TrendMacrolytics

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POLITICAL PULSE

The Purple Finger of Fate

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The successful Iraq election opens a window for pro-growth policy success.

Three weeks ago we talked about a mini-bubble of fear enveloping the market in advance of the **Iraq** elections -- in every way a smaller echo of the bubble of fear that preceded the **US** presidential elections last year (see "Waiting for the River" January 18, 2004). Now we're beyond the event horizon -- not only without a terrorist attack disrupting the world's supply of oil (or anything else), but with **President Bush** being to an important extent vindicated in yet another major initiative that the conventional wisdom had written off as dead on arrival. Bush now has to his credit a new icon of freedom -- the purple finger. His opponents have **Howard Dean**.

With that, judging by the somewhat improved tone of the stock market this week, the way forward toward pro-growth economic policies has become a little clearer. Remember, the 2003 tax cuts were enacted during a brief window following the invasion of Iraq, when Bush's credibility as a war-time president was running high. A similar window could be opening up now, which is why Bush deferred the State of the Union address until after the Iraq elections and waited to use it to offer the first specifics about the reform of **Social Security** with personal accounts.

What we heard last night about Social Security reform all points toward exactly the kind of proposal we anticipated late last year (see "Next Year's Miracle" December 14, 2004). It's a three-way combination of 1) restoring system solvency by paring back the automatic benefit increases scheduled under current law; 2) offsetting that to a large extent by offering personal accounts with inheritable property rights, in which workers can earn market rates of return; and 3) minimizing the bond issuance required to fund the personal accounts by keeping their size modest (growing over time to a maximum of 4% of wages per annum). Altogether it has the properties of a debt restructuring through a debt-for-equity swap: creditors (in this case, workers, in their capacity as future retirees) would agree to reduce their claims against a risky creditor (in this case, American taxpayers who will be unable to deliver future scheduled benefits) in exchange for equity (in this case, personal accounts in which workers have property rights). It would surely be the largest debt restructuring in the history of the world. From the standpoint of the federal government's balance sheet, the system's $10.4 trillion unfunded liability -- an unbonded debt of the federal government that accrues interest every year just like any debt -- would be swapped for slightly less than $1 trillion (present value) in bonded debt.

Don't underestimate the positive effect that accomplishing this would have on the economy and the markets. The elimination of a major default risk vector in public finance would free up risk-bearing capacity to work in other more productive ways. The creation of new property rights in mandatory employment-based savings would function as a virtual tax cut on labor income, which would permanently increase labor force participation. And most important, debt and equity markets will be able to find a more efficient equilibrium once Social Security savings, which are among the most efficient bearers of long-term equity risk, will no longer be forced by law into intermediate-term Treasuries. The new equilibrium will undoubtedly feature higher stock prices and lower bond prices, all else equal.

Can it be done? Yes, and it probably *will* be done. But batten down the hatches for another bitter partisan struggle. Hopefully, at least the details Bush offered last night will be enough to quell the internecine warfare among reform advocates -- warfare centered on how to deal with the political risks inherent in reform. Specifically, there are two third rails here: benefit cuts and debt issuance. The more you cut benefits (or, more precisely, decelerate existing automatic increases), the less debt you must issue. One faction among the reformers -- known unfairly as the "free lunchers" -- has advocated not cutting benefits at all, and instead permitting large personal accounts that would require issuing a great deal of debt in order to fund. Their political calculus is that even small benefit cuts are politically fatal, but "debt doesn't matter." Bush has split the baby, by putting benefit cuts on the table (cleverly citing past **Democratic** advocates for each of them), and limiting the size of personal accounts, and concomitantly reducing the size of the required debt issuance. If the "free lunchers" want reform at all now, they're going to have to accept half a loaf, and we suspect they will.

The worst bitterness in the upcoming debate will come from the 527 organizations on both sides of the issue are geared up to spend many millions of dollars poisoning the airwaves over the next several months. No doubt much of it will rely on the same scare tactics that were employed by the same organizations in the presidential election -- much of it oriented toward the riskiness of equity investing, forecasts of the poor returns that can be expected from stocks over the long term, and cataclysmic visions of the US as a debtor nation going hat in hand to **China** begging to be bailed out.

Considering that many equity investors are all too ready to believe such things to begin with, the battle for Social Security reform could be a significant damper on sentiment. So a mini-bubble of fear may linger for a bit. But stocks are severely undervalued according to our model, so it's difficult for us to see much downside risk here. And the upside could be considerable -- both short-term, as the issue resolves one way or the other and sentiment improves; and long-term, if the issue resolves successfully.

Bottom line: The successful Iraq election could mark a turning point in President Bush's ability to get pro-growth initiatives successfully accomplished. The battle over Social Security reform will be an ugly struggle, so sentiment could continue to be depressed. But stocks are deeply undervalued, and just at the time when improving chances for pro-growth policy breakthroughs offer considerable upside potential. TM