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What Do The Mid-Term Elections Mean For Investors?

It seems like the 2010 campaign season has been in force forever (or at least since the 2008 election), but the dust finally has settled and the results are in. Although a couple of races remain too close to call, the Republican party won a resounding victory in gaining over 60 seats to retake the House of Representatives (the largest shift since 1948), while the Democrats managed to narrowly hold on to the Senate. From an investment perspective, observers now are turning their attention from following the candidates' promises to wondering what the election results, and the seating of the 112th Congress in January, might mean for the financial markets. In the following pages, we take a look at the prevailing political trends, discuss a few "hot button" issues that will have some bearing on the financial markets and offer some thoughts as to how the election results might impact investors' portfolios.

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A Look at the Results

Much has already been written about why the election results were what they were (and much will continue to be written), but we thought it would be helpful to briefly offer our perspective as well. In the closing months of the campaign season, President Obama tried to frame the national debate over the midterm elections as a choice between two opposed political agendas and not as a referendum on his presidency. Based on the results, and on the exit polling, he was clearly unsuccessful. In our view, the results can be viewed as a repudiation of President Obama and his legislative agenda.

Many voters are clearly unhappy with the direction the country is headed and approached the polls with a "throw the bums out" mentality. Many people feel that elements of the recession lasted longer and were deeper than they expected and, more to the point, conditions grew worse than the President expected them to be. Given this backdrop, the midterm elections can, in many ways, be seen as a reflection of America's frustrations with weak economic growth. The strength of the Republican victory suggests to us that the GOP will be very aggressive in terms of exerting its "mandate" to change taxation and spending policies. The degree to which the Republicans will be successful will depend, to a large extent, either on the degree to which they can overcome threatened or actual vetoes by the President, or the degree to which the executive and legislative branches can compromise on legislation. In any case, however, the balance of power has shifted somewhat toward the Republicans and we do not expect them to be timid about exerting their newfound power.

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The Overall Market Impact of the Elections

In most cases, we believe the answer to the question "how much will the election impact the markets?" is "less than you probably think." In general, predicting how financial markets may react to the political backdrop can be a very tricky business. While political and legislative actions certainly can affect the performance of the markets, at the end of the day market fundamentals historically have proved to be far more important. In most cases, asset allocation, valuations, earnings and the other basic determinants of performance will have far more effect on an investor's portfolio than election outcomes will.

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The important wrinkle we would add for the 2010 midterms, however, is that in this case, the election results (and the political backdrop as a whole) probably matter more than they usually would. With a still-weak economy, ongoing credit-related issues, lingering deflationary pressures, structural imbalances in terms of high deficits and the pending scheduled expiration of the Bush tax cuts, we believe that Washington has quite a bit of work to do to help the American economy continue to recover in the short term, and expand in the long term. Regarding the short-term outlook, the economy is continuing to muddle through, and is not strong enough that it can do without some meaningful incentives for jobs creation and capital formation. At the same time, the government needs to address the long-term fiscal imbalances to prevent high deficits from acting as a detractor from economic growth.

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There is a widely held opinion that divided government can be good for the markets and the economy, since divided governments are less capable of "meddling" in the free markets. Certainly, there are times when this can be true (such as during the late 1990s). At present, however, we do not believe this to be the case. If the government is not able to come together and address some of the serious economic problems facing the country, these problems will almost certainly escalate.

Removing the "Uncertainty Effect"

Regardless of how (or if) the government elects to take action on the broader economy and regardless of what the new legislative priorities are in the coming year, one immediate and positive result of the elections is that the outcome has gone from being an "unknown" to a "known." In other words, there is no longer any uncertainty over the election results.

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It is a truism that markets loathe uncertainty, and in the current environment, uncertainty over the political and regulatory backdrop has acted as a modest drag on the stock market. From the perspective of a corporate board of directors or a CEO, many have been concerned over the prospects of additional government regulation of their industries. Rightly or wrongly, some looked at the results of healthcare reform and financial regulatory reform as a negative for those particular industries, and adopted a "who's next" stance. Because some corporations have been uncertain about the future of regulatory policy, they were reluctant to spend some of the capital they have been keeping on the sidelines. More political clarity should translate into increased corporate spending levels.

Although the political backdrop is always a wildcard, and it is not clear how the new Congress will approach regulatory issues, it should be obvious that in the 112th Congress it will be more difficult to pass the sort of wide-ranging reforms that took place in the 111th, and that there would have been essentially a zero percent chance that the 112th Congress would have passed the healthcare and financial reform legislations. Again, rightly or wrongly, this sort of backdrop is viewed as more market-friendly by most corporate boards and CEOs, who should be more willing to put capital to work, which should, in turn, be a positive for equity markets.

Tax Policy

The economic and political issue of primary concern to most investors is tax policy. There is both the immediate question of what will happen with the Bush-era tax cuts, as well as the longer-term question of the future of tax rates. We think that it is telling that President Obama and the 111th Congress were not able to come to a resolution on whether the Bush tax cuts should be extended, modified or be allowed to expire. In the late summer, it appeared that there was a chance that a modified version of the tax cuts could have been extended that would have raised income tax levels only for the highest tax brackets, but the GOP was opposed to that plan, and enough Democrats in Congress were also uneasy about that prospect. Given the makeup of the new Congress, this sort of compromise now seems to be completely off of the table.

At the same time, however, we are hopeful that the Congress and President Obama will not simply let all of the tax cuts expire without any action at all. If the government is unable to come together on this issue, it would be extremely bad news for the economy. The expiration of the tax cuts would act as a de-facto tax increase, which would noticeably increase the probability of the United States experiencing a double-dip recession.

From our vantage point, we think the most likely outcome would be that the government essentially defers on the question, votes to extend nearly all of the tax cuts for a limited amount of time (probably for at least a year) and takes up the harder debate at some point in 2011. There is a real possibility that this decision is made by a lame duck session of the 111th Congress before year-end.

In any case, even if the Bush tax cuts are extended, the government will have to find a way to reduce deficits in the years ahead. This could take many different forms, including increasing some taxes for higher-income Americans, expanding taxes on corporations, raising payroll taxes, raising taxes on foreign-sourced earnings or adjusting the Alternative Minimum Tax, among other options. Additionally, the government will likely have to find ways to reduce spending levels, including entitlement spending reforms. The reality is that Americans should expect at least some tax increases in the years ahead. Such a scenario will likely act as a modest, but not insurmountable, headwind for stocks.

Stock Markets and the Election Cycle

Over the long term, we believe that modest levels of economic growth should be enough to allow corporate earnings to continue to make gains and push markets higher. Valuations appear attractive to us and we expect the prevailing economic environment to be bumpy, but conducive to decent market performance going forward. Nothing that has happened on the political scene has changed any of that.

In addition to the fundamental reasons that we believe equities look attractive, the history of market performance around midterm elections suggests that stocks may be in for a good run over the next year. Although we would caution investors not to make too much of historical trends, the period from right before through many months after a midterm election is historically the strongest time for equities in the 4-year election cycle.

Tax Rates and Municipal Bonds

Peter Hayes, Managing Director, *head of the Municipal Bonds Group within BlackRock Fundamental Fixed Income*

Although potentially higher tax levels are generally viewed as a negative from an investment perspective, we would point out that municipal bonds 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 perform well relative to other areas of the market.

Municipal bonds historically trade at pre-tax yields well below those of Treasuries, but offer the prospect of a higher tax-equivalent yield. For an investor in the 35% tax bracket, for example, a taxable investment would need to pay more than 6% to outpace the return of a tax-exempt bond yielding 4% (on an after-tax basis). As tax rates increase, the benefit of tax exemption would be amplified, allowing investors to keep more of what they earn. This should lead to increased demand for traditional tax-exempt municipal bonds at a time when supply is relatively low, creating a favorable backdrop that could translate into income enhancement and some degree of capital appreciation potential for investors.

J.P. Morgan recently conducted some research into this trend, analyzing the S&P 500 Index in the 2 months prior to a midterm election through the following 6 and 12 months. Their research showed that markets gained an average of 1.4% in the lead-up to the elections and then posted significant gains. Although markets tended to do slightly better when there was no change of control of Congress, the effect was not significant.

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Midterm Election Scenarios (1920 to Present)

	# of Elections	Average S&P 500 Performance		
		2 Months Before Midterm	6 Months After Midterm	12 Months After Midterm
All Midterm Elections	22	1.4%	14.7%	16.7%
No Change in Control in House or Senate	16	2.2%	17.3%	17.1%
Change in Control in House and/or Senate	6	0.3%	10.7%	16.9%

Sources: J.P. Morgan; FactSet. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

These findings are consistent with another historical trend that shows that the third year of a President's term (which, in this case, would be 2011) has been the strongest from an equity markets perspective.

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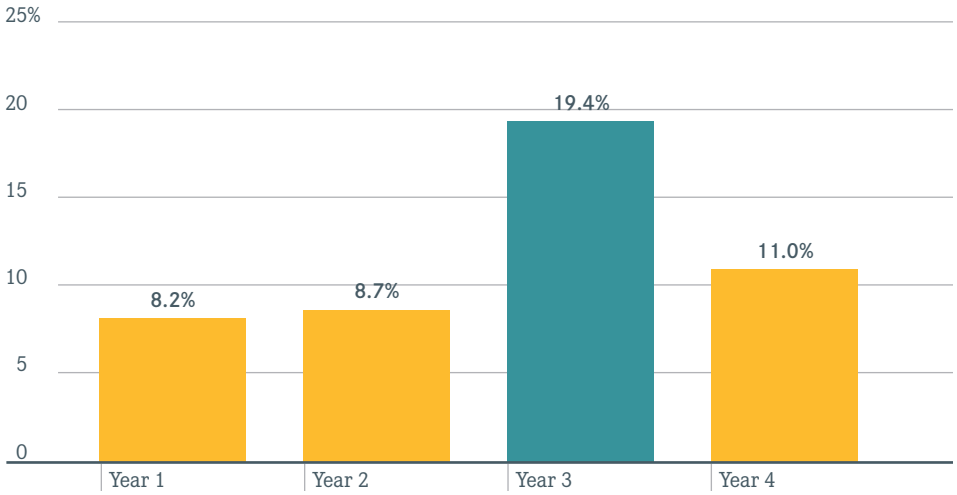
S&P 500 Total Return by Presidential Year (1928 – 2009)



Source: Strategas Research Partners. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

Looking ahead to 2012

It may seem too early to start thinking about the next round of national elections in two years, but the 2012 elections will have an impact on how the next couple of years shape up. Politics seem to have become more contentious in recent years and the election season seems to grow longer and longer, which to us means that there is a limited window of opportunity for the government to enact new legislation and to address both short- and long-term economic problems before the 2012 elections overshadow everything else.

Relative Winners and Losers

One of the more interesting topics about which to speculate is what might happen in terms of legislation that potentially could impact some different sectors of the market. As we noted earlier, there is always at least some uncertainty surrounding what types of legislation might be passed in the prevailing political environment, but following are some thoughts about how some equity sectors might be affected.

Healthcare

- In general, we believe that the election results are a net positive for the healthcare sector and for healthcare services companies in particular. Although it is extremely unlikely that the healthcare reform bill will be completely overturned, some elements of it could be slowed (and possibly amended) by a more Republican-dominated Congress.

Financials

- There is likely more legislation forthcoming regarding financial regulatory reform. A more Democratic-oriented Congress would have pushed harder for additional reform, meaning that financial services companies are likely to benefit on a relative basis with the new Congress.

Manufacturing & Infrastructure

- Within both parties, protectionist trade sentiments are running high. While protectionist policies could benefit traditional manufacturing in the short term, they also act as a net detractor to global economic growth.
- President Obama and congressional Democrats tended to have an increased focus on infrastructure improvements. With their power now diminished, the pending environment is likely to be a modestly more difficult one for infrastructure-related companies.

Energy

- Traditional energy companies are likely to do better with the new Congress. This is particularly true in terms of offshore drilling companies, which should benefit from a friendlier Congress.
- In contrast, alternative energy companies will likely not do quite as well, since there is likely to be a reduced focus on issues such as climate change and global warming.

Education

- The for-profit education sector should benefit from the makeup of the new Congress. Democrats were looking to increase regulatory scrutiny of this sector, which is now less likely to happen.

Defense

- Defense and national security-related companies should benefit with the new Congress. The defense budget is likely to come under pressure no matter who is in Congress, but that pressure will likely be lessened in the 112th Congress than it otherwise would have been.

Retail

- With tax policy likely to be friendlier to higher-income Americans with the new Congress, higher-end retailers should do better, while mass-market retailers will likely see a more difficult environment.

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BlackRock maintains a presence in every major capital market, which provides a unique vantage point from which to identify trends early and capitalize on market opportunities. In addition, the firm's size and scale provide tangible benefits to BlackRock portfolio managers, who are afforded unprecedented access to the management teams of the companies in which they invest.

Ultimately, we believe the combination of BlackRock's scale, global market insight and leading-edge risk management capabilities positions the firm to deliver consistent long-term investment results with fewer surprises.

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