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

MACROCOSM

Waiting for the River

Tuesday, January 18, 2005
Donald Luskin

It's another high-stakes hand of Texas Hold-'em, Bush style.

We find ourselves back in the "bubble of fear" that gripped the markets before last year's presidential election, albeit only a junior version of it so far. It's all the same stuff. Once again we have a bitter and divisive political death-struggle over economic policy, in which it seems that anti-growth arguments are dominating the public debate -- but this time its about **Social Security** reform, rather than taxes. And once again we have fears of pre-election terrorism -- but this time it's the **Iraq** election we're focused on rather than the **US** one. So the risk-sensitive crude oil price has mounted its biggest rally since last year's all-time high. And the equity risk premium, as measured by our Yield Gap model, has risen to its highest levels since the pre-election market bottom on October 25, when it was as high as it's been at any time over the last 20 years, with only four exceptions. We remain positive on stocks and the economy (see "The Rate Stuff" January 5, 2005) and expect that we'll come through this little bubble of fear just like we came through the last big one.

It's beginning to seem as though having to grit one's teeth through regular crises of confidence a hallmark of investing in the **Bush** era. Over the four calendar years that Bush has been in office, the S&P 500 has cumulatively returned about 2% -- a small number perhaps, but remarkable, really, considering the sky-high equity valuations and impending deflationary recession Bush inherited. How we got to that small return speaks volumes about Bush's political style. Think of each year as a hand of Texas Hold-'em. The first quarter is the deal; the second is the flop; the third is the turn; and the fourth is the river -- the final card. Bush -- reputedly an expert poker player in college -- always seems to win on the river, at the very last minute. If you'd invested in stocks in just the fourth quarter of every year, your cumulative return would have been 47% for the four years. The problem, obviously, was with the other three quarters. During those quarters Bush followed the old poker maxim, "Always underplay a strong hand." It's how he lures his opponents into "misunderestimating" him, and overplaying their own hands. It's worked every single time.

We're not positing a tradable "seasonal pattern" to the market during the Bush era (and we don't think we're going to have to wait for the fourth quarter of 2005 for stocks to make the next move higher). But the poker analogy does help contextualize our current situation with regard to Social Security reform. Once again, Bush is taking on a titanic political challenge with profound long-term growth implications. Once again, the debate appears to be almost entirely dominated by Bush's opponents: the mainstream media is overbrimming with anti-reform tirades, laced with the usual plausible-sounding doomsday scenarios and buttressed by more than a little economic disinformation. And once again, the administration is nearly silent -- no concrete plan has yet been made public and the disinformation goes unchallenged: all we hear are not entirely coherent stump speeches and vague platitudes from the president and **Treasury secretary John Snow**. At this point in the hand of poker, even enthusiastic supporters of reform start questioning their beliefs, and wondering if this is really politically feasible after all. It's nervous-

making for markets not so much because of the risk that reform won't happen (after all, we don't have reform *now* to lose) -- rather, there is the ominous sense that, in the **White House**, nobody's home.

For all that, the economic case for Social Security reform is actually very simple, very compelling, and very pro-growth. And the president's reform proposal (as we forecast it -- see "Next Year's Miracle" December 14, 2004) is a powerful and remarkably elegant minimalist solution. Its package of small benefit enhancements for the lowest earning workers and the removal of automatic large benefit increases that exist under current law is alone sufficient to entirely erase the system's $10.4 trillion unfunded liability. The establishment of modest personal investment accounts (which, we now hear, would be expanded over time) would restore benefit levels to those payable under current law, but would require the issuance of new government debt to replace the tax dollars diverted into the accounts. The present value of such debt would be under $1 trillion. In effect, then, a $10.4 trillion undocumented debt will have been replaced by a $1 trillion documented one. Over $9 trillion in debt will have been wiped off the national balance sheet with the stroke of a pen, and nobody will have gotten hurt. That's really all you need to know about reform -- and it just doesn't get much better than *that*.

Can it happen politically? Of course it can. Yes, we are reminded constantly (by the opposition) that Social Security is the third rail of American politics. We are told (mostly by **Democrats**) that the **GOP** is divided on the issue. But the fact remains that the public overwhelmingly understands the reality that Social Security is economically unsustainable, and strongly favors a system under which they would have a vested property right in their future benefits (as they would with personal accounts). Don't forget that when **Clinton** was president, Social Security reform was a major initiative among "New Democrats" -- some of them even flirted with a concept as capitalistic as personal accounts. It's a winning issue -- the third rail is dead. The driving energy of the opposition today is little more than the fact that Bush is *for* it. That's not likely going to be enough to either meaningfully divide the GOP on it, nor sufficiently unite the Democrats against it (the GOP would only have to find a handful of turncoats). This will be another hand of Hold-'em where it looks for all the world like Bush has nothing in the hole -- but then he wins on the river.

For all these reasons, on the list of risks for equity investors to worry about, we'd suggest not losing a lot of sleep over today's geopolitical and economic policy panics. Their downsides are highly unlikely, and their upsides are much more likely than markets expect. If you must worry about something, worry about **the Fed**. We continue to hope for and expect more aggressive tightening than the fixed income markets are looking for, but a renewed climate of uncertainty could cause the Fed to drag its heels. Evidence that the Fed is willing to look across the valley of fear and keep on tightening will be very bullish indeed. TM