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What's Spooked Stocks?

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Already nervous stocks have been discounting deepening political risks.

"Inflation worries" have been widely offered up as explanation for the **stock market's** last three bad days, but it doesn't quite wash. Yes, each day some **Fed** official has made public remarks highlighting the risks of inflationary pressures, and the **prices paid** components of both **ISM surveys** this week showed significant jumps. But none of that is especially surprising or out of pattern at this point. And how is it that this inflation scare has affected just stocks? Other more typically inflation-sensitive and Fed-sensitive markets have not acted as you'd expect them to -- **Treasury bonds** and **interest rate futures** have been virtually flat; **commodities** and **energy** have moved lower; and the most sensitive of all, **gold**, was moving lower until yesterday. As glad as we are, in some sense, to have everybody finally talking about the very thing that has worried us for most of the last two years, we'll have to look beyond inflation to explain what has suddenly happened to stocks.

Perhaps it's enough to point to what has been a regular quarterly stock market anxiety attack at the onset of **earnings season**, as the continuing mood of pessimism continues to foresee a **"soft patch"** that never comes. But beyond that, we think stocks have been spooked by the convergence of several destabilizing **political developments** this week, creating a **risk to growth** by threatening the already fragile **pro-growth policy consensus**. An immediate casualty if that consensus unravels would be the extension of the **2003 tax cuts** on **dividends** and **capital gains** under **budget reconciliation** late this month. Beyond that looms the specter of the **Republicans'** loss of **congressional control** in the **2006 mid-term elections**.

This kind of risk as been in our minds for more than a month, since **Hurricane Katrina** threw **Washington** into a frenzy of recrimination (see "Blamestorm" September 6, 2005). But matters have actually gotten meaningfully worse since then. To be sure, Katrina immediately put the **Bush administration** and the **GOP majority** on the defensive, but at least their response was event-focused and decisive (if sometimes ill-advised). Subsequent developments have been deadweight losses to the GOP's potential to deliver a pro-growth agenda. This week former **House majority leader Tom DeLay** was indicted on new charges which, while still unlikely to lead to conviction, are *more* likely to do so than the original charges. **Karl Rove** has been called to testify again before a grand jury concerning the alleged **Valerie Plame** leak, leading to renewed speculation that he may be a target of the investigation. Perhaps most damaging of all, the nomination of **Harriet Miers** for the **Supreme Court** has been poorly received by **President Bush's conservative base**, who regard it as a sign of the administration's capitulation to the opposition. Considering how *that* nomination decision appears to have been made, it is unsettling to see the subject of the upcoming nomination of **Alan Greenspan's** successor at the helm of the Fed surface in public debate this week, with Bush emphasizing in a press conference his primary requirement that the nominee be independent.

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Against this backdrop we have **Senate Finance Committee chair Chuck Grassley** continuing to hold the extension of the 2003 tax cuts hostage to his bill to expand **Medicaid** benefits for Katrina victims (see "Monetary Step Forward, Fiscal Step Backward" September 29, 2005). Grassley's bill is still opposed by the **White House**, and in a hearing yesterday, Grassley highlighted the risk to his necessary cooperation in extending the tax cuts. He told **Treasury Secretary John Snow**, "Unfortunately, the White House is working behind the scenes against me and I resent that, especially considering all that I've delivered for the White House in the past five years." At the same time, **Senators Chuck Schumer** and **Lindsay Graham** are accelerating their threats to reintroduce **protectionist** legislation to impose heavy tariffs on goods from **China** unless the **yuan** is more aggressively revalued, and urging Snow to have Treasury make an official finding that China is manipulating its currency. Finesse and strength are required for the administration to deal with these threats as effectively as they have in the past, and this week the visible supply of those qualities has been disturbingly low.

Bottom line: Already apprehensive coming into the first post-Katrina earnings season, falling stocks this week have discounted an environment of increasing political risk. But we continue to think that fears of a "soft spot" are overdone, and don't believe this earnings season will disappoint any more than the others this year have (this morning's better than expected **payroll** report underscores the extent to which macroeconomic strength continues to be underestimated). And as we've noted many times in similar situations over the last two years, political risks are not political realities -- they are just risks, and always exaggerated by partisans and **the media** seeking to exploit them. The fact that extending the tax cuts is being held hostage is an indication of just how valuable they are understood to be. And everyone in the majority, now seemingly so consumed by infighting, is well aware that aborting budget reconciliation would be a mutual assured destruction outcome. We fully expect that the necessary deals will be made. With stocks **undervalued** by almost 50% according to our model (based on **forward earnings yields** and **long-term Treasury yields**), we see little additional downside to betting that the risks we now face will, in fact, not become realities. Stocks remain the king of the **carry trades** (see "The King of Carry Trades" June 14, 2005). TM