TrendMacrolytics

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POLITICAL PULSE

Beyond Disappointment

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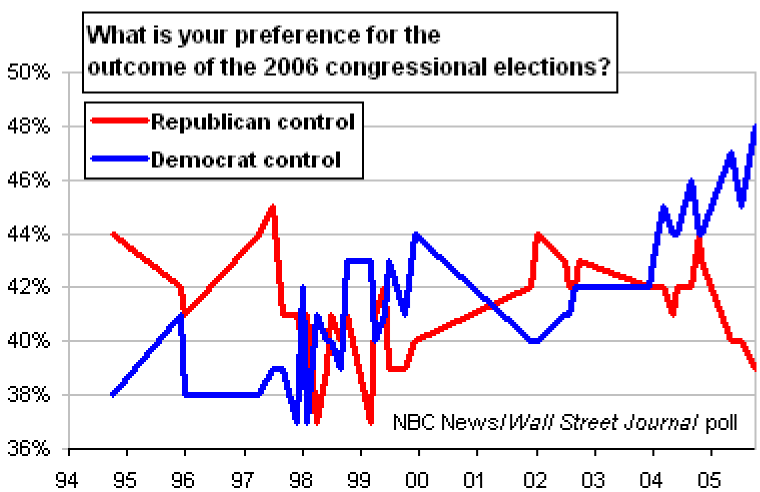
Why do stocks hang tough while the Republican pro-growth consensus continues to unravel?

Yesterday the prospects for **extending the 2003 tax cuts** on **dividends** and **capital gains** were dealt two new setbacks. The **Senate Finance Committee** deadlocked on **Chairman Chuck Grassley's** initiative to extend the tax cuts by a single year, from 2008 to 2009, with **Maine's Republican senator Olympia Snowe** acting as the swing opposition vote. At the same time, **Republican majority leadership** in the **House of Representatives** postponed yesterday's scheduled vote on **spending reconciliation**, for lack of **GOP** support -- even after controversial authority for **oil drilling** in the **Alaska National Wildlife Reserve** and the **outer continental shelf** had been stripped out. These important **pro-growth** votes are now deferred into an indeterminate future, and the **pro-growth consensus** in **Congress** appears to be continuing to unravel.

And yet the **stock market** was sharply higher yesterday. Stocks have been steady all week, even as **policy uncertainty** has increased to the point where just about the only thing we can say with confidence is that **George W. Bush** won't be re-elected in 2008. In our model it is axiomatic that **equities** should react negatively to uncertainty in general, and especially to explicit policy threats to **growth** -- and the increasing likelihood of failure to extend the 2003 tax cuts is both. So what's going on?

One possibility is that, as we have previously speculated, stocks have already discounted the impossibility of extending the 2003 tax cuts (see "A Setback for Extending the 2003 Tax Cuts" November 9, 2005). If that's true, then yesterday stocks were free to celebrate the continuing decline of oil prices and a good **bond auction** without regard to tax policy disappointments, because **expectations** were already so low.



A broader way of saying the same thing is that stocks may see, in yesterday's seemingly negative legislative developments, the kind of **political train-wreck** after which things can only get better. Indeed, it's hard to see how things could get worse for the Republican majority. An **NBC News/*Wall Street Journal*** poll released yesterday showed nationwide preference for **Democratic congressional control** to be even stronger than the preference for

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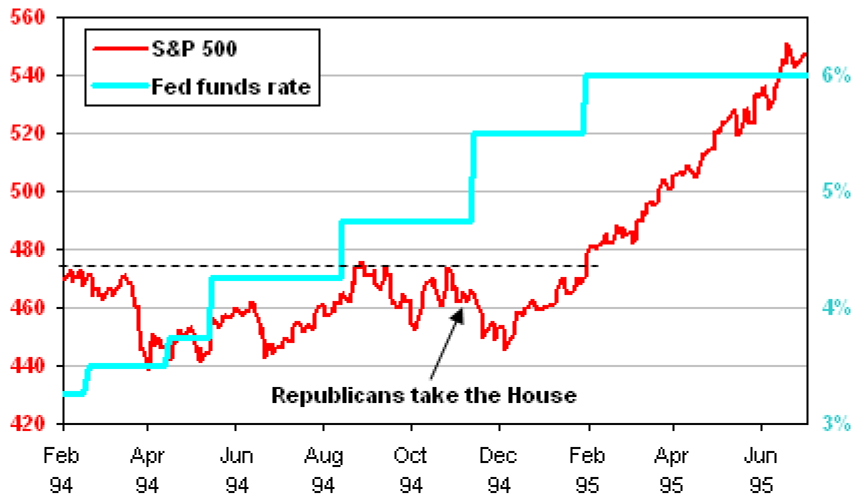
Republican control in 1994, just before the **Newt Gingrich's "Republican revolution"** captured the House. The poll also found 51% of Americans favor defeat of their own congressional **incumbent** in 2006. Even though it must be noted that the 1003 respondents represent fewer than three persons per congressional district -- and that the anti-incumbent percentage was even higher in 1992, when the incumbent Democrats actually *gained* seats in both the House and the Senate -- if these polling results aren't a **wake-up call**, we can't imagine what would be.

An important corollary would be that, if the tax cuts *are* extended this year -- or, more broadly, if the Republican majority rallies around re-energizing the pro-growth consensus -- it would be a big **positive surprise** for stocks. What are the chances? For extending the tax cuts, there is still hope. First, there are still tricks that Senate Finance can employ to work around Olympia Snowe, including winning a Democratic crossover vote. Five of the nine Democrats on the committee are from **"red states,"** and another two are from **"blue states"** that would be particularly threatened by the risk of Republican retribution by not extending the **Alternative Minimum Tax patch** for another year. And even if extension of the 2003 tax cuts is not included in the Senate's version of a **revenue reconciliation bill**, it could yet appear in the House version and thus still make its way into the eventual bill negotiated in **conference**. It continues to be reported that **House Ways and Means chairman Bill Thomas** intends to include a two-year extension of the tax cuts in his **mark**, due next week. But curb your enthusiasm. As one congressional source told us yesterday, if the House can't even pass a simple spending bill, how can they possibly pass a tax bill?



Bottom line: Our **base case** continues to be **bullish**, as it has been consistently for the past two and a half years, since the 2003 tax cuts on dividends and capital gains were first enacted. But there are more imminent threats on our **strategic radar** than at any time since then. The potential unraveling of the Republic pro-growth consensus could lead, *extremis*, to loss of Republican control of Congress in 2006, a concomitant long-term diminution of growth expectations. Also, the imminent attainment by **the Fed** of a **normal, non-accommodative fed funds rate** -- at the same time as a **new chairman** takes the helm -- ushers in a period of particularly intense risk of **hawkish overshoot** (see "Job Market Myth vs. Reality" November 7, 2005). But stocks remain cheap, with the **S&P 500** having returned less than a 2% capital gain year-to-date, while **forward consensus earnings** have risen 14%. So if everything continues to go wrong, the downside is to some meaningful extent already covered. That said, let's not be naive: if the wheels really come off the Republican pro-growth consensus, there will be losses in stocks. But let's not entirely lose confidence, either. If the Republicans can right themselves -- as, indeed they still possibly could -- we might see a replay of late 1994. A surge then in the S&P 500 came from the convergence of two forces that could both replay in the coming months. First, the Fed could signal soon, as it did then, that the **rate-hiking regime** will be concluded. And second, the Republicans could retake the Congress again, just as they took the House in 1994. Back then they retook it from the Democrats. This time around they could retake it from themselves. TM