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POLITICAL PULSE

Waiting for a "Swift Boats Moment"

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Undervalued stocks need a catalyst that clears the overhang of tax policy risk.

It used to be that the four most expensive words on Wall Street were "this time it's different." But this time it's different. Today the four most expensive words on Wall Street are "everything's on the table."

President Bush spoke those four words on February 16, when he let it be known that he would entertain raising or eliminating the cap on wages subject to payroll taxes in order to stimulate a bi-partisan dialog on **Social Security** reform. With those four words spoken, the NASDAQ 100 lost 60 points in five sessions, and as of today, on net, it has not recovered those points. Growth-sensitive stocks are discounting some probability that reform -- something that we have seen as extraordinarily bullish for the economy and for stocks -- could come at too high a price: a huge tax increase levied upon **America's** most critical marginal labor producers (see "Pyrrhic Victory?" February 23, 2005).

This risk has important externalities. The divisive debate about Social Security reform, combined with the **Bush administration's** new-found commitment to spending restraint in this year's budget, has lowered the chances of significantly extending -- never mind making permanent -- the 2003 tax cuts. At this point, the best we can hope for is the extension of the cuts in the dividend and capital gains rates by two years. We think that is, indeed, just what we will get at the end of the day. But it will be months until the end of the day arrives, and when "everything's on the table" -- when undecided senators and congressmen are being asked on the one hand to extend the tax cuts, while on the other hand they are being told that raising the payroll tax is one of the "good ideas" we must "listen to" -- those will be long and nervous-making months.

It didn't have to be this way -- and right after last year's presidential election it didn't seem like it was going to be. When President Bush won a larger than expected mandate in the popular vote, and when the **Republicans** won a history-defying increase in the control of **Congress**, it seemed like making the 2003 tax cuts permanent would be a cake walk. And the stock market rallied accordingly, with growth stocks in the lead. Stocks had sagged in the first half of last year -- growth stocks most of all -- as Bush's electoral chances fell, and it seemed that his pro-growth tax cuts were destined for sunset or repeal. Then in the second week of August -- the very week that the **Swift Boat Vets**' book about **John Kerry's** war record became available -- stocks began to turn around, just as Bush's chances, and the chances of extending the tax cuts, did. But when Bush won big in November, he didn't do what most presidents would do: that is, use his political momentum to pick off low-hanging political fruit such as the tax cuts. No, Bush didn't act like the typical lottery winner who buys a new RV for his mom and puts the rest in the bank. Instead, Bush used his winnings to buy more lottery tickets. He took on Social Security.

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And so we see the stock market acting this year precisely as it acted last year, because "everything's on the table" again -- *then*, because the election was uncertain, and *now*, ironically, because the election was so definitive. Technicians will enjoy this ominous parallel: in 2004 the year-to-date high for the S&P 500 was on March 4 -- this year it was on March 7. In 2004 the year-to-date low was on March 24 -- this year it was on March 29. So if past continues to be prologue, we'd now expect to see a rally back to the vicinity of the highs of the year, if for no other reason than that stocks are almost preposterously undervalued relative to bonds (yes, even after the big back-up in bond yields over the last two months). But as long as "everything's on the table," it's difficult to see how stocks could sustain meaningful new highs. What is needed now is this year's "Swift Boats moment" -- something that crystallizes confidence in the sustainability of pro-growth tax policy. Getting a budget through **Congress** -- with tax cuts extended -- would go a long way, of course. But resolution of the Social Security debate -- ideally, taking off the table tax *increases* that could more than erase the extended tax *cuts* -- would be better still.

There are surely ways that could happen. In conversations with Republican law-makers, we get the strong sense that lifting the wage cap is an "over our dead bodies" issue. We are hearing that the only way such a thing would be possible would be if it came in combination with offsetting tax cuts elsewhere. A popular alternative among Republicans -- and one that might fly with **Democrats** as well -- is the idea of means-testing. Yes, means-testing is effectively a tax, but it is a particularly benign one in terms of incentive effects: it is deferred into the deep future, and concerns benefits that most high earners have mentally written off long ago anyway. For all that, though, there's no guarantee that lifting the wage cap *won't* happen -- especially if it comes to a showdown between stonewalling Democrats and Republicans filled with religious zeal for the "Ownership Society."

Another simpler way to take tax risk off the table would be for President Bush to abandon the Social Security reform initiative. The cost would be to kill, at least in the near time, the potential for two very bullish things -- the restructuring of an $11 trillion debt overhang, and the simultaneous wholesale elevation of economy-wide risk tolerance through the advent of personal accounts that could invest in stocks. But the benefit would not only be that it alleviates tax risk. At the same time, if could set up the **GOP** to achieve a wider margin of congressional control in the 2006 elections by running against "obstructionist Democrats" -- and *then* taking on Social Security reform, and any number of other pro-growth initiatives, with an expanded majority. The set-up for this is already in place. According to polls, the administration's efforts this year have elevated Social Security to among the top domestic concerns of voters; more than two thirds believe the program is either in "crisis" or faces severe challenges; and more than half believe something should be done about it right away. By saying "everything's on the table," President Bush has eliminated any possible Democratic objection to bi-partisan participation in a solution. The trap is ready to be sprung: "The American people overwhelmingly agree that something must be done, and I said I'd listen to all good ideas -- yet, out of sheer selfish partisanship, the Democrats won't even talk to me about it. So now, more in sorrow than in anger..."

That, by the way, is a scenario rather than a prediction. Everything we hear from the administration tells us that the Social Security reform initiative is proceeding full speed ahead. Perhaps someone in the **White House** has taken note of how the stock market has firmed up over the last two weeks, while the reform debate was temporarily crowded out by news of **Terry Schiavo** and **Pope John Paul II**. But that said, watching the ticker isn't President Bush's style. While stocks were in crisis during the invasion of **Iraq** in 2003, the President told us, "I won't let the stock market drive the war" (see "Notes from the West Wing" April 3, 2003). So we may have to live for a while with a distribution of possible futures that has very fat tails -- on the right, revolutionary pro-growth economic restructuring, and on the left, the biggest tax increase in history.

Bottom Line: Tax policy risk is holding back stocks this year, much as it did last year. Stocks are deeply undervalued, though, and we are probably in midst of a rally that will challenge the highs of the year. To make meaningful new highs, though, tax policy risk has to be taken off the table. When that happens, the restoration of low interest rates to more normal levels won't hold back undervalued stocks -- and the growth sectors that have fared the worst this year will lead the way.