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Markets eye 4 horsemen of Obama's second term

Weekend Investor

Election-night balloons deflate quickly; huge deficits do not

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CHICAGO (MarketWatch) Whether you exhaled or gasped over the presidential election result, there's no denying what comes next: A deficit and budget slugfest that will play out against a vulnerable U.S. economic recovery and Europe's own debt mop-up.

That means if you believe that the so-called fiscal cliff, in the shape of a planned $600 billion of federal spending cuts and higher taxes, threatens the growth-stock strategies favored during the election runup, it may be time for a little insurance.

Stock-market Armageddon portfolio? Not quite. Canned beans? You bet.

David Rosenberg, Chief Economist & Strategist at Toronto-based investment manager Gluskin Sheff + Associates, trotted out his "four horsemen of risk" in an August commentary, a time when trading screens flashed green and candidates' grins flashed white.

Rosenberg's sober point then and now: The White House occupant won't matter much because: Europe is unstable; severe drought drove up food prices in the U.S. and globally (so, yes, we need to talk about inflation): demand for U.S. exports is weakening, and the fiscal cliff, which he says threatens to erase three- to five- percentage points from U.S. GDP.

So, how do investors position their portfolios against the four horsemen of President Barack Obama's second term? First, look at each risk individually:

1. Europe

Central bankers in developed nations will be reluctant to raise interest rates while Europe drags down global growth.

With that in mind, bond and exchange-trade fund strategists at BlackRock Inc. offered a list of bulk goods for your portfolio pantry: Corporate debt and tax-exempt municipal bonds, gold and (most) commodities.

These categories look attractive relative to stocks and government bonds given expectations for an extended stretch of low U.S. interest rates. President Obama will likely retain the mostly dovish Federal Reserve Board, for now.

“Focus on income rather than capital appreciation in higher-yielding fixed income (investments),” says Jeff Rosenberg, chief investment strategist at BlackRock Fixed Income. But, he adds, “Watch out for the moment when inflation or economic growth pushes up rates. One strategy is to be relentlessly neutral; buy undervalued assets and sell similar, but pricier, ones.”

2. Inflation

Central banks are convinced they’re fighting deflation, and it may be hard to fight that. But Gluskin Sheff’s Rosenberg, BlackRock’s fixed-income team and others are concerned about pockets of inflation not factored into the broad price indexes.

“The U.S. is a massive food producer on a global scale and as such plays a key role in influencing prices in the world market,” David Rosenberg says. As such, there was a drought, but not in the money supply.

“A flood of dollars by the Fed has had the effect not of CPI inflation, but asset-price inflation in bonds and stocks,” says Rex Macey, chief investment officer of Wilmington Trust Investment Advisors. “Higher valuations today mean lower returns tomorrow.”

Gold, the historic anti-inflation go-to, gained after the election. Gold ETFs, including SPDR Gold Shares (US:GLD) , were buoyed because Obama’s win is seen sealing low near-term interest rates.

3. Export weakness

Gold strengthens — but so does the U.S. dollar, and that could drastically change the fortunes of export-oriented firms.

First up for the greenback is near-term volatility, according to the consensus. But then, the dollar becomes more attractive. “Dollar buying returns under fiscal and growth risks,” the Bank of America/Merrill Lynch Global Research team argues in a client note.

And who are the buyers for U.S. exports if the dollar is strong, European demand remains sluggish, and the mood of emerging economies sours, Rosenberg wonders. Investors who assume that a weak dollar and global recovery will fuel U.S. exports (and shares of exporters) might rethink that stance.

Moreover, a stronger U.S. dollar will lower the home currency in Canada, Australia and other commodity-based economies, boosting their exports and the pro-commodity investing story.

4. The fiscal cliff

Debate will swirl around a resolution to the fiscal cliff in coming weeks, but clearly the uncertainty is spurring near-term volatility. Read more: MarketWatch's coverage of the fiscal cliff issue.

“Even the Federal Reserve has gone on record to warn Congress that the central bank will not be able to offset the economic shock that stems from the sudden sharp hike in taxes and severe spending cuts,” says **Bernard Baumohl, chief global economist at The Economic Outlook Group.** That said, he’s optimistic that Congress will reach a compromise before the Dec. 31 deadline.

BlackRock's team, meanwhile, is hunkered down for Washington's slog through the debt and deficit problem and the Fed's status quo. Their low-rate-environment, defensive stock leanings: energy and health care.
But even if the fiscal cliff is averted, there may be a less obvious risk underfoot. "If there's anything that could derail us it's an ordinary, cyclical recession," writes investment manager Josh Brown of Fusion Analytics, who also writes The Reformed Broker blog.

For his clients, Brown notes in a blog post on Nov. 7, "What we're doing is kicking out low-conviction holdings and a lot of our higher-beta stocks and funds.

"We'd love to be wrong," Brown adds, "see a massive economic expansion and just buy 'em back. But the typical recession means a 30% peak-to-trough drop in equities from peak to trough and we manage money for people's retirements. A phone call from us to one of our client households to apologize for a 30% drawdown would simply be unacceptable.

"So we get defensive and allow things to develop," Brown says. "We get a bit more liquid with the expectations of better entries. Because the evidence piling up is now too weighty for us to do otherwise."