U.S. Flash

Strengthening economy buttressed Obama's victory

Our presidential vote-share model indicates that improving economic fundamentals contributed to President Obama's victory on Tuesday. In August, our model predicted a majority vote for the GOP if the economy continued to weaken and the stock market sank prior to the election. The key economic indicators in our model, however, strengthened during September and October, and using recent actual data, the model pointed to an Obama win.

The model helps us to understand the economic factors that shaped the election's outcome. Six months ago, when economic conditions were much bleaker, Romney's pitch to undecided voters that he was the better candidate to improve the healthcare system, reduce the deficit, address ongoing regulatory challenges, and expand opportunities for the middle class held more sway. As the unemployment rate descended below 8%, however, and the stock market continued its upward march, manufacturing output steadied and the housing sector saw broad improvement. Consequently, many swing voters ultimately attributed the strengthening economy to President Obama's leadership.

With the election settled, Washington's focus now turns to the 2013 Fiscal Cliff, as the expiration of prior tax cuts and previously negotiated expense reductions will hit with full force and reduce expected economic growth if laws are not changed. Measures to partially extend existing tax cuts and dampen automatic spending reductions are most likely to be enacted and would significantly decrease the probability of a recession in 1H13. Both Republicans and Democrats must recognize that a compromise is necessary; to reduce deficits, the budget needs a combination of increased revenue and lower spending.

Table 1
Presidential Vote-Share Model
(blue=Democrat advantage, red=GOP advantage)

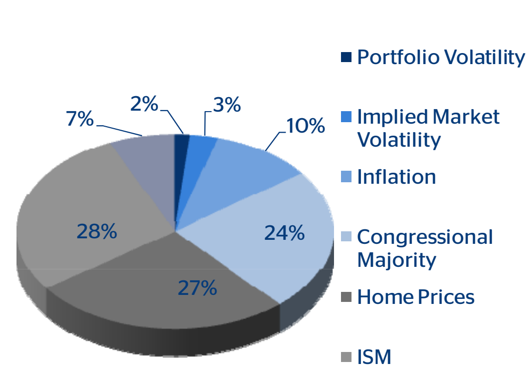
	Tax[1]	Dow[2]	VIX	Inflation[3]	House Control	Home Prices[3]	ISM	GOP Vote-Share*	Actual Results (as of Nov. 8)
August forecast under deteriorating economy scenario								*53.3%*	*Obama: 50.4%*
Prediction with data through October								*47.3%*	*Romney: 48.1%*

Source: BBVA Research
* Represents the predicted Republican share of the popular vote
1Peronsal Current Taxes as reported by the BEA
2Realized Dow Jones Industrial Index Volatility
3Variable is conditioned to fluctuate with incumbency (0 if no incumbent)

Latest economic factors shifted in Obama's favor

In August, with economic activity slowing in Europe and domestic indicators nearing ominous tipping points, our election model pointed to a victory for Mitt Romney if the economy worsened. Economic activity, however, strengthened during September and October and tipped the scales back in favor of the President. Driving the improvement over August were better than expected employment growth and a rebound in manufacturing activity from the summer slump. Moreover, inflation eased as oil and gas prices slid, thus lowering voter angst over rising costs. Furthermore, the housing sector continued to strengthen slowly, as home prices (and hence net worth) improved, and low interest rates and government-backed programs fueled home purchases and refinancing activity. Borrowing costs remained low and the stock market continued its ascent; both factors were supported by the Federal Reserve's September announcement of an expansion of its quantitative easing program (QE3). Taken in sum, these factors aided the President's decisive win and nearly 54% job approval rating as indicated by exit polls.

Chart 1
Vote-Share Model Factors, Percentage of Variation Explained



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Voters agreed with Obama's narrative on the economy

Four years of poor economic performance and persistently high unemployment were not enough to send Mitt Romney to the White House. President Obama has underscored throughout his term that he was handed one of the worst economies in the history of the U.S when he took office in 2009. The unemployment rate was 7.8% when he took office and quickly accelerated to 10% by October of the same year. Excluding Franklin Delano Roosevelt, no other president has taken office with an unemployment rate higher than 7.5%. Moreover, economic growth was in free fall in early 2009. Only FDR and Harry Truman were tasked with turning around an economy that was contracting in nominal terms. Also, Reagan was the only president to have been re-elected since WWII with a jobless rate above 6%. Regardless of the unprecedented circumstances of his first term, the President still has many challenges ahead. Softening the fiscal cliff and reaching long-term compromises on fiscal sustainability are the number one priority.

Chart 3

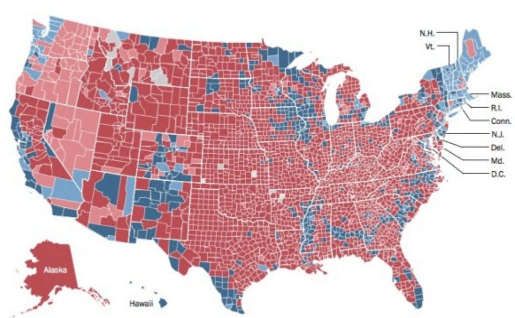
The Fiscal Cliff: Budget Impact of Current Law and Expected Impact in 2013

Fiscal Cliff (FY13)	US $bn	Expected Impact (% of GDP)
Automatic cuts in the Budget Control Act of 2011	89	0.38
AMT Patch: Indexing AMT to inflation	150	0.35
End of Bush-era tax cuts	168	0.20
Reduction in employee social insurance contributions	98	0.17
Extension of maximum period of entitlement for unemployment benefits	26	0.05
New taxes related to health insurance reform	31	0.04
Routine extension of short-term tax relief	38	0.04
Reduction in Medicare's payment rates to doctors	15	0.04
Total	**615**	**-**
% of GDP	**3.9**	**1.3**

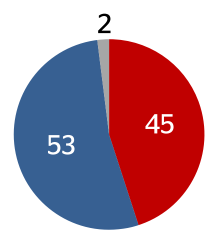
Note: Column 2 represents the current estimates of the full budgetary impact if current law remains unchanged. The realized impact of the fiscal cliff will depend on the political process and changes to these measures. We estimate the expected impact of these provisions as a percentage of GDP by multiplying the budgetary impact with fiscal multipliers and our assigned probability of the measure's extension.

Source: BBVA Research and CBO

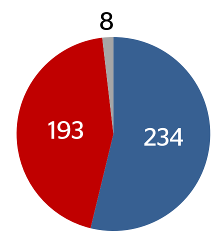
Electoral Map: Party Vote by U.S. County



U.S. Senate: 113th Congress



U.S. House 113th Congress



Source: WashingtonPost, BBVA Research

*Undecided races are too-close to call as of Nov 8

Fiscal sustainability and compromise are essential for second-term success

The uptick in economic activity prior to the election reinforced the President's electoral margins as our vote-share model predicted. There are many challenges that lie ahead, and finding solutions will not be easy. Challenges include the rising cost of healthcare, the declining performance of public education, aging infrastructure and practical approaches to immigration and energy. Obama's victory speech indicates that these issues are cornerstones to his 2nd term agenda; however, all efforts could be sidelined if he does not address the most immediate and perhaps greatest challenge that the U.S. faces: long-term fiscal sustainability.

Ultimately, all of the aforementioned areas will succeed or fail based upon the ability of President Obama and Congress to compromise on a federal budget that sets the United States on a viable fiscal path. After four years of deficits in excess of $1 trillion, a rising debt servicing burden threatens to consume a greater share of the already stretched budget. Inaction now will only increase uncertainty and could send the U.S. into a vicious cycle of debt accumulation, weak economic growth and lasting damage to potential output. The opportunity cost from such fiscal mismanagement, in the short-run, could exceed 6.2 million jobs and 8.1 percentage points of economic growth over a two year horizon (for more on economic uncertainty, refer to our 3Q12 US Outlook).

Currently, U.S. policy makers are still in control of the long-term fiscal course, and President Obama along with Congress will direct policy during the next four years. Since January 2011, however, neither side was willing to break the do-nothing cycle and reach a lasting compromise. With a divided Congress, there is still a high degree of uncertainty regarding the potential for compromise between the parties during the president's second term. Short-term patches are no longer sufficient to ensure U.S. global competitiveness, and the costs of inaction today will only rise.

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