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

POLITICAL PULSE

Policy Paranoia

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Donald Luskin

Stocks are exaggerating the risk that the Social Security debate is getting out of control.

It was difficult last week not to recall the visual signature of the final leg down in the bear market that ended in 2002 -- the televised image of **George W. Bush** reassuring the nation while the stock ticker in the corner of the screen showed the market in free-fall. Then **Congress** was in a frenzy of hasty legislation in the wake of the **Worldcom** accounting scandal, and it was clear that Bush would have no political choice but to sign whatever regulatory monstrosity emerged from the process -- and, indeed, he did happily sign the regulatory monstrosity known as **Sarbanes Oxley**.

The similar risk today is that Bush has opened a tax/regulatory Pandora's Box by putting on the table the reform of **Social Security** -- without bounding the debate with a specific proposal. In the absence of such a proposal, last week the legislative process of reform began to be seen as dangerously out of control. On Wednesday the ***Washington Post*** featured coverage of statements by **House Ways and Means Committee Chair Bill Thomas** suggesting that Social Security reform should only be considered in the context of a debate on tax reform. Tax reform could be a wonderful thing, but there is considerable risk in undertaking it hastily, and Thomas was quoted as saying legislation could be on the president's desk in just five or six months. Then on Thursday the ***New York Times*** ran a story stating in its headline and lead paragraph that House **Republicans** were "urging the White House to consider tax increases as part of any deal." Markets have been looking forward to making Bush's 2003 tax cuts permanent -- not dealing them away in the context of Social Security reform. Yet with these risks in the background, and with no specific reform proposal yet on the table, Bush gave an inaugural speech Thursday that scarcely mentioned economic matters at all -- while the ticker in the corner of the screen showed stocks moving to new lows year-to-date.

Don't panic. The risks are not as severe as the **Democratic**-leaning media establishment would have you believe. Republicans aren't urging tax increases -- readers who looked beyond the first paragraph of the story discovered that they're actually suggesting that the White House listen politely while *Democrats* urge tax increases. And this isn't the first time that Bill Thomas has thrown his weight around -- and it's not always bad when he does. Recall that in 2003 it was Thomas's interference that resulted in Bush's lopsided dividend tax cut being transformed into a more optimal mix of dividend and capital gains tax cuts.

The moment is not without risk. Democrats would love nothing more here than for Bush's Social Security reform initiative to be his Hillarycare -- the failed, grandiose over-reaching initiative that will break his political momentum. It certainly seems that the Democrats are utterly dominating the debate now. Their critiques are mostly nonsense, frankly -- much as it was nonsense in 2003 for **Robert Rubin** to argue against a capital gains tax cut on the grounds that it would make the stock market go down because investors would have less disincentive to sell stocks. But all the White House is doing in response now -- at least all the media establishment will let us hear -- is to offer easily caricatured exaggerations such as Bush saying in a town hall meeting that Social Security will be "flat bust" in 2042. So nonsense dominates the outward public perception of the debate. And markets have to wonder not only whether Bush will get Social Security reform done, but whether at this point he can even get his 2003 tax cuts made permanent.

So with these risks in the background, we see the equity risk premium swelling to levels not seen since before the presidential election. Our valuation model shows, as of Friday, the S&P 500 to be almost 36% undervalued. On Friday the growth-sensitive technology sector fell to its lowest valuation since January 1996, almost 40% undervalued. Yes, believe it or not, the risk premium in the tech sector is even greater right now than it was on the day of the very bottom in October 2002. The risks we face today hardly justify such valuations. Even in an environment of continuing bad news, truly important declines just don't start from valuation levels like this. If anything, it's the opposite. In the year following January 1996, the information technology sector returned 56%. In the year following the October 2002 valuation low, it returned 78%.

Once again, we find ourselves watching George W. Bush play high-stakes political Texas Hold-'em, and once again he is underplaying a strong hand (see "Waiting for the River" January 18, 2004). The opposition, at the same time, is overplaying a weak hand -- much as it did during the election. All the same players -- the New York Times, George Soros, and so on -- are all making the same mistakes. For example, a Democratic PAC still convinced that issues are won by throwing money at radical web sites has just funded one called "ThereIsNoCrisis.com". This is poker, and there are no guarantees. But it is clear that equity valuations are exaggerating the present policy risks and ignoring considerable upside potential.

BOTTOM LINE: Stocks, especially the technology sector, are strongly undervalued here. There are real policy uncertainties to be sure, but they are already priced to a considerable extent. There is little to be risked, and much to be gained, by betting that the pro-growth policy initiatives in place will succeed. TM