

Government – Buy, Sell, or Hold?

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Grant's Spring 2010 Conference
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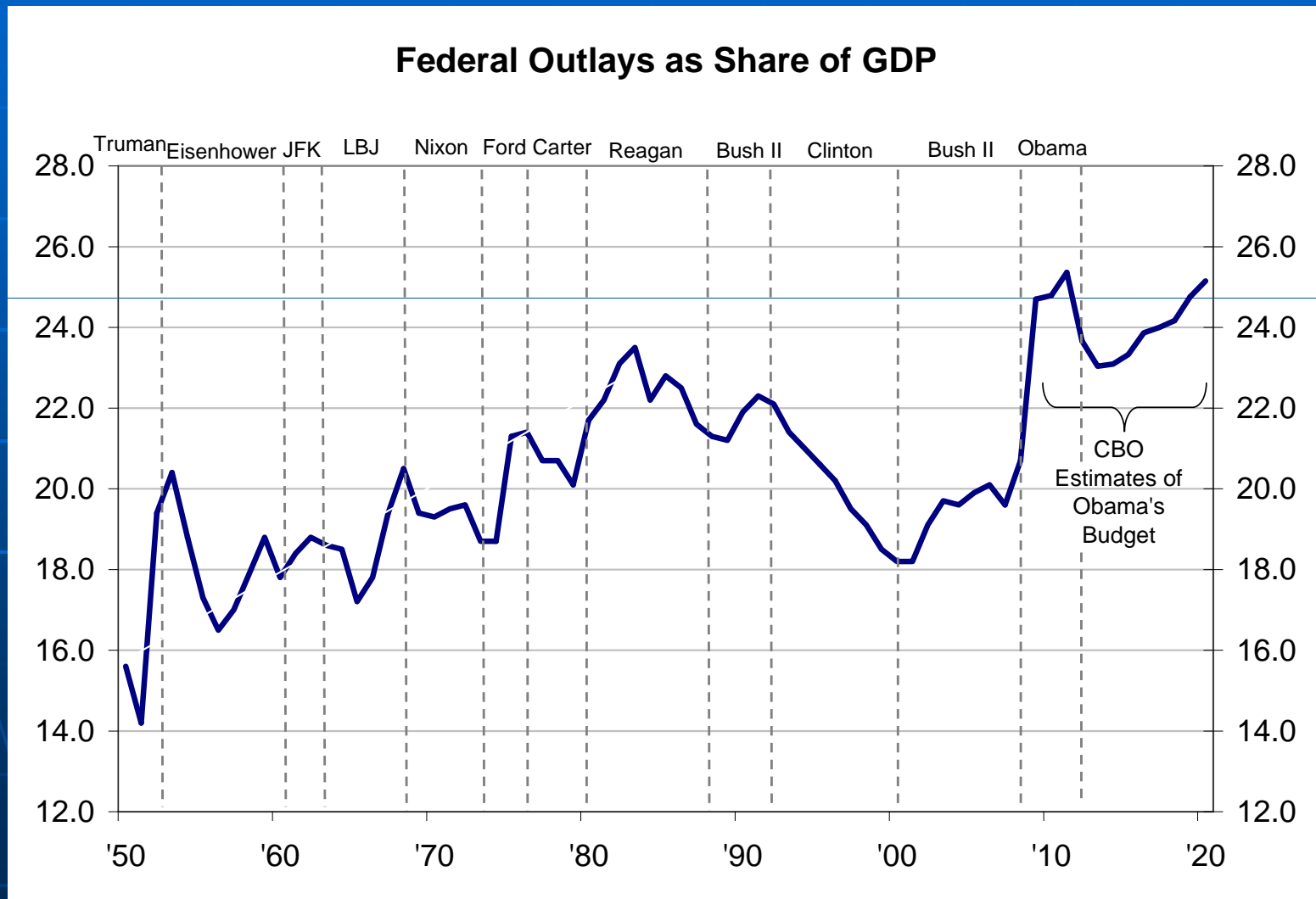
Overview

- 1. '08 was the reverse of '80 – Obama's election is to activist govt what Reagan's was to limited govt.**
- 2. The trend toward activist govt will go through a correction, not a reversal.**
- 3. Investment implications.**

I. '08 Was the Reverse of '80

- No stable equilibrium, but long swings in the role of govt in the economy.
- Reagan's election in '80 gave identity and momentum to the drive toward limited government.
- Obama's election in '08 will give momentum to the drive toward a more activist government.

I. '08 Was the Reverse of '80



Sources: Economic Report of the President, CBO.

I. '08 Was the Reverse of '80

■ Partisan angle

- Each swing actually started under the “opposite” party.
- Swings don't dictate outcomes but create a home-field advantage.
- Clinton and Ike as parallels.

I. '08 Was the Reverse of '80

- **Monetary policy angle**
 - **Swings in government's role have been associated with swings in inflation.**
 - **Volcker's anti-inflationary monetary policy was a parallel to Reagan's small govt agenda.**
 - **The expansion of the Fed's balance sheet in the last 2 years is a good parallel to the activist govt agenda.**

I. '08 Was the Reverse of '80

- Initial successes produce momentum, but then excesses (inflation with bigger govt, bubbles with smaller) and unmet needs develop.
- Tied to the tradeoff between individual security and macroeconomic instability.

I. '08 Was the Reverse of '80

Exit Polls on the Role of Govt

| Govt should do... | <u>2000</u> | <u>2004</u> | <u>2008</u> |
|--------------------------|--------------------|--------------------|--------------------|
| More | 43 | 46 | 51 |
| Less | 53 | 49 | 43 |

Source: CNN.

I. '08 Was the Reverse of '80

"Government is not the solution to our problem; government is the problem."

Reagan, Jan 1981

"Only the government can break the vicious cycles that are crippling our economy."

Obama, Jan 2009

II. Big Govt – Correction Or Reversal?

- **But the big govt agenda is running into difficulties**
 - **Obama's approval is down.**
 - **Nov '09 gubernatorial elections.**
 - **Massachusetts Senate election.**
 - **Mid-term range looks between bad (big losses) and worse (lose majorities).**

II. Big Govt – Correction Or Reversal?

| | All Adults | | Party Identification | | |
|-----------------------------------|------------|---------|----------------------|------------|--------------|
| | Feb '09 | Sep '09 | Sep '09 | | |
| | | | <u>Dem</u> | <u>GOP</u> | <u>Indep</u> |
| A) Gov't should do more | 51 | 45 | 72 | 16 | 35 |
| B) Gov't is doing too many things | 40 | 49 | 20 | 82 | 56 |

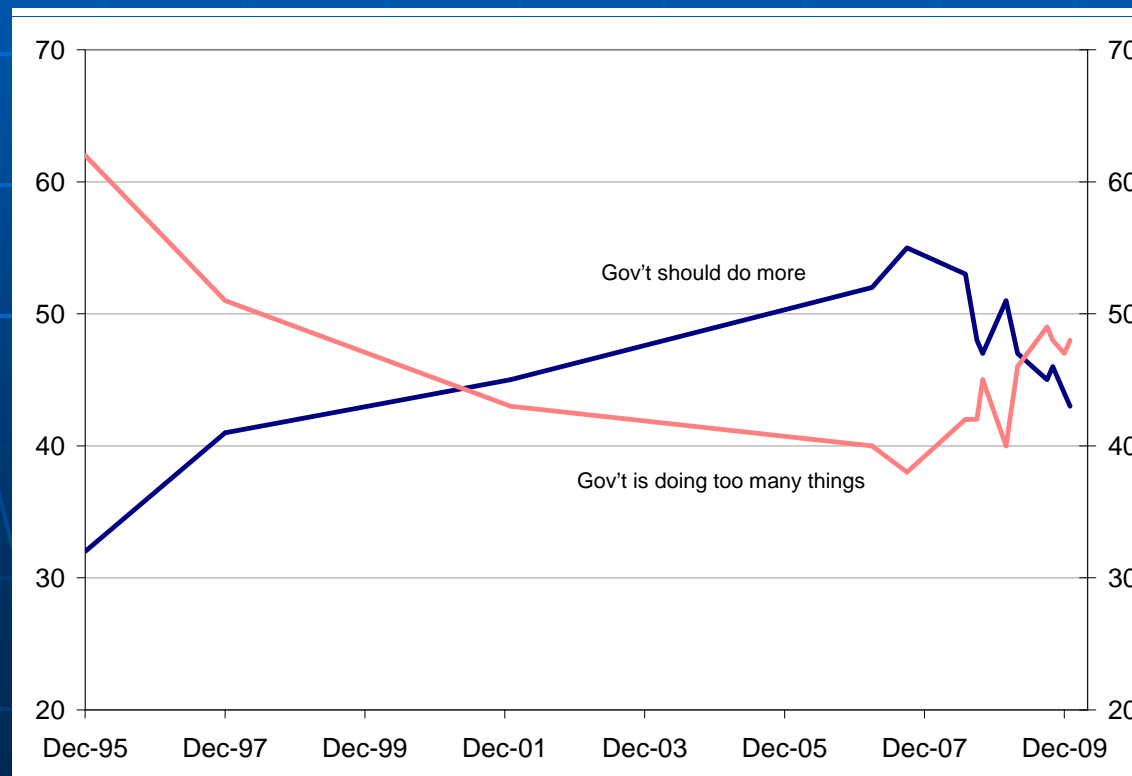
II. Big Govt – Correction Or Reversal?

- **Both had initial success on budget and taxes but ran into trouble deeper in their agendas (Soc Sec for Reagan, health care for Obama).**
- **Both were initially aided by severe recessions but then were dragged down by them (Reagan's approval bottomed at 35%, lost 27 House seats in 1982 – proportionate losses for Dems this year would be 34).**

II. Big Govt – Correction or Reversal?

Statement A: Government should do more to solve problems and help meet the needs of people, or

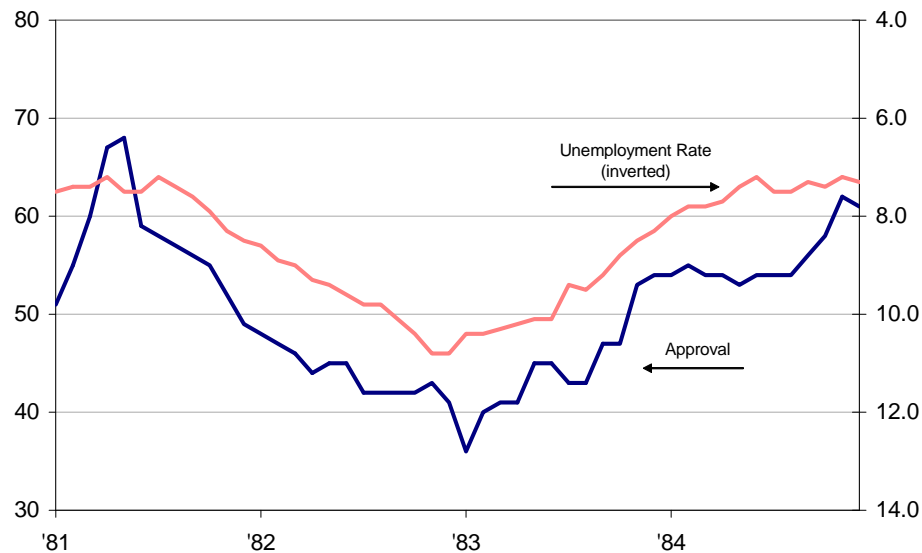
Statement B: Government is doing too many things better left to businesses and individuals.



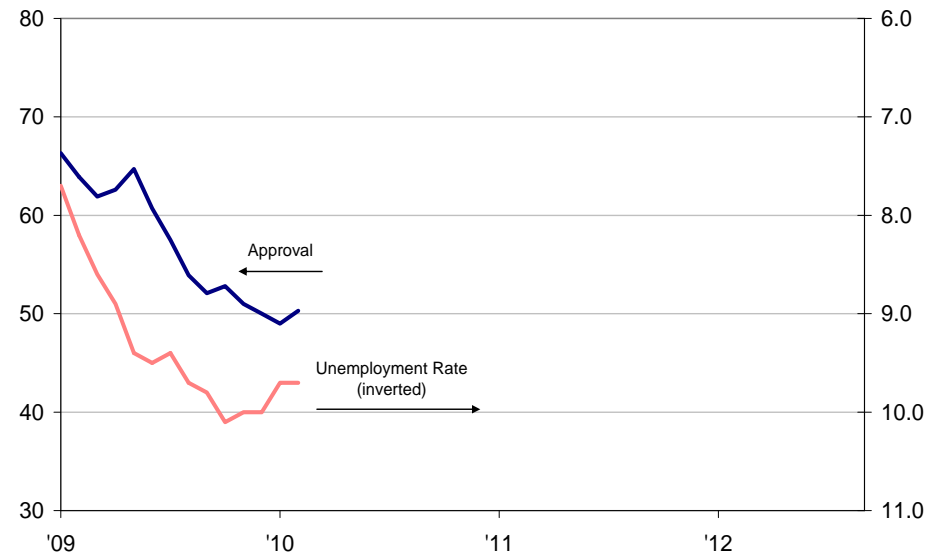
Source: NBC/WSJ.

II. Big Govt – Correction or Reversal?

Reagan Job Approval vs Unemployment Rate (Inverted)



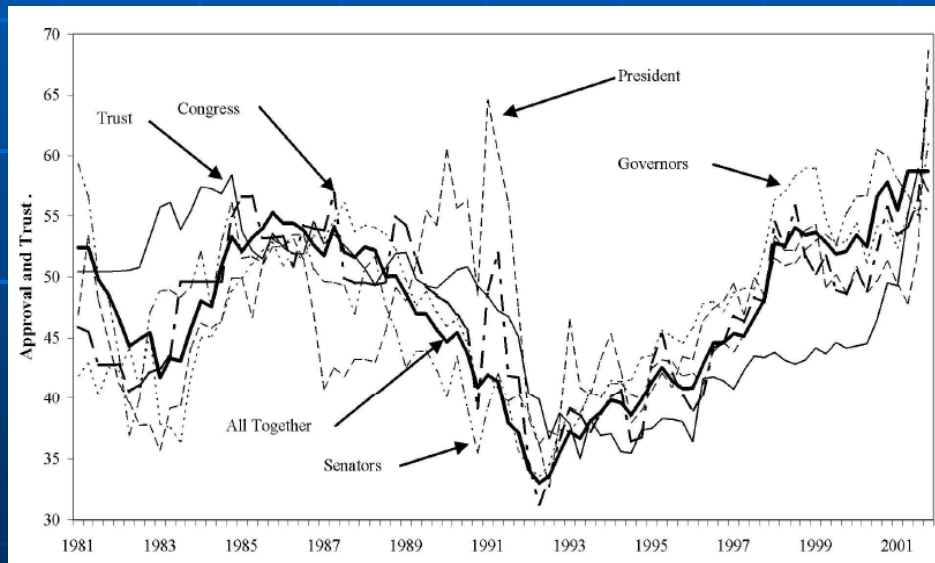
Obama Job Approval vs Unemployment Rate (Inverted)



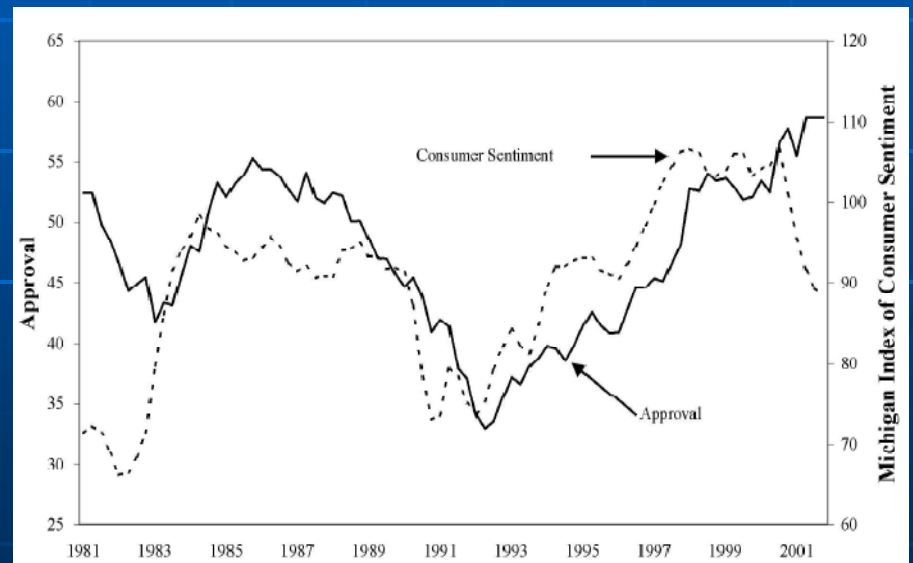
Source: Gallup.

II. Big Govt – Correction Or Reversal?

Generic Approval Quarterly, Along with Approval of Presidents, Senators, Governors, Congress and Trust in Government



Generic Approval and Michigan Index of Consumer Sentiment



Sources: The Monkey Cage blog, 'Tides of Consent' by Jim Stimson.

II. Big Govt – Correction Or Reversal?

To win congressional majorities, Democrats have to win in Republican areas, but the reverse isn't true.

Senators from states that have voted for the other party's presidential candidate in 2 of the last 3 elections

| | |
|--------------------|-----------------|
| Republicans | 5 of 41 |
| Democrats | 29 of 59 |

The problem for House Democrats is too many representatives in GOP districts

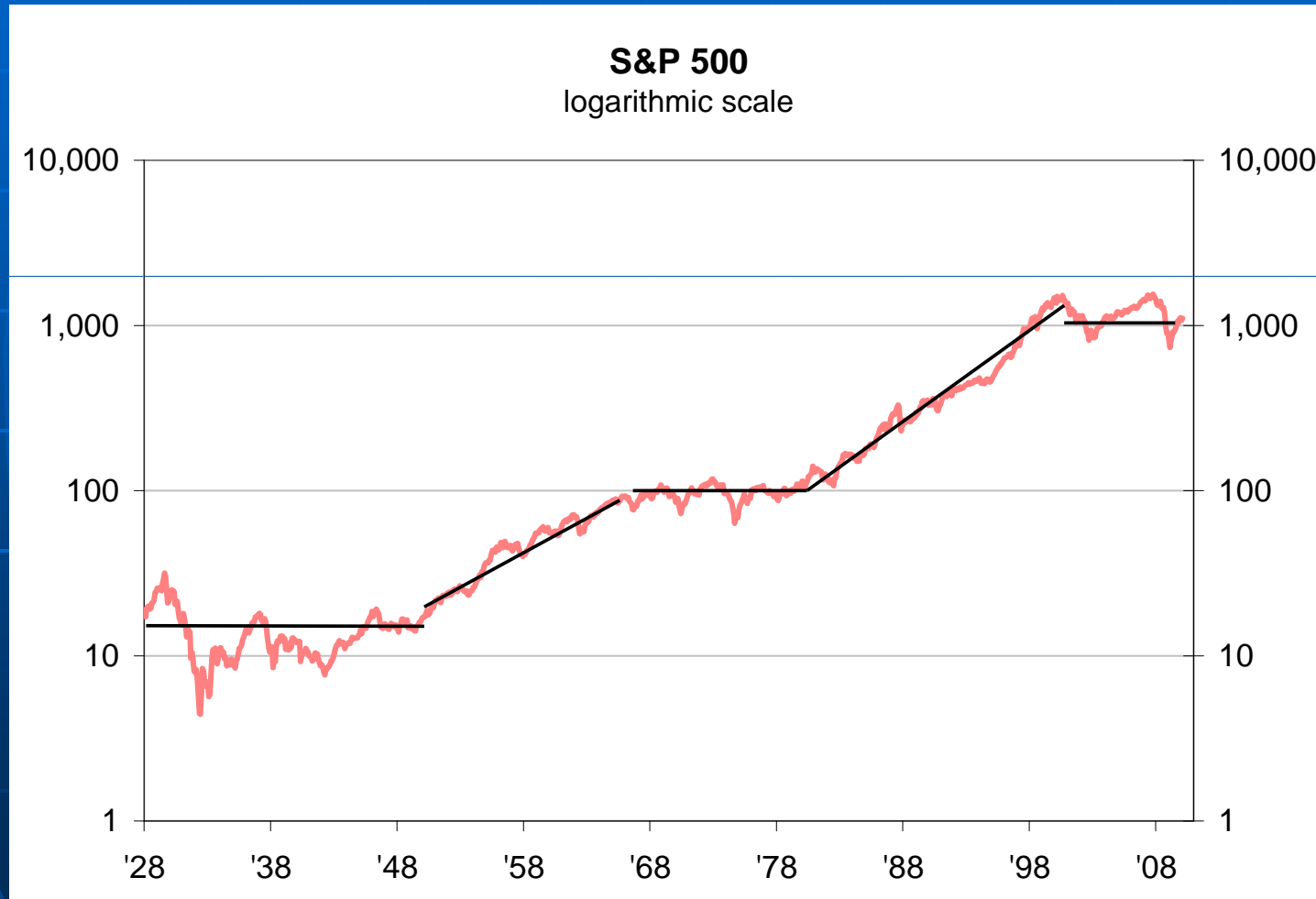
| | GOP-Leaning Districts | Swing Districts | Dem-Leaning Districts |
|-------------|------------------------------|------------------------|------------------------------|
| Republicans | 151 | 23 | 4 |
| Democrats | 48 | 50 | 159 |

Source: The Cook Political Report.

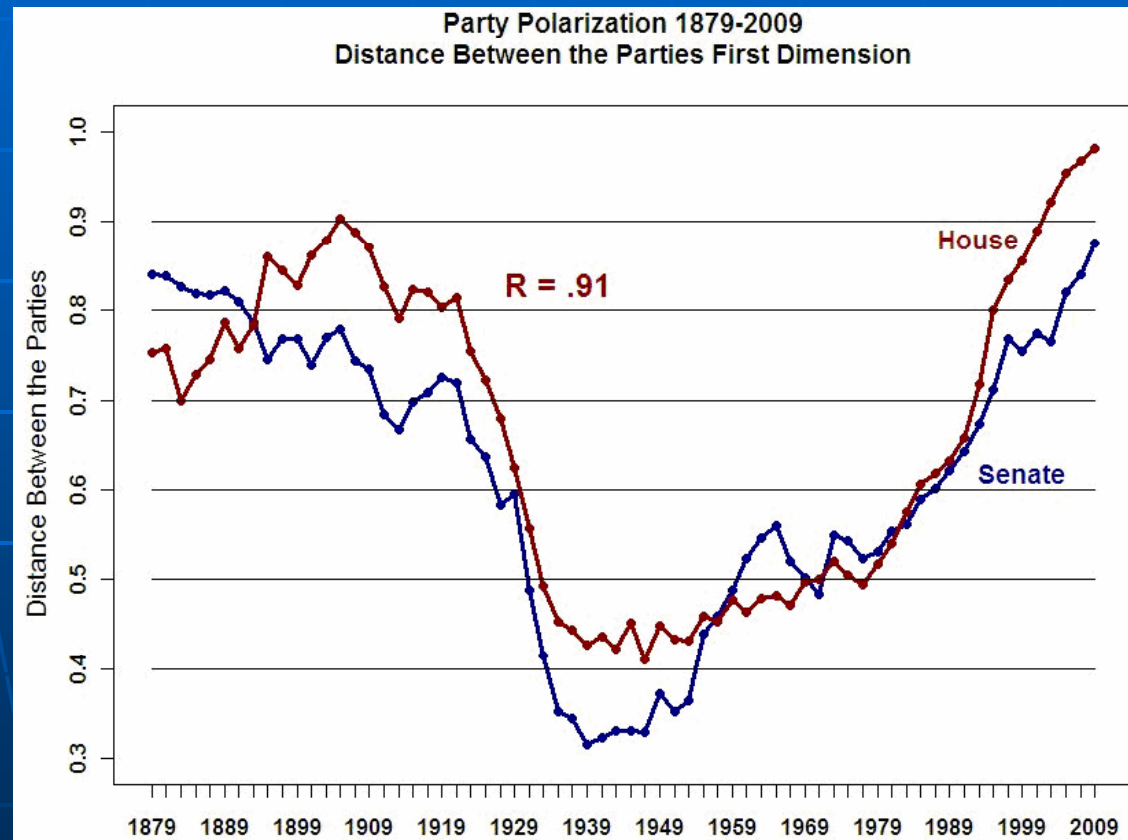
III. Investment Implications

- Beware “Rorschach risk.” One of the biggest mistakes an investor can make is to expect markets to validate one’s political views.
- That said, more activist policies probably contribute to lower equity returns on a secular basis.
- This impact will be hard to play on a macro level.
- Supply-side effects exist but are usually overwhelmed in the short-run by other factors.
- The sector effects are likely to be greater than the macro effects.
- If stalemate returns to Congress, investors can pay less attention to this change but shouldn’t ignore it, as for most issues there is a regulatory fallback to the legislative process.

III. Investment Implications



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Source: "Polarized America The Dance of Ideology and Unequal Riches," by Nolan McCarty, Keith T. Poole and Howard Rosenthal

III. Investment Implications

HMOs' Relative Performance To S&P 500

