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The Republic of Hanging Chad

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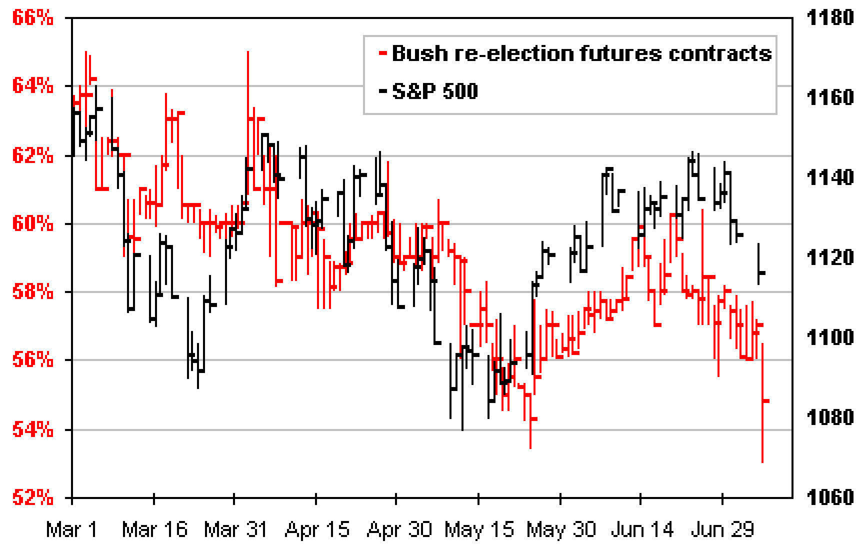
Markets twist in the wind while tax and monetary policy are up for grabs.

At first blush **John Edwards** must have been a good choice for **John Kerry's** running mate, because yesterday **George Bush's** chances of re-election fell to new lows. As measured by the political futures contracts traded online at **Tradesports.com**, at the lows of the day Bush's chances were only 53%. It's no coincidence that it was a bad day for stocks, too.

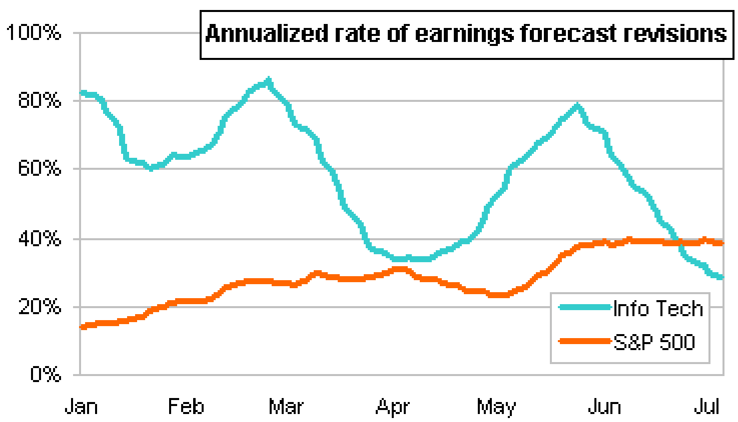


As we've noted for most of this year, the stock market and the Bush contract have moved hand in hand. Their coincident mid-May lows coincided with the climax of chaos in **Iraq**, and their recovery coincided with Bush's powerful PR offensive to articulate the objectives and strategies behind the war. The market and the Bush contract topped out together in late June as Bush's visibility fell following the **Reagan** memorial. Bush's opposition has had the stage ever since, with the release of **Michael Moore's** film "Fahrenheit 9/11" and yesterday's announcement about Edwards.

For equities in this year of political volatility, we've said buy the dips, and we've said sell the bounces. We wrote a month ago when stocks were in an upswing, "the next several months will be frustrating ones for equities. It's going to be difficult for stocks to do much more than move back up through the year's trading range" (see "Summer of Our Discontent" June 7, 2004). Now, if Bush's chances of re-election remain little better than 50/50, it seems likely that stocks will have to move further back down through the trading range. For stocks, it amounts to another "hanging chad" election -- a squeaker where we have to wait another four months for the results to be counted, and critical economic policy risks to be resolved.

As we've pointed out so many times before, the key reason for the linkage between the market at Bush's re-election probabilities is the risk to Bush's pro-growth tax policies. Markets have to discount for the chance that the reduction in tax rates on dividends and capital gains enacted last year would be weakened or repealed by Kerry, or at best be allowed to sunset away in 2008. Kerry's present position is that he would retain the lower rates for individuals with incomes below $200 thousand, and for everyone else revert to taxing dividend income at ordinary rates (which he would restore to 39% for the highest income-earners), and capital gains at 20%. If enacted, Kerry's policies would have the immediate effect of depressing equity prices, through simple arbitrage, by having arbitrarily lowered the after-tax return to capital. Longer term, the higher cost of capital and higher barriers to entrepreneurial risk-taking would depress economic growth, which would further depress equity prices. The virtuous cycle that was begun at the market bottom of March, 2003 -- when Bush's tax cuts first started to be a real possibility -- would start to run in reverse.

Another risk is that, under a Kerry administration, there is every reason to expect that regulatory taxes on the economy would be increased. Yes, Bush allowed himself to be forced into signing the **Sarbanes Oxley Act** (while acting enthusiastic about it), he's made a few protectionist mis-steps, and he's done little to reverse the antitrust activism of the **Clinton** era or to reign in the excesses of either **Eliot Spitzer** or the plaintiff's bar. In the domain of regulation, Bush is no Reagan -- but at least his instincts are not to seek to increase regulation. Kerry, on the other hand, speaks frequently of "corporate Benedict Arnolds," has proposed numerous regulatory initiatives from trade to health care, and has chosen as his running mate a trial lawyer.



Just as equity markets are discounting these risks, the real economy may be beginning to reflect them as well. All indicators are that the economy is still expanding robustly, but there can be little doubt that the pace of expansion has slowed from the red-hot levels of last year's second half. This is perfectly reflected in one key indicator we watch closely -- the annualized rate of month-over-month consensus earnings forecast revisions. For the S&P 500 overall, they are running at a robust 40%, but they've been flat there since mid-May. More troubling is that the pace of revisions in the Information Technology sector -- a bellwether for growth -- have fallen below that of the overall S&P 500, to about 30% from peaks at and above 80% at various points earlier this year.

Such evidence of slowdown is not necessarily a death-knell for the expansion. But it is certainly a warning bell. There's no escaping the iron law that economic activity will not only slow down in anticipation of higher tax rates, but also when there is merely uncertainly as to what tax rates will be. Yes, there's always *plenty* of uncertainty about that (which suggests that the economy could at all times perform better with the removal of that uncertainty). But the level of uncertainty now is much higher than usual, coming into a 50/50 election that amounts to a clash of absolutes on tax policy.

What's worse, there's more than one tax uncertainty operating now. Inflation is a tax as surely as income, dividend, and capital gains taxes -- and uncertainty about the future rate of inflation is now higher than it has been in years. It's not just that we strongly disagree with **the Fed's** mistaken "measured" approach to raising rates, and predict that an outbreak of core CPI inflation to at least 3% is now inevitable (see "Measure *This*!" June 25, 2004). It's that at this point, we can't have much confidence that it won't be far worse -- internally, the Fed's policy mechanism is in considerable disarray. This was evident from last week's nearly nonsensical statement following the **FOMC's** decision to raise the fed funds target by 25 basis points (see "Gitlitz *Live!* on the June FOMC Meeting" June 30, 2004).

More alarming evidence can be found in the minutes of the FOMC's May meeting. In one passage, dissent against both the prevailing inflation dovishness and the dominant "output gap" model was noted: “Others, however, were less confident about the degree of restraint on prices, noting that inflation predictions based on estimated output or employment gaps were subject to considerable error.” There was also debate about the expression "measured" -- which first appeared in the May statement, and again in the June statement: "A number of policymakers were concerned that such an assertion could unduly constrain future adjustments to the stance of policy should the evidence emerging in coming months suggest that an appreciable firming would be appropriate. Others, however, saw substantial benefits to inclusion of the proposed language.” For this kind of thing to be included in the minutes reveals that there are plenty of chads hanging at the Fed, and puts the lie to the Fed's façade of harmony -- and may indicate we could soon see either some dissent surfacing in public statements, or some shifts in their characterization of the policy outlook. In fact, this could be their way of broaching the possibility of such a shift. That's something we'd applaud -- but in the meantime, it seems that stable-money monetary policy is as much a 50/50 thing as pro-growth tax policy.

The bull market and the economic expansion born in the double-bottom of October 2002 and March 2003 were the products of stable-money monetary policy and pro-growth tax policy. Now, just 16 months later, the boom is at risk because those policies are at risk. These policy risks will crystallize into certainties over the next four months -- and the art of equity investing over that time will be to get just ahead of the crystallization. In our view, at this exact moment there's no need to take a stand one way or the other as to how it will turn out. But if we had to guess, it would be that Bush will be re-elected and that his tax policies will survive to at least 2008 -- and that the Fed will end up being forced to raise rates at a greater-than-"measured" pace sufficient to keep incipient inflation from attaining truly dangerous levels. All that would bode for a significant rally in the fourth quarter of this year. For bonds, as we've said before, there's no way out -- the only question is: death by rate hikes, or death by inflation? TM