

Greg Valliere Monthly Commentary

Update as of December 17, 2013



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GREG VALLIERE: Well, hello, everybody. It's Greg Valliere at the Potomac Research Group, recording with a slight head cold on December 17th, so please excuse my voice. But there are several things I wanted to talk about, as this very interesting year comes to a close.

I think, first and foremost, it's really useful to contrast what was going on a year ago right now as compared to what we have here in 2013. First and foremost, I think there was a great deal of uncertainty and market confusion about Washington, with a fiscal cliff looming, with the headwinds of higher taxes and the sequester also looming 12 months ago. Here we are now with a very, very different scenario.

We have, of course, as you know a budget deal that pretty much takes the budget off of the front burner until October of 2015. So we have over a year-and-a-half of relative calm on the budget front, with one exception that I'll get to in a second. But I think that is a big plus. I think it's also a plus that there's not the headwind of higher taxes that we saw a year ago. So while it's probably a bit much to extrapolate this one budget deal and say things are much better in Washington, that we're all singing Kumbaya -- it is a step forward. And I think it does allow taxpayers, and businesses and the markets some degree of certainty going forward for the next year-and-a-half. And I'm in a very large camp that believes the economy in 2014 is going to be surprisingly strong, maybe growing by more than 3%.

We also had, of course, a year ago, the Fed continuing to pump liquidity into the economy, continuing to buy treasuries and mortgage-backed securities. And now we're at a situation as I record this, where the Fed is getting very close to the beginnings of some tapering. We don't know as I record this whether it started this week or whether the Fed will wait until later in the winter, but it's clearly coming. And the point I would make there comes from our consultant and my good friend, Don Kohn, the former Fed Vice Chairman, who has made it quite clear that the Fed is really anxious to focus on forward guidance for the fed funds rate, letting the markets know, in my opinion, that we still probably have a couple of years to go before the federal funds rate gets increased.

I think as part of this scenario the Fed will make it obvious that tapering is not the same thing as tightening, that they will take a very long time, and pretty much look at the inflation rate more than anything else. I think that's a key, and a key departure from previous Fed strategy that they would look at this very, very low inflation rate as a reason for waiting for, again, maybe two years

before they raise rates. So I think that's another positive development as the year comes to a close.

I think that in looking at other stories the one thing that you have to be a bit concerned about going into 2014 is the fact that we'll have another fight over the debt ceiling. I don't think that it will revive any fears of a default crisis, nothing, certainly, along those lines. I think the Republicans have pretty much learned that this type of brinksmanship like we saw in October backfires. It hurt their brand, and the Republican leaders that we've talked to over the last several weeks are determined not to have another showdown like the one we had in October on the debt ceiling. That said, I think they do have a laundry list of things they would like to extract from the White House in order to get the debt ceiling raised. And I'm sure when this occurs—this fight probably will be in March, maybe April, since the Treasury numbers look so good—I'm sure at that point there will be some jockeying, there might be a little bit more fiscal restraint put in place.

A quick word on fiscal restraint, I think there's a misconception that the sequester has been killed. It's been modified a bit. The impact of sequester in this upcoming year won't be quite as strong as it would have been. It's being offset by largely higher user fees. But sequester is still very much alive, and I think that it will continue to be a trump card by this very conservative house that will seek more fiscal restraint down the road. I do also think that as we get new deficit estimates in the next several weeks, it will become increasingly apparent to everyone that the budget deficit is truly in free-fall. The progress there is remarkable, and I think that will persist for at least two or three more years before anyone in the markets has to worry about deficits heading higher again or dramatic new spending. That just isn't in the cards, as the House, in all likelihood, stays Republican.

So I'll close as I mention the 2014 election with a couple of comments on politics. First, I would say that the chances now look extremely remote that the House would go back to the Democrats. It's been a rough stretch for this president with Obamacare largely being a self-inflicted wound for the White House. And I think, therefore, the chances that the Democrats could get 17 seats, which is the magic number to take the House, those chances now are pretty much zero. I think, actually, the Republicans could gain a seat or two. It's going to be tough for the Democrats because of the way the districts are drawn, some might say gerrymandered, and also, of course, because of the deep antipathy toward Obamacare. If the economy really does pick up next year, I think that would be an offsetting factor and could keep the Democrats' losses in the House to a minimum.

In the Senate, it still looks to me as if the Democrats will maintain control, but it's still a very, very close call. The magic number there is six, and my guess is the Republicans have a real good chance of picking up a net of three or four, maybe even five. So it's a close call, and I have to conclude that one way or another, the Senate will be more conservative after the 2014 election than it is now.

So the mood of fiscal restraint, I think, will persist. I don't see a lot of big surprises, though. I don't see any radical new tax changes. I think they're going to go slow on issues like immigration reform. We'll get into the laundry list of issues on next month's call, but I think the main theme here is that the really radical brinksmanship that unnerved the markets throughout much of 2013 is pretty much done. I think neither party wants to return to that level of bitterness and acrimony, and I have to conclude that's a pretty good story.

So that's it for today and this year. I would like to just thank all of you for your support and friendship. It really has been very gratifying. And I'll look forward to seeing you and working with a lot of you again next year. So long, and happy holidays.

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