TrendMacrolytics

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So Far So Good

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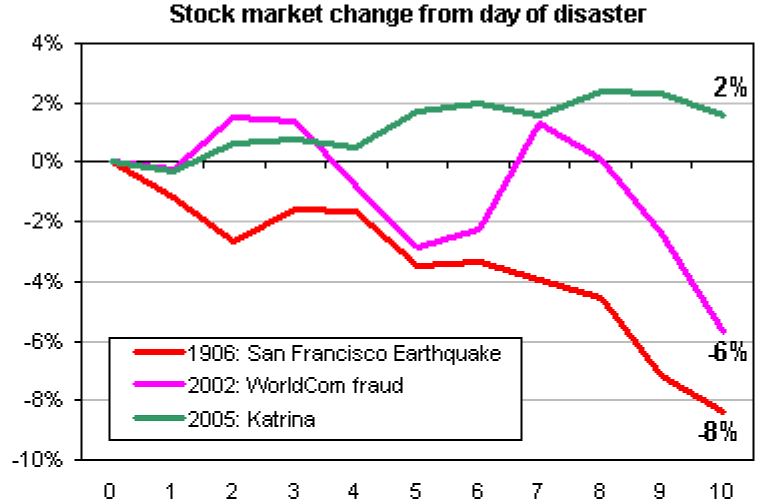
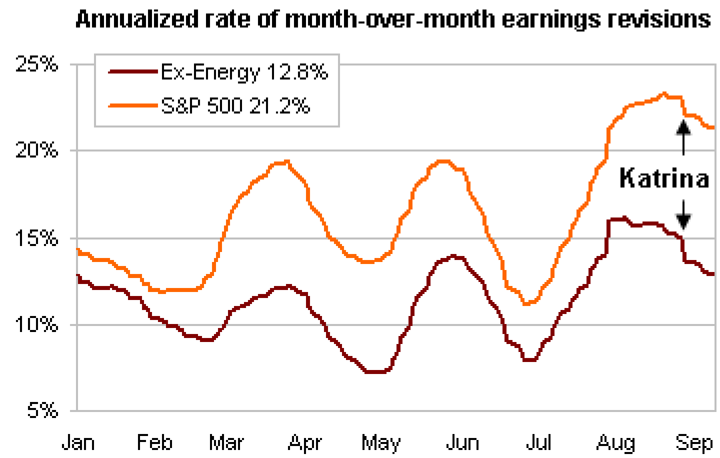
Pro-growth policy is still on track, despite post-Katrina economic and spending shocks.



Stock prices have pulled back a bit, but they remain tangibly higher than they were before **Hurricane Katrina** flooded **New Orleans**. Over the same number of days, stocks were 8% lower following the **San Francisco** earthquake and fire of 1906, and 6% lower following the revelations of **Worldcom's** accounting fraud that led directly to the **Sarbanes Oxley Act**. Stocks seem to us to be saying three things here -- 1) that they were deeply **undervalued** to begin with coming into this crisis; 2) that they don't foresee any serious long-term first-order **macroeconomic shocks** arising from it; 3) and that they don't foresee any catastrophic **policy errors** being made here in the legislative rush to provide "relief."



In the short-term, there will surely be macroeconomic shocks. This started showing up sharply in **earnings forecast revisions** immediately following the flood of New Orleans, when the scope of the catastrophe became obvious. The annualized rate of month-over-month revisions for the **S&P 500 ex-Energy** had been above 15% before Katrina -- it now stands at 12.8%. Even at that, though, 12.8% is still a very fast rate of earnings growth, and the drop so far appears to be entirely within the normal cyclical range. If there's a major disaster over the horizon, the bottoms-up earnings consensus isn't sensing it.

On the policy risk front, we are still betting that the $70 billion in **tax cuts** over five years built into **Congress's budget reconciliation process** will be accomplished. This would include a two-year extension of the 2003 reductions in **tax rates** on **dividends** and **capital gains**

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(extending their sunset from 2008 to 2010), the extension of **expensing provisions** for **small business**, and the extension of the **Alternative Minimum Tax "patch."** These three elements "score" at a "cost" of $90 billion, with the difference to be made up in "offsets" from closed **loopholes** and disallowed **shelters**. Under the reconciliation process, the votes are almost surely there -- only 50 votes in the Senate are required for passage (with **Cheney** breaking the tie with his 51st vote). There was a risk that the reconciliation process would be aborted by virtue of being delayed from its original mid-September reporting deadline, but the **Senate parliamentarian** approved an extension to late October for the part of the process devoted to spending, and the same ruling will no doubt apply to the inevitable delay of the revenue part.

Based on our sources, the **White House** and both **Senate** and **House** leadership remain strongly committed to this **pro-growth** policy. While there has been some promotion in the **mainstream media** this week of the idea that Katrina-driven spending is making Congress **deficit**-phobic, the pro-growth message is a persuasive one. As White House counselor **Dan Bartlett** said publicly yesterday, laying the groundwork for **President Bush's** speech tonight, "the American people have been hit with an enormous tax in the size of gas prices...We shouldn't be adding to that burden on families across America by raising their taxes, which would only...set back our efforts to help people get back on their feet." And Katrina or no Katrina, even **Democrats** have a motive to go along with this year's package of tax cuts. Without the extension of the AMT "patch," at least 5 million Americans will immediately face higher effective **income tax rates** by virtue of the loss of **deductibility** of **state income taxes** -- and that's something that hits high-tax **"blue states"** the hardest.

Bottom line: The extension of pro-growth tax policy appears to remain on track, albeit delayed until late October. The more proximate risk is the possibility that **the Fed** will make the **inflationary** error of **accommodating** Katrina by pulling back from its **"measured" rate-hike** regimen (see "Grand Illusion" September 12, 2005). It is concerning to us to see **gold** -- the most important indicator of inflation expectations -- trading above 450. But for the moment we still regard the possibility of a Fed error as a risk, not a reality. So once again, while we wait to get beyond the risks, we continue to see stocks as the king of **carry trades**, a near-**arbitrage** in which one can accrete rapidly growing earnings while bearing only historically low opportunity costs (see "The King of Carry Trades" June 14, 2005). TM