What Will the Elections Mean for Investors?

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BLACKROCK

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It has been a long and contentious political season, but in a few short weeks, voters will cast their ballots to elect the 44th president of the United States and the 111th Congress. As voters follow the presidential debates, review the latest polling data and watch a seemingly endless stream of campaign commercials, many are wondering what a Barack Obama or John McCain victory might mean for financial markets. How would different administrations affect (and be affected by) the economic landscape? How would potential tax changes impact investors' portfolios? Would there be different investment opportunities under different administrations? In this report, we take a look at some possible scenarios and consider what implications the elections might have for investors.

The Overall Impact

The most asked question among investors when it comes to the elections is "how much will the outcome affect my portfolio?" In our view, the answer is "probably not as much as most think." It is important to remember that any campaign promises eventually will have to be passed and funded by Congress. As a result, the Congressional elections may play as large a role as the presidential election in determining how markets react. Specifically, in this election cycle, we believe the make-up of the Senate will be critical. Currently, there are 51 Democratic senators (more precisely, 49 Democrats and 2 Independents who caucus with the Democrats) and 49 Republicans. Assuming the Democrats increase their margins in the Senate (which most observers agree is likely), Democrat President Obama would have a far easier time having his legislation passed than would Republican President McCain. In any case, we believe it is extremely unlikely that the Democrats will be able to pick up enough seats to have a filibuster-proof majority (which would require 60 seats). A similar situation exists in the House of Representatives, where Democrats currently have roughly a 55% to 45% advantage. They are likely to pick

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up additional seats in the next Congress and will be able to increase their power, but we expect that the Republican Party will be able to continue exerting influence on the legislative agenda.

As a larger point, we would emphasize that elections are just part of the long list of variables that affect financial markets. Market fundamentals historically have proved to be far more important. We believe asset allocation, valuations, earnings, yields, the economic outlook and the other basic determinants of market performance will have far more influence on an investor's portfolio than will the election outcomes.

The Economic Backdrop

The economy has emerged as one of the key issues on which voters are focusing in this election cycle, and with good reason. Economic growth has been slowing, credit issues continue to dominate the headlines, the labor market has come under pressure and consumer confidence has been taking a hit. In this environment, both McCain and Obama have been suggesting different tonics to cure the ailing economy. By our analysis, the reality is that no matter who is elected, the U.S. economy will have to weather at least several more quarters of weakness.

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An environment of weak economic growth will complicate matters for the new administration and the new Congress, and will likely make it more difficult to enact some of the wholesale changes that the candidates have been discussing—simply put, there probably will not be enough money available to enact every campaign promise. As an example, we would point to the ambitious healthcare platforms offered by both candidates. Obama has been promising to create a new program for low-income Americans that would provide them with subsidies to purchase health insurance. McCain has proposed ending the current system of employer-sponsored health insurance in favor of individually purchased plans. Both plans would require significant tax incentives and/or spending increases, and while it would not be surprising to see some sort of changes in the way healthcare insurance functions, the realities of the federal budget will force the new administration to curtail some of its plans. From an investment perspective, this again means that proposed healthcare changes are unlikely to affect the markets as much as some think.

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The flip side of this economic picture is that we are almost certain to see some form of additional fiscal stimulus next year as well as additional legislation aimed at helping the housing market. On the stimulus front, we may see additional tax rebate checks for individuals. These helped bolster consumer spending levels in the middle of 2007, but did not have much carry-through to the rest of the economy. We believe business stimulus packages focused on tax incentives for investment or hiring might have a longer-term effect. On the housing front, there has been some discussion about legislation focused on limiting the short-term risks to home prices and bank lending. Such legislation is likely to come to fruition once the political season is over, which could help ease some of the pressure on the housing market.

Tax Policies

The economic issue of primary concern to most investors is what will happen on the tax front. Conventional wisdom suggests that Republicans lower taxes and Democrats raise them, but the reality is more complicated. In the current election cycle, it is really more about the calendar than the candidates. With the economy almost certain to be weak at the beginning of the new administration, we think it

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is a foregone conclusion that the government will be forced to borrow more money and to increase tax rates simply to keep the government running. It is important to emphasize, however, that while tax rates will likely climb during the next president's administration, the repercussions are not likely to be as severe or as sudden as many fear. The U.S. economy is still in the midst of a period of economic weakness, and politicians are not likely to dramatically increase tax rates when times are difficult for their constituents.

The proposed tax policies of the two candidates are quite different, and would have distinct effects on different people. For example, Obama has been pushing for higher marginal tax rates for individuals in the highest tax brackets and reductions for those in the lowest. Furthermore, he has proposed taxing "carried interest" from hedge funds and private equity investments at marginal income tax rates. In contrast, McCain has stated his opposition to tax increases for higher-income Americans and would prefer to maintain the status quo on carried interest. From a more general perspective, if Obama becomes president, overall tax levels are likely to go up more than they would should McCain get elected (specifically for higher-income Americans). One area of tax policy that could see some additional change is the current structure of the Alternative Minimum Tax (AMT). The AMT has been affecting an increasing number of Americans in recent years, and has become less and less popular, and it is a possibility that the AMT could be adjusted as part of the next tax package.

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Another tax issue weighing on investors' minds is the outlook for continuing the favorable tax treatment of long-term capital gains and qualifying dividends (the 15% tax rate currently is set to expire in 2010). Obama has indicated that he plans to eliminate this favorable tax treatment (although he has stated that dividend income for lower-income Americans would not be affected). It seems quite likely that under an Obama administration, dividend income and capital gains tax rates will increase for many, if not most, investors. McCain, in contrast, has been a strong advocate of tax cutting and would like to see the current favorable treatment stand. In our opinion, however, President McCain would have extreme difficulty convincing Congress to go along with his tax plans. In particular, it is almost impossible to imagine a Democratic-controlled Congress extending the current capital gains and dividend tax treatment. By this measure, then, we think higher tax rates for investors will be a headwind for equities (albeit not an insurmountable one) in the next administration.

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Trade Issues

Another issue receiving increased attention has been trade policies. McCain has long been a free-trade proponent and, as president, would likely continue to push for the types of expanded trade agreements that have been a hallmark of both the Clinton and Bush administrations. Obama, in contrast, focuses more on protecting U.S. industries, and on environmental issues and labor rights, when considering trade issues. He voted against the Central American Free Trade Agreement (CAFTA) and during the primary season questioned the merits of the North American Free Trade Agreement (NAFTA). In the next administration, we expect trade to remain a hot-button issue and one that could have an impact on the markets. On balance, Obama's attitude toward trade issues tends to benefit traditional American manufacturing industries, but we would also point out that protectionist policies run the risk of slowing overall economic growth and can add to inflation concerns via wage pressures.

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The Fixed Income Outlook

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Over the past 10 years or so, the amount of private credit (e.g., corporate and mortgage-backed bonds) in the fixed income marketplace has increased as a share of the total marketplace at the expense of public credit (i.e., Treasuries and municipal bonds). This is likely to change during the next administration. Because of the weak economic backdrop, the federal government (as well as state and local governments) will be borrowing more and issuing more debt, while at the same time private borrowers will likely scale back their bond offerings. Theoretically, expanding the supply of Treasuries should mean yields would move higher (since demand would drop), but in the current environment, weak economic growth should keep Treasury yields from climbing excessively.

In our opinion, the outcome of the elections will not have a highly significant impact on relative opportunities within fixed income sectors. At current yields, Treasuries appear overvalued, and we do not see the political landscape changing that outlook in the near future. In contrast, we do believe that higher-quality investments continue to represent attractive investment opportunities. In particular, government-guaranteed Ginnie Mae mortgage securities are trading at attractive premiums, as are some higher-quality credit-backed areas of the market.

A Focus on Municipals

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Another area of the market that we would emphasize is municipal bonds. While the likelihood of higher tax rates is a negative for some investments, municipals are one of the few areas of the market likely to benefit from increased taxation. As tax obligations increase, the tax-exempt nature of municipal bonds becomes more attractive to a wider audience. This, in turn, should help municipal bonds to perform well relative to other fixed income assets.

An additional factor underlying the attractiveness of municipal bonds is the potential for increased infrastructure spending in the next administration. Obama in particular has been emphasizing the need for more spending on projects such as highway improvements and bridge renovations, many of which would be financed through the issuance of bonds. Some of these would be traditional municipal issues and some would take the form of corporate bonds (since some infrastructure elements have been privatized). In any case, we believe that during the next administration, we will witness an increase in investment opportunities in infrastructure financing.

Even outside of the tax and political landscape, municipals are quite attractive at present. Usually, municipal bond yields are lower than Treasury yields, but as a result of the credit-related turmoil, this relationship has recently changed and municipal bond yields have been trading at levels close to (and in some cases in excess of) Treasuries, representing an attractive premium for munis.

A Look at Equity Sectors

With the important caveat that earnings and other fundamentals will have much greater impact on markets than legislative decisions, we do believe that an Obama or a McCain administration might affect various industries in different ways that could have implications for equity portfolio positioning.

Sector	Obama Administration	McCain Administration
Energy	Obama's administration likely would be more "green friendly," and will focus more heavily on climate change and global warming, which could benefit alternative energy companies.	Traditional energy companies likely would benefit under McCain, due to his preference for expanding production. McCain also has been a proponent of increased nuclear power, which could help that industry.
Healthcare	Universal healthcare has been a key pillar of Obama's campaign. It is difficult to predict exactly what impact his plans might have, but there is a general sense that managed care companies would face increased costs under his initiatives.	A McCain administration would likely adopt a more "hands-off" approach to the current healthcare system, and an absence of increased regulation would likely be beneficial to pharmaceutical and insurance companies.
Manufacturing	Obama has been emphasizing his goal of keeping more manufacturing jobs in the United States, which could benefit some traditional manufacturing companies. Additionally, his focus on infrastructure improvements could be a boon for construction-related companies.	Globally oriented multinationals would likely benefit from McCain's free-trade stance.
Defense	There is a perception that defense industries would fare worse under Obama, but the reality is that there would likely be little difference between the two since overall defense spending is unlikely to be reduced in the current environment.	One area that could be affected is missile defense systems. McCain has been committed to these systems, while Obama has been more skeptical of their effectiveness.
Retail	Obama's tax policies likely would benefit less-wealthy Americans, which could, in turn, help mass-market retailers.	McCains tax policies would stimulate spending among high-income consumers, which should help upscale retailers.

Predictions

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Bob Doll: Most signs point to a Democratic sweep in this year's elections. The desire for change and President Bush's unpopularity, which so dominated the 2006 midterm elections, prevails still today. Additionally, the Democrats are enjoying fundraising advantages this election cycle that will be difficult for the Republicans to overcome. The outlook of Republicans in Congress continues to look grim, and even some leaders in the Republican Party are talking about the likelihood for additional losses in GOP seats in Congress come November. In all, I expect Obama will occupy the White House with increased Democratic majorities in both houses of Congress. However, as indicated above, it is unlikely that the Democrats will gain enough seats in the Senate to completely drive the agenda, so Republicans will still have an impact on policy.

Peter Fisher: I agree that the Democrats appear positioned to win the field. The only additional prediction I would offer is that after Election Day, the "experts" will look back and collectively decide that the election was determined by some event that we could not predict today. (For example, I would point to the infamous Dukakis "tank" photo as the event that turned the 1988 election.) With the odds in Obama's favor, something will occur during the election season that will allow us to create a narrative surrounding the idea that either Obama was able to lock down victory or let it slip through his fingers.

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