America's financial markets

The Bush bounce
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Investors cheer the election, shrugging off higher interest rates and economic fears

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THE American stockmarket's verdict on the election was plain: hooray for George Bush. When early exit polls on November 2nd suggested that John Kerry would become president, equity prices dropped. They changed course abruptly once the true result emerged: according to a survey of 40 hedge funds by International Strategy & Investment, a research firm, these investors went from net short to net long as soon as the election results became clear.

A week later, the market had not given up its gains. A surprisingly good jobs report on November 5th, indicating that non-farm employment had risen by 337,000 in the previous month, did the market no harm at all. And share prices were never likely to be perturbed by the Federal Reserve's decision, on November 10th, to increase the federal funds rate by a quarter-point, to 2%. The Fed’s plans had been clear long before, and the rise had been priced in. Indeed, several further increases are generally expected.

By and large, Mr Bush's re-election has been good news for companies that benefit from increased public and private spending, friendly government and low taxes—most companies, in other words. The gainers include department stores, health care and defence (see chart), along with heavy machinery, air
freight and industrial metals. Stocks with large dividends also rose strongly, reflecting a belief that under Mr Bush taxes on capital will be lower than they might have been under Mr Kerry. Only two sectors have slipped. One is energy, perhaps because Mr Bush would allow more drilling in America and thus boost supply. The other is textiles, possibly because Mr Bush seems keener on free trade than Mr Kerry.

Furthermore, it could be that investors were quite happy with continuity. Despite a lot of gloomy talk—about rising oil and petrol prices, and the slow pick-up in employment as the economy has grown—the American economy is not in noticeably poor shape. Growth is pretty strong. Inflation is low, though showing some signs of rising. Unemployment, at 5.5%, is a little lower than when Bill Clinton was re-elected in 1996.

Corporate profits have risen by 75% over the past three years and profit margins are approaching their highest in three decades, according to Silvercrest Asset Management. Interest payments as a percentage of GDP have fallen back to the levels of the early 1980s, before junk bonds and highly leveraged acquisitions became popular and made it easy for companies to pile up debts. Bond defaults are low. Small and mid-sized companies are in better shape than they have been in four years, says James Hance, vice-chairman of Bank of America. For the first time in years, there are signs that these companies' deposits are beginning to fall. This might be a sign that demand for commercial and industrial loans, which has stagnated in the past few years, is about to increase.

There is more. Although the Bush administration is not perceived to be especially close to Wall Street—unlike Mr Clinton, Mr Bush has not yet appointed a treasury secretary from a financial firm—it is seen as a friend of business. Thus the election relieved the market's concerns that new taxes would be imposed. Besides the Republicans' successful defence of the White House and gains in Congress, judges backed by business groups were elected in several states. Initiatives to curtail litigation were passed in California, Florida, Nevada and Wyoming. That may help businesses facing class-action lawsuits over asbestos, medical malpractice and behaviour in securities markets. President Bush wants still more tort reform. President Kerry might have looked more threatening, with John Edwards, a former trial lawyer, as his vice-president.

However, by no means is everything rosy for the stockmarket, which has had a curious year. Although the economy has been doing decently and profits for the companies making up the S&P 500 are likely to be 20% higher this year than last, on the eve of the election share prices stood roughly where they had on January 1st, having surrendered all the gains they had made earlier in the year. Maybe uncertainty about the election had something to do with this.

The cloud around the silver lining

Looking ahead, the sinking dollar (see article) should be a fillip to American exporters, but it will also add to inflationary pressures. Household savings are low: if these have to rise, then consumers will spend less. Corporate earnings are still growing strongly, but the pace is fading. Profit growth of 10% next year, which many analysts expect, sounds brisk but is only half this year's rate; the year after, it may be slower still. If the job market is tightening at last, then this will push up wage costs. Worse, America has a huge government budget deficit that can only be reduced by extraordinary
economic growth, higher taxes or spending cuts. Worse still, Mr Bush shows little inclination to plug it: many on Wall Street hoped for a Kerry victory if only because a split between Congress and the executive might have halted spending growth.

This caution about the economy is visible in the niggardly yields on Treasury bonds. Despite the Bush victory—possibly meaning more government borrowing than a Kerry presidency—the latest, bullish jobs report and the upward path that the Fed appears to be setting for short-term interest rates, the ten-year note still yields a mere 4.2%, the stuff of fantasy for most of the past four decades. Though this spells bliss for borrowers, it may also signal that bond markets are gloomy about growth.

And after the markets' brief burst of post-election euphoria, they will have to look ahead to what Mr Bush might do in his second term. Several initiatives he intends to pursue will have a direct impact on the public markets, notably the creation of some form of individual retirement accounts in place of Social Security and a broad revision of the tax code. None of this will be easy nor perhaps even feasible. Making it all a bit more difficult will be the likelihood that Alan Greenspan, chairman of the Federal Reserve, will finally retire at the end of his term in two years. The name of his replacement may mean as much to the markets as did the American people's verdict on November 2nd.