked up advocacy of that issue a few weeks ago - finally) and the fact that the heart of all our economic / political / investment issues may be confidence and attitude (the "malaise" for long time readers) rather than anything fundamental or technical, but they are certainly all wrapped into one big messy stew.

Thank you as always for your business and advocacy, and I wish everyone a great fall and continued success. Please call or e-mail if you have questions or would like to discuss things further.

Cheers!