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## *Political notes*

### *Key points*

- Political events are affecting the market.
- The Chinese economy continues to grow quickly but Chinese leaders are signaling tighter monetary policy, worrying markets.
- Recent declines in stock prices likely reflect increases in the numbers of investors who are expecting, as we are, only modest rates of economic growth.

Recent political events have had market implications. The January 19 election in Massachusetts of Republican State Senator Scott Brown to the U.S. Senate has obvious implications for health care reform, taxes, and the power of the Democrats to unilaterally set the national agenda.

Forecasting is an occupational hazard we've learned to accept. On the Tuesday that Brown was elected, Jim Cramer of CNBC's *Mad Money* said Brown's victory could mean a "gigantic rally" the next day. It's understandable that such an apparently pro-business event would be perceived as positive for stocks. However, for reasons we'll explain later, that one-day forecast proved wrong, as the market fell Wednesday (and Thursday and Friday). Even a broad index of health care stocks fell. In fact, the market has given back all of this year's gains in the last few days.

### *Of banks, Bernanke, and "the Supremes"*

The Obama administration has proposed restricting the size and activities of large banks in an attempt to limit the risk-taking activities of institutions that are effectively protected by taxpayers. If these institutions exit proprietary trading, possible outcomes might include short-term disruptions, especially in arbitrage-related markets, followed by a period of above-average hedge fund returns due to less competition for profitable trades.

Ben Bernanke's current term as chairman of the Federal Reserve ends this month. Given the animosity toward bankers and anger at the handling of the financial crisis, it's not surprising that senators might offer his head on a platter. The doubt about his confirmation for a second term is causing some uncertainty about the course of future Fed policy and is rattling markets.

The decision by the U.S. Supreme Court to strike down restrictions on corporate campaign spending appears pro-business. We can envision politicians with outfits resembling NASCAR drivers.

### *Municipal challenge*

Turning from the federal to the state level, our municipal bond group recently noted how the "Great Recession" has battered state and local government finances. Resultant problems are likely to persist for several years, especially given the likelihood of a slow national economic recovery. The federal government's economic stimulus payments to the states provided a crucial stopgap. Since tax-collection

levels lag changes in the economy, state and local governments' balance sheets are expected to remain stressed, at least through the next year, and even once the private sector returns to growth mode. Personal income and sales taxes drive revenue at the state level. Real estate- and property-related tax collections, which are more stable but lag recoveries further, dominate locally administered revenue. Despite our expectation that state and local governments' fiscal woes will continue for several years, we remain confident about longer-term prospects for the municipal bond market.

### ***China's challenge***

Chinese authorities released some important data this week. The nation's economy grew at a real (inflation-adjusted) annualized pace of 10.7% in the fourth quarter. It was the strongest quarter of the year, and it came with hints of higher inflation. We're fans of emerging markets because of their growth potential. However, the Chinese also indicated that they are likely to tighten their monetary policies. As noted, stocks in the United States fell on Wednesday. The likelihood of restrictive Chinese economic policies and concerns about Greece's fiscal situation are the best explanations for the dismal performance of stocks globally over the latter half of this week.

### ***Earnings season***

Earnings season is under way. The profit reports coming in are similar to those issued three months ago, except for weaker reports from financial companies. Bank of America, Citigroup, and Morgan Stanley are the biggest negative influences on the overall averages because of the size of their earnings shortfalls relative to Wall Street expectations. Some of the shortfalls owe to costs associated with repaying taxpayer funds borrowed under the federal government's Troubled Asset Relief Program, as well as fees levied by the Federal Deposit Insurance Corp. With about 17% of the companies in the S&P 500® Index reporting, 81% have beaten the average earnings-per-share estimate (compared to 83% last quarter for the same companies) and 64% have topped revenue estimates.

### ***Slow U.S. economic growth***

This week saw a number of other economic releases. The Producer Price Index, a measure of inflation at the wholesale level, rose 4.4% on a year-over-year basis in December, in line with expectations of 4.5%. Housing starts were weaker than anticipated in December (557,000 vs. 572,000, annualized) but building permits were stronger (653,000 vs. 580,000, annualized). Initial jobless claims were worse than expected during the week ended January 16 (482,000 vs. 440,000). The Federal Reserve Bank of Philadelphia's manufacturing-oriented Business Outlook Survey showed growth in January for a fifth straight month but less than anticipated. Finally, the leading economic indicators tracked by The Conference Board rose 1.1%, better than expected.

Taken together, this economic data supports our view that we are in a recovery with slow economic growth. There is little to suggest strong growth at this time. While we are not surprised, our sense is that Wall Street—with notable exceptions, such as PIMCO—has been expecting more. The recent selling is likely due to disappointment and an adjustment to more muted growth expectations.

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### ***Disclosure***

# MARKET NOTES



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