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Greg Valliere Monthly Commentary

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Greg Valliere
Chief Political Strategist
Potomac Research Group

GREG VALLIERE: Well, hello, everybody. It's Greg Valliere at the Potomac Research Group, recording on March 25th, about to talk about three really significant stories that have grabbed the attention here in Washington and increasingly in the markets. So I'm going to talk a bit about the growing chances that the Republicans will do very well in this fall's elections, secondly, a couple of thoughts on comments by Janet Yellen, who spoke a few days ago about the timing of the first Fed rate hike, and third, a comment or two on Vladimir Putin's move into Crimea.

But let me start with a story that really has this entire city buzzing, and that is the likelihood that the Republicans will do extremely well in this fall's elections. There were shockwaves in this city after the special election in Tampa, Florida a few days ago that saw the Democrat, who was very well funded and very well known, get defeated by an unknown Republican who was a lobbyist, no less, here in Washington.

The Republican made the entire election a referendum on Obamacare. And the fact that the Republican won really got the attention of Democrats, who will tell you in private that they now feel the House is virtually lost. The magic number for the Democrats to take the House this fall is 17, and I'm beginning to think there's a good chance that the Republicans will *add* seats to their House majority, based on Obamacare and based on the way the districts are drawn.

The other big political story that has everyone buzzing is the growing likelihood that the Republicans are now within shouting distance of taking the Senate. The magic number there is six. There are 11 seats held by Democrats that look vulnerable, and of that 11, I'd say at least five or six look really vulnerable, while I don't see any Republican seats that seem likely to fall. They have some vulnerability in Kentucky, but I think Mitch McConnell will win that race. And, there might be some vulnerability in Georgia, although that's a pretty conservative state, and I think the Republicans will keep that seat.

So the bottom line to me is that the Republicans will gain strength in both houses, and that, of course, means that this move toward fiscal restraint, which has been a really big story in the last couple of years, I think will continue for at least another two or three years.

Is there anything that could save the Democrats? Could something change this scenario? And I would say, yes, there's one thing the Democrats have to hope for. It's not a turnaround in public attitudes on Obamacare. I think that's too late. I think public attitudes are pretty much in stone that Obamacare has been a debacle.

The one thing the Democrats could hope for is that by late summer we see an economy that's growing by 3-1/2, maybe even 4 percent, that we see interest rates still quite low, that we see the budget deficit continuing to fall, and we see the unemployment rate getting close to 6%. You can't rule that out. I think it's probably a stretch, but if we saw by late summer the economy clearly turning around, I think it would lessen the Democrats' losses. I do think the House is pretty much beyond their reach, but they could keep their Senate losses to something more manageable, like three or four seats, if the economy is clearly coming back. But barring that, I do think increasingly this looks like a very nasty election for the Democrats, and Obamacare is the major reason why.

The second big story that everyone in this town is talking about involves comments that Janet Yellen made a few days ago at her first press conference. As many of you know, I'm a big fan of hers, and I think she will be a very good Fed Chairman, but I do think she made a rookie mistake. I think she was a little too flippant, a little too indiscrete when she said that once the Fed tapering is over, which we all assume will be late fall, that the Fed could begin raising interest rates within six months. Well, that certainly got the markets' attention, and I think that she probably regrets being that explicit. I think she probably would have preferred to say, 'You know, we'll begin thinking about a rate hike in 6- or 8- or 10 months after we end the tapering,' because I do feel that she, deep down in, is extremely dovish, and I think it would take a while for her to conclude that a rate hike is necessary once the tapering is over.

I think overlooked in the last couple of weeks is the Fed's declaration that even once they do begin raising rates, once the economy clearly can survive without training wheels, that the Fed will keep rates lower than they ordinarily would. They had words to that effect that to me indicated the beginning of a rate increase pattern would be really slow, and that they would move in very tiny increments, certainly not doing anything to unnerve the markets. And as my dear friend, Liz Ann Sonders, has commented, the stock market could flourish with rates going up 100- 150 basis points (or more).

There certainly is ample historical evidence to show that the stock market does quite well as interest rates rise. We'd have to see a really dramatic increase in rates, which nobody at the Fed anticipates, before the stock market, I think, begin to view this with alarm. Because the bottom line here is that the Fed would be raising rates because the economy is getting better and can stand a climate of rates going up, not because there's a great fear of inflation. I think the inflation threat will remain pretty subdued for the next couple of years.

So I'll give Janet Yellen one. She made a little mistake, but I think we still have a long way to go before this Fed changes from its extremely dovish policies.

The third big story in this town and the big story in the world, of course, is what Vladimir Putin did in Crimea. I would argue that he miscalculated. He is now stuck in a region that is an economic basket case, a failed welfare state that the Russian government is going to have to pump billions and billions of dollars in. And, in the meantime, Putin has lost the prize, the prize being Ukraine and Kiev.

I think there's very little chance that he would move into Eastern Ukraine, and I don't think that's because of the threat of sanctions. So far the US sanctions have been pretty wimpy. Other global entities will step up the sanctions, freezing the Russians out of the G7, for example. But I think what really will preclude Putin from moving into Eastern Ukraine is the threat of a really ugly market verdict. It's worth noting that when he first went into Crimea, the Russian stock market fell by 11% in one day. The ruble had a precipitous collapse, and the Russians had to raise interest rates to protect the ruble against an inflationary run.

So I think Putin is not stupid, and he knows that leaders have been brought down probably more than any other reason by collapsing economies. And I think Putin knows that if he did something as brazen as move into Eastern Ukraine, the market reaction would be swift and it would be very negative for his overall economy.

In the meantime, I don't see a total rupture in relations between the US and the Russians. I think there are just too many projects that both countries are involved in that can't totally be abandoned. One, of course, would be the disposal of chemical arms in Syria. Another one, even more important, would be the talks with Iran on Iran's nuclear development. These talks are now entering a very sensitive stage, with a deadline in mid-summer, and I think the Russians still could play a reasonably constructive role in that, as well.

So I don't see a rupture. I don't see Putin going into Eastern Ukraine. Yes, he has annexed Crimea and that's gone, but I would argue that Crimea could become an albatross for him financially over the next few years, as Georgia has become an albatross for Moscow, as well.

So those are three big themes. I would just conclude by saying that for investors I still think the outlook in my city is pretty good -- with an improving economy, a dovish Fed, a continued sharp drop in the budget deficit, and increasingly, an election outlook that most people in the markets would probably welcome.

So that's it for this month. I look forward to talking to you again soon. So long.

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