TrendMacrolytics

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POLITICAL PULSE

Quag Miers for the Fed

Monday, October 24, 2005

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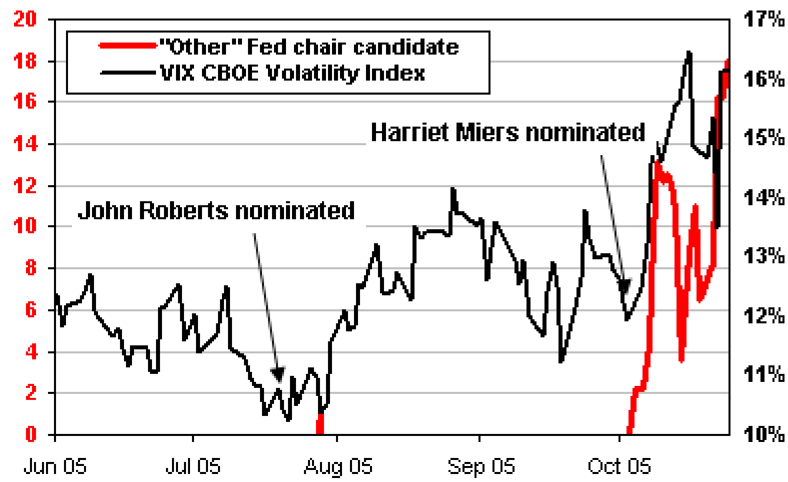
Handicapping how a dysfunctional White House will select the next Greenspan.

Stock market volatility, as measured by the **VIX volatility index**, made its lows for the year on July 20, at about 10. VIX had not been that low since February, 1994. In fact, it has only been lower than that on 14 days over the last 20 years. From that low, it has steadily risen (though, perversely, it fell during and immediately after **Hurricane Katrina**). VIX currently stands at about 16, which is at the lower bound of normal (the 20-year average is about 20) -- having spiked higher following a bottom on October 3. All of which begs the question: if the most expensive natural disaster in our nation's history couldn't elevate investor **risk perceptions**, *what did?*



The answer is: *politics*. VIX turned up from near-historic lows immediately after **John Roberts** was nominated for the **Supreme Court**. The bottom from which VIX's current surge started from a higher bottom on the very day **Harriet Miers** was nominated. The Roberts nomination was only the starter's pistol for an episode of normal political uncertainty. But the Miers nomination was something else entirely. It catalyzed a revolt against the **Bush administration** from its own political base, and the political ineptness of the choice revealed a **White House** whose policy apparatus has been rendered dysfunctional by the distraction of the increasingly threatening **CIA** leak scandal. Why should markets care? For one thing, we're now entering the delicate final days and weeks in the **budget reconciliation** process in which the **2003 tax cuts** on **dividends** and **capital gains** are up for extension by two years. This may well be the last chance for extension of this critical **pro-growth** policy during this administration, and a crippled White House will make it that much harder to get it done. Just as important, markets now have to appraise the disturbing reality that the same White House that nominated Harriet Miers is going to nominate a new **Federal Reserve chairman**. In fact, as the chart above shows, the very day that Miers was nominated, the **online futures markets** on Fed chairman candidates at **Tradesports** began to reflect a significant risk that the next chairman would be "other," *i.e.*, a marginal unknown whom the market is not expecting, someone other than **Ben Bernanke**, **Martin Feldstein**, **Glenn Hubbard**, **Larry Lindsey** or **Donald Kohn**.

The White House has announced that it will make its choice today. Based on what we have been hearing from sources for quite a while, this is an accelerated schedule and suggests that a dysfunctional White House on the defensive has been moved to announce sooner than it

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otherwise would -- either to distract from the Miers and CIA fiascos, or just to show that it can still *do something*. Hopefully the White House feels under pressure not just to do something, but to *do something right*. What might that mean for the Fed chair nomination?

- **Ben Bernanke** would be the easiest choice in this embattled environment. He is the candidate the market expects, having scored highest in a ***Wall Street Journal*** poll of economists two weeks ago, and being ranked first among candidates on Tradesports (his futures contracts have spiked to all-time highs today). Bernanke is our front-runner, not just because the market expects him, but because a risk-averse White House will probably see the "most expected" choice as the safest.

- **Donald Kohn** would also be an easy choice now, because he is widely reported to be **Alan Greenspan's** preferred successor. If the White House feels its own credibility is damaged or seeks plausible deniability, it can defend picking Kohn by deferring to Greenspan. On the other hand, in an environment in which the administration is already being accused of cronyism in the selection of Miers, it may be difficult to select a relative unknown who is, in fact, Alan Greenspan's crony. All that said, we see Kohn as the second most likely choice.

- **Glenn Hubbard** would be the choice if the White House wants to take this opportunity to mend fences with its political base. As the architect of the 2003 tax cuts, Hubbard is a favorite among the **"growth wing"** of the Republican Party. If Miers disappointed the **religious right** bloc of **GOP** single-issue voters, Hubbard could solidify another key bloc. If the White House seeks a "John Roberts of Fed chairs," that man is Hubbard -- solid conservative pedigree, but confirmable. We rank Hubbard as third.

- **Martin Feldstein** has a strong "grand old man" factor in his favor, but the pro-growth base remembers him as an apostate against tax cuts during his years in the **Reagan** White House. We believe that this disqualifies him in an environment in which the base is already in rebellion.

- **Larry Lindsey** is probably seen as too politicized a figure. We consider him to be a non-starter in this environment.

Bottom line: Glenn Hubbard would be the most bullish nominee for markets and the economy -- among the known candidates he is the most pro-growth, and his nomination would signal the triumph of courage and principle over political expediency at the White House. Donald Kohn, a lifelong bureaucrat with no experience in markets, intellectually captured by the anti-growth religion of the Phillips Curve and the output gap, would be the most bearish choice (see "Attack of the Kohn-heads" October 12, 2005). Ben Bernanke, the most likely choice, is probably a neutral for the market, being in between Hubbard and Kohn philosophically, and already discounted as the most likely nominee. TM