NOW FOR THE HARD PART

Investing After the US Elections

NOVEMBER 2012

BLACKROCK®

After 1 million-plus TV campaign spots, $6 billion in spending and countless volunteer hours, the 2012 US elections delivered the same divided government — faced with the same burning issues.

Topping re-elected President Barack Obama's to-do list is striking a deal on the nation's budget — a goal that so far has proved elusive. The hard work has not even started, and markets have yet to factor this in. Our main conclusions immediately after the elections:

- Neither party has a clear mandate after the elections. This likely means slow and tortured progress toward avoiding the imminent "fiscal cliff" of automatic tax hikes and spending cuts and putting the country on a sustainable budget track. Another debt downgrade could result.
- What is next? It is a toss-up between two of our three fiscal cliff scenarios: the sky dive off the cliff or the last-minute hard stop. We see a high likelihood of "cliff anxiety" in coming months. Expect market volatility to increase from the current eerily low levels. A swift and clear solution would be a big plus for risk assets.
- Even under a best-case scenario, however, the US economy is likely to run into trouble next year. A probable hike in payroll taxes and lapse of extended unemployment benefits alone would slice the current 2% gross domestic product (GDP) growth in half. This could cool appetite for US assets from global investors already suffering a mild case of cliff jitters.
- Powered by shale oil and gas, the United States could become the biggest G7 growth story — if politicians cross the aisle and compromise. We would love to see a sudden outbreak of statesmanship.

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SO WHAT DO I DO WITH MY MONEY?™

Play Defense

Market volatility has been eerily low in a very uncertain world. Consider out-of-the-money options to hedge against temporary risk asset sell-offs or to participate in relief rallies.

Low for Long

The US Federal Reserve is likely to keep rates low for a long time. This is whetting investor appetite for yield, and bodes well for corporate credit and tax-exempt municipal bonds. Gold and most commodities look good.

Beware Bonds

Focus on income rather than capital appreciation in higher-yielding fixed income. Watch out for the moment when inflation or economic growth pushes up rates. Some bonds have tiny yield "safety cushions" to make up for price declines. One strategy is to be relentlessly neutral: Buy undervalued assets and sell similar, but pricier, ones.

Go Global

Ultra-loose monetary policies have propped up US stocks, but the rally is getting long in the tooth. Consider emerging markets and selected (discounted) European stocks.

Election Dividend

Cash-flow-rich companies that pay *and* increase dividends remain among our top global stock picks — even with a US dividend tax hike. US payout ratios are at record lows and investors are desperate for income.

Selective in Sectors

We like energy, especially oil producers and infrastructure, and see divided government lessening the risk of onerous regulation. Most healthcare stocks should do well, especially after a deficit reduction deal. Financials will struggle with low rates and lots of rules, but we favor mortgage lenders due to the nascent US housing recovery.

Careening Toward the Cliff

The fiscal cliff is near and it is real. What can we expect in the remaining, holiday-shortened weeks of 2012?

Two scenarios remain from the three possibilities we outlined in *US Election Cliffhangers* in October 2012: the sky dive and the hard stop. This may be the real deal breaker — and it is a toss-up at this point.

The sky dive would see the nation go off the cliff, giving lawmakers political cover to compromise and reach a skeleton deal sometime in January. The hard stop would entail a Band-Aid agreement before the fiscal cliff measures take effect Jan. 1. (Our third scenario, the bungee jump, disappeared along with Republican hopes for a landslide victory.)

Boosting the odds of the hard stop is the drumbeat of CEOs and others calling for compromise to avoid a new recession. Washington may actually listen. In addition, the need to raise the statutory debt limit and fix a tax provision that would have millions of households pay the Alternative Minimum Tax (AMT) may give politicians the "air cover" to strike a deal.

The risk is, however, that both parties dig in and choose to plunge off the cliff. Democrats can point to the presidential victory to force higher taxes for the wealthy. Republicans can validate their stance for spending cuts and no tax hikes by emphasizing their solid control of the House.

The sky dive theoretically makes it easier to compromise on the key taxation issue. Once the tax hikes go into effect on Jan. 1, Washington can cut taxes for everybody! But the paralyzing effect of forced spending cuts and likely market gyrations make the sky dive a risky gambit for both parties.

Safe Harbor No More

Whatever happens, the US economy is likely to lose steam. For example, we fully expect a return to higher payroll taxes and an end to extended unemployment benefits. These two measures alone are estimated to cut economic growth by 1% next year. See the table below.

The US Federal Reserve stands ready to come to the rescue — and the election result will likely mean the Fed maintains its ultra-loose monetary policy stance. Record-low rates and trillions of dollars in monetary stimulus by the Fed and other central banks, however, have failed to spur much credit growth and economic activity.

Faltering US economic momentum may give global investors second thoughts about holding US assets. Equities, in particular, are vulnerable. They have outperformed other markets this year, and now are much richer than global stocks on key measures such as price-to-book ratios.

The country's status as a safe harbor may be wrecked by another round of wrangling on raising the statutory debt limit. Gross US debt is expected to hit the $16.4 trillion limit in the first quarter — and extra spending to help victims of Superstorm Sandy could speed the ascent to the ceiling.

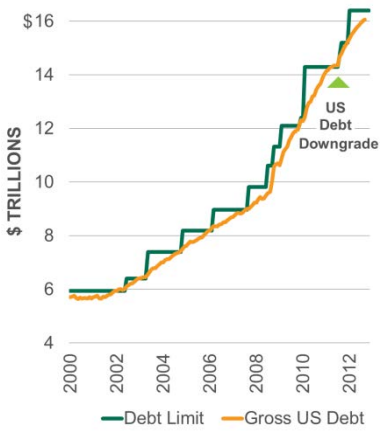
Ratings agencies may well downgrade US debt for a second time should 2011-esque drama ensue around the debt ceiling — and absent any moves to address long-term fiscal deficits. They have specifically tied potential downgrades to progress on deficit reduction.

This time, a downgrade may be more than a reputational slap, as many funds are prohibited from holding single-A assets.

CLIFFHANGERS AHOY!

Fiscal Cliff Components and Debt Ceiling History

	CLIFF EVENT	CLIFF DETAILS	GDP IMPACT
TAX POLICY	2001/2003 tax cuts expire	▸ Marginal tax rates increase; top rate rises to 39.6%, from 35% ▸ Estate taxes return to a 55% top rate with a $1 million exemption ▸ Long-term capital gains taxes increase to 20%, from 15% ▸ Dividends taxed as ordinary income, from 15% ▸ Alternative Minimum Tax no longer indexed to inflation ▸ Education, retirement and low-income tax benefits expire	1.9%
TAX POLICY	Payroll taxes	Employee payroll taxes return to 6.2%, from 4.2%	0.8%
TAX POLICY	Other tax benefits	Research and experimentation tax credits disappear	0.5%
TAX POLICY	Affordable Care Act	New taxes on high incomes for new healthcare legislation	0.2%
SPENDING CUTS	Mandatory budget cuts (sequestration)	Defense spending cut by 10%; other spending by 8% $1.2 trillion in spending cuts over 10 years	0.5%
SPENDING CUTS	Unemployment	Reduces period people can collect unemployment insurance	0.2%
SPENDING CUTS	Medicare payments	Medicare rates for doctors cut by nearly 30%	0.1%
	Other	*Congressional Budget Office estimates not linked to policies*	0.9%
	TOTAL		**5.1%**



Sources: Credit Suisse, Congressional Budget Office, Office of Management and Budget, Thomson Reuters, US Treasury and BlackRock.
Notes: Estimated impact in calendar year 2013.

"Do Nothing" Is Not an Option

Cheap shale oil and gas could re-industrialize the United States and make its economy the envy of the world, as we detailed in *US Shale Boom: A Case of Temporary Indigestion* in July 2012. But this potential game changer becomes real only if Washington rediscovers the art of compromise.

"Do nothing" does *not* maintain the status quo. It involves serious tax hikes. A full fall off the cliff is just too ugly to contemplate, with a total GDP drag of as much as 5%.

Doing nothing about annual budget deficits exceeding $1 trillion is not an option either. The United States (and many other developed countries) have created piles of debt that will likely brake growth for decades. We need to see the outline of a comprehensive budget deal to turn things around. It is a long, painful road of tax hikes and benefits cuts.

Once gross debt reaches 90% of GDP for at least five years, it starts to dampen economic growth, restrict policy choices, drive up costs for all borrowers and leave a nation at the mercy of (foreign) creditors.

The triumvirate of US entitlements — Social Security, Medicare and Medicaid — currently eats up two-thirds of the government's revenues. Our view: This is not sustainable.

Death and Taxes

At the same time, US tax revenues are comparatively low, ranking at the bottom of developed economies at around a quarter of GDP. See the table on the right. The ugly truth: Taxes will need to go up to put the country on a sustainable budget track.

Benjamin Franklin was right when he wrote: "Nothing can be said to be certain, except death and taxes." These days, we are not so sure. The US tax code is not just complicated (some 72,000 pages with 173 tax credits and deductions), it also changes all the time with more than 100 temporary provisions. This causes a permanent state of uncertainty.

This needs a fix. Every tax exemption has fervent supporters, however. We believe comprehensive tax reform is destined to land in the "too difficult" box in 2013 — making it tough for businesses to invest with confidence.

This is bad news for a sound long-term budget, but good for municipal bond investors. Any real fiddling with munis' tax-exempt status is unlikely at a time when state budgets need all the help they can get. We believe the market could easily stomach a possible 28% cap on tax exemption if it applies to newly issued bonds only (and is not whittled down further).

Similarly, we could see most dividend stocks stomach dividend taxes rising to perhaps 20% to 25%. US companies have tended to make investors whole by upping the payouts when taxes rise, according to Goldman Sachs research. Sitting on record-high cash piles, they can afford it.

TAXING DIFFERENCES

Tax Revenues, GDP Growth and Debt of Top 25 OECD Countries

Country	Tax Revenue to GDP (2010)	Change From 2000 (Percentage Points)	Annual Real GDP Growth (2000-2010)	Gross Debt to GDP (2011)
Denmark	48%	-2	0.9%	44%
Sweden	46%	-6	2.4%	38%
Belgium	44%	-1	1.6%	98%
Italy	43%	1	0.7%	120%
Norway	43%	0	1.7%	50%
France	43%	-2	1.4%	86%
Finland	42%	-5	2.1%	49%
Austria	42%	-1	1.7%	72%
Netherlands	39%	-1	1.6%	65%
Germany	36%	-1	1.2%	81%
UK	35%	-2	2%	82%
Israel	32%	-4	3.8%	74%
Spain	32%	-2	2.3%	69%
Poland	32%	-1	3.9%	56%
Portugal	31%	0	0.9%	108%
Canada	31%	-5	2.2%	85%
Greece	31%	-3	2.2%	165%
Switzerland	28%	-1	1.9%	47%
Japan	28%	1	0.9%	230%
Turkey	26%	2	4.3%	39%
Australia	26%	-5	3.1%	24%
South Korea	25%	2	4.6%	34%
US	**25%**	**-5**	**1.8%**	**103%**
Chile	20%	1	4.2%	11%
Mexico	19%	2	2.1%	44%

Sources: OECD, IMF and Thomson Reuters.
Note: Tax revenue includes taxes on income, profits, payroll, property, goods and services, and social security.

New Cast of Characters

The status quo election result does not mean nothing will change in Washington. Get ready for a new cast of characters, from top government posts to chiefs of key regulatory bodies and Congressional committees. Everybody and everything will likely be in a holding pattern for the next six months.

Massive financial reforms will grind on — and we have only seen the tip of the iceberg. Of the roughly 400 rules in the Dodd-Frank Act (Wall Street reform), just one-third has been finalized. Until the dust settles, most US financial stocks will remain under a cloud.

Housing reform is also likely to get a push. We do not expect our prescription for a healthy housing market to be adopted in full, but would cheer clear rules, as described in *In the Home Stretch? The US Housing Market Recovery* in June 2012.

Insurance Sale!

We see a high likelihood of "cliff anxiety" in coming months. Expect market volatility to increase from its current eerily low levels. Other uncertainties abound: Europe's debt crisis, China under new management and Iran's nuclear program. And those are just the ones we know about.

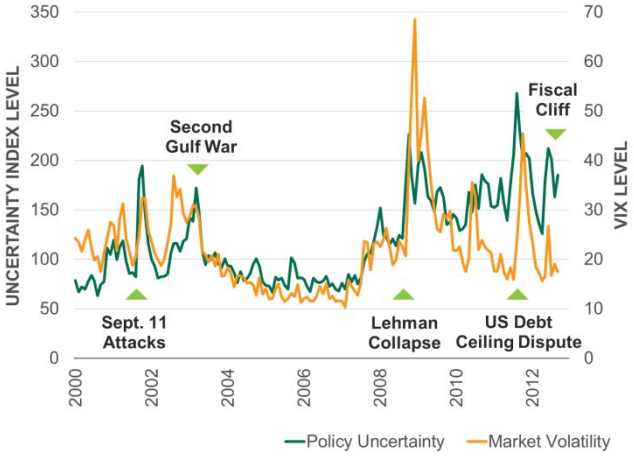
We flagged the disconnect between markets' belief in an 11th-hour rescue and the belief of Washington insiders that political dysfunction would push the nation off the fiscal cliff before. Even now, none of more than 80 economists polled by Bloomberg forecasts a GDP contraction in the first half.

As the cliff nears, more investors are starting to see the harsh reality. Policymakers in Washington and elsewhere typically only act when their hands are forced. And their threshold for market pain is much higher than that of the average investor.

Volatility has been very low while policy uncertainty has been very high. See the chart on the right. Bottom line: It is not too late to insure against market gyrations in the next couple of months — at pretty competitive rates.

IT'S TOO QUIET OUT THERE

Policy Uncertainty and Market Volatility, 2000-2012



Sources: www.policyuncertainty.com and Thomson Reuters.
Notes: Volatility measured by the Chicago Board Options Exchange's VIX index. The Policy Uncertainty Index uses newspaper coverage of policy-related economic uncertainty, the number of federal tax code provisions set to expire and disagreement among economic forecasters.

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