Days of Reckoning

The Potential Impact of the 2012 Elections on the Markets

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Executive Summary

Elections can, and often do, matter for markets, but not necessarily for the reasons investors tend to emphasize. For example, there is little historical evidence that markets perform better or worse depending on which party occupies the White House. There is also no concrete evidence that markets do better under divided government, a myth that seems to have taken hold thanks to the bull market of the 1990s.

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However, while the political alignment of a government has had little discernible impact on market performance, policy does. Economic positions, such as tax policy, have in the past influenced how financial markets behave. For investors looking to handicap the impact of November's elections, we believe there are three policy prisms through which to judge the outcome: potential for avoiding the "fiscal cliff," impact on tax policy, and the extent to which the outcome raises or lowers the likelihood of dealing with longer-term imbalances, specifically the unsustainable nature of the current entitlement system and the growing dysfunction of the US tax code.

In the near term, investors should focus on the elections' implications for the fiscal cliff, specifically the pending changes to tax rates. Given the fragility of the US consumer, should all or most of the fiscal drag hit on schedule, the risk of a recession would rise significantly. Any outcome that limits the fiscal drag is likely to be viewed as a positive, particularly as it relates to tax rates. In the past, rising marginal tax rates have exerted a modest, but significant, negative impact on equity markets; from an investing standpoint, investors should be more concerned over rising tax rates than lower government spending in 2013. The longer-term issue is broader tax reform, as the US tax code—particularly its growing instability—is arguably acting as an impediment to the recovery.

However, perhaps even more important for investors could be the impact of the elections on the longer-term economic and fiscal environment. The elections may determine at least two critical issues: entitlement and tax reform. Fiscal pressure will finally hit a tipping point later this decade as the full brunt of demographic shifts begins to hit pension and healthcare obligations, even though deficits are likely to fall in the coming years. The next administration is the last chance to adjust these programs before large deficits become structural. Should the election results fail to bring about a consensus on entitlement reform, the consequences could be even higher debt burdens that will impact the US economy for decades and be a game changer for the markets.

As investors begin to handicap the elections and discount their significance, we believe they should view it from the perspective of which configuration is most likely to tackle these problems. On that score, the recent polarization of Congress suggests that divided government is likely to make the task more difficult. As of this writing, that still appears to be the most likely outcome.

Introduction

Democracy is the recurrent suspicion that more than half of the people are right more than half of the time.
—E.B. White

If nothing else, the parties and participants will be more familiar. After a summer spent familiarizing ourselves with the nuances of Greek politics and the acronyms for the latest European bailout funds, a fall spent focusing on the more familiar—though arguably no less dysfunctional—Republicans and Democrats might be welcome. However, while the landscape is more familiar, the potential dangers are just as great. Whatever happens, the elections will matter for financial markets.

The backdrop to the elections is the US economy, which, while doing better than Europe, is struggling. By any metric this has been the weakest recovery in the post-World War II period. The consumer is still coping with the twin burdens of too much debt and too little income. With overall GDP growth at barely 2%, the economy remains dangerously close to "stall speed," a condition in which any exogenous shock can push the United States back toward recession.

This is the first reason the elections matter—the "fiscal cliff." If the elections produce another partisan and divisive outcome, this will, at the margin, make it more difficult to address the fiscal cliff in the relatively short period between the day after the elections and January 1. On the other hand, any outcome that allows for a quicker and more definitive solution should be market-friendly.

The elections also matter for the longer term, perhaps more so. Put simply, the day of reckoning is approaching for the United States to finally address its unsustainable fiscal path. In the absence of significant reform, the three large existing entitlement programs—Social Security, Medicare and Medicaid—will eventually consume the entire federal budget. Under current policies, by the end of the decade budget deficits are scheduled to start to rise again as the costs of Medicare and Medicaid explode. If structural reforms are not introduced during the next administration, the trillion dollar plus deficits of the past four years will eventually become structural, with significant long-term impacts on the markets.

The second long-term issue is the tax code. While never a paragon of logic or simplicity, in recent years it has become much worse. The proliferation of temporary provisions adds to the economic uncertainty and further discourages investment and spending at a time when the economy is struggling with anemic demand. Again, given the numerous headwinds facing the economy—a consumer deleveraging, uncertainty over the European Union and deteriorating demographics—over which the government has little or no control, it seems unnecessary to compound these issues with a tax code increasingly resembling a Rube Goldberg contraption, and an ever-changing one at that.

Myths Surrounding Elections and the Markets

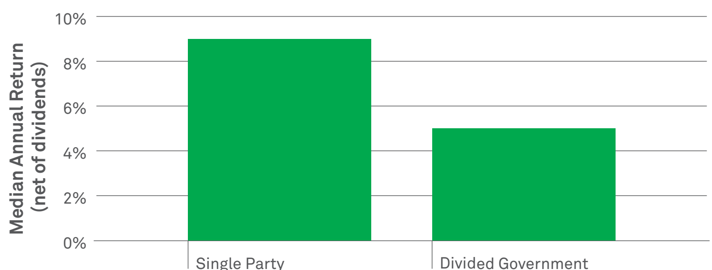
Before addressing the issues that are likely to drive financial markets in the coming years, it is worth dispelling two myths that seem to persist about how elections impact the market.

Myth #1: Party affiliation of the president alone influences market returns.
There is little to no evidence to support this. Over the past century, which party occupies the White House has had no discernible or consistent impact on US equity markets. Since 1900, when a Democrat has been in the White House, the average return for the Dow Jones Industrial Average (DJIA) has been around 8.5%; for Republicans, the average has been around 6% (neither average includes dividends). When you adjust those averages for the market's volatility—the standard deviation on the DJIA's return has been roughly 22% over the past century—the numbers are statistically the same.[1] The party affiliation of the president has had no consistent influence on stock market performance.

Myth #2: Divided government is good for the financial markets.
Following the halcyon days of the 1990s, many investors have come to believe this. The argument goes that divided government moderates the worst instincts and excesses of each party. Another variant on this theme is that under divided government spending is constrained, as the parties will generally not agree on spending priorities. As a result, spending is low, tax receipts pile up and surpluses abound.

This was certainly true in the 1990s, but that seems to have been an anomaly. Looking at the last century of data, there is no evidence that divided government produces better returns. In fact, while the numbers are not statistically significant and should be taken with more than a grain of salt, in the past equities have actually done better when one party has controlled both Congress and the White House (see Figure 1).

Figure 1: Dow Jones Industrial Average Annual Returns (1900 to Present)



Source: Bloomberg 6/1/12. Index returns are for illustrative purposes only. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

[1] Source: Bloomberg. Standard deviation is a measure of how widely values are dispersed from the average value (the mean).

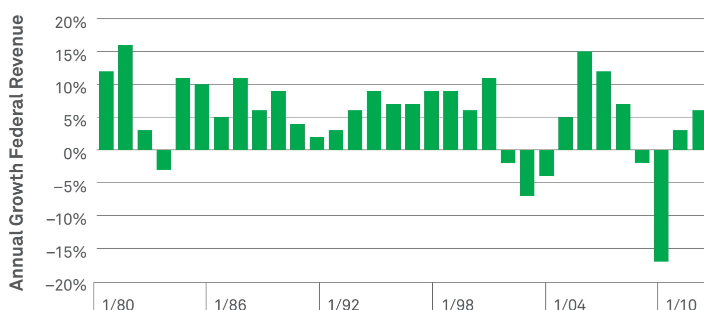
The boom in the 1990s was a function of many factors: a secular drop in interest rates, the taming of inflation and a productivity surge as business integrated new technologies on a large scale. To be fair, there was also some modest spending restraint, but much of that can be attributed to the peace dividend following the end of the Cold War. None of these factors are repeatable nor can they be attributed to a government split by political affiliation.

Furthermore, while investors sometimes attribute the modest deficits and eventual surpluses of the late 1990s to Washington's temporary parsimony, there was another, more important factor at work—strong and unusually steady economic growth. The mid-to-late 1990s produced above-average revenue growth thanks to a booming economy. Not only was the growth strong, but it was also remarkably consistent to a degree rarely seen in the past and not seen since.

Between 1994 and 2000, government revenue increased by 8.3% a year, well ahead of the average since 1980 of around 5.3% (see Figure 2). Even more impressive was its stability. During that six-year period, the revenue growth range was relatively tight, from a high of 10.8% to a low of 7.4%.

Unfortunately, conditions are very different today, and the political composition in Washington is unlikely to change the underlying fundamentals that are hampering growth. From the perspective of the economy, the headwinds of the three Ds—debt, demographics and deleveraging—will exert a drag on growth regardless of the occupant of 1600 Pennsylvania Avenue. From the perspective of investors, the secular drop in inflation and interest rates has run its course. Having done so, no matter who wins in November we are unlikely to witness another round of multiple expansion similar to the 1990s.

Figure 2: US Federal Revenue (1980 to Present)



Source: Bloomberg, as of 6/1/12.

What Does Matter: Policy

None of the above implies that the outcome of these elections is irrelevant for financial markets. While politicians cannot fix much of what ails the global economy, sensible economic policy would help mitigate the damage. There is also quite a bit that politicians can do to make matters worse. In short, the elections will matter a great deal. In one sense, typical political hyperbole is probably justified in that these will be pivotal elections for the economy and the country's economic future.

There are a number of issues, both long- and short-term, that can only be solved in Washington. The absence of progress will likely worsen the economic malaise and in the case of the fiscal cliff push the United States back into recession. On the other hand, real progress on taxes and entitlements could remove at least some of the headwinds holding back growth.

Starting with the fiscal cliff, it's worth quantifying just how significant a headwind this could be. Under current policy, the United States will experience roughly $600 billion of fiscal drag in 2013, with the lion's share in the form of higher taxes (see Figure 3). This fiscal drag will be equivalent to roughly 4% of GDP, a particularly large amount for an economy barely growing at 2%.

There are two reasons the fiscal cliff poses such an existential threat to the recovery. First is its size: the full brunt of the expiration of the Bush tax cuts and spending cuts would mark the largest fiscal drag in decades. The size of the tax hikes alone is equivalent to roughly 3.5% of GDP. By comparison, the next largest was a tax hike equivalent to approximately 1.7% of GDP in 1968, followed swiftly by an economic contraction in 1969.

Figure 3: Cost of Federal Fiscal Policies Set to Expire in 2013 Under Current Law

Fiscal Policy	Dollar Value 2013 ($ Billion)
Emergency Unemployment Insurance	–35
Payroll Tax Holiday	–110
Bonus Depreciation	–64
Affordable Care Act (Obamacare)	–46
Bush Era Tax Cut (Top Bracket)	–83
Bush Era Tax Cut (Other Brackets)	–198
Automatic Spending Cuts (Sequestration)	–90
Total	**–626**

Source: US Economic Viewpoint: Fiscal Cliffhanger, Bank of America Merrill Lynch, Economics United States, May 2012

The second risk revolves around the fragile state of the recovery. Despite four years of deleveraging, household debt is still at 112% of disposable income, versus 90% as recently as 2000 and a long-term average of 78%.[2] Even with a perpetuation of the low rate environment, debt levels still appear unsustainable, suggesting several more years of deleveraging. In addition to high debt levels, income growth has been anemic over the past four years.

Furthermore, whatever small income growth consumers have enjoyed has been flattered by rising transfer payments from Washington. Since 2008, more than half of all growth in disposable income has come from increasing transfer payments. To the extent these are also impacted by the fiscal cliff—for example, extended unemployment benefits expire—this will further cut into disposable income growth, of which there is little to start with.

Should the fiscal cliff hit without substantial change, there is a reasonable chance that the US economy will slip back toward recession early next year, a view shared by the Congressional Budget Office (CBO). The latest CBO estimates (May 22, 2012) suggest that the fiscal drag will result in the economy contracting by approximately 1.3% during the first two quarters of 2013 and growing a paltry 0.5% for the entire calendar year. In addition, to the extent that the fiscal cliff looks likely, both businesses and households are likely to cut back their spending in anticipation of the hit, a factor that could exert a drag as early as fourth quarter of this year.

Should this occur, stocks are vulnerable. While equity markets have certainly discounted slow growth, valuations are not so low as to suggest that investors expect another recession. Evidence we're slumping toward that outcome is likely to push stocks lower and volatility higher.

From an investor's standpoint, there is another concern: historically, rising individual tax rates have been negative for stocks, even when higher taxes have not led to an outright recession. Figure 4

Figure 4: Partial History of Marginal Income Tax Rates Adjusted for Inflation

Year	Income Brackets	First Brackets	Rate	Top Bracket Income	Adj. 2011	Comment
1913	7	1%	7%	$500,000	$11.3M	First permanent income tax
1917	21	2%	67%	$2,000,000	$35M	World War I financing
1925	23	1.50%	25%	$100,000	$1.28M	Post-war reductions
1932	55	4%	63%	$1,000,000	$16.4M	Depression era
1936	31	4%	79%	$5,000,000	$80.7M	
1941	32	10%	81%	$5,000,000	$76.3M	World War II
1942	24	19%	88%	$200,000	$2.75M	Revenue Act of 1942
1944	24	23%	94%	$200,000	$2.54M	Individual Income Tax Act of 1944
1946	24	20%	91%	$200,000	$2.30M	
1954	24	20%	91%	$200,000	$1.67M	
1964	26	16%	77%	$400,000	$2.85M	Tax reduction during Vietnam War
1965	25	14%	70%	$200,000	$1.42M	
1981	16	14%	70%	$212,000	$532k	Reagan era tax cuts
1982	14	12%	50%	$106,000	$199k	"
1987	5	11%	38.5%	$90,000	$178k	"
1988	2	15%	28%	$29,750	$56k	"
1991	3	15%	31%	$82,150	$135k	
1993	5	15%	39.6%	$250,000	$388k	
2003	6	10%	35%	$311,950	$380k	Bush era tax cuts
2011	6	10%	35%	$379,150	$379k	

Source: Wikipedia

[2] Source: Bloomberg, as of 6/30/12.

provides a partial history of major changes to the tax code. While there are certainly exceptions, in the past rising marginal rates have not been good for stocks.

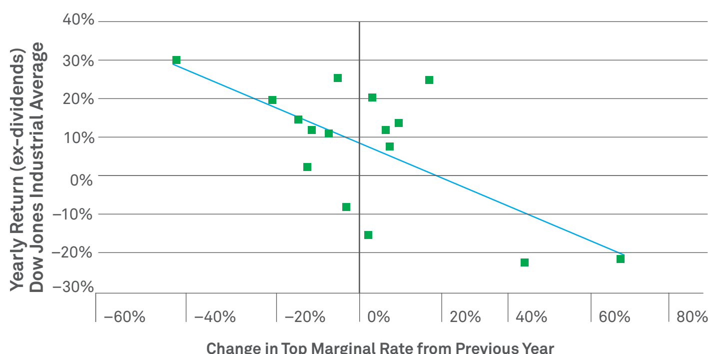
Since 1917, rising taxes—defined by a higher top marginal rate—have been associated with lower equity returns (see Figure 5). While the impact is not massive, historically changes in the top marginal tax rate have explained a significant portion of US equity market returns.

In fact, a simple model regressing annual equity returns on changes in the top marginal tax rate actually produces reasonable results. The model assumes an average return of approximately 8.6%, very close to the long-term average for the DJIA of around 7.2% net of dividends. The basic formula is that for every 1% increase in marginal rate, DJIA return tends to drop around 0.5%. Not huge, but the relationship is statistically significant. Interestingly, there has been no similar relationship between changes in government spending and equity returns. If the past is to be prelude, then from the perspective of an equity investor, the pending tax hikes—not a reduction in government spending—are the real risks to the market.

Entitlement Reform: Our Can-Kicking Days are Coming to an End

These elections will likely influence financial markets well beyond 2013. From healthcare to military spending, the composition of the next government will influence both growth rates and how that growth is allocated. For investors, there are at least two big macro issues to focus on—entitlement spending and tax reform. Let's start with the former, which is simply unsustainable, a condition that will probably become apparent before the end of the next presidential term.

Figure 5: US Equity Market Performance and Change in Tax Policy (1917 to Present)



Source: Bloomberg 6/1/12. Past performance is no guarantee of future results.

According to the Census Bureau's 2010 report, over the next decade the number of Americans 65 and older will increase from 40 million, or 13% of the population, to 54 million, or 16% of the population. And due to longer life expectancy, as well as the large number of aging baby boomers, the percentage of Americans over 65 will continue to rise with time. By 2035, there will be 77 million Americans over the age of 65, accounting for approximately 20% of the population.[3] As we discussed in our June *Market Perspectives* (see "Not so Golden Years"), this will wreak havoc with the US entitlement system.

Historically, US taxes have equated to approximately 18.5% of GDP. The Congressional Budget Office estimates that by 2050 the combined costs of Social Security, Medicare and Medicaid will exceed this level. In other words, without massive tax increases (or changes in programs), within 40 years these three programs will consume all the revenue of the federal government.[4]

In addition to the question of unfunded liabilities, there is the more immediate problem of ever-growing federal debt. The longer these issues remain unresolved, the more debt will add to an already significant burden.

As of the end of June, US gross federal debt was approximately $15.7 trillion, equivalent to roughly 97% of GDP. Looking at debt held by the public—which excludes those Treasuries held by the Social Security Trust Fund—the picture looks slightly less threatening. But even under this calculation, federal debt is roughly $10.5 trillion, up from less than $5 trillion as recently as 2008. Assuming current law and policies are extended—known in budget parlance as the extended alternative scenario—by 2022 publically traded federal debt will exceed 90% of GDP, and by 2026 it will exceed its historical peak of 109%.

Leaving aside the moral and political issues, debt of this magnitude is likely to exert a significant economic drag. In their recent paper "Debt Overhangs: Past and Present", Carmen Reinhardt, Vincent Reinhardt and Kenneth Rogoff quantified the impact of large sovereign debt burdens on growth.[5] The authors find that prior instances of debt levels above 90% of GDP are associated with an average growth rate of 2.3% (median 2.1%) compared to 3.5% during lower debt periods. In other words, high debt burdens reduce long-term growth rates by roughly one-third.

Even more important is how long this debt "hangover" impacts growth. The average duration of debt overhang episodes was an astonishing 23 years.

[3] Census Bureau, U.S. Population Projections. Accessed at www.census.gov/population/www/projections/summarytables.html, accessed February 10, 2010.

[4] *Investment Outlook*, PNC, E William Stone, CFA CMT, June 2012.

[5] *Debt Overhangs: Past and Present*, Carmen S. Reinhart, Vincent R. Reinhardt, and Kenneth S. Rogoff. National Bureau of Economic Research, Cambridge, MA, April 2012.

To state the obvious, should we allow to this occur, it would be a game changer for US financial markets. While investors have reconciled themselves to another year or two of sluggish growth, there is little to suggest that the market has discounted another one to two decades in the slow lane. Such an environment would require rethinking long-term assumptions on earnings growth and margins, and by extension what is a reasonable multiple for a market.

If the next administration cannot begin to make a dent in the fiscal position, investors should reconsider the long-term argument for US stocks, or at the very least demand a larger discount to reflect a secular deceleration in growth rates. At the same time, under this scenario, the risk of Japanese-style stagnation becomes more of a threat, and investors may need to reconcile themselves to a semi-permanent state of low yields.

Spin the Wheel: Next Year's Tax Rate

In addition to entitlement programs and the debt build-up, the tax code has arguably become a significant impediment to growth, not just in the distant future but today. While this topic could consume many tomes, consider two aspects that are most impacting US competitiveness—high corporate rates and the growing instability of the tax code.

Figure 6: 2011 G-7 Statuatory Corporate Tax Rates

Country	Statutory Corporate Tax Rate (*including subnational taxes*)	Effective Marginal Tax Rate (*including subnational taxes*)
Canada	27.6%	33.0%
France	34.4%	28.3%
Germany	30.2%	23.3%
Italy	31.3%	24.0%
Japan	39.5%	42.9%
United Kingdom	26.0%	32.3%
United States	39.2%	29.2%
G-7 average excluding the U.S.*	**32.3%**	**31.9%**

* The G-7 average is calculated using 2010 gross domestic product (in current US dollars) as weights. Source: OECD.

Source: President's Framework for Business Tax Reform, A Joint Report by the White House and the Department of Treasury, February 2012

The United States now has one of the highest corporate tax rates in the developed world. While it is true that a series of loopholes and credits means that few companies pay the marginal rate, the high rate coupled with complexity has become an unnecessary burden on business (see Figure 6). Nor is it clear that the current code is producing much revenue. As a percentage of GDP, corporate taxes are 1.2% and were as low as 1% in 2009, down dramatically from their recent peak of 2.7% in 2007. While some of this is clearly due to the impact of the recession, today's numbers compare poorly with other recessions. In 2001, tax revenues were still 1.5% of GDP and in 1992 they bottomed at 1.6% of GDP. [6]

Furthermore, the United States is the only industrialized OECD country that continues to employ a worldwide system of taxation. The high tax rate and the potential for double taxation, while somewhat mitigated by provisions such as deferral and the foreign tax credit, harm the ability of US companies to compete against foreign companies that face little or no home country tax. [7]

There is a second issue that is adding to the uncertainty plaguing business, as well as individuals. Whether Republican or Democrat, most would agree that predictability is a desirable feature in a tax code. Unfortunately, over the past decade the US tax code has moved in the opposite direction.

There are different ways to measure this, but simply consider the growing number of temporary provisions embedded in the tax code. In contrast to the 25 expiring expenditures in the 1985 tax code, 2010 had more than 141 provisions that would expire within two years. Many of these provisions were renewed again with the passing of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. [8]

The absence of clarity is arguably another headwind restraining corporate spending. Given that the corporate sector is the one segment of the US economy with the wherewithal to dramatically increase spending, lingering uncertainty over the tax code is an unnecessary hindrance. There are bipartisan efforts currently in both the House and Senate to study ways to improve the tax code. A political outcome that supports those efforts and leads to more certainty could help spur some increase in capital spending and potentially hiring, and with it faster growth.

[6] Tax Policy Center Urban Institute and Brookings Institution. Accessed at http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=205, accessed July 3, 2012.

[7] Statement of the US Chamber of Commerce Hearing on the Need for Comprehensive Tax Reform to Help American Companies Compete in the Global Market and Create Jobs for American Workers, May 12, 2011.

[8] *Lessons from the 1986 Tax Reform Act: What Policy Makers Need to Learn to Avoid the Mistakes of the Past,* Jason Fichtner and Jacob Feldman. Mercatus Center, George Mason University, April 2011.

Will Anything Be Settled In November?

From an investment standpoint, the best outcome in November would be some consensus that enables government to begin to tackle both the short- and long-term policy issues. What are the odds that this will happen? As of today, the most likely scenario is a continuation of divided government. Whether that translates into a consensus on reform remains to be seen.

Starting with the presidency, despite the weak recovery most factors still favor a second Obama term. This rests on several principles. First, the odds greatly favor an incumbent. Since World War II, only three sitting presidents have lost re-election: President Ford in 1976, President Carter in 1980 and President Bush, Sr. in 1992. In all three elections, the sitting president was hampered by a primary challenge from their party's flank, something that President Obama has not had to contend with. Second, most polls still show a small but meaningful lead for the president. More importantly, polls in swing states further favor the president.

> *"While it has become a cliché to say that Washington has become more divided and compromise more difficult to reach, there is actually a fair amount of evidence to support this thesis."*

The election will be won or lost in the Electoral College, and will ultimately depend on a few key swing states. Currently, the electoral math provides more paths to victory for President Obama than it does for Governor Romney. Based on analysis by *The New York Times*, Obama has 217 likely electoral votes, with 185 solid, while Mitt Romney has 206 likely votes, with 158 solid. While exact numbers differ, most analysts acknowledge the existing math.

The counterpoint to the above argument, and the main reason the election is likely to be excruciatingly close, is the economy, and more specifically the jobs market. No president since Franklin Delano Roosevelt has won re-election with the unemployment rate above 7.4%. As of May, unemployment stood at 8.2% and few economists expect it to be much different on Election Day. That said, given the advantages of incumbency and the realities of the Electoral College, the odds still favor a narrow victory for the president.

Turning to the Senate, current polls suggest that whichever party controls the Senate in 2013 will enjoy the narrowest of margins and no party looks even remotely likely to capture a filibuster-proof majority (60 seats or more). Currently, Democrats hold a narrow majority of seats, 53 to 47. That is likely to narrow even further in 2013, if for no other reason than that the Democrats will be forced to defend more open seats.

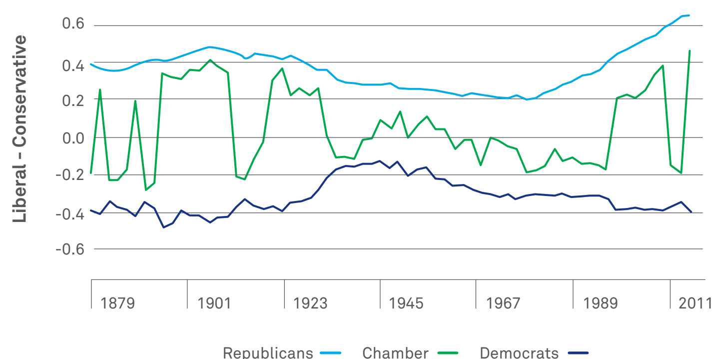
Senate Democrats are defending 23 seats, while Republicans need only defend 10. Just as with the president, incumbency confers a huge advantage in Senate races, suggesting that Republicans are likely to pick up several seats. The most likely outcome next January is a Senate nearly evenly divided, with no party holding more than a one or two seat majority. Given Senate rules, the minority party will still be likely to hold most legislation hostage. Absent a major swing, it looks highly likely that the House of Representatives will remain in Republican hands.

A more quantitative look at the odds supports the likelihood for a continuation of divided government. The Iowa Electronic Markets (IEM) is currently pricing in roughly a 70% chance of divided government in the elections (22% chance of a Republican sweep, 10% chance of a Democratic sweep).[9]

Assuming this is the case, what are the prospects for more compromise, or at least more compromise compared to the last Congress? While it has become a cliché to say that Washington has become more divided and compromise more difficult to reach, there is actually a fair amount of evidence to support this thesis.

Figure 7 measures partisan votes in the House of Representatives.

Figure 7: House Chamber and Party Medians on Liberal-Conservative Dimensions (1879 to 2011)



Source: www.npr.org, accessed June 4, 2012, Keith Poole University of Georgia, Howard Rosenthal New York University

[9] *US Economic Viewpoint*, Bank of America Merrill Lynch, May 30, 2012.

Based on this study, it is not an exaggeration to say that politics is more partisan than at any time in living memory. The two parties are more ideological than at any time since the post-Civil War period and it is simply becoming rarer for Congressmen to cross party lines on a vote.

Nor is this dynamic confined to the House. Most people typically think of the Senate as the more deliberative and less partisan body, but using the same methodology, polarization in the Senate is also at the highest level since the late 19th century. This situation is likely to be exacerbated by the retirement of several moderates from the Senate. The hard fact is that in the current environment, compromises like the1986 tax reform or the 1996 welfare reform look unlikely.

Conclusion

Never put off until tomorrow, what you can do the day after tomorrow.
–Mark Twain

For several years now the US government has faithfully been following Mark Twain's admonition. Whether due to an historically high level of partisanship or an all too human desire to avoid hard choices, Washington has been unable to provide any long-term solutions to issues as far ranging as entitlement spending to the nature of the US tax code. This has hurt financial markets, but to the extent that other countries were in worse shape–at least nobody speculated as to whether the United States of America would exist next year, a comment that doesn't hold for the European Union–the circumstances were not as dire as they might have been. To date, the United States has benefited in a very real way from Europe's dislocations. As Europe has faced an existential crisis, the dollar has rallied and yields have plunged. Rightly or wrongly, investors rushed to what has been perceived as the last safe haven.

However, in a few months' time market attention is likely to shift 3,000 miles to the West, from Brussels and Berlin to Washington. The risks surrounding European banks and sovereign debt will not go away, but this fall US politics are likely to increasingly drive investor sentiment. From the fiscal cliff to the long-term solvency of the federal government, markets may not be as forgiving of further procrastination.

In the near term, bitter and divisive elections that produce more stalemate will make it more difficult to avoid the pending fiscal drag. Even assuming this can be postponed, US economic growth is dependent on a number of structural issues: a sensible overhaul of the tax code and reforms of the long-term entitlement state. If the elections make either of these more likely, a rally is probably justified. If, on the other hand, we wake up on the morning of November 7 with continued divided government and no consensus on reform, an inconclusive outcome in other words, Europe may no longer be the biggest problem child in the global economy.

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