

October 12, 2012

"The US is the best looking horse in the glue factory."

-ERSKINE BOWLES, CO-AUTHOR OF THE SIMPSON-BOWLES DEFECIT REDUCTION PLAN.

"We have a leaderless government right now."

-ALAN SIMPSON, THE PLAN'S OTHER CO-AUTHOR.

A most important election. Presidential elections are almost always over-hyped. Typically, they don't live up to their billing as the newly elected "messiah" finds himself unable to alter the nation's course as he and his supporters had hoped (and promised).

Occasionally, though, these actually are momentous events leading to policy changes with economic and social developments that reverberate for decades. The elections of FDR and Ronald Reagan come to mind as two—and ideologically opposite—examples.

For investors, it's obvious that this November's face-off between President Obama and Gov. Romney has enormous implications. Simply from a tax standpoint, it looms very large indeed with the potential for the tax rate on dividends to effectively triple. But there is much more at stake than "just" taxes.

The simplistic view is that a binary outcome is up ahead: Either Mr. Obama is re-elected and the current status of massive deficits, proliferating regulations, and incontinent Fed policies continue or Mr. Romney wins, leading to a far more business- and investment- friendly environment.

As noted in last week's EVA, the market reaction to Gov. Romney's surprisingly effective debate performance lends credence to the notion that his victory in November would trigger a market rally. But as I suggested a week ago, this view might be erroneous, at least over a longer time frame.

Backing up for a moment, I would contend that there are actually three not two possible scenarios. The first is that President Obama returns to the Oval Office and continues to "anti-triangulate." By that I mean he stays on the course of the last two years with a highly divisive tone that feeds class resentment and political polarization. In other words, he refuses to follow in the footsteps of the Clinton administration in its highly productive second term.

In the minds of many EVA readers, I know that is precisely what they believe lies ahead, particularly if the presidential and congressional results appear to confer a "mandate" to Mr. Obama. The president could logically perceive this as validation of his leftward lurch of the last two years.

However, there could be a most surprising plot twist.

Another try at triangulating? One of my 10 annual forecasts for 2010 was that President Obama would move back to the center. This call, as is often the case with my predictions, caused considerable incredulity among my readership. As it turned out, he actually did—until around November of that year.

Almost immediately thereafter, his tone shifted dramatically. As Rep. Paul Ryan confided in a recent private speech I attended, roughly two years ago the president went into campaign mode and refused to negotiate. Instead, he sought to paint a very stark contrast between his view of

the nation's direction and that of the GOP. According to Rep. Ryan, this caught him and his colleagues totally off guard.

The president's pivot away from center might have been a reaction to the "shellacking," as he called it, that the Democratic Party took in the 2010 mid-term elections. He may have felt it was his attempts at reconciliation and compromise, after the bitterness of the highly partisan Obamacare battle, that cost his party so dearly two years ago.

Whatever the reasons for his attitude change, it's hard to dispute that the result has been a country more divided than it has been in several decades. Naturally, both parties need to share the blame for this sad state of national affairs. Another consequence is that this has become the worst recovery in the post-war era. Businesses have been reluctant to hire and invest. Banks have been just as wary about lending. The ultra-critical element of money multiplication, which causes velocity, has been totally missing in action.

As a result, the Fed's injection of trillions of dollars of reserves into the financial system has been remarkably ineffective at reviving the economy, as have the roughly equivalent trillions of dollars of deficit spending. The lack of confidence in the future has largely neutralized this unparalleled degree of stimulus.

It's possible that Mr. Obama's rejection of the "Clinton model" may cost him this election. On the other hand, if he wins, especially resoundingly, it might be considered a political masterstroke, albeit one with a host of adverse economic effects that have caused a number of influential Democrats to publicly assail their own party's leader.

Therefore, it's possible a second-term Obama, who no longer needs to worry about re-election, will seek to undo the damage that his campaign strategy has caused. This is certainly a very unconventional view, but regular EVA readers know that is one of my specialties. And I'm also aware that it's a perception that many of you find ludicrous in the extreme.

Yet, I believe there's a reasonable chance that a second-term Obama could decide to embrace much of the resurgent Simpson-Bowles plan. This package of solutions, authored by the president's bipartisan panel to return our country to fiscal soundness, has many fans, including yours truly, despite its imperfections.

Paul Ryan, like the president, has taken considerable heat for not endorsing Simpson-Bowles. Personally, I think both he and the president made a grievous error in failing to back this very comprehensive and credible plan. However, during the same event referred to above, Mr. Ryan said that he had proposed his counter-plan expecting Mr. Obama to do the same with the idea that they would work out a compromise. Instead, the president went dark on this vital issue.

But with no need to run for elected office again, that could change in a big way. And, ironically, such an outcome could be a major problem for the financial markets.

When money starts moving. Second-term presidents tend to have one overarching concern: their legacy. It's almost inconceivable to me that President Obama will want a continuation of what has been seen over the last four years to go down in the history books as his bequest to America. Again, I realize many EVA readers disagree with me vehemently on that point and they could be right.

So, assume for just a moment that Mr. Obama does embrace Simpson-Bowles, or something along those lines, wrong-footing almost everyone including the financial markets. If suddenly the

dark cloud of national insolvency is lifted, tax rates are reduced for individuals and businesses, loopholes are closed, the Tax Code is greatly simplified, social security is bolstered, and Medicare/Medicaid are reformed, a funny thing is almost certain to happen to those trillions of dollars lying fallow in the banking system. They will begin to go forth and multiply—and multiply and multiply.

If you think I'm exaggerating, please realize the normal multiplier on a dollar of reserves in the banking system is 70; today it is just 6.7. Or, looking at the experience of the last four years, the Fed has boosted reserves by \$1.5 trillion and the M2 money supply has risen by only \$2.3 trillion, implying a multiplier on that reserve injection of just 1.5.

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For the long-term health of the economy, that's exactly what our economy needs to avoid duplicating Japan's lost decade (actually, make that two lost decades). But it will also put the Fed into a wickedly difficult quandary of its own making. Either it sits by and lets velocity pick up with trillions of excess liquidity still in the system or it begins to frantically sell off the government bonds and mortgages it has been gorging on for the last four years.

In the first instance, inflation will go ballistic and so will interest rates. In the second, inflation will be kept under control but at the expense of much higher interest rates. In other words, rates go up regardless though the latter scenario will be much less painful in the long run than the former.

Now let's consider what is likely to happen should Mr. Romney be elected, assuming he has at least one body of Congress in his corner. One reason why his debate performance played well, in my opinion, is that he said a number of things that were pretty much straight out of Simpson-Bowles, especially his ideas for tax reform.

Therefore, I think a Romney-Ryan recovery plan, especially if it is to gain bipartisan support, will look a lot like Simpson-Bowles. My sincere hope, which a new acquaintance of mine with friends in high places has been working feverishly to bring about, is that it will also include some of Woody Brock's best ideas (see

[Woody Brock EVA](#) for a recap of his solutions). In fact, without special growth-boosting measures, like a domestic Marshall Plan driven by the private sector to rebuild our decaying infrastructure, I worry that the interest rate run-up could abort the recovery.

But my most immediate concern, and that of the Evergreen investment team, is what happens to the world of yield instruments should the above circumstances come to pass.

The printing press giveth—and taketh. Although I have become increasingly alarmed over Ben Bernanke's multi-trillion dollar print-athon, it's been extremely kind to Evergreen clients. They are enjoying another strong return year, making the last four years, when so many have struggled mightily, solidly profitable. But all good things come to an end—the question is how soon?

My colleagues and I are convinced that once the markets get wind that rates are headed up, the devastation in the bond market and all the related areas, like MLPs and REITs, will be immense. Millions of investors controlling trillions of dollars have been forced into longer term and riskier investments. The thought of this herd doing a mass exodus is the stuff my nightmares are made of. However, once the panic burns itself out, it will be an extraordinary buying opportunity—assuming it's the right kind of rate rise like the type the Fed did in the 1980s and 1990s.

If it's the wrong kind, such as in the 1970s, when the Fed was consistently behind the inflationary curve, it will be a much trickier time to be an income investor. However, because the bond market is far more sensitive to inflation than it was in the early to mid-1970s, it is likely to force the Fed's hand. Yields will most probably jump well ahead of inflation, cooling the economy in the process. Yet it will unquestionably be much messier if the Fed isn't also moving short rates up to keep inflation at bay.

As conveyed in past EVAs, our plan is to watch money velocity extremely closely to gain an advance warning of when the great reversal is at hand. It continues to be our view that as long as money velocity is falling, inflation and/or a sustained increase in interest rates are almost impossible. We hope to be ahead of when a velocity shift is widely perceived by watching things like bank lending, private sector borrowings, business confidence, and doing our own calculation of money velocity (since the official numbers are only released quarterly).

Of course, there is still that third election scenario where Mr. Obama is elected and decides to stay on his present course. If so, what has worked well for the last four years—yield investments and gold—will likely continue to excel at the expense of almost everything else. That is, until the bond markets decide to treat the US like Spain or Italy (and soon, in my view, France).

Bye, bye Bennie? There is also the risk that a "validated" Obama, believing he was re-elected to make America more like Europe (or even California), will go after the investor class with a vengeance. In that case, more unconventional investment strategies would be necessary, such as shifting assets into vehicles like Asian bonds, offshore gold, overseas agricultural opportunities, and international real estate.

Evergreen is working on a contingency plan, a wealth protection strategy, to shield our clients in case things break badly. This might even entail the opening of an Evergreen office in either Vancouver, B.C., or Hong Kong, the latter being where our partners at GaveKal are based.

While it might seem like there isn't much difference—at least as far as interest rates go—between a re-elected Obama who moves toward center and a Romney presidency, there likely will be—speed. Gov. Romney has vowed to fire Ben Bernanke and replace him with a hard-money Fed chairman. If he follows through, that announcement alone is likely to send seismic tremors throughout bond land.

Of course, as even his supporters would admit, Mr. Romney has been a tad "fluid" on more than a few of his positions. Further, as my astute colleague, Jeff Eulberg, has pointed out, it's not easy to remove a sitting Fed chairman (though Jimmy Carter did exactly that in 1979). Mr. Bernanke's term isn't up until the end of 2013 but even if Romney doesn't show him the door, it's possible he might choose to resign rather than serve under an adversarial president.

No one knows, of course, how this will play out. But any hint of an end to the Fed being the buyer of first resort of government bonds and mortgages is nearly assured to lift rates. Should the perception take hold that the Fed might actually become a seller of its vast trove of Treasuries, rates might increase as rapidly as has the cost of running for president.

Evergreen has already started to position clients in income investments with reduced interest rate risk, such as floating-rate bonds. We have also been accumulating issues with high original interest rates and relatively short effective maturities. Moreover, we have certain hedges in place

that generally increase in value when rates rise. Yet, the reality is there is no way to fully insulate income portfolios from a surge in rates—at least not without taking a huge cash flow hit.

As far as the stock market goes, the return of confidence and money velocity is likely to be a mixed bag. Sharply rising interest rates are always a headwind for stocks, but there will be winners as well as losers. Such a paradigm shift is likely to be very tough on the recent darlings—utilities, REITs, and, even our cherished MLPs. However, cyclical stocks, underachievers over the last five years, could perform reasonably well.

To sum up, my team and I have created the flow chart shown below. Obviously, it's just a rough schematic of what might happen. There are certainly countless other implications of which candidate wins, but this is mainly concerned with the impact on interest rates.

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However, immensely more important than my political speculations is the critical issue of money velocity (and the related multiplier effect). Evergreen is blessed to now be Evergreen GaveKal with direct access to some of the greatest macro-economic minds known to man—or woman. We also are fortunate to have Woody Brock as our economic consultant as well as other brilliant friends like Grant Williams and John Mauldin. You can rest assured that we will be working very hard to discern when the age of easy money ends and the new era of interest rate normalization begins.

David_Hay_Signature

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