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MACROCOSM

Policy Takes A Right Turn

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Trade, monetary and tax policy risks all abated last week: good news for stocks.

I've been on deep vacation for the last eleven days, during which there have been several important **policy developments** -- all good for **stocks**. Here's a quick review.

YUAN REVALUATION AND PROTECTIONISM Last Thursday **Senators Charles Schumer** and **Lindsey Graham** agreed to shelve their **China tariff bill** set for a vote in July after a meeting in which **Treasury Secretary John Snow** and **Fed Chair Alan Greenspan** convinced them a **yuan revaluation** is coming. Schumer said after the meeting that the revaluation "could well occur in a very short while, in the next few months." Predictably, the next day a spokesman for the **People's Bank of China** said "we never make predictions and there is no timetable." But four days *before*, Chinese **Premier Wen Jiabao** had told a meeting of **Asian** and **European** finance ministers, according to the government-run ***People's Daily***, that "China would push forward the reform in a responsible manner" under the three principles of "independent initiative," "controllability" and "gradual progress" -- and that this would "demonstrate China's intention to enhance its image as a responsible big country, an image built up during the 1997 Asian financial crisis." In our view, there's little doubt that we are seeing the kind of coordinated mutual stand-down that we have been predicting since the Schumer/Graham bill first touched off a **protectionism** wildfire in April (see "Tsunamis! Killer Asteroids! Protectionism!" April 21, 2005). This substantially withdraws one of the most dangerous **Swords of Damocles** that had been overhanging the **world economy** and the **US equity market**.

THE FED REMAINS MEASURED As colleague **David Gitlitz** pointed out on Friday (see "Fine Fettle" July 1, 2005), **the FOMC** did the right thing by hewing to its course of **"measured" fed funds rate hikes**, and not bowing to pressure to pause the rate hikes coming from **bond** bulls, **soft-spot** bears, or **hedge fund** suicide bombers. We continue to agree with the Fed that today's rates are "still accommodative" -- thus we see ourselves still in the midst of a salutary **rate normalization**, not an economy-strangling **tightening**. As such, the Fed's resolve is equity-friendly, because it portends the successful abatement of **inflation risk** without eventual **monetary shock-treatment**. By the end of the year, if it is clear the normal rates at around 4% to 4.25% have indeed been sufficient to deal with inflation risk, then the single largest Sword of Damocles overhanging stocks would be withdrawn. Stocks could then correct their long-standing **undervaluation** by rallying as they did beginning in late 1994 when the end of a rate-hiking cycle came into view. In the 12 months after the second-to-last hike in that cycle -- one that would be considered a whopper by today's standards, on November 15, 1994, raising the funds rate 75 basis points from 4.75% to 5.50% -- the **S&P 500** rallied 26.7%.

GLOBAL WARMING CARBON TAX Two weeks ago it seemed that bi-partisan pressure was building in the Senate for imposition of a **carbon tax** on greenhouse gas emissions, with **Republican Senate Energy Chairman Pete Domenici** indicating he would back a draconian tax plan promoted by **Democrat Jeff Bingaman**. Since then, an even harsher bi-partisan proposal from **Senators John McCain** and **Joseph Lieberman** was defeated, and Domenici has backed off his support of Bingaman after a meeting with **Dick Cheney**. Just as important, heading into this week's **G8 meeting** in **Gleneagles**, **President Bush** has made is crystal clear in a series of statements that he will not bow to intense pressure from **Britain's Tony Blair** and other European leaders for the **US** to sign onto the **Kyoto Protocol** treaty. One more Sword of Damocles withdrawn.

Bottom line: The Fed has done the right thing to hew to its measured rate-hike regime. And the **Bush administration** has done the right thing by reining in Republicans and standing firm against foreign allies who support anti-growth tax and protectionist policies. Thus three important threats to the economy, and to equities, have been either withdrawn or significantly lessened. And ahead of what will surely be a bitter, divisive and distracting national debate over the replacement for **Supreme Court Justice Sandra Day O'Connor**, it's useful to see a reaffirmation and re-energizing of the administration's pro-growth mandate. We continue to see stocks as massively undervalued relative to bonds, and see these developments as important steps toward an inevitable upward revaluation. TM