Manulife Asset Management

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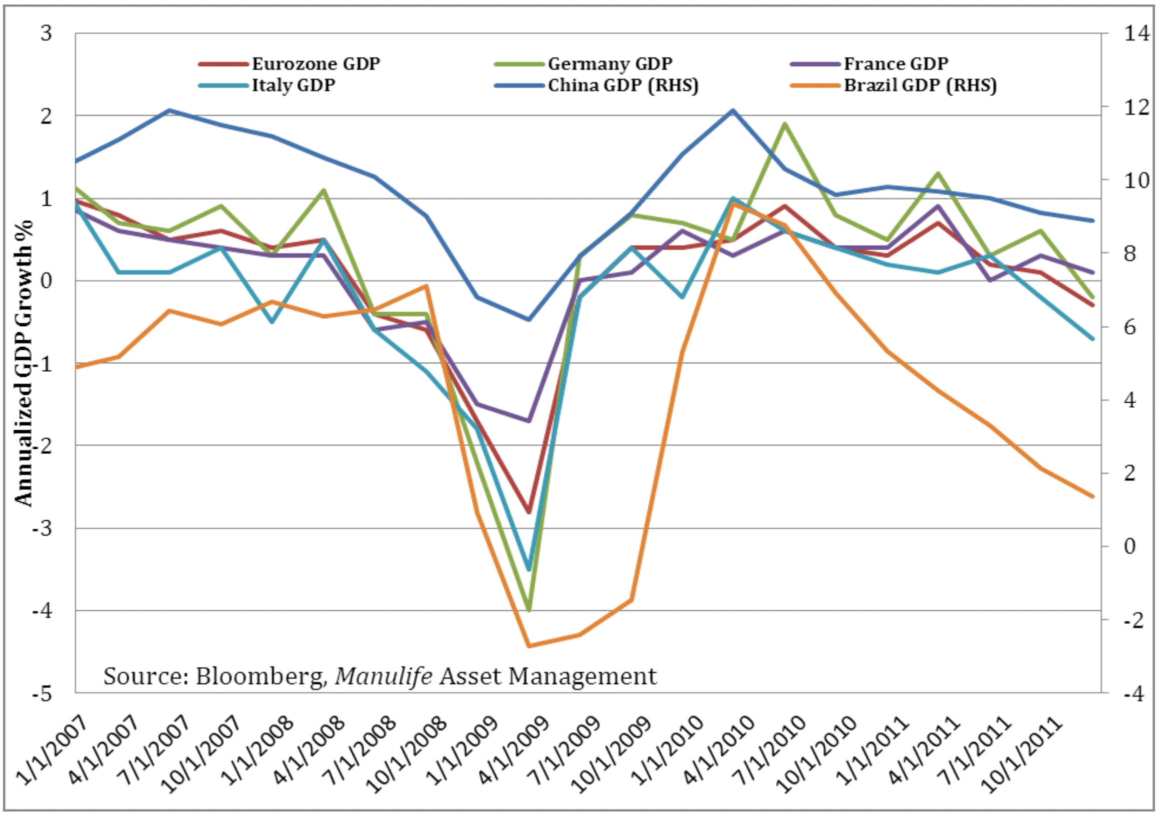
INVESTMENT NOTE

Romney vs Obama

Implications of the upcoming presidential elections to the US economy and investment market

Another interesting earnings season is coming to a close with 98% of companies having reported. The main theme emanating from the second quarter earnings season was that sales and earnings growth is slowing materially compared to first quarter. Aggregate sales growth was a weak 0.60% while earnings grew at an unflattering -0.01%; much weaker when compared to last quarter which saw sales growth of 5.80% and earnings growth of 6.45%. Current analyst estimates of earnings growth for 2013 of roughly 12% appear to be ambitious given the lower guidance provided by many companies this quarter.

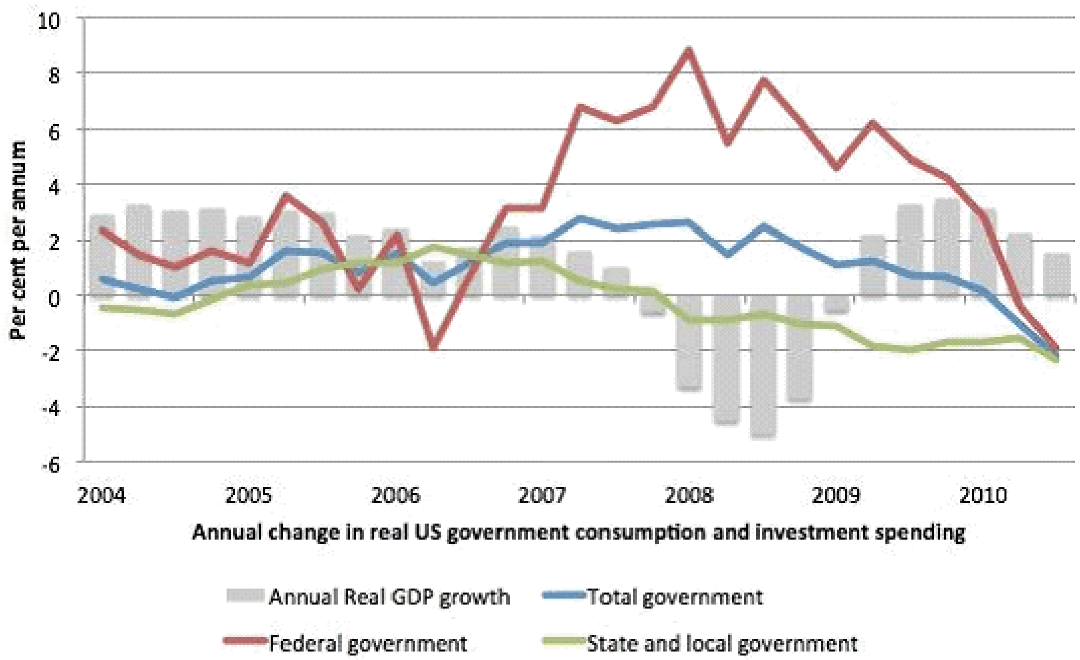
On the macro economic landscape, global growth as well, has been slowing. The chart below illustrates that many developed and developing countries are experiencing slowing economies. Recent global PMI (purchasing managers index) data also confirms weakness in the macro environment. Although recent housing data from the United States has been encouraging and US labour growth appears to have bottomed, the health of the global economy runs contrary to recent equity market performance.



The S&P 500 Index has rallied close to 12% year to date and 2.50% in August. It is a surprising turn of event (albeit a positive one) that the markets have rallied given the earnings and global economic picture just described. While the specific effects, positive or negative, of quantitative easing by central banks on their respective economies are up for debate, programs of QE appear to have supported a rally in risky assets. The question is how much any further quantitative easing will aid the markets, and how much has already been priced in. Given the strength of the S&P 500 Index in light of earnings and economic weakness, one can presume some factor for the possibility of QE3 has already been priced. While the potential for weaker earnings exists going forward, we expect that QE3 may extend the rally at the margin, however exhaustion may also be beginning to set in on investors' opinion of the effectiveness of further action.

With the selection of Paul Ryan (R) of Wisconsin as Mitt Romney's running mate in the upcoming U.S. Presidential election, a clear message was sent by the Romney camp. Their solution for a weak economy is in part smaller government, responsible budget spending and lower taxes for corporations and households.

Although the Romney camp may allude to President Obama's administration as free spending liberals, the chart below shows that government spending as a percentage of GDP has been falling. The concern is what effect could a potential change in philosophy, in terms of spending, have on an already weak economy. Is now the time to materially decrease spending? Government spending has been the crutch for the economy as consumers went through a period of deleveraging while at the same time corporations have been unwilling to use the record amounts of cash on their balance sheets.



Source: Bloomberg, Economic Insight

Starting in the New Year, the Bush Tax Cuts expire, the Temporary Payroll Tax ends and the automatic sequesters set in. As a result, the US budget deficit is set to shrink from US$1.1 trillion to US$641 billion or from 7.3% of GDP to 4.0% of GDP. Estimates are that the economy may shrink by 2.9% in the first half of 2013 with growth resuming to a mere 1.9% for the second half of the year. If the proposed cuts occur in their entirety, they, coupled with a slowing economy and continued headline risk from Europe, provide a very uninspiring environment for 2013. That being said, politicians across the world have illustrated their ability to deviate from their original policies. The makeup of Congress and the Senate will help investors determine which policies are likely going forward.

More to the question of Obama or Romney, and who are investors voting for in the upcoming election. The potential effectiveness of either President Obama or Mitt Romney's fiscal policies can be debated but their views on monetary policy are more certain. Mitt Romney recently stated that he would not renew Federal Reserve Chairman Ben Bernanke's position, a clear signal of "if I win, Ben's out". This was an interesting move, potentially complicating Bernanke's willingness to act in upcoming Fed meetings. Ben Bernanke has always been cognizant of the reputation of the bank independence among investors and the public. If he were to implement another round of quantitative easing, might it appear biased in light of economic data that is neither overly positive nor overly negative?

Time will tell how the markets would react should Romney win and fulfill his promise to remove Bernanke from his current post. The market is familiar with the current Fed Chairman and his policies. As chairman, Bernanke with the help of the Treasury was able to navigate a US financial system from the brink of collapse. And his quantitative easing policies have been beneficial for risky assets. If Mitt Romney were to be elected, who would he replace Ben with? What would be the new chairman's view towards policy? Will he be as accommodative as Helicopter Ben has been thus far? Unfortunately for investors, current campaign policies pose more questions than they answer; and we are well aware of how the market treats uncertainty.

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