

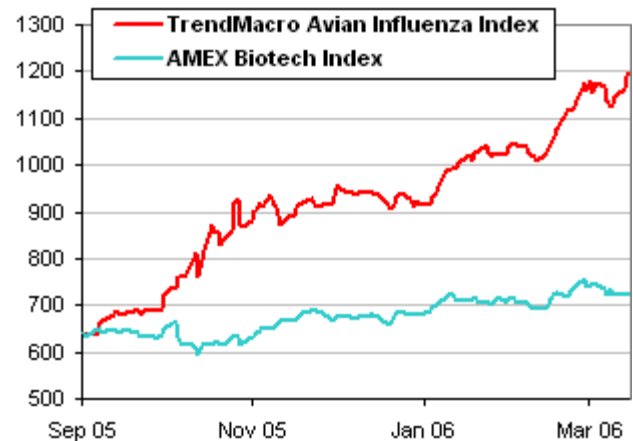
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Quick Takes

Thursday, March 16, 2006
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Updates on extending the 2003 tax cuts, and the avian influenza theme.

AVIAN INFLUENZA A week ago Monday we wrote about investment opportunities arising from the increasingly frightening **news flow** about **avian influenza** (see "[Avian Flu: Risk and Opportunity](#)" March 6, 2006). Since then, the our **Avian Influenza Index** of 17 companies involved in **diagnostics, therapeutics and vaccines** pulled back briefly, and has now broken out to a new all-time high. Having now discussed the avian influenza **theme** with a number of our **clients**, we have been surprised to discover that none has been investing in it (the only exceptions being, here and there, one or two stocks in our Index which happened to be held for other reasons). This gives us significant comfort that even though our Index is up 30.4% year-to-date, the theme has not been over-exploited.



Our intuition about why the clients we've spoken to have not been involved in this theme is that (1) our clients are a level-headed and skeptical lot, and naturally give little credence to **media hysteria** and **end-of-the-world scenarios**; (2) this particular end-of-the-world scenario is so potentially catastrophic that, if one gives any credence to it at all, the only sensible thing to do is *sell everything*. So let us be clear about the nature of the opportunity we see in this theme. We are by no means forecasting that the present **high-pathogen strain of A(H5N1)** will **mutate** into a robust **human-to-human transmissible** form and trigger a **1918-type** pandemic -- although we acknowledge that there is, indeed, some small risk that just that will happen. We liken this situation to the **Y2K millennium date rollover** problem -- a well publicized risk that will generate a great deal of excitement, and against the possibility of which a great deal of money will be spent. We are arguing that when **infected migratory birds** start appearing on **US soil** and across **the Americas** later this year, a fresh **news cycle** will spin that excitement and that spending up to a fever pitch. We think the 17 companies we have identified stand to be significant beneficiaries. If nothing else, some of these companies will have their **research** agendas funded and accelerated -- and their **regulatory burdens** eased -- by the avian flu scare. Even if (as we hope and expect) nothing even remotely like an A(H5N1) pandemic ends up occurring, the byproduct of the interim scare could well be one or more company-transforming **blockbuster drugs** that could be useful in treating influenza and other **viral infections**. Thus we see our 17 companies as a portfolio of **options**. All it takes is for one to finish in-the-money.

EXTENDING THE 2003 TAX CUTS We continue to be optimistic that the **2003 tax cuts on dividends and capital gains** will be extended for two years (to 2010) under the **filibuster-proof budget reconciliation process**. While the **breakout** in **stocks** to near five-year highs on Wednesday afternoon was surely tied to changing **Fed** expectations, we believe it was also tied to an important **Senate** vote taken late in the day -- a vote that served as a referendum on extending the tax cuts. **Democrats** forced a **roll-call vote** on an amendment that would reinstitute "**pay-go**" **budget rules**, requiring that any tax cuts be offset by matching **spending cuts**. Because even **growth-stimulating** tax cuts are **scored** as dead-weight **revenue losers**, such a rule would have the effect of making most tax cuts -- including extending the 2003 tax cuts -- politically infeasible. In a dicey **election year** in which **Republicans** are eager to show their **fiscal discipline** *bona fides* to the **conservative base**, this amendment was hard to vote against -- yet 50 Republicans -- even rock-ribbed pork-buster **Tom Coburn (R-OK)** -- did just that, and the amendment was thus defeated. This is a strong indicator that the Republicans still have the votes in the Senate -- if just barely -- to extend the 2003 tax cuts.

The **House/Senate conference committee** charged with completing tax reconciliation met for the first time yesterday, so the hard horse-trading of crafting an actual bill is now underway. There will be the temptation to compromise just to get something done -- by such means as extending the 2003 cuts by a single year, rather than two. But a dedicated contingent of **pro-growth** advocates in the Senate has adopted this as a signature issue. We hear that one of them, **Mike Crapo (R-ID)**, is circulating a letter already signed by twenty senators insisting that the extension be for the full two years. Procedurally, this work must be completed before **Congress** can get on with other urgent matters, such as **pension reform** and the 2007 budget. So we'll know soon -- and hopefully one of the major risks to growth, and one of the major obstructions to the absorption of the near-record **equity risk premium**, will be removed. **TM**