

Greg Valliere Monthly Commentary

Update as of July 8, 2014



Greg Valliere
Chief Political Strategist
Potomac Research Group

GREG VALLIERE: Well, hello, everybody. It's Greg Valliere at the Potomac Research Group, recording on July 8th.

Happy Fourth! I hope you're all having a great summer. And I thought what I would do in this month's call is talk about some of the issues that may loom in the second half of the year. As most of you know I have been unabashedly bullish, even about Washington developments for the past year or so, yet as we enter the second half, I see a few potential potholes, nothing serious, but still some things that I think as investors we all have to be concerned about.

I'd say at the outset that the big overriding story clearly is that this economy is accelerating, and potentially accelerating dramatically, with improvement clearly in the labor market, improvement just about everywhere you look—housing, maybe even business fixed investment—a very positive story for economic growth. But at the same time, there are three things I want to talk about that I think we have to be cognizant of.

The first is I think that the legislative outlook in Washington is not quite as peaceful as it was in the first half. As we all recall, the Republicans decided, I think, wisely, that they would not have a fight over the debt ceiling, so we didn't have to worry about a default crisis. They didn't want to shut down the government. We got a budget deal between Paul Ryan and Patty Murray. We got a farm bill. We've had signs that Congress was embarrassed by their job approval rating -- which has fallen below 10%. Yet as we begin the second half of the year some more crises potentially loom as the dysfunction between the two parties persists.

First of all, I think there's going to be a real threat of highway funding being cut off by early August, as Congress grapples with how to pay for the Highway Trust Fund. It looks as if there will be a patch of three- or four months, maybe lasting through the election—what a surprise—but there's still going to be an issue of highway funding, and in some states, already, there's been a curtailment of highway projects. Secondly, I think that business groups are going to be very concerned right up until October 1, over the Ex-Im Bank, the Export-Import Bank. Some conservatives in the House want to kill it, feeling it is an unfair subsidy, that it is another example of Washington picking winners and losers. This is all part of the story of both parties, the left and the right, beginning to really lash out against crony capitalism. So that's going to be an issue.

The biggest issue though, is on the budget. And even though we did get that deal between Paul Ryan and Patty Murray, there's still disagreement on specific funding levels for the 12 appropriation bills, and there's a chance that there will be talk in late September about a government shutdown. I think the chances of that happening are quite slim, but the chances of people getting worried about it will be increasing as we go well into September before this is finally resolved.

And then you have the big threat, a looming threat, later in the winter over the debt ceiling, which expires at the end of March. Many of the new Republican leaders who were elected after the shocking defeat of Eric Cantor have vowed that they will not again capitulate, that they will insist on something from the White House, some concession, in order for them to vote for an extension of the debt ceiling.

So it's not quite as dysfunctional as it looked in October of last year, but I think some of the peace that we saw in the first half is beginning to break down.

A second story that concerns me a bit involves the Federal Reserve. Obviously, they're going to end their asset purchases this fall, and obviously they now have to begin a serious consideration of when they have the first rate hike. This could be a messy process, with a cacophony of Fed comments in the press, with some hawkish governors saying they want a rate hike by the winter, with some dovish governors thinking that we can wait until roughly a year from now. I think the specter of this being debated in public and with people pouring over the FOMC minutes has the potential to unnerve the markets, with the Fed obviously having to confront the issue of a rate hike, but doing it in a public way that could be confusing for the financial markets.

After the last unemployment report, which we got about a week ago, I think you have to conclude that the timetable for a Fed rate hike has been pushed up a bit. It's still in my opinion not going to come until late in the first half, but a lot of us thought it might not come until the second half, until we've started to see the clear signs of improvement in the labor market. I would agree with my dear friend, Liz Ann Sonders that a 25 basis point hike in the funds rate is not going to be deadly for the stock market. A hike in the funds rate is simply an indication that the economy is healing and doesn't need training wheels anymore. It certainly is not indicative of any big inflation threat that's imminent. But at the same time, I think all of this rhetoric, this incessant speculation, especially in the media, may be a bit unnerving.

The third story in the second half that you have to be concerned about is geo-politics. You've got to conclude that this horrible story unfolding in Iraq, a civil war, a sectarian civil war between Sunnis and Shiites has no clear end game. I think that Bagdad will be safe. I don't think Bagdad will fall, but there are big parts of that country now under the control of fanatic Sunni terrorists, this ISIS, that I think will use this territory as a training ground for terrorism that will be exported to the West. It's something that US intelligence officials are very concerned about. They have nothing but contempt for Maliki, who never tried to have an inclusive government in Iraq, and I think this may drag on for quite some time with a vacuum. That vacuum is that the US does not want to get involved in a major way. I think the White House correctly is reading public opinion in the US which is increasingly isolationist. And with that vacuum, I think, comes Iran to fill the gap, to play a bigger role in trying to defend the interests of the Shiites. This is a story that could drag on for months and months and months, keeping upward pressure on the price of oil, and increasing the threat of terrorism around the world.

So those are three stories that I think don't look as good as they did in the first half—more legislative uncertainty, perhaps confusing rhetoric coming out of the Fed, and of course geo-politics. That doesn't

mean this is going to be a negative second half. Again, I think the economy is poised to grow quite nicely. But it is a concern, a bigger concern than I had six months ago.

Final point, very quickly that I would make, of course, involves the fall election. With each of these monthly calls, I will do a quick update. No change in my outlook for the House. That will stay Republican. I think the Republicans have a chance to actually gain a handful of seats in the House. The Senate is still a very close call, where six seats, a gain of six, would give the Republicans control. They're close. I could point to 10 or 11 seats held by Democrats that look very shaky, half of which look really vulnerable. And I still think the Republicans have a chance to keep all of their seats, including Mitch McConnell's in Kentucky.

If there is a key variable, there are two: Number one, could signs of an improving economy turn the tide? Could it make the Democrats' chances a little bit better? Maybe, but I think we need a lot more numbers like that jobs number we got right before the Fourth of July. I think there would have to be two, or three, or four more great, great numbers before most Americans would conclude that the economy has really turned around. And, secondly, could there be slightly higher turnout among women who did not like the Supreme Court rulings—and many women didn't like the Supreme Court rulings—and of course Hispanics, who see in the Republicans a party that's now talking openly about mass deportations, a party that has no interest in immigration reform. If female and Hispanic turnout is just a little bit higher, it could make the difference in two or three Senate races, maybe the one in Colorado, for example. So those are still two variables that make me think it's not a slam-dunk that the Republicans take control of the Senate, but I'd have to say right now, they're the slight favorites to get those net six seats to take control of the Senate.

So that's it for now. I hope you enjoy the rest of the summer, and I'll be back in early August with another update on what's happening in Washington. Talk to you soon. Bye.

This commentary occurs monthly. The information provided through the Greg Valliere commentary is for general informational purposes only and represents the views of the speaker, but may not represent the views of Schwab, its affiliates, or any of their employees or officers. Nothing in this commentary should be considered as a solicitation or a recommendation by Schwab to buy, sell or continue to hold securities or other investments, or open an account. The information in the presentation is from what is considered a reliable source; however Schwab does not guarantee the accuracy, completeness or reliability of the information. Some of the statements in this presentation may be forward looking and contain uncertainties. There can be no guarantee of future performance. Changes in economic or market conditions as well as other factors may affect the relevance of the views and opinions expressed.

This material is for institutional investor use only. This material may not be forwarded or made available, in part or in whole, to any party that is not an institutional investor.
(0714-4654)