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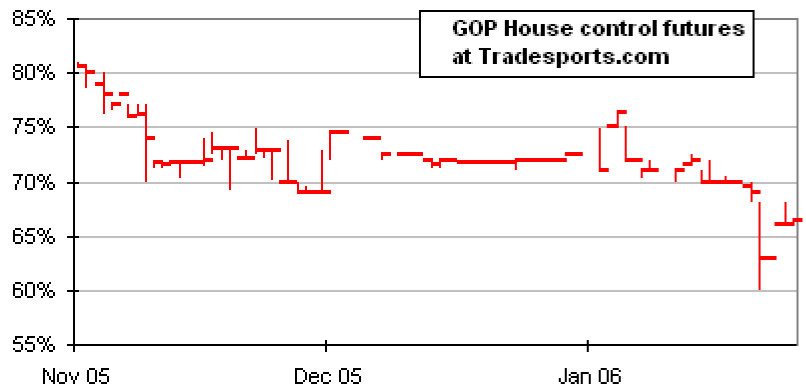
MACROCOSM

Election Risk: It's Back

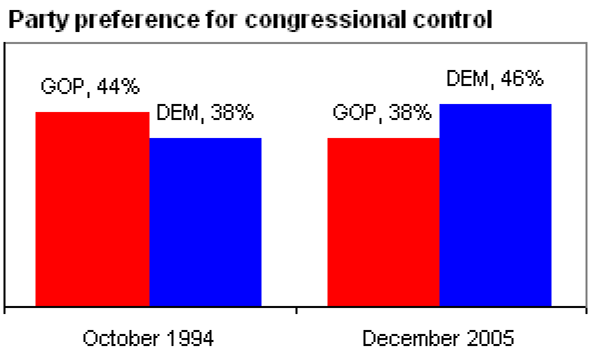
Thursday, January 26, 2006
Donald Luskin

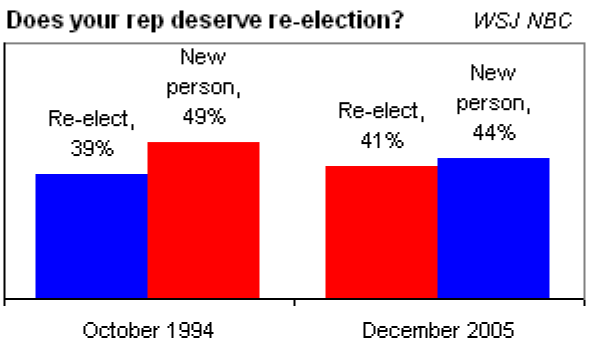
The 2006 congressional elections are coming into view as a driver of stock prices.

We wrote last Friday morning that we were "uncomfortable with this New Year's rally" (see "Resilience or Folly?" January 20, 2006), but we didn't anticipate that almost all the **stock market's** 2006 year-to-date gains would be gone by the end of the same day. Our discomfort came from the belief that those gains had been driven largely by incorrect **expectations** that **the Fed** is **"one and done"** with a final **rate hike** at next Tuesday's **FOMC** meeting. We have maintained that those expectations would be defeated by further rate hikes, and wrote two weeks ago, "When the stock market gets the message, it will come *un*done" (see "Accidentally on Purpose" January 11, 2006). Those expectations now stand at levels lower than they were at year-end, reflected in yesterday's new year-to-date lows for both **fed funds futures** and **10-year Treasuries**.



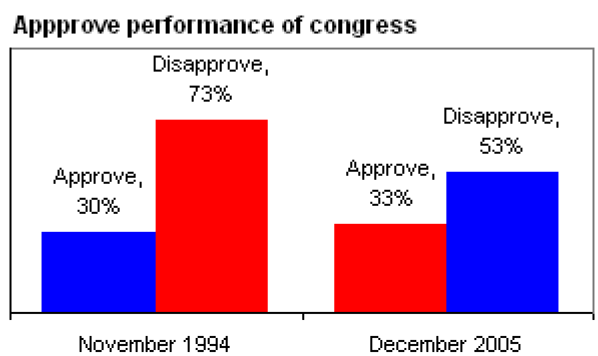
Nothing in that analysis specifically explains the exact timing or the severity of last Friday's drop. We have another idea of what might have moved stocks that day. This may not be the answer either, but we can't help but note what is at least a striking coincidence, and one that highlights what we think will surely be an important **theme** for markets this year. On Friday, there was a precipitous drop in the **forecasted probability** that the **Republicans** will retain **control** of the **House of Representatives** in this year's **mid-term elections**, as reflected in the online **political futures contracts** at **Tradesports.com**. On that day, the probability for **GOP** control fell to as low as 60%, having traded in the 70%'s for the previous two months. It's also noteworthy that the first several days of 2006 saw a rally in the control probability, coinciding with the best days year-to-date for stocks. We're not saying that the stock market is literally moved by these online futures contracts themselves. But we are sure that, all else equal, **equity valuations** are harmed by the kind of **political uncertainty** reflected in the drop the contracts took on Friday. And it is our judgment that both **the economy** and equities will suffer without a **GOP majority** in the House to propel **pro-growth economic policy**, and serve as a bulwark against **anti-growth policy**. Just as in 2004 getting the **presidential election** right was the key to getting the stock market right, this year the key may be getting the congressional election right.

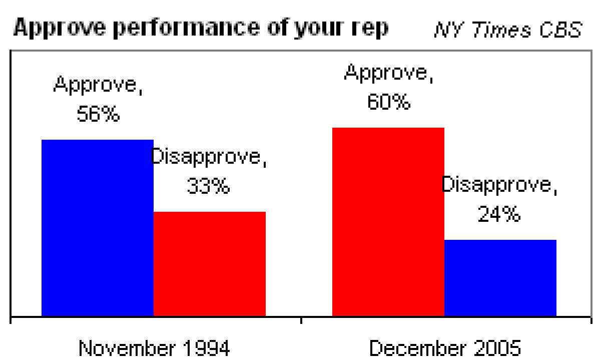




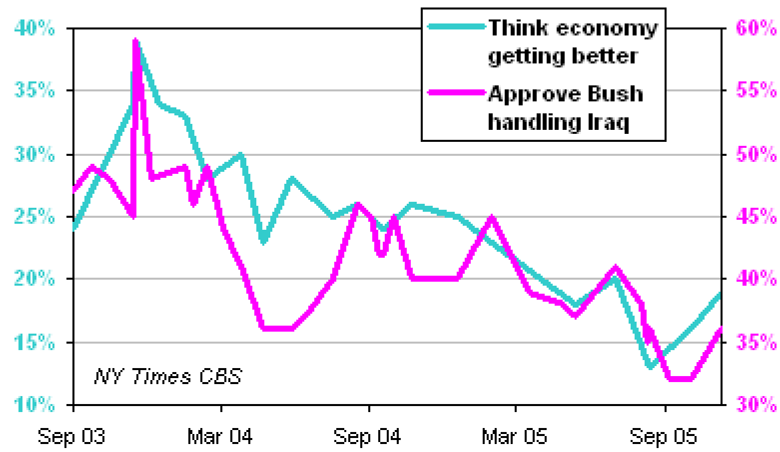
Yes, every two years during the **Bush presidency** the conventional wisdom has forecasted that the GOP would lose ground in **Congress**, and every two years GOP gains have proven that wisdom wrong. But this time around there's reason for concern. The latest ***Wall Street Journal* NBC poll** currently puts the preference for congressional control more strongly in favor of **Democrats** than it was for Republicans just before the 1994 election, when the GOP took control of the House for the first time in 40 years. But this dire view is not the only polling result. This top-down party preference is probably only a generalized reflection of President Bush's flagging **approval ratings**, because the same poll found that the bottoms-up preference to re-elect **incumbents** is slightly greater now than it was in 1994, and the preference to "give a new person a chance" markedly lower. Another more optimistic view comes from the ***New York Times* CBS** poll, which frames the question in terms of congressional job approval. As hard as it may be to believe considering today's poisonous political atmosphere, more people today approve of Congress's performance -- and fewer disapprove -- than in 1994. The same pattern obtains whether the question is top-down concerning Congress itself, or bottoms-up concerning one's individual representative.

It would only take 15 seats changing parties for the GOP to lose the House. According to the **Cook Political Report**, there are no individual races in which a seat currently held by the GOP is forecasted to be lost -- but neither are there any currently Democratic seats forecasted to be lost. Among currently GOP seats, nine are rated as **"toss-ups,"** and another nine are rated as only **"leaning"** to the GOP. That makes 18 GOP seats up for grabs -- if the GOP loses 15 of them and picks up none from the other side, then it loses the House. One non-public source tells a somewhat more alarming story. According to a leading pollster who conducts **private polls** for incumbent GOP congressmen and candidates, if the election had been held last November -- at the peak of the **White House CIA** leak scandal -- the GOP would have lost control of congress right then and there. He now says the situation has stabilized somewhat, but he worries that survival this November will depend on a combination of events both within and beyond the candidates' control.





First, this source believes that the GOP must overcome the frustration and disgust within its own base concerning the toxic combination of alleged **corruption** and **runaway government spending**. The present contest for House **majority leader** is an excellent opportunity for the GOP to manage perceptions about both issues. We hope and expect that **Ohio's John Boehner** will become the new leader, seeing him as positioned with sufficient distance from the discredited **DeLay** regime to be credible on **lobbying reform** and **spending restraint**, but not so much an idealist that he will be incapable of real-world action. Happily, from our conversations with Boehner, we believe he profoundly understands the economic and political dynamics of pro-growth policy -- especially tax policy. His election as leader would raise the odds of the extension of the **2003 tax rates on dividends and capital gains**, and of a further extension of the **AMT "patch."**



Second, our pollster source believes that the 2006 election may hinge importantly on perceptions of what is happening in **Iraq**. We've resisted that view, despite urgings from some of our more politically attuned clients, believing Iraq to be primarily a concern within **the Beltway** and among the **media elite**, but with no real salience for voters. Our source believes his polls prove us wrong on that. He argues that the evidence shows that even voters who do not assign great importance to Iraq on a rank-ordered list of priorities nevertheless are negatively influenced by it. Our source claims that the widespread public misperception that this booming economy is performing poorly is, in fact, a form of psychological spillover from a sense of failure in Iraq. Indeed, there is confirmation of this even in publicly available polls, which show economic optimism peaking in late 2003 with the capture of **Saddam Hussein** -- and falling ever since, as has approval of Bush's handling of the war. Our source believes that a **reduction in US troops** stationed in Iraq would be an effective signal of success -- and he fully expects that reductions will be accomplished by election day.

Bottom line: Pending further developments, our operating assumption is going to be that the GOP majority will survive the election. In typical **Bush era** fashion, it will probably be a squeaker that will maximize uncertainty and suspense along the way (and, consequently, investment opportunities). In the shorter term, Fed expectations are still in play. It's possible that a weak **GDP** report tomorrow will revive hopes for "one and done," but those hopes should be quickly dashed once **Ben Bernanke** takes the helm next month and starts gently **conditioning the market** for at least one more rate hike, and very probably more. So the next step for stocks is to get used to the idea that the Fed has further to go, and to come to realize that somewhat higher rates are better for growth than an **inflationary breakout** that would only lead to even higher rates later. From here, with such a large fraction of year-to-date gains already eliminated and so many high hopes dashed, we are willing to be more constructive on stocks than we have been over the last several weeks. Absent any dominating election developments, we would see a further **dip** in stocks driven by Fed concerns as limited by today's already deep **undervaluation** relative to **consensus earnings forecasts** and **bond yields**. Such a dip would be a **buying opportunity**. TM