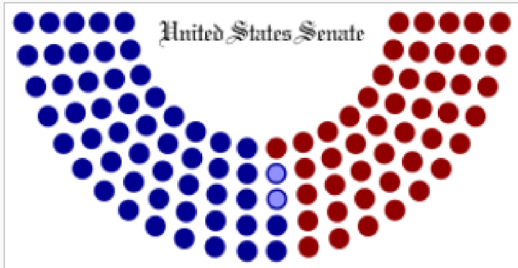
"One faction of one party in one house of Congress in one branch of government doesn't get to shut down the entire government" – Barack Obama, 30th September 2013.....

……. shortly before the Republican led Congress did exactly that. The well-publicised and **shambolic US government "shutdown" on 30th September is the culmination of 18 months' worth of "school playground" style in-fighting** between a heavily divided Congress, which has faced stalemate on everything from "Obamacare" to Syria. This lurch from Fiscal Cliff to the debt ceiling, via Quantitative Easing (QE) tapering, Syria, back to QE and finally to the budget deficit/debt ceiling comes at the same time that equity **investors have pushed the S&P 500 to an all-time high of over 1700**, fuelled by growing confidence in the housing market, expectations of falling unemployment and strong corporate earnings.

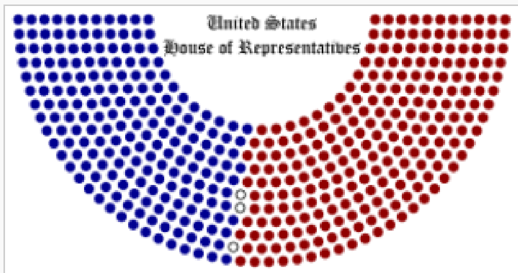
This month we focus on the key factors that have led to US markets surging higher, whilst the reputations of key decision makers in Washington (particularly the Republican Tea Party) continue to sink to new depths. We explain why we believe that this longer-term rally in US equities is probably sustainable, albeit with short-term volatility along the way.

Firstly, we examine why **investors have lost faith in Washington's ability to make cohesive decisions on key policy issues**…… and perhaps this is an inevitable consequence of a Democrat president leading a Congress with a Republican majority whilst at the same time the Senate actually shows a very small Democrat majority, **making for a heavily divided government** (see opposite). Below we highlight some of the most important policy issues that have been fudged over the last 12 months:

Divided they fall…………



Senate party standings (as of June 10, 2013)
- 52 Democrats
- 2 Independents, both caucusing with Democrats
- 46 Republicans



House party standings (as of September 26, 2013)
- 232 Republicans
- 200 Democrats
- 3 vacancies

Fiscal Cliff

Before Christmas last year we witnessed "school playground" style partisan infighting in Congress, relating to the extension of the US debt ceiling and the manner in which the US would balance the budget (tax increases or spending cuts). The **"Fiscal Cliff"**, as it was dramatically dubbed, **turned out to be more of a small pothole than the Grand Canyon** and agreement was reached as expected. However it still rattled investors who feel much more comfortable when they know that there are no bumps along the road.

Response to Syria

Vladimir Putin has been widely credited as being the architect of the deal to avoid war in Syria and in the process has shown to be one or two steps ahead of Obama at every turn, who in turn was hampered by lack of support in Washington for military action. The uncertainty surrounding the likelihood of conflict made investors very nervous and whilst **gold is typically a major beneficiary of any conflict, the continuous "Will they, won't they?" has simply added volatility.** Now that the prospect of conflict is receding, the **prospects for gold look increasingly negative.**

Lack of tapering

This is the big one. After a surprise announcement in May that tapering should be expected as early as September (leading to a plunge in equities), **the Fed chairman surprised everyone again on the 18th September by announcing that they were not going to start tapering after all**.

This made a mockery of a concept called "forward guidance", where the US was intending to gently forewarn the markets about impending changes. **The US dollar was a major casualty, and has fallen dramatically over the quarter as expectations of an early end to QE have temporarily faltered.**

The next Fed Chairman: Yellen or Summers?

Well, **we know who it's not going to be**, after the president's favourite for the role, Larry Summers, unexpectedly ruled himself out because of pressure from within Obama's own party. Obama was furious and again **markets were surprised as Summers had been seen as an aggressive but very able candidate** who does not believe in the need for more QE, whereas **Yellen is Bernanke's sidekick and much more likely to maintain the status quo**. Whilst the next chairman has not yet been announced, **Yellen is now favourite and the US dollar took another pounding** as a result (see overleaf) because the market now expects QE to be around for longer.

"Shutdown" in Washington

Last week, Ted Cruz (Republican Senator and Tea Party poster boy) made a dramatic, but largely irrelevant 21 hour Senate speech (during which he didn't once pause for a bathroom break!) slamming "Obamacare", with the aim of delaying funding for the federal government. This proved largely futile but did at least generate some major headlines.

Then on Monday 30th September and in typically overhyped fashion, **Bloomberg television ran a "Countdown to Shutdown" clock in the bottom left corner of the screen following the fear of a temporary US Government "shutdown" of state funded services** after the house couldn't reach agreement on the future costs of Obama's "Affordable Care Act". **The resulting fear about the lack of balancing of the US budget** (see "Fiscal Cliff" above) **led investors to once again seek safety.**

Washington in turmoil, so what's the good news?

It should be clear to all readers that the **markets have lost confidence in the Federal Reserve and Washington's policy makers** and that the major casualty has been the US dollar. It doesn't help British owners of dollars that in recent months the UK economic data has been incredibly robust.

But notwithstanding this political squabbling and lack of direction, the **US stock market has touched all-time highs over the last 3 months.** Whilst the "Price to Earnings" (P/E) ratio of the S&P 500 is currently sitting at about 18x earnings and therefore is above the longer term average, the "12-month forward P/E" (what analysts expect US equity values to be in 12 months' time) suggests that, at 15x, the **market is expecting earnings to continue to increase materially next year.**

When it comes to economic data, admittedly the encouraging growth in the housing market has temporarily run out of steam after a period of reasonable strength (but from a relatively low base), however manufacturing data has been strong of late and increasingly trending positive.

The key will continue to be unemployment, given that Bernanke made a marked and consistent reduction in longer term unemployment one of his key catalysts for the tapering of QE. **The unemployment rate has fallen more quickly than expected** however this is partly because of reduced labour force participation, which is distorting the figures. Therefore the jury is still out as to when real unemployment numbers will start to fall materially and as a result when tapering will begin in earnest.

Over the coming months we believe that markets will become much more sensitive to this kind of short-term US economic data, with a particular emphasis on jobs numbers, or "non-farm payroll data" as it is known.

This reliance on small pieces of key data will inevitably add to volatility in US equities in the short term. So **investors must tread carefully**, however we believe that **those that are prepared to "stay the course" will be longer-term beneficiaries**, regardless of the significant short term noise caused by the shambles in Washington.

The US dollar's fall by 9% against Sterling to about $1.62 since the beginning of July offers opportunity to invest now. A weaker dollar helps US exporters and subsequently increases the likelihood of greater growth prospects for the US. However in the meantime UK investors' equity investments across the pond have fallen in value in Sterling terms and this has proved painful. However we do **expect the US dollar to slowly rally when tapering does inevitably start and this will therefore boost the value of UK investors' US assets.** Also, whilst the US dollar is so weak, this should help to stimulate increased merger and acquisitions (M&A) activity from bargain hunting British companies looking to buy cheap US counterparts and this unlocks value for shareholders.

Secondly the markets' reaction to the US "government shutdown" has been muted at best so far (the S&P 500 fell only 0.6% in response), which shows the depth and breadth of support for US equities at present.

Thirdly, **as disastrous as "government shutdown" sounds it was only 17 years ago that this last occurred**, during Bill Clinton's first term in office due to (wait for it) Washington in-fighting over the cost of Medicare. Then, it took 21 days before funding was agreed and **yet the longer term impact on markets was negligible**. In fact, whilst it would be wrong to draw too many parallels, it's worth noting that **the S&P 500 doubled in value over the 2 years that followed.**

So all in all **we still favour US equities** and re-iterate our recommendation to **underweight emerging market equities**, particularly after a relief rally of late. Developed equities are still our preferred markets at present despite the headlines in Washington. We feel that the **US, UK and Japan will continue to benefit from flows of capital** leaving emerging markets looking for a new home and we feel that the weaker US dollar gives investors a good opportunity to buy and hold US assets in the run up to the inevitable onset of QE tapering.