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The Fed may not know what deflation is, but they know how to fight it. Sadly, the GOP neither knows what growth is, nor how to stimulate it.

Much as the political climate favoring pro-growth tax cuts has taken a positive turn since the November 5 elections gave **Republicans** control of the **Senate**, obstacles remaining in the way of significant incentive-oriented policy should not be underestimated. No question, it would be tempting to attribute the market's recent energetic performance to anticipated fiscal policy payoffs of undisputed GOP control of the levers of government authority. To the extent the election results are helping instill a measure of confidence that a generally more growth-friendly tax and regulatory environment is likely to take hold, it has certainly been a positive factor at the margin. The evidence strongly suggests, though, that the reignition of the equity rally that began on October 10 has been tied most closely to signals from **the Fed** over the past two weeks offering reassurance that it would, if need be, take concerted action to thwart deflationary forces from taking root.

That would appear to affirm the analysis we've presented over the past several months, suggesting that deflation risk remained a prominent hurdle in the path of the market's capacity to capture the highly attractive risk premiums in financial asset prices. A major missing link was an acknowledgement by the Fed of those risks, which would suggest that the central bank is prepared to take appropriate action against them (see "Better Late Than Never" November 8, 2002). If the Fed has indeed now provided the necessary commitment to quell the deflationary risks to capital, a continued, sustained absorption of risk premia could well be in store, with an accompanying shift toward greater risk preference across a range of asset classes. A harbinger of that shift can now be seen in the junk bond market, where spreads had blown out to record levels around the time of the equity market's bottoming in early October. At 800 basis points, the S&P Speculative Grade Credit Spread has rallied by more than 200 basis points. Half of that has come in just the last two weeks, since Fed officials have taken obvious steps to assure the market that they would be prepared, if conditions demanded, to initiate extraordinary anti-deflationary operations.

As we noted in a *"Trend Macro Live!"* bulletin, in his November 13 testimony to the **Joint Economic Committee**, **Fed Chairman Alan Greenspan** took care to acknowledge the Fed's awareness of deflation risks. On that occasion, he emphasized that there was "no meaningful limit" on the liquidity the Fed could provide by directly purchasing assets if its rate-targeting procedures were incapacitated by deflationary influences. In his appearance last week before the **Council on Foreign Relations**, Greenspan expanded on that message, telling the group: "There's a general view that as the federal funds rate gets closer and closer to zero, that at zero we are out of business. That is not the case. We are very far from the Fed being restricted," he said, adding that the Fed could then purchase longer-term securities to inject the necessary liquidity.

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Last week, the newest Fed governor, former **Princeton** economics professor **Ben Bernanke**, gave a speech to the **National Economists Club** entirely devoted to the theme: "Deflation: Making Sure 'It' Doesn't Happen Here." Bernanke actually takes a fundamentally flawed demand-based view of the deflation process, maintaining that a falling price level is the "result of low and falling aggregate demand." Deflation, in fact, is the manifestation of central bank monetary policy error which creates an excess scarcity of dollars relative to demand, raising the exchange value of money relative to goods and services priced in dollars, and thereby causing dislocations which result in "low and falling aggregate demand." At the same time, Bernanke's exposition suggests that while he may not understand what *causes* deflation, he knows what should be done to *overcome* it. "US dollars have value only to the extent that they are strictly limited in supply," he said. "But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost. By increasing the number of US dollars in circulation, or even by credibly threatening to do so, the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services."

Given that the most sensitive market price indicators -- foreign exchange, gold and broader commodity indexes -- already reflect a significant subsidence of deflation pressure since early this year, this kind of official handholding could go a long way toward relieving the remaining risks. We have maintained that those risks were primarily occasioned by uncertainty about the extent to which the Fed recognized the deflationary dangers of its own making, and would allow the reflationary impulses seen this year to be sustained. That uncertainty, it would seem, has now been substantially resolved. When it comes to the Fed, of course, it always pays to not lose sight of the potential for overshooting, and that in endeavoring to quash a deflation that has already been substantially relieved, the Fed's posture could well swing toward an inflationary excess liquidity position (see "A Deflation Dichotomy" November 18, 2002). At this point, though, all indicators suggest that those risks remain well contained.

Based on what we see as a credible anti-deflation commitment by the Fed, and our expectation that this will continue to relieve the economy's current spasm of risk-aversion, we are increasing the allocation to equities in our Model Position long the S&P 500, raising it to approximately 65%. That said, we are not allocating more to equities at this time, pending evidence of progress in fiscal policy to match progress in monetary policy.

On the fiscal policy front, there are indeed some promising indications emerging in the post-election atmosphere on Capitol Hill. If the axiom that "personnel is policy" holds true (which it usually does in Washington), the move of **Senator Don Nickles** to chairmanship of the **Senate Budget Committee** is potentially huge. Nickles replaces **Pete Domenici**, a veteran of the budget wars going back 20 years who, while well-meaning, could never get past the notion that the federal budget's relative deficit or surplus position was at the center of the economic universe. Nickles is a supply-sider who understands that deficits are the consequence of broader economic forces, not their cause, and appreciates the important incentive effects of marginal tax rates in shaping economic choices.

In the coming Congress the Budget Committee will be critical in the tax debate. With only a 51-member majority, tax legislation proceeding through the **Senate Finance Committee** would be subject to filibuster, which takes 60 votes to shut down. If a tax measure is included as part of the budget reconciliation process, however, it is not subject to filibuster and would require only a simple majority to win passage.

That's the good news. The less-than-good news is that while a Nickles-assembled budget will likely include as much tax action as can be politically tolerated in this environment, that probably won't amount to much, at least not any time soon. With deficit-phobia again the compulsion of

the day in our nation's capital (as reflected no better than in our hapless **Treasury Secretary, Paul O'Neill**) the thinking now is that a tax package will necessarily be limited to a 10-year "cost" of no more than $200 billion. Among options currently on the table, those that would have significant incentive-oriented effects would be few and far between. That might include an acceleration into next year of the rate cuts scheduled for 2004 (but not those scheduled for 2005 and 2006), an exclusion from taxation of perhaps as much as $1,000 per year of dividend income, and an acceleration of so-called "marriage penalty relief," which mainly involves a widening of the 10% bracket. Under this scenario, nothing will be done on capital gains, upper-bracket rates, or expensing of capital expenditures. In other words, don't expect anything that comes of Washington next year to bear much resemblance to the **Reagan** economic recovery package of 1981. TM