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

MACROCOSM

Tsunamis! Killer Asteroids! Protectionism!

Thursday, April 21, 2005

Donald Luskin

Add another one to the list of risks driving stocks to historic undervaluation.

Bonds, it seems, fear nothing. **Stocks**, it seems, fear *everything*. As we've detailed over the last two weeks, stocks do have very real tax and inflation risks to worry about (see "Waiting for a 'Swift Boats Moment'" April 7, 2005; and "Back to Square One" April 15, 2005). And several clients have called in to highlight to us what they see as other important policy risks that are in play now, too (one of which we will discuss in this report). As these risks have accumulated, the risk premium in stocks has continued to widen. As of yesterday's close, if the **S&P 500** were just 1.3% lower, its valuation relative to forward consensus earnings and **Treasury bond** yields would be right where it was on March 11, 2003, in the pit of the international diplomatic crisis leading up to the invasion of **Iraq**. Just 5% lower and valuations would match those of October 9, 2002, the panic climax of a 1000-day bear market that was the worst since the **Great Depression**. If the world really is coming to an end, it would seem that it's already in prices. If it's not, then stocks are very cheap. If the risks currently in play do not eventuate, or eventuate in substantially less than worst-case forms -- as we expect -- then there is considerable room on the upside. We've said that before, and we've been early. But we stand by it, now more than ever.

Protectionist trade policy risk was highlighted yesterday when **Democratic Senator Charles Schumer** announced that **President Bush** supported his amendment to impose 27.5% tariffs on all imports from **China**, to be triggered if negotiations fail to get China to end its peg of the **yuan** against the **dollar**. The administration quickly and firmly denied it, declaring that it would be ineffective and would violate **World Trade Organization** rules. But while disagreeing with tariffs as a means, the administration agrees with the amendment's ends -- to put pressure on China to revalue the yuan. The administration claimed yesterday that China now has in place all the institutional mechanisms required to support a full floating exchange rate, and may be on the verge of taking "interim steps" on the way to implementing it.

The **White House** has no illusions that a floating yuan is going to make any real difference to **US** competitiveness in the unskilled labor markets in which China excels. President Bush said this week it was "not a panacea," and **Council of Economic Advisors** member **Kristin Forbes** noted that increased imports from China "largely reflect decreased imports of the same goods from other countries." Yet the White House feels it must be seen as "doing something," as protectionist impulses in **Congress** mount. Schumer's amendment will be voted on by the end of July, having survived a motion to table by a resounding vote of 67 to 33. **Republican** senator **Lindsey Graham**, the co-sponsor of Schumer's amendment, calls it "a political wildfire being spread throughout the House and the Senate." Faced with the potential catastrophe of what amounts to a **Sarbanes-Oxley** of protectionism, a White House that has always found it politically impossible to use the veto pen is doing everything it can to get China to take those "interim steps" as soon as possible, including unofficial conferences at last weekend's **G-7** meeting (which China nominally boycotted), and hints that **Treasury** might officially brand China a "currency manipulator" in its ominously delayed semi-annual report on trade.

The worst-case risk here is the manifold damage that would be inflicted on the global economy by imposing tariffs against China, and further by risking an unknown series of retaliations. That's an outcome that neither the administration nor China wants, and it's unlikely to happen. Even if the Schumer/Graham amendment were enacted, there is plenty of wiggle room in the language as to what constitutes failure of negotiations, so enactment would not immediately -- nor, necessarily, ever -- lead to imposition of tariffs. With or without enactment, China will most likely find a dignified way to announce that it has unilaterally decided to make a small modification in its peg or the band around the peg -- something it has full scope to do already under its own official policies, and which the global currency markets have been expecting for a long time. Ironically, China would probably end up better off if it re-engineered its peg so that the yuan is not the passive victim of the implicit revaluations and devaluations that have been the consequence of being tied to an alternately deflating and inflating dollar. If the US would just stop humiliating China by ordering it do this, China may well find it is motivated to do it for its own selfish reasons.

It's not without risk, though. The dollar peg has proven to be a reliable port in a storm for China, helping it weather some extraordinary challenges. It would remain to be seen if a new and possibly more complex currency regime could be successfully executed by what is, in many ways, still a very primitive economy. But that risk is for the future. For now, the relevant risk is a runaway train of protectionism here at home. So if China announces a change in the peg, expect a very positive reaction from markets -- but it won't be because such a change would actually do anything good for the US economy. It won't. But it will take a very serious risk off the table.

Bottom Line: Add the threat of protectionist legislation to the long list of policy risks we are facing. But as with inflation risk and tax policy risk, markets seem to be in the mood to price for the worst, with stocks just a day or two's trading away from matching the deepest undervaluations in two decades. With respect to all these risks, the worst-case outcomes are highly unlikely in our view -- but flirting with them seems to be "the Bush way" (see "Waiting for the River" January 18, 2005). We reiterate our belief that valuations put a rough floor under stocks here. Any good news, or any change in sentiment, leads to considerable upside. TM