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If government slows, markets may rally

Expected shift in political power in Washington this fall could improve the business climate in the U.S.

Amid the pessimism surrounding the equity markets, I am going on record now to say look for a year-end rally.

The reason is simple: government gridlock. As the odds increase that Republicans will take control of the House in November, government will grind to a halt and stocks will respond positively.

It's really a very simple equation: predictability equals profit. Simply put, money hates "change." The more that government mixes things up, the more likely money is to remain on the sidelines. This is good for ideologues, but bad for business.

The more unpredictable any environment becomes, the greater the likelihood of loss – financial or otherwise. The more change that is introduced, the less predictable things become.

It was the very absence of change that made the final years of the Clinton administration so salutary to the capital markets.



FINANCIAL
FOCUS

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With the demise of the Soviet Union, for the first time in history there were no global bad guys. Free market capitalism won and democracy was breaking out everywhere. The world became a global village, and we were all going to live happily ever after.

This virtuous cycle accelerated when Democrats gave up their majorities in both the House and Senate in 1994 and government ground to a halt. Bureaucrats got out of the way and America got down to business. Peace equaled predictability, which equaled profitability.

The same process will likely repeat itself in November. There will be a big power shift in Congress. This will have the desired effect of slowing the President's "change" agenda.

As the odds increase that Republicans will take control of the House in November, government will grind to a halt and stocks will respond positively.

Business and capital markets should respond positively to this. There is a perception that Washington has moved too far, too fast. This has been deeply unsettling to capital markets.

This is exacerbated by the negative rhetoric coming from the political class regarding business. It may be politically expedient to excoriate big banks and big business for reckless behavior. However, all it does is hinder hiring and capital deployment for the long term.

If this midterm election follows historical precedent and Democrats lose their congressional majorities, the pace of change will grind to a halt and the rhetoric will be dialed back. This will create a less "punitive" environment for business.

Money should begin to move off the sidelines, and this will encourage employers to hire. The spirits necessary to drive any bull market – which have been so sorely lacking of late – should return. The market will anticipate this by rallying.

As developing and emerging markets continue to outpace the U.S. in terms of growth, I would capitalize on a rally by investing in exchange-traded funds here. If the market rises domestically, theirs will rise even further. That is where to invest.

And as a reminder, for protection from coming inflation, remember to also start taking some of those profits from bond portfolios and diversifying into high-quality inflation hedges such as:

- Income-producing commercial real estate in the DST (Delaware Statutory Trust) or TIC (Tenant-In-Common) format. Such real estate, with increasing cash flow, acts like an inflation-protected bond.

- Commodities or commodity funds.

- Gold exchange-traded funds. They are easy and inexpensive to buy and sell, and they invest 100 percent in gold bullion.

- Publicly traded Canadian energy royalty trusts. They are completely liquid and one of the highest yielding fixed-income assets available. They also should be big beneficiaries of the increase in oil prices that is sure to come in the wake of the gulf oil disaster.

And remember, watch for that year-end rally.

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