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Investor Doomsday? Not Necessarily

By PAUL J. LIM

WITH the election behind us, Wall Street is turning its attention to another suspense thriller: the Washington battle to head off automatic spending cuts and tax increases that could kick the economy into recession next year.

The conventional wisdom is that the fight over this so-called fiscal cliff "may cause investors to sell, and contribute to more volatility in the coming month or two," said Jeffrey N. Kleintop, chief market strategist at LPL Financial.

History shows only that the markets tend to be volatile and unpredictable in the aftermath of close national elections. In election years since 1976, between Election Day and Dec. 31, the Standard & Poor's 500-stock index has lost as much as 9.6 percent and gained as much as 7.6 percent.

Still, despite the real possibility of economic peril — the Congressional Budget Office predicts that gross domestic product will shrink next year if Congress and the White House can't reach an agreement — a recession and bear market aren't the only possible outcomes that investors should brace for.

For starters, many economists think that while certain items may be allowed to lapse, like the payroll tax holiday and extended emergency unemployment benefits, they doubt that Congress and the White House would allow the economy to go completely a full fall. In fact, the consensus among forecasters surveyed by Blue Chip Economic Indicators is that the economy will avoid recession and grow modestly in 2013.

Earlier this year, the budget office predicted that the full possible effects of the situation — including the expiration of the so-called Bush tax cuts and automatic spending reductions put in place in last year's contentious debt-ceiling debate — could shave as much as $800 billion off gross domestic product in 2013.

But Mike Dueker, chief economist for Russell Investments, says he thinks policy makers may ultimately reach a fiscal-tightening agreement that will result in a much smaller drag on G.D.P.

Marie M. Schofield, chief economist at Columbia Management Investment Advisers, agrees that a moderate tightening is likely. "The question in my mind is if this is going to be a fiscal cliff or a fiscal bunny hill," she said. Rather than let everything expire and kick in, she said, Congress could find a way to postpone certain important decisions.

If Congress were to stretch out the crisis over several months, it could mute these problems enough to make them manageable in investors' minds, said James W. Paulsen, chief investment strategist at Wells Capital Management.

Mr. Paulsen notes that, like the European debt crisis this year, the situation might turn out to be a series of chronic problems that are dealt with sequentially, not as a single financial disaster.

There is some evidence, he says, that the market views the problem in these terms. Despite growing concerns this year, he notes that the CBOE Volatility Index, or VIX, a closely watched gauge of investor fear, remains below 20, after having approached 50 last summer.

“To me, this is evidence that the financial markets are desensitized to this doomsday thinking,” he said.

He notes that many elements of the economy are healing in the meantime.

The labor markets, for instance, are slowly but surely improving. Consumer confidence is at a five-year high. And the housing market shows clear signs of a rebound. The latest reading of the Case-Shiller Home Price Index, for instance, found that home values in the 20 largest metropolitan markets gained 0.9 percent in August over July.

G. Scott Clemons, chief investment strategist of Brown Brothers Harriman, says the nascent housing recovery is significant.

“The real engine of economic activity is still personal consumption,” he said. “So the housing and labor markets are the canaries in the coal mine for the economy. As long as those parts of the economy are still chirping, we’re fine.”

Henry B. Smith, chief investment officer at Haverford Trust, sees another script to consider.

While it’s not the most likely outcome, there is a possibility that the debate in Washington will eventually lead to major tax and spending reforms.

Under this bullish alternative, he said, the lame-duck Congress finds a way to postpone spending cuts for at least a couple of quarters. Then, beginning next year, the president and Congress tackle spending, taxes and entitlements not in piecemeal fashion, but through a comprehensive tax reform and deficit reduction plan.

“If that were to happen, in our view, you’d see everyone’s 2013 G.D.P. estimates come up,” he said, adding that it would unleash pent-up demand both in the economy and the markets.

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