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What the New Congress Means for Markets

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What does the new Congress mean for your investments?

Maybe it's a little early to prognosticate. Results are still coming in. Investors are going to have to wait to see more specifics from the new Congressional leaders. And there's a two-month lame duck Congress to get through before the new team takes charge. We don't even know if the Bush tax cuts will be extended beyond Dec. 31–and, if so, for how long.

But I'm not one to hang around. And if investors want to look ahead, they're not completely blind. We have two sets of clues: History, and the plan that the Republican leaders themselves laid out nearly two months ago, in their 48-page Pledge to America.

Neither is a perfect guide. But they may not be completely useless. What can they tell us?


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THE STOCK MARKET. Unclear. Watch out for anyone who tells you "divided government is good for the stock market." The historical basis for this – such as data since 1949 via the Stock Trader's Almanac-is meager. You can't extrapolate universal rules from such a small amount of data. The results are too heavily skewed by the Reagan (1981-86) and Clinton (1995-2001) booms under divided governments. "The mantra that gridlock is good for the markets is not borne out by the evidence," says Bob Johnson, senior managing director at the CFA Institute, a trade organization for professional investors. A case in point: The stock market has gained 40% since the Democrats took full control in Jan. 2009.

LARGE CAPS. Positive. Yes, the new Congress may be pro-business. But that should favor those who can pay to play. That means big companies with cash, clout and contacts. Think: Big oil, pharma, and the Wall Street banks. Large companies boomed following the "Republican Revolution" of 1994. Large companies also have other advantages for investors today. After years of underperforming small caps, many of them look reasonably priced. Those with big dividend yields should benefit from extensions of the Bush tax cuts, which favor dividend income. And large companies are most able to benefit from overseas growth and a weaker dollar (more on that below).

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SMALL CAPS. Unclear. They should benefit if the Republicans follow through on plans for lighter regulations and a small business tax cut. But the biggest issue for them remains the domestic economy, still burdened by high unemployment and heavy debts. According to the Pledge, the new Congress plans to axe any remaining stimulus and cut back on discretionary spending. Will this austerity help the domestic economy in the short-term? Hardly. Look at Ireland, where the economy is in freefall. A further headwind for small cap investors: The stocks have already outperformed for a decade. The cycle may be due to turn.

DOLLAR. Negative. That, at least, is the take if the Republicans follow through on the budget ideas in the Pledge to America. If so, we can probably expect skyrocketing federal deficits and maybe even a dollar crisis. The Pledge calls for trillions of dollars in tax cuts, yet offers few major plans for savings. As the free-market Cato Institute dryly noted, the 48-page document "contains more pictures of Republican members of Congress than it does evidence that the GOP is seriously prepared to cut spending." It even balked at abolishing the federal "wild horse and burro program," the Institute added. No wonder the dollar has already come down a long way in recent months, in anticipation of this and Ben Bernanke's next wave of money printing.

BONDS. Negative. The new political climate hardly looks helpful for bond investors. If taxes are cut and deficits soar, the federal government will have to issue many more bonds. That alone should depress prices. At some point it may start to undermine confidence in federal finances. And then there's the risk that political gridlock may degenerate into something worse–political paralysis. That would hardly help confidence either. The outlook might be OK if bonds were already cheap. Instead they're expensive.

Today Uncle Sam can borrow for 30 years at less than 4%–very cheap rates by historic standards. Lenders are taking a big gamble that inflation will stay low, and our public finances will remain strong.

GOLD. Positive. Eric Singer, manager of the tiny, offbeat Congressional Effect mutual fund, has followed the gold price since it first floated freely nearly 40 years ago. His findings: Over that time, gold typically beat stocks by a wide margin during periods of one-party rule, while stocks outperformed during periods of gridlock. What does this mean? Maybe something, maybe not. After all, it's only a few decades' worth of data. And the situation may be very different this time around. Today Mr. Singer asks the best question of all: "Will this be 'your father's gridlock'?" No one knows. The gold boom is 10 years old, which ought to make investors wary. But if the Republicans make good on the budget plans in their Pledge to America and the dollar tanks, it's hard to see how gold does badly.

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