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THE PRICE OF POLITICS

What Policy Uncertainty Means for the Economy and the Markets

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PERSPECTIVES

EXECUTIVE SUMMARY

RUSS KOESTERICH
Managing Director,
BlackRock Chief
Investment Strategist

Despite an improving labour market, exceptionally high corporate cash levels, and diminishing risks from Europe, both U.S. businesses and consumers continue to exercise caution. Companies, and increasingly households, are flush yet confidence remains low, which is translating into lackluster spending. Personal consumption remained stuck at 2% in the third quarter of 2013, while cash-rich companies continue to emphasize share buybacks over new investment. To the extent fundamentals are improving, the caution exhibited by both consumers and businesses seems puzzling. While there are several factors contributing to the malaise, uncertainty over public policy appears to be part of the problem.

Historically, high levels of uncertainty over policy and the political environment have undermined both business and consumer confidence. Political gridlock and uncertainty also tend to unnerve investors and lead to higher levels of volatility (a phenomenon suspended last year thanks to massive central bank liquidity).

December's budget deal removes the risk of another U.S. government shutdown, but partisan gridlock and unresolved battles over regulatory issues may dampen spending and increase volatility in 2014. In particular, we would watch the progress of the Affordable Care Act (ACA) as lingering uncertainty regarding the rollout and implementation has the potential to suppress consumer confidence. For U.S. businesses, the stability, or lack thereof, of the tax code and transparency over regulatory issues are likely to be important determinants of corporate confidence, and by extension spending. However, on the positive side, any unexpected breakthroughs in Washington have the potential to release pent-up demand and boost growth.

INTRODUCTION

"Doubt is not a pleasant condition, but certainty is absurd."
—Voltaire

The last half of 2013 witnessed some genuine economic improvement. Job growth accelerated, home prices continued to increase and manufacturing expanded at a brisk pace. Yet spending remains subdued relative to history. Although household wealth has surged, there has been no acceleration in household consumption. On the corporate side, companies are sitting on a record pile of cash and enjoying stellar margins, but capital spending remains lackluster. During the first three quarters of 2013, real fixed investment grew at an average annualized pace of around 3.5%, well below the average of the previous three years (Source: Bloomberg).

While sluggish personal income growth is partly to blame, it does not explain all of the softness. Nor does it address why companies continue to be so conservative when it comes to capital spending. While consumers and to an even greater extent businesses have the wherewithal to spend, what they seem to lack is the conviction.

A HOUSE DIVIDED

Investors have become somewhat numb to Washington's dysfunction—although massive amounts of liquidity have also repeatedly helped soften the blow—but many individuals, CFOs and CEOs apparently have not. The generally negative news out of Washington appears to be contributing to the lack of consumer and business confidence.

Why should this be the case? Hasn't Washington always behaved this way; if so, why are politics having an outsized effect today?

To start, things *have* actually gotten worse in U.S. politics. Washington is genuinely more polarized, and as a result less prone to compromise. This polarization is evident in the increasing divergent voting patterns of the two parties (See Figure 1).

The attached graph measures this difference in Congressional voting patterns by party. The first thing to note is that, based on this metric, partisanship is indeed at a multi-decade high. Second, the chasm between the two parties appears to be growing, not shrinking. Finally, this phenomenon is not just limited to the "hot heads" in the House of Representatives; the gulf between the parties has also been growing in the Senate, traditionally the more "deliberative" body. In short, U.S. politics seem to have indeed become more partisan in recent years, and in the process more dysfunctional.

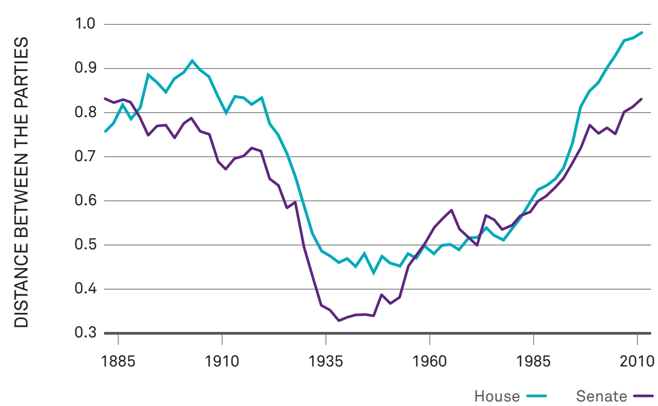
DESTINATION UNKNOWN

When considering Washington's impact on the economy, investors often focus on the fiscal dramas of the past few years. Yet in many ways Washington's larger impact is more subtle, often buried within impenetrable legislation. The economy and investors may have shrugged off the last government shutdown, but recently enacted laws such as Dodd-Frank and the Affordable Care Act (ACA) will exert a significant impact—for good or ill—on the economy for years to come.

Not only are these laws enormous in scope and complexity, but they are still largely "works-in-progress." Uncertainty regarding how these laws will be implemented is a very real challenge for many industries. To the extent companies lack clarity, it follows that they will be more conservative in their investment.

Just how bad the problem has become is apparent when you quantify the level of uncertainty. One effort in this direction is the Economic Policy Uncertainty Index (EPUI), a measure constructed by a team of economists from

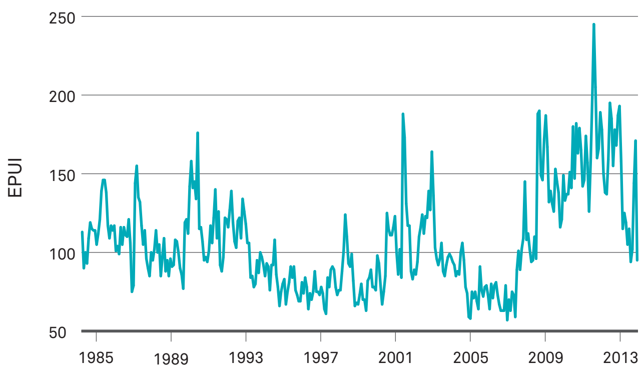
FIGURE 1: U.S. PARTY POLARIZATION (1885-2010)



Note: This measure of political polarization is derived from analysis of the voting patterns of Congress and is based on the relative divergence in the average positions of Democratic and Republican legislators.

Source: "Polarized America" by McCarty, Poole and Rosenthal.

FIGURE 2: U.S. ECONOMIC POLICY UNCERTAINTY INDEX (1985 TO PRESENT)



Source: http://www.policyuncertainty.com/us_monthly.html, accessed on 12/4/13, BlackRock.

Stanford and the University of Chicago (see Figure 2). To measure policy-related economic uncertainty, the index relies on three types of underlying components.[1]

First is an index of search results from ten large newspapers: *USA Today*, the *Miami Herald*, the *Chicago Tribune*, *The Washington Post*, the *Los Angeles Times*, the *Boston Globe*, the *San Francisco Chronicle*, *The Dallas Morning News*, *The New York Times*, and *The Wall Street Journal*.[2]

Second, the index draws on reports by the Congressional Budget Office (CBO) that compile lists of temporary federal tax code provisions. The index measures the annual dollar-weighted number of tax code provisions scheduled to expire over the next 10 years.[3]

Finally, the index draws on the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters. The EPUI utilizes the dispersion between individual forecasters' predictions to construct indices of uncertainty about policy-related macroeconomic variables.[4]

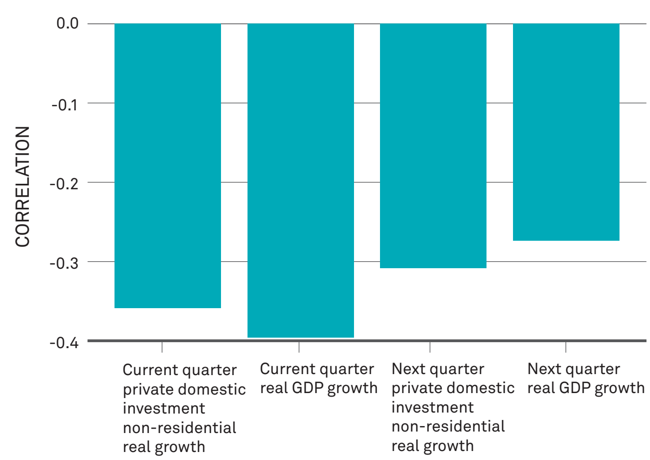
Based on this particular index, investors are not imagining things when they say uncertainty has risen. While policy uncertainty fluctuates over time—it surged early in the fall and then plunged in November—it has, on average, been much higher over the past five years. Since the advent of the financial crisis, the index has averaged roughly 155, well above the pre-crisis average of 87.

What accounts for this increase? The polarization in Congress is one factor. Another is a growing tendency to disguise the true cost of tax breaks by including "sunset provisions." These provisions, known as "tax extenders," are becoming more ubiquitous. For example, the research tax credit has been extended 15 times since being enacted in 1981.[5] Today, there are nearly 200 "temporary" provisions in the tax code requiring extensions.[6] For any company attempting to forecast its future liabilities, long-term tax planning has become a near impossibility.

THE PRICE OF UNCERTAINTY

To the extent uncertainty is actually higher, and not just a function of the very human habit of nostalgia for a "simpler time," this matters for both the economy and financial markets. In the past, higher levels of political and policy uncertainty have been associated with lower levels of economic activity. In particular, higher uncertainty has generally coincided with both lower gross domestic product (GDP), in both the current quarter and the next, as well as lower investment (see Figure 3).

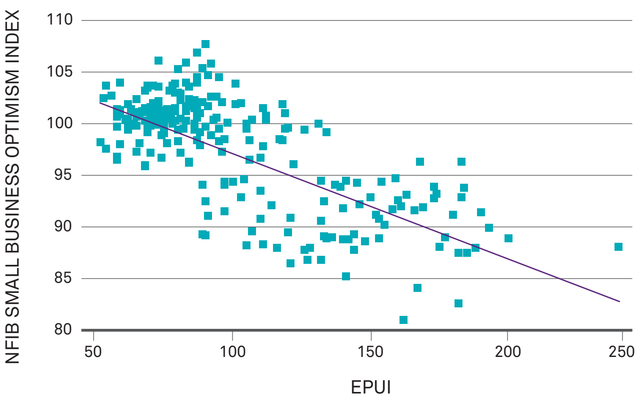
FIGURE 3: CORRELATION WITH QUARTERLY-AVERAGE EPUI



Source: Bloomberg, http://www.policyuncertainty.com/us_monthly.html, accessed on 12/4/13.

1. http://www.policyuncertainty.com/methodology.html, accessed 12/11/13.
2. Ibid.
3. Ibid.
4. Ibid.
5. "Tax Provisions Expiring in 2013 ("Tax Extenders")," Congressional Research Service, Molly Sherlock, November 5, 2013.
6. http://petri.house.gov/issue/taxes, accessed 12/11/13.

FIGURE 4: U.S. POLICY UNCERTAINTY VS. BUSINESS CONFIDENCE (1994 TO PRESENT)



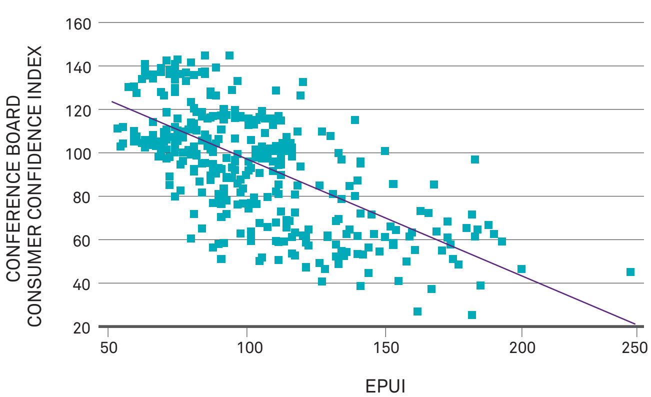
Source: EPUI and Bloomberg, 12/15/13.

Of course, high correlation does not necessarily imply that uncertainty is causing slower growth, but there is a credible mechanism that explains this phenomenon.

To the extent policy uncertainty is higher, both business and consumer confidence tends to be lower. Historically, the relationship has been strong. In the case of business confidence, the level of the EPUI explains roughly half the variation in business confidence (See Figure 4).

In the past, every one point rise in the EPUI has been associated with a 0.1 drop in business confidence. The most recent example of this relationship occurred last fall. The budget debate and government shutdown quickly pushed a measure of business confidence from a one-year high to a seven-month low. As confidence is in turn associated with spending, to the extent that policy uncertainty lowers confidence it also reduces spending, and by extension growth.

FIGURE 5: U.S. POLICY UNCERTAINTY VS. CONSUMER CONFIDENCE (1985 TO PRESENT)



Source: EPUI and Bloomberg, 12/15/13.

"The fact that policy uncertainty, while fluctuating, has remained comparatively high over the past five years helps explain why consumer confidence has remained so low."

Lower business confidence and investment are not the only way higher uncertainty negatively impacts growth: Consumers also react to rising uncertainty.

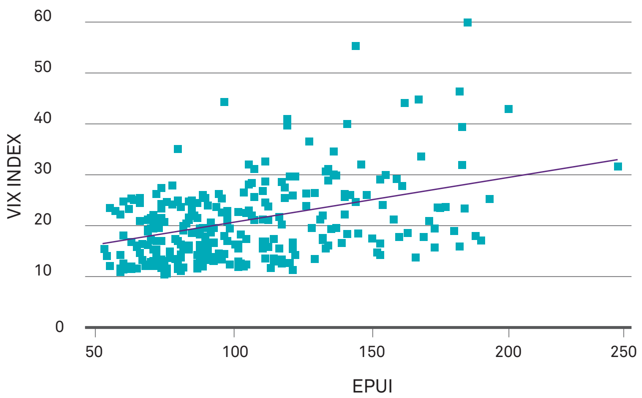
The relationship between political uncertainty and consumer confidence is quite strong. In the past, every one point increase in the EPUI has been associated with a half point drop in the Conference Board's measure of consumer confidence (see Figure 5). This relationship was also in evidence during the government shutdown—between August and October the EPUI rose by 69 points, or nearly 70%, while consumer confidence fell by approximately 12%.

The fact that policy uncertainty, while fluctuating, has remained comparatively high over the past five years helps explain why consumer confidence has remained so low. Despite an improving job market and household net worth hitting a peak of $77 trillion in the third quarter of 2013, most measures of consumer confidence have contracted since the summer. For example, the Conference Board's measure of consumer confidence sunk to a seven-month low in November. While confidence did rebound in December, it still remains below last summer's peak and well below the long-term average.

IMAGINE WASHINGTON....WITHOUT THE FED

Not surprisingly, investors also react skittishly to too much confusion out of Washington. A cursory look at the past four years reveals how many of the market's gyrations were driven by or exacerbated by events in Washington. This relationship is evident in the correlation between U.S. equity market volatility—as measured by the VIX Index—and the EPUI. In the past, the level of uncertainty has explained roughly 20% of the variation in volatility. As a rough rule of thumb, for every one point increase in the EPUI, equity volatility has increased

FIGURE 6: U.S. POLICY UNCERTAINTY VS. U.S. EQUITY VOLATILITY (1990 TO PRESENT)



Source: EPUI, Bloomberg, 12/15/13.

by roughly 0.1 (see Figure 6). Thus, if political uncertainty were to rise again from its long-term average to levels witnessed during the government shutdown, you would expect a nine to ten point increase in market volatility.

Given this relationship, why didn't volatility spike higher in 2013? Even during the peak of the government shutdown, volatility, as measured by the VIX Index, only reached the low 20s, barely above the long-term average. Part of the reason is that while the federal government was adding to the uncertainty, investors were benefiting from an unusual amount of *certainty* from a different Washington institution: the Federal Reserve. The knowledge that the Fed was buying $85 billion a month of Treasury and mortgage-backed securities went a long way toward mitigating any investor anxiety. Last year, Washington's impact on investors resembled a Russian novel—volatile, ill-tempered father and soothing, overprotective mother—with the federal government providing the drama and the more maternal Fed desperately trying to keep everything calm.

A NEW FLAVOUR FOR 2014?

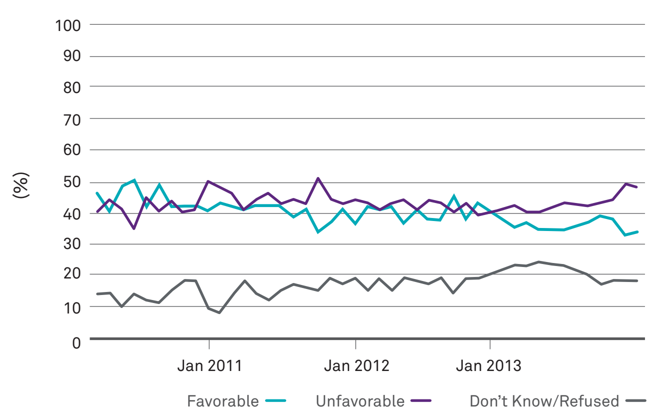
Going into 2014, many investors feel they can breathe easier, at least as it relates to politics and policy. While the decibel level in Washington will certainly rise as we approach the midterm elections, investors were reassured by the fact that politicians actually delivered on their promise to reach a budget accord. The deal passed in mid-December removes the threat of a government shutdown for the next two years.

However, the budget deal eliminates one threat, while ignoring several others, most importantly the debt ceiling, which will hit again sometime next spring. And even if Congress decides that the period right before midterm elections is not the most opportune moment to threaten financial oblivion, there are non-fiscal sources of uncertainty that will crop up this year.

As highlighted previously, the banking sector faces uncertainty surrounding the Volcker Rule, which will limit proprietary trading, as well as the broader uncertainty surrounding the implementation of Dodd-Frank. For anyone wondering why contemporary legislation is creating more uncertainty, Dodd-Frank provides a useful illustration. The law runs to roughly 1,000 pages and will be administered by five separate agencies. By way of comparison, Glass-Steagall, which defined banking for roughly 60 years, was 37 pages long.

Dodd-Frank and other industry specific laws represent potential sources of confusion for particular businesses. However, there is a much more far reaching law that will impact virtually every business and a good chunk of the electorate: the Affordable Care Act. As of this writing, the jury is still out on whether or not the rollout will improve from the confusion that characterized its introduction. As of late December, Americans remained skeptics (see Figure 7). The most recent CNN poll, dated December 26, showed a record 62% of respondents opposing the new law compared to 35% in favour.

FIGURE 7: AFFORDABLE CARE ACT TRACKING POLL



Source: Henry Kaiser Family Foundation, http://kff.org/interactive/health-tracking-poll-exploring-the-publics-views-on-the-affordable-care-act-aca/, accessed 12/23/13.

FIGURE 8: U.S. EQUITY MARKET VOLATILITY (2010 TO PRESENT)

Source: Bloomberg 12/15/13.

What is clear is that the ACA will impact many Americans in a much more visceral and direct way than Dodd-Frank or even the repetitive fiscal soap operas of the last three years. Uncertainty over availability and cost of healthcare will have, and to some extent may already be having, a far greater impact than anything else Washington is likely to do, or not do. To the extent Washington is a source of anxiety in 2014, the efficacy of the ACA is likely to be the issue to watch.

OUTSIDE THE UNITED STATES: WHAT TO WATCH

As investors have been repeatedly reminded over the past several years, the United States does not have a monopoly on political problems. Markets careened in 2010 and 2011 on fears of a breakup of the eurozone (see Figure 8). And while we see less systematic risk in Europe, uncertainty over the banking sector and frugality fatigue allow for the possibility of a repeat.

Investors will also have to contend with elections in 2014 in several key developing countries, including Indonesia, Turkey, India and Brazil. In addition, other potential sources of volatility include European parliamentary elections, referendums on independence in both Scotland and the Spanish region of Catalonia, and the uncertain paths of reform in both China and Japan (see Figure 9).

Finally, we remain concerned about the Middle East. As of this writing, the violence in Syria was spreading into Lebanon, Libya remained mired in factional fighting, sectarian violence was rising in Iraq, and the world's newest country—South Sudan—was descending into chaos. Although oil production has been rising in the United States, many of the countries in the Middle East and Africa are witnessing falling production due to growing unrest and terrorism.

FIGURE 9: KEY POLITICAL EVENTS IN 2014

Date	Country/ Region	Event
1/25/2014	U.S.	Key Fed meeting 1/24/2014 to 1/25/2014
2/7/2014	U.S.	Debt ceiling limit
2/11/2014	China	EU-China trade summit
Spring 2014	China	"two conferences"
4/1/2014	Japan	3 percentage point consumption tax increase takes effect
4/25/2014	U.S.	Key Fed meeting 4/24/2014 to 4/25/2014
5/26/2014	Europe	European parliament elections 5/22/2014 to 5/26/2014
By 5/31/2014	India	General elections, which would provide clearer direction on India's economic reforms
6/20/2014	U.S.	Key Fed meeting 6/19/2014 to 6/20/2014
7/9/2014	Indonesia	Presidential election: the pro-reform governor of Jakarta, Joko Widodo, might enter the race and focus the election around economic growth
9/18/2014	Europe	Scotland independence reform
10/5/2014	Brazil	General elections
By 10/2014	Europe	AQR deadline
11/4/2014	U.S.	Mid term elections
12/2014	China	Central Economic Work Conference: sets economic targets for the following year
2014 (date unknown)	Europe	German constitutional court hearing on the OMT

Source: Bloomberg, BlackRock.

CONCLUSION

"To succeed in life, you need two things: ignorance and confidence."
—Mark Twain

Political and policy uncertainty is a constant. There is always a contentious issue to debate or a government on the verge of collapse. What is different now is not the presence of uncertainty, but the level. Uncertainty is difficult to measure, but there is evidence that investors today are contending with an unusually volatile environment. Political division in the United States is the highest it's been in the post-World War II period. In Europe, the unfinished business of reconciling a fragmented banking system and structural reforms in much of southern Europe casts doubt on the entire eurozone project. Finally, many emerging markets—from China to Brazil—are struggling with politically contentious reforms as their old growth models are in need of a tune-up.

In 2013, despite heightened uncertainty, volatility remained muted. This was partly a function of good luck, but there was another, more significant factor at work. Central bank purchases from the Fed, and increasingly the Bank of Japan, provided a palliative in the form of massive liquidity, even when political dysfunction rose. In some ways, the ineffectiveness of fiscal policy and a general state of political paralysis encouraged central banks to be even more aggressive than they otherwise might have been. Witness last fall's decision by the Fed to hold off on tapering, a decision partly reached due to the looming threat of a government shutdown.

For 2014, there are a few lessons for investors. First, policy uncertainty may remain elevated, even if the catalyst looks different than the last few years. In particular, we would focus on the implementation of the ACA. Second, with the Fed winding down QE, central banks will not be as helpful in mitigating volatility as they were in 2013. If political uncertainty remains elevated, this scenario is inconsistent with volatility at these levels, particularly if liquidity decelerates. Under these circumstances, investors should be long volatility.

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