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

MACROCOSM

Quick Takes

Thursday, November 3, 2005
Donald Luskin

Energy and consumer themes, Bush one year after, looking to 2006, and extending the 2003 tax cuts.

THEME WATCH: ENERGY VERSUS CONSUMER Less than a month ago we noted how sharply **sentiment** among many investors we talk to had swung to triumphalism about **energy stocks** and despondency about **consumer stocks** (see "Played Out" October 5, 2005). We suggested the contrarian strategy of shorting **Exxon Mobil** and using the proceeds to buy **Wal-Mart**. Since then Wal-Mart is up 9.5% and Exxon Mobil is down 2.5% (against an **S&P 500** total return of 2.3%), as our forecasts for both a resilient **post-Katrina economy** and lower **oil** and **natural gas** prices has been borne out. With sentiment the way it was a month ago, even if those forecasts had not come true, it's hard to see how any money could have been made taking the other side of that trade. Now, as a trading matter, the extremes of that sector-specific sentiment have receded a bit. But our macro forecasts remain intact.

BUSH II, A YEAR ON It's now been exactly a year since **President Bush** was re-elected in a surprisingly definitive vote, and **Republican majorities** in the **Senate** and the **House** were strengthened. We had predicted that result, and the fourth-quarter rally in equities that would be associated with it (see "The Bush-Bashing Bubble Has Burst" September 7, 2004). That said, our expectations for progress on **pro-growth economic policy** and some lessening of the fever pitch of partisan rancor have proven to be wrong. The sustained production of political talking-points designed to prove that the economy is weak or weakening -- and the failure of the administration and the majority to articulate either a clear vision of success or a way forward -- no doubt contributes mightily to the pessimistic sentiment that still rules in many investors' minds. Barely a day goes by when we don't get an email from a client asking us about a new rationale for impending economic collapse, or forwarding to us a media story or "study" or "report" purporting to identify a particular catalyst for cataclysm. For all that, no matter how hard one has looked for even a "soft spot" since the election, it simply has never come -- even back-to-back mega-storms haven't been able to do it. In market terms, since the election, the total return to the S&P 500 has been 9.2% -- a 12-month return that just slightly misses the long-term historical average, and handily beats that of **10-year Treasuries** at only 0.9%. **Consensus forward earnings** for the S&P 500 have grown 16.2%. And it's not just all about oil. The total return to the **S&P 500 ex-energy** has been 6.2% since the election, and ex-energy forward earnings are up 10.1%. Those entirely respectable results have come in an environment of policy disappointment, starting from a point of great expectations for Bush and the majority. But today those expectations are at the bottom, with the **White House** and **Congressional leadership** torn by scandals and humbled by political mis-steps. Well, it's all upside from here.

LOOKING TO 2006 We stand one year from **mid-term elections**, and once again the buzz is that the Republican majority is going to be decimated by **Democratic** challengers. In the last two elections such expectations were pinned --wrongly -- on the strong historical pattern that the party who holds the White House suffers losses in Congress. This time around that conventional wisdom is being buttressed by Bush's low approval ratings, the congressional leadership scandals, and fallout from the administration's response to Katrina. It would indeed be a blow to growth expectations for the Republicans to lose control of Congress. But a sober look at the prospects suggests that no such thing is in the offing. The **political futures contracts** traded at **Tradesports.com** -- the online **"prediction market"** that brilliantly forecasted the 2006 election (see "A Big Score" November 5, 2004) -- sets continued **GOP** control of Congress as a probability of almost 80%. And conventional bottoms-up race-by-race analysis suggests the same thing.

- In the Senate, there are 18 Democratic seats coming up for election in 2006, but only 15 Republican seats. No races are currently expected to be losses for either incumbent party. Of the 15 GOP seats, there are three toss-ups, and 2 that only lean toward the GOP. On the Democratic side, there there is one toss-up and seven leaners. If the GOP lost every toss-up and leaner, that would make a 50/50 Senate (assuming the Democrats lose none of their own toss-ups or leaners).
- In the House, again no races are currently expected to be losses for either incumbent party. The GOP has four toss-ups and 13 leaners, while the Democrats have three toss-ups and eight leaners. If the GOP lost all its toss-ups and leaners, that would be just enough to slightly tip control to the Democrats (again assuming the Democrats lose none of their own toss-ups or leaners).

EXTENDING THE 2003 TAX CUTS The **budget reconciliation** process continues to slowly roll through Congress. The **spending** side is getting most of the attention and controversy, with almost no focus on the **revenue** side -- which is where the **2003 tax cuts** on **dividends** and **capital gains** and the **AMT patch** can be extended. Spending is being voted today in the Senate, with the House expected to vote next week, after which it goes to **conference**. Once the spending side comes into clearer view, we'll start to see specifics on the revenue side, starting with a **chairman's mark** from **Senate Finance chair Chuck Grassley**, as soon as next week. Based on conversations with Congressional contacts, we expect the mark to contain the extensions. We have less telemetry on what could come from **House Ways and Means chair Bill Thomas**. But in both cases, we still hear loud and clear what we have heard all along -- that extending the tax cuts is contingent on achieving at least cosmetically respectable spending cuts first (see "The McCain Mutiny" September 23, 2005). That seems on track to happen at the moment, though there is the risk that the process could come off the rails at any time (for example, the White House is now threatening that President Bush will use his **veto power** for the first time if **Medicare prescription drug benefit subsidies** for **pharmaceutical companies** are cut). We are still optimistic about extension of the tax cuts, and far more optimistic than the consensus. But at this point it's highly likely we won't know until after **Thanksgiving**.

Bottom line: Our core macro call continues to be for robust expansion. At this point the biggest risk factor is that the **Fed** will **overshoot** as the current **rate-hiking regime** reaches **normality** early next year (see "No Dove" November 1, 2005), but absent that we see policy coming into healthy **equilibrium**. So we continue to see stocks as deeply **undervalued** and bonds as deeply **overvalued**, and within equities we continue to prefer neglected **large-cap growth** over popular energy and **small-cap value**. Stocks writ large remain the king of the **carry trades** (see "The King of Carry Trades" June 14, 2005). TM