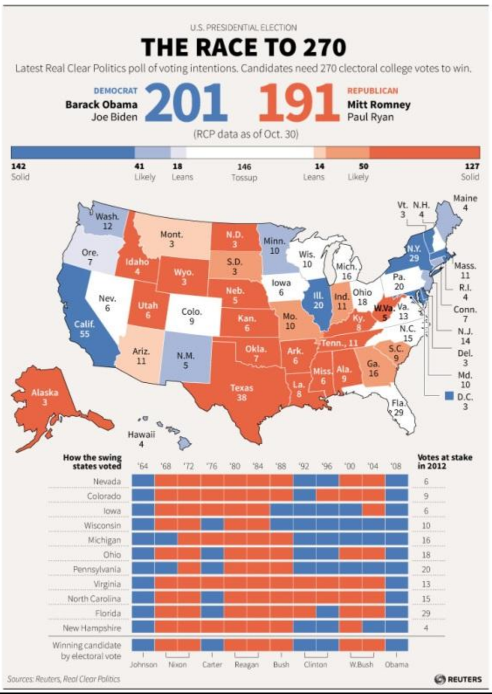
"There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know." Donald Rumsfeld

That clears it up, then. Who really knows what's going on in the US at the moment? There are certain things that we know with absolute certainty that we don't know:

1) Who will win the election?
2) What is the economic impact of Hurricane Sandy?
3) When will the US economy run over the "Fiscal Cliff"?



We all know that **the election result is on a knife edge**. Ironically the biggest storm to ever hit US soil could end up being good news for Obama's re-election prospects. It has been an opportunity to show strength as "Commander in Chief" and demonstrate what a fantastic leader he is in a time of crisis. So far he has played the role perfectly and this may end being the deciding factor come polling day. Poor Romney doesn't know where to turn. Carry on campaigning and risk looking heartless, stop campaigning and risk losing ground in the swing states. Instead he's taken the ineffectual middle ground and turned a "campaign event" into a "storm relief event" – I guess he had to try something. Polls suggest that Obama is still ahead - just. He is expected to be favourite to win 201 votes against Romney's 191 with 146 swing state votes to play for. Because Obama starts off with a greater likely number of states' electoral votes, Romney must win a higher number of the 7 to 10 states that remain truly competitive.

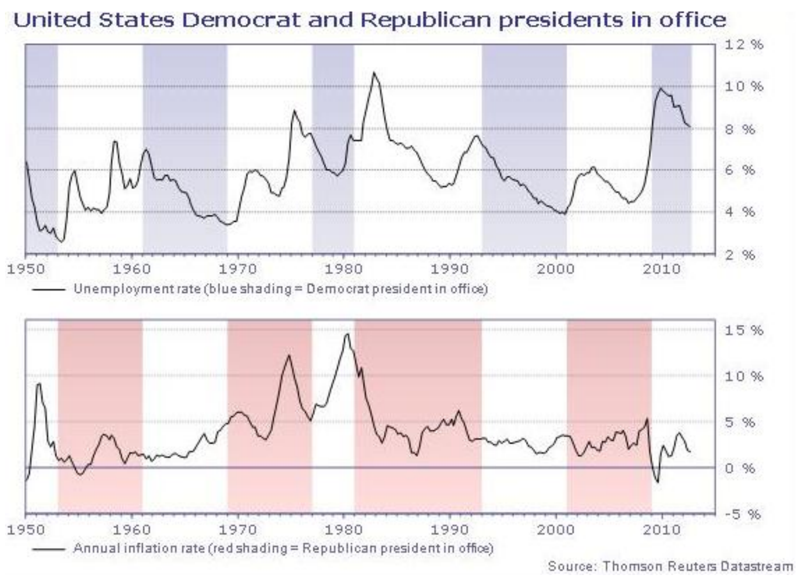
What is the market impact either way? A recent survey (Barclays polled their institutional clients) suggests that an **Obama victory** would be mildly **bad for equities** but relatively **good for bonds** (short term). Meanwhile, those surveyed believe that a **Romney win** would be **good for longer term equity** prospects but definitely **bad for bonds**. The market perceives that Romney would show better stewardship of the US economy and that his administration would better handle fallout from the fiscal cliff. However, his pledge to sack Bernanke would unsettle bond investors who fear a change in policy at the Federal Reserve.

Either way, **taxes are going up** and **spending is going down**. Federal spending now accounts for about 23% of US economic output, while taxes account for only 15% - this imbalance isn't going to correct itself and the debt burden is expected to grow by $11bn over the next decade if nothing is done. Romney plans to cap deductions and credits for all, affecting the middle and higher earners the most. Obama plans to pick on the wealthiest only, but like Romney, is focussing on deductions and credits rather than explicit tax hikes.

What can we learn from the past?
For what it is worth, history tells us that unemployment tends to fall during a Democratic presidency whilst inflation tends to increase. This is partly a function of "filling the punch bowl", which may not be feasible this time around.

Who does the market want to win?
We believe that equity markets won't be too bothered in the short term whoever wins the election. However a Romney victory will worry the bond markets (uncertainty if Bernanke is sacked).

The Sandy Effect? No change in growth estimates
The tragic human impact to one side, the effect of Sandy on US GDP is estimated to be 0.1%, i.e minimal. It could actually be good for US GDP next year due to re-structuring contracts.



Final thoughts

Regardless of who wins, consider the possible impact of the fiscal cliff on issuance of US Treasuries. This is expected to shrink from \$1.2tn in the current fiscal year, to about \$700bn in FY'2013 and \$370bn by FY'2015. The 40%-plus drop in supply, along with the likely hit to the real economy, would be undoubtedly bullish for Treasuries.

This just serves to highlight that whoever wins this election, the economic storm that is the "fiscal cliff" is still by far the most pressing issue facing the next administration. Everything else is just whispering in the wind.

Chart 5: Treasury issuance could shrink sharply in early 2013 if fiscal cliff goes into effect

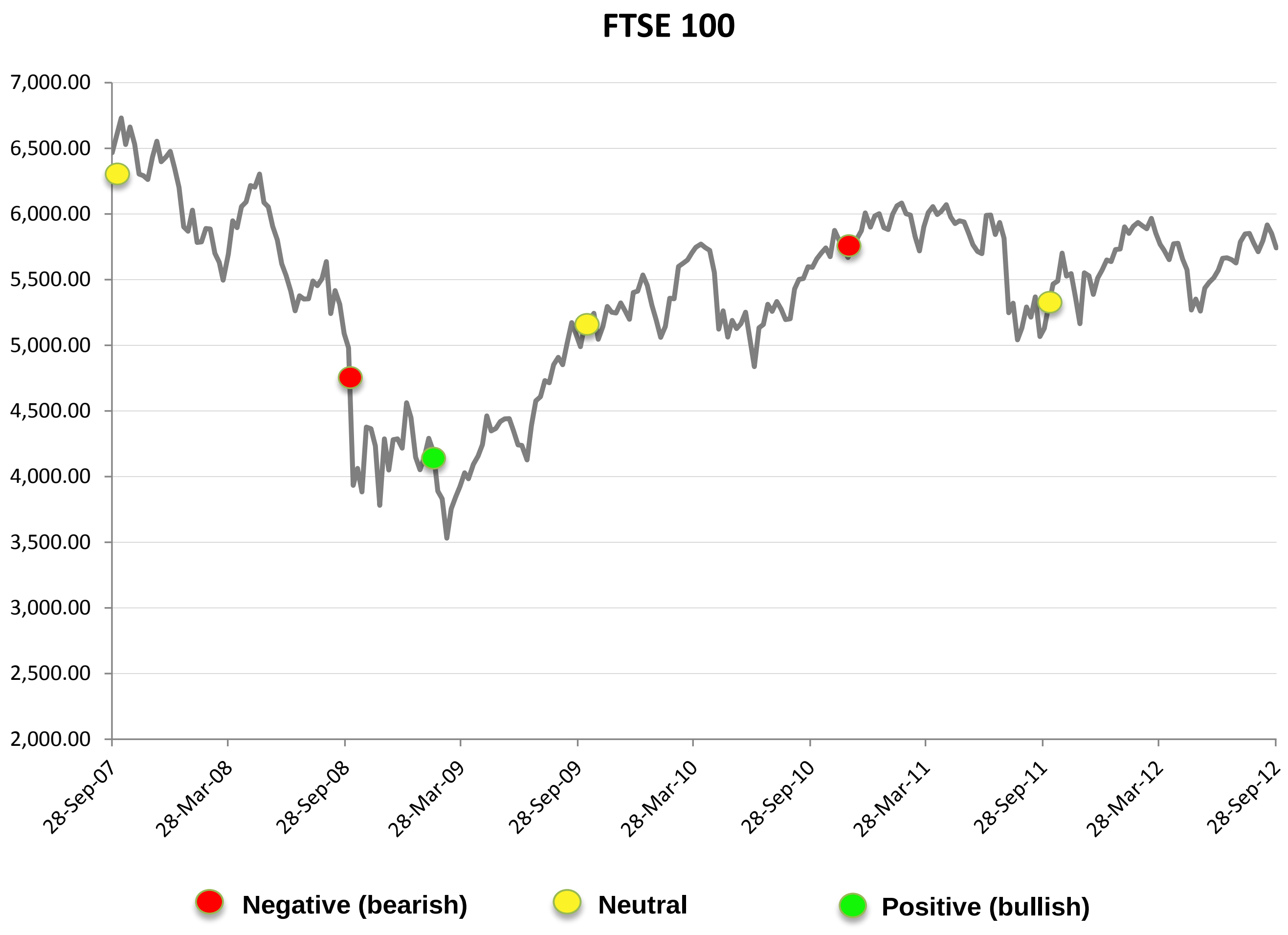
The current policy scenario assumes extension of most, but not all current policies. It assumes that payroll tax cuts are not extended and a spending freeze remains in effect. A full extension of all policies would result in FY'2013 issuance of about \$1.2tn.

Source: US Treasury, Congressional Budget Office, SG Cross Asset Research/Economics

Market "Stance"

At Mountstreet Partners we position our clients' portfolios to reflect our outlook for equity markets over the coming quarter.

The chart below illustrates our current "market stance" which is **NEUTRAL.** Each of the dots on this chart represents a change in our market stance and this demonstrates the decisions that we believe that we would have taken over the last five years. In September 2011 for example, the stance changed from **NEGATIVE** (red dot) to **NEUTRAL** (yellow dot).



With so much stimulus already delivered, and promise of more if required, we still believe that investors would be foolish to "fight the FED". However, the impending fiscal cliff and lower earnings estimates could change the game.

The Mountstreet Partners outlook currently remains NEUTRAL but could turn "BEARISH" soon.