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THE ROAD FROM HERE

For the past couple weeks, markets – and market commentators – have been preoccupied with the drama unfolding in Washington. The partial government shutdown, and the threat of a debt ceiling-induced sovereign default, gave the 24-hour news-mongers plenty to talk about. Now analysts are wringing their hands over the damage that may or may not have been done to the economy – damage exacerbated, in our minds, by the emotion-laden conviction, earnestly felt by liberal Democrats, establishment moderates, and Tea Partiers alike, that the *other guys* are driving the country straight off a cliff.

Time for investors to take a deep breath. Recall what I wrote in August: that (a) we would likely see a federal government shutdown for the very reason that any damage to the economy would be both modest and temporary, (b) a debt ceiling-induced default had the potential to do serious and long-lasting harm to the economy, and was therefore extremely unlikely to actually happen, (c) the political battle over these matters would be messy, ugly, and unpredictable, which markets would find unsettling, and (d) the resolution would likely be a short-term ceasefire that kicks the can a few more months down the road. So really, things played out pretty much as expected.

Expecting trouble may not be as good as avoiding it, but for investors, in a world where many things lie beyond our control, it's the next best thing. So what should we expect next?

- The budget deal that reopened the federal government last week extends funding to January 15 and the debt ceiling through February 7. This has given rise to worries that we will see yet another shutdown and/or debt ceiling crisis a few short months from now. That's possible, but unlikely. Republicans in Congress are still licking their wounds and are unlikely to have much appetite for another high-stakes clash so soon. Come the new year, the most likely outcome is a short-term extension of the current ceasefire. But there's also a distinct possibility Congress and the President might be able to strike a win-win deal, trading sequestration cuts for long-term entitlement reforms, which would move the U.S. in the right fiscal direction.

- Unfortunately, the continued focus on budget squabbles leaves Washington with little bandwidth for two other issues, immigration reform and tax reform, where meaningful progress could provide a more substantive boost to the U.S. economy. The difficulties plaguing the implementation of Obamacare cast a further shadow over the 18% of GDP driven by health care, as well as the broader labor market, and contribute to the sense of uncertainty and hesitation already felt by businesses and consumers.

- With all the focus on politics, though, it's easy to overlook the deeper changes holding us back from a stronger US recovery. Due to technology and globalization, the country has seen a structural shift away from many of the middle-income jobs that formed the backbone of the middle class, even as those same developments have boosted opportunities for higher-income earners. Rising income inequality is disrupting established patterns of consumer demand, and a soft labor market – particularly for younger Americans – is holding back household formation. With U.S. consumers still in the process of deleveraging – particularly on their homes – improvement to real incomes is going to be key to getting Americans buying again.

- For all these reasons, the Federal Reserve is likely to continue its QE purchases through December, and delay the much-anticipated taper. Markets like easy money, but this is a double-edged sword. First, it's far from clear that further QE is having any real positive impact, given that 85% of the money that's been created is just sitting on banks' balance sheets as excess reserves (and which some worry could serve as dry tinder for future inflation). Second, the continuation of QE reinforces the market's growing psychological dependence on the Fed, and its fear – evidenced in its skittish reaction to any truly positive economic news – of the uncertain future lurking beyond the confines of its QE cocoon.

- Still, from an investor's point of view, U.S. corporations look attractive. Earnings growth may be sluggish, but profit margins are wide and balance sheets are solid. All the cash sitting on corporate balance sheets may represent a hesitation to invest and drive growth, but also indicates a capacity to pay out higher dividends, buy back shares, and snap up smaller companies. Price-to-earnings ratios are reasonable and, based on historical experience, have room to grow. The energy revolution in U.S. shale oil and gas, in particular, is a major trend that is going to make American companies more competitive.

- At the same time, the rest of the world faces real challenges. Germany's effort to remake the Eurozone in its own image is not really a viable solution to Europe's woes. Chinese leaders may chuckle at the "dysfunction" of American democracy, but China faces a wrenching economic adjustment and tough reforms that have been put off for far too long – with the very real prospect of a "hard landing" along the way. The momentary prospect of QE tapering revealed the vulnerabilities of emerging economies like India and Turkey that have coasted on capital inflows to pay for rising energy imports and postpone much-needed reforms. Brazil risks squandering historic opportunities due to patronage and graft, and the shale revolution threatens to pull the rug out from under Russia's resource-mafia economy. The point is not to predict global doom and gloom, but to emphasize that the U.S. economy, for all its troubles, stands out as a relatively positive story

in a very challenging global environment – which is why, whenever uncertainty looms, U.S. Treasuries and the U.S. dollar remain the "safe harbor" of choice for global investors.

Over the past few weeks, politicians in D.C. have taken us on a roller coaster ride. But like all roller coasters, this one was governed by the law of conservation of energy. There were plenty of ups and downs, twists and turns, but in the end, we got off pretty much the same place we got on, albeit a bit sick to our stomachs. For better or for worse, the budget battle in Washington didn't really change the big picture for investors. It's time to take a deep breath, and recognize that.

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