TrendMacrolytics

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THOUGHT CONTAGIONS

The Politics of Expansion

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The conventional wisdom is catching up to the market in seeing the economic expansion -- and that presents some new risks.

Much that we have long predicted has been revealed over the last two weeks to be unmistakably true: the **US** economy is growing rapidly, and the long decline in payroll employment has reversed. Stocks have not especially reacted to the news, because this is only "news" at all to economists who follow backward-looking government statistics. Real economic participants, on the other hand, have personally lived the turning point from recession to expansion in real-time as it has developed.

Yet it is not irrelevant to markets that the conventional wisdom has finally begun to shift. That shift will set in motion new psychological, political and policy dynamics that will feed back into the economy and the markets, for good and for ill.

One important emblem of the shift in conventional wisdom -- and its implications -- is the lead editorial in the Sunday ***New York Times***, calling upon the **Federal Reserve** to raise interest rates in light of better-than-expected economic data. In a *TrendMacro Talking Points* bulletin sent out over the weekend, our colleague **Bruce Bartlett** noted:

> "It's extremely rare for the *New York Times* to editorialize about the Fed, and rarer still for it to devote the lead editorial position in its heavily-read Sunday edition to this topic. So the *Times* is clearly sending an important message. That message, I believe, is to the Democratic Party and it is that inflation and rising interest rates need to replace jobs and growth as its principal attack on Republicans...necessitated by excellent recent data on growth and jobs.
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> "...The goal is to prepare the ground for Democrats to adopt a Ross Perot-like obsession with fiscal responsibility that could undercut President Bush's support among swing voters. It will also serve to soften the left-wing image of Howard Dean, the likely Democratic presidential nominee, by giving him a conservative issue to run on.
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> "I don't think this strategy will work, but it might if Democrats are able to force Republicans to backslide on taxes in order to deal with the budget deficit. If Democrats are successful in making the deficit the issue, then they will have a much more effective way of attacking tax cuts than just saying that they are a give-away to the rich, which is about all they have had to say up until now. Basically, the hope is to replay the 1990-92 game and get Bush to undermine his own base by backtracking on taxes, as his father did, while Democrats play up their Clinton-Rubin budget surplus record and promise that tax increases *a la* 1993 are good for growth."

Whether or not Bartlett's precise scenario comes to pass, the essential take-away here is that inflection points in the conventional wisdom are always risky for markets -- even when they are triggered by inherently good things -- because they open up new opportunities for policy mischief. We see **Bush's** tax-cuts as having been essential to igniting the new expansion, and would see any threat to those tax-cuts as being very bad news. So it would be no surprise to continue to see the stock market fail to "react to the good news," because the market will instead be taking a time-out to evaluate the risks, costs and benefits of a new world in which the reality of expansion goes from being a well-kept secret to just more grist for the political mill.

Objectively, much good can come from this change in psychology. For one, we have been arguing for some time that the Fed should raise rates -- anything that nudges them in that direction is a good thing. We expect that after some predictable buffeting, the stock market will quickly overlook any mistaken fears that rate hikes could choke off the expansion at this point. More broadly, a shift in psychology toward heightened expected returns and a more widespread tolerance for risk will contribute mightily to the sustainability of the expansion (see "Another Virtuous Cycle" November 6, 2003).