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# Don't Put a Fork In It

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**The Fed's not done, and either is extending capital-friendly tax rates.**

The **"one and done" consensus** that the **Fed's** current **rate-hiking cycle** will peak at 4.5% at the January 31 **FOMC** meeting (**Alan Greenspan's** last) has started to get more aggressive over the last few weeks. **Fed fund futures** are now priced for a less than 100% probability of a 25 basis point **hike** in January, and a number of economics pundits have started to say "done right now." We think the consensus is wrong, just as it has been wrong consistently throughout this hiking cycle. It's almost hard to believe, but one year ago when the fed funds rate was 2.25%, futures were priced for a funds rate of less than 3.25% by year-end 2005. At the same time our own forecast was much more on the mark --saying that the funds rate would end the year closer to 4.5% (see "Risking the Spread" January 28, 2005).

To the extent that the "done" consensus has been responsible for the move in **equities** this week to new recovery highs, then we expect there will be some retracement when the consensus is, once again, defeated by reality. In the meantime, deeply **undervalued stocks** (especially the **inflation plays**) have room to run -- so long as there are no overt signals from the Fed to correct the consensus. Silence from the Fed, as long as it lasts, will give the impression that the consensus is being validated. But just as likely the explanation is that communications from the Fed will be fewer and more circumspect for a while here -- an extended "quiet period" designed to give incoming chairman **Ben Bernanke** the courtesy of being able to operate with maximum latitude.

The "done" consensus has consistently underestimated the strength and durability of this **economic expansion**, the mounting evidence of **inflationary pressures**, and the Fed's **risk management** commitment to keep a lid on the inflation that it deliberately initiated in 2002 and 2003 as a firebreak against the perceived risk of catastrophic **deflation**. Most recently, the consensus has been encouraged by the brief **yield curve inversion** of the last week of last year, and this week's release of the **minutes** of the most recent FOMC meeting. We don't take a **flat** or inverted yield curve as a sure sign of impending **recession**. Based on Alan Greenspan's many remarks about it, and Ben Bernanke's focus on a **"global savings glut"** as an explanator of apparently extreme **risk tolerance** in the **bond market**, we don't think the Fed -- under either chairman's leadership -- is especially worried about the yield curve, either. As to the FOMC minutes, we simply don't see the **dovishness** that the market seems to see (for both topics, see "False Positive" January 3, 2006). At the same time, there continues to be evidence of inflationary pressure in **gold**, **commodities**, **energy**, and the **dollar**. And strong macro numbers are continuing to surface -- for example, as we predicted, the **unemployment rate** fell this morning below 5% (see "Bernanke's Conundrum" December 20, 2006). So whether the Fed comes at it from the point of view of risk management, market price signals, or **neo-Keynesian output gap theory**, it all points to a Fed destined to complete the current r**ate normalization exercise** at a funds rate of no less than 5%.

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Meanwhile, **Congress** recessed in December without completing either the **spending** or **tax** sides of **budget reconciliation**. Spending will be taken up as soon as the **House** reconvenes in late January, with a floor vote on a bill the House already approved in late December, now needing to affirm purely technical amendments made by the **Senate**. The bill passed the House the first time only by a narrow margin when a number of **Democrats** who probably would have voted against it were absent; the second vote will be a squeaker, but **leadership** will go all out to get it done. Assuming passage, the next step will be for **House/Senate conferees** to take up the tax side, with floor votes probably not coming until late February or early March. At stake will be three issues of importance to the economy and the markets:

- The **alternative minimum tax "patch"** must be extended for another year to prevent up to 19 million upper middle class workers from falling, for the first time, under AMT -- which would amount to a $30 billion/year **tax increase** for them. This will get lots of media attention, as the risk is right here, right now. By the time congress acts, those 19 million workers will have already worked up to a quarter of the year to which the bill will retroactively apply.

- **Republicans** will push for a two-year **extension of the 2003 tax cuts on dividends and capital gains** (which are currently set to expire after 2008), and will use the urgency of extending the AMT "patch" to get what they want. AMT will be taken out of the reconciliation bill because it can pass the Senate without risk of **filibuster**; the more controversial extension of the 2003 tax cuts will stay within filibuster-proof reconciliation, where the only issue is whether enough **GOP "moderates"** in the Senate will go along. It will be very close, but at this time we still favor the likelihood of passage.

- The Senate's version of tax reconciliation contains a provision for a $4 to $5 billion one-time **windfall profits tax** on the **integrated oil industry**, levied through a technical rule change in the way **inventories** are valued. At this time, with gasoline prices far from their post-Katrina highs, we see an utter absence of support in Washington for this provision. We think it will just fade away, unless there is a massive rally in gasoline prices .

**Bottom line:** These two issues form the backdrop for starting to do some scenario planning for the first half of 2006. We won't hear much about tax cuts for the next several weeks while Congress remains in recess, so it will be Fed expectations that drive markets short term. So long as the "done" consensus remains intact, stocks should be strong. The **stock/bond risk premium** remains at very elevated levels, continuing to suggest that stocks are strongly undervalued and bonds are strongly **overvalued**. This is borne out by the fact that **long-term Treasuries**, which ostensibly should have been the biggest beneficiaries of a resurgent "done" consensus, have gone virtually nowhere while stocks have moved to new recovery highs. At these valuations, any good news, real or imagined, will be good for stocks; but there's essentially nothing that could be very good for long-term bonds, because the most bullish expectations have already been more than priced in. When stocks eventually have to deal with the reality that the "done" consensus is wrong -- probably shortly after Bernanke takes the helm in February -- there will be a retracement, accompanied by much wringing of hands and gnashing of teeth. Potentially some of the disappointment will be offset, shortly afterwards, by successful resolution of tax reconciliation process. Ultimately, equities that have been so undervalued for so long will finally absorb their enormous accrued risk premium when (1) the Fed is *really* done, (2) the Fed is done at a level such that sensitive markets such as gold are able to signal all-clear on the inflation front, and (3) there is a political consensus capable of perpetuating **pro-growth tax policy**. TM