Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

A Girlie Man Economy?

Thursday, September 9, 2004
David Gitlitz

Hardly. Politicized pessimism notwithstanding, animal spirits are very much alive and well.

Even under the best of circumstances, a heated national political campaign is unlikely to provide an ideal backdrop for a rational and dispassionate public discourse on economic performance and the candidates' contrasting policy approaches. Heading into the heart of this fall's presidential race, economic perceptions were tending to hew more closely to the claims of **Democratic** challenger **John Kerry** than to those of the incumbent **Republican**, **President Bush**. As we have noted, those perceptions were being shaped in no small measure by national media that consistently present a dim economic perspective to seize on President Bush's purported vulnerability for his economic record (see "Risks to Expansion: Reality or Spin?" August 20, 2004).

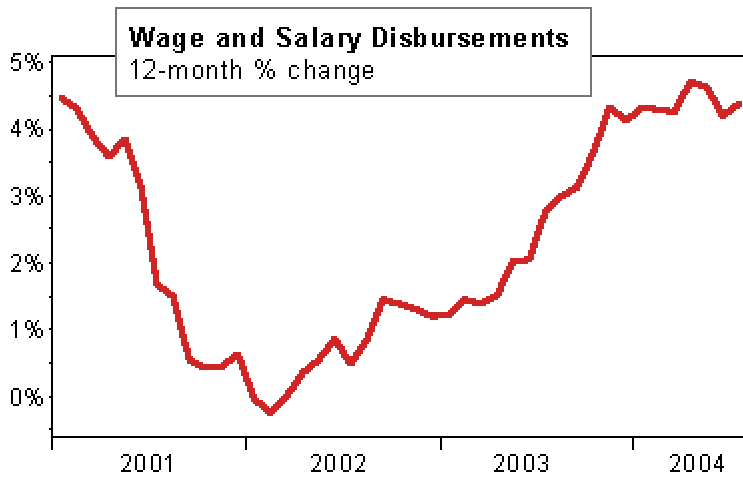
Coming out of last week's Republican convention -- that for the first time gave Bush a clear-cut lead in the polls -- we may be witnessing a subtle but notable shift in the economic/political *zeitgeist*. For one thing, both the ***Time*** and ***Newsweek*** polls show Bush with a lead over Kerry for the first time in months on the issue of who voters think would do a better job handling the economy. It could be that **Arnold Schwarzenegger's** admonition "don't be economic girlie men" had a galvanizing effect, at the margin, on voter perceptions of Bush's economic management (see "The Bush-Bashing Bubble Has Burst" September 7, 2004). But it may also be that as voters focus more intently on the ballot choice come November 2, a clearer perspective on their economic well-being as well as the policy alternatives posed by the competing candidates is coming into view.

There is a critical self-reinforcing quality to this choice as it relates to the market's discounting of future economic prospects, as well as those prospects themselves. Since early this year, we have detailed the degree to which the equity market has moved in concert with the changing odds on President Bush's re-election (see, first, "Tough Time for Tech" March 8, 2003). At issue are the pro-growth tax policies -- including the deep cuts in capital gains and dividend tax rates -- that President Bush proposed and won passage of last year. By boosting marginal after-tax rates of return and concomitantly cutting the cost of capital, those tax cuts were the *sine qua non* of the accelerated pace of expansion that took hold last year. President Bush wants to make the cuts -- which are due to sunset in 2008 -- permanent. Senator Kerry, in probably his most unequivocal and clearly enunciated policy stance, wants to repeal them -- as well as the cuts in marginal tax rates on taxpayers with annual incomes above $200,000. Under the circumstances, it's not difficult to see why the markets would greatly prefer a Bush victory, nor why political uncertainty likely has been playing some role in the economy's deceleration from its most vigorous growth levels of last year and earlier this year.

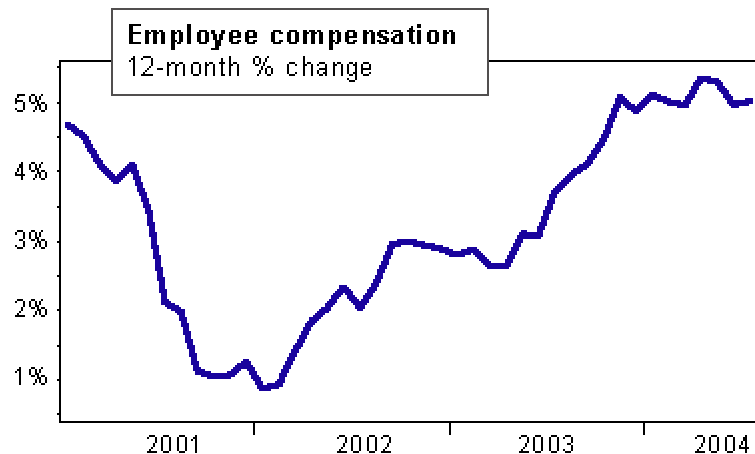
While the media regularly characterize the economy with adjectives such as "fragile," "frail," "troubled" and "soft," it appears that voter attitudes are coming to reflect the fact that their own

incomes are in a solid uptrend, and the prospects for continued improvement look good. Indeed, even more important than current conditions, forward-looking indicators of wealth creation and risk bearing suggest the outlook favors a sustained period of economic vitality. Despite the best efforts of left-leaning political and media elements to sow doubt and foreboding, this is no "girlie man economy."

No question, with real growth of 2.8%, the economy endured a slowdown in the second quarter from the better than 4% growth rates of the previous four quarters, due largely to the drag on consumption caused by the oil price spike. Anecdotal evidence suggests that those effects lingered into the third quarter in some areas, such as chain-store sales. At the same time, uncertainties created by the oil surge likely have contributed to a cautious attitude among employers that has kept a lid on payroll growth. With Senator Kerry being counseled by his advisers -- including former president **Bill Clinton** -- to make jobs a key focus of his campaign, no doubt we will continue to hear the already familiar refrain that Bush will be the first president "since Herbert Hoover" to show a net job loss during his term. Even after last Friday's report showing growth of 144,000 non-farm payrolls in August, which represented a recovery from two months of paltry expansion, with a gain of 1.7 million over the past year, segments of the press were eager to advance this theme.



The August jobs report "did little to diminish the liability that the U.S. labor market poses to President George W. Bush in his bid for reelection," **Dow Jones** asserted in its news dispatch on the employment report. To support its political judgment, the news service offered this description of recent labor market performance: "After a strong start in the summer of 2003, the job-market recovery lost steam in the spring of 2004." In fact, the empirical record shows exactly the opposite, as payrolls continued to *decline* on net through the summer of 2003, while spring 2004 saw the *strongest* growth of payrolls yet seen in the labor-market recovery.



Of course, were it actually the case that the current job markets bears any resemblance to the **Hoover** era, it would also be characterized by slow or nonexistent wage and salary growth. To be sure, in the world as represented in the news pages of the ***Washington Post***, among others, that's the way it is. "Ongoing pressures of global competition, and the insatiable demand of Wall Street for growth in earnings," the paper lamented last week, "continue to keep a tight lid on the kind of across-the-board pay increases that come with genuine recoveries." Perhaps the *Post*'s newsroom is as dark and gloomy as the economic perspective propounded in its pages

and the data isn't readily visible to its writers and editors. The fact is that average weekly earnings of the non-supervisory personnel covered by the monthly employment report are up at annual rate of more than 8% the past two months, the strongest rate since 1997. Looking at longer-term trends in a broader scope of the workforce, the signs are also positive. In the past 12 months, aggregate wage and salary income has grown by 4.4%, and has sustained a level above 4% for the longest period -- nine months -- since the months preceding the 2001 recession. Including benefits, total employee compensation has risen 5% in the past year, and that rate has also been maintained for the longest period since prior to the recession.

For our purposes, however, these indicators of current prosperity would be far less meaningful were they not matched by forward-looking indicators showing that the market's animal spirits remain robust, pointing to solid growth ahead. High-yield credit spreads, a critical gauge of the market's risk propensity, would be widening significantly if the market perceived rising default risk resulting from a weakening economy. On the contrary, the S&P speculative grade spread has actually contracted, on net, by more than 20 basis points since mid-August, and at about 400 bps is at a level that has been a consistent indicator of vigorous future growth. We take it as no coincidence, by the way, that this bullish turn in the high-risk spread coincided to the day with the revival of President Bush's re-elect chances as reflected in the political futures contract traded online at **Tradesports.com**. TM