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POLITICAL PULSE

Quick Takes from Washington

Thursday, February 2, 2006
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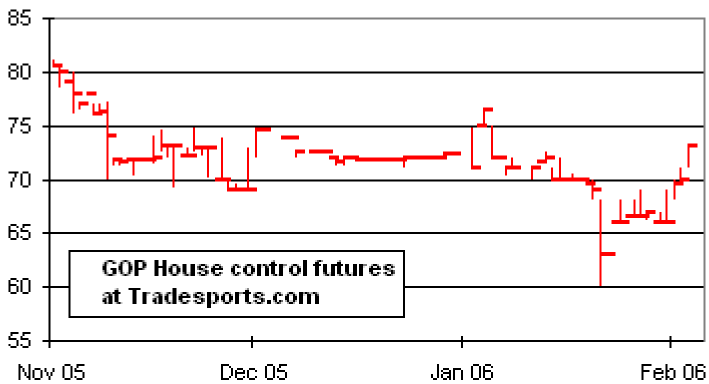
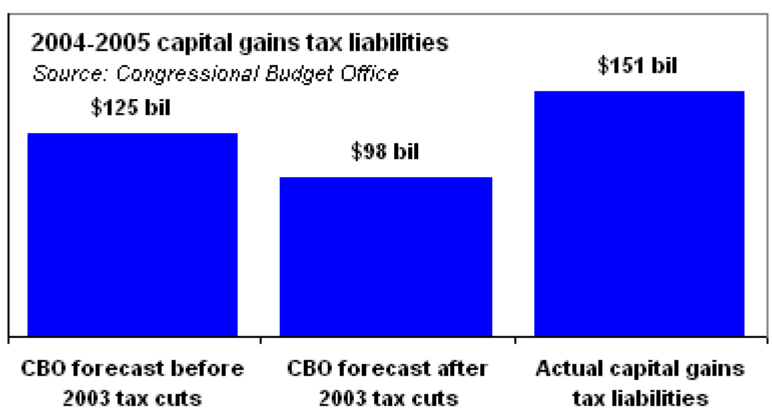
Extending the tax cuts and the GOP majority, new Fed governors, new CEA chair.

TAX CUTS AND THE REPUBLICAN MAJORITY Extending the **2003 tax cuts on dividends and capital gains** and extending the **GOP's control of the House of Representatives** are interlinked processes, and both moved one step ahead yesterday when the House voted to approve last year's **spending reconciliation bill** (it had already been voted in December, but had to be voted again because of technical changes made subsequently by the **Senate**). The bill passed by the narrowest possible margin, and only with the last-minute switch of a single **swing vote** by a GOP representative from a **blue state**. But this vote shows that a politically vulnerable **Republican majority** under embattled **leadership** can still make things happen. It clears the deck politically for belated processing by the House and the **Senate** of last year's **tax reconciliation bill**, including extension of the 2003 tax cuts. And under Senate rules, the passage of the spending bill means that $70 billion in tax cuts can be accommodated within the **filibuster-proof reconciliation framework**, not just $60 billion.



This is encouraging news because (1) **the economy** and the **stock market** will perform better if the 2003 tax cuts are extended, (2) improving prospects for extending the tax cuts improve the chances that the GOP will retain **control** of the House in the November **elections**; and (3) the economy and the stock market will perform better if the GOP keeps control. The **futures contracts** on GOP House control at **Tradesports.com** have now moved back into the 70's (reflecting a better than 70% **consensus probability** that the GOP will keep control). Futures in this online **"prediction market"** have been broadly correlated to performance of stocks so far year-to-date, including a surge in the opening days of the new year, and a precipitous drop a week ago Friday (see "Election Risk: It's Back" January 26, 2006).



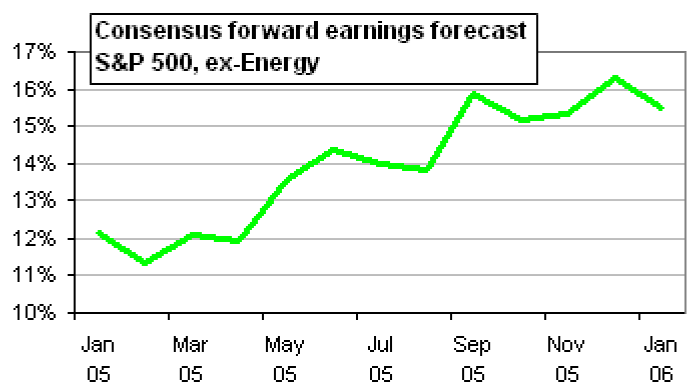
The political effort to extend the 2003 tax cuts got another boost last week from the release of the

Congressional Budget Office's latest annual ***Budget and Economic Outlook***. This document revealed a surge in capital gains tax **revenues** in the wake of the tax cuts. At $151 billion, capital gains tax liabilities in 2004 and 2005 exceeded the $125 billion that the CBO had forecasted *before* the tax cuts were enacted -- and blew the doors off the revised-down $98 billion the CBO forecasted *after* the tax cuts were enacted. Whatever else the opponents of extending the tax cuts may say about them, no one can say they didn't pay for themselves.

At this writing, the Senate is debating its version of the tax reconciliation bill -- even though that bill was already passed last November, a month before the House passed its version. Under the **Constitution**, tax bills must originate in the House, so the Senate is now obligated to re-enact its version. Also, because various **Katrina**-related provisions that are now being handled separately, other provisions can be included in their stead. There is little chance that leadership will try to force extension of the 2003 tax cuts into the bill, wanting not to risk a **test vote** at this time. Tactically, the purpose of this revised bill in the Senate is simply to get into House/Senate **conference**, where the heavy lifting of getting the extensions enacted can take place.

FED BOARD NOMINATIONS Last week the **White House** announced the nomination of **Randall Kroszner** and **Kevin Warsh** to fill two empty seats on the **Federal Reserve Board of Governors**. The announcements were made before the confirmation of **new chairman Ben Bernanke**, but according to sources both nominees have Bernanke's blessing. Kroszner is a free-markets oriented **political economist** at the **University of Chicago** (he says his inspirations as an economist are **Hayek** and **Friedman**). Warsh's career was in **investment banking** until he joined the White House in 2002 as a policy advisor. He is a **lawyer** by training, and while we have no love for lawyers, any Fed seat occupied by a lawyer means one seat *not* occupied by an economist -- and that's a good thing. Particularly in this case, Bernanke needs the diversifying inputs of a non-academic who has experience in markets and politics. We are especially encouraged by indications that Warsh will be open to out-of-consensus inputs, such as **forward-looking market-price indicators** of **inflation risk** such as **gold** and **commodities**.

CEA APPOINTMENT The White House announced this week that **Edward Lazear** will replace Ben Bernanke as chairman of the **Council of Economic Advisors**. Lazear is a scholar at the conservative **Hoover Institution**, and a professor at the **Stanford Graduate School of Business**. He's a strange but wonderful choice for CEA -- strange because his work focuses entirely on ***micro*economics**, not **macro**, and wonderful because *micro*economics is the part of academic economics that is actually true. His specialty is **labor economics**, and his approach is rigorous, empirical and apolitical. In a year when 30 **state legislatures** are considering **union**-promoted bills that would target **Wal-Mart** for punitive taxes, like the one just enacted in **Maryland**, Lazear could be a useful voice of reason.



BOTTOM LINE: Equity and **fixed income markets** are still in the painful process of recognizing and digesting the reality that the Fed has further to go in its **policy normalization process**, and ultimately coming to accept that rates sufficient to quell **inflation risk** are a good thing (see "On the FOMC Meeting" February 1, 2006). In the meantime, we see political and tax policy uncertainties moving in a constructive direction. Deep **undervaluation relative to still-robust consensus earnings forecasts and still-low interest rates** puts a floor under any serious downside in stocks here, and the likely positive resolution of current risks would unlock substantive upside potential. TM