Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

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Rain on the Tax Cut Parade

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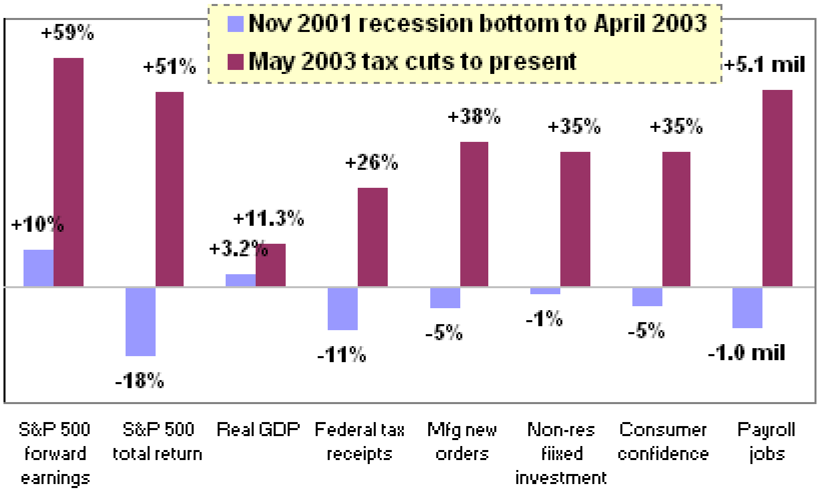
Donald Luskin

Now stocks have to worry about a Democratic House, and a Fed that is "putting uphill."



Before we turn to the question of why **stocks** fell last week just as the **Senate** and the **House** voted to extend by two years the **2003 tax cuts on dividends and capital gains**, let's take a moment to savor what an important **pro-growth development** we have here. Now the **lowest tax rates on investment income** in modern times are law through the 2010 tax year. As the chart above shows, before these low tax rates were put in place, the current **economic expansion** that officially began in November 2001 was anemic at best, with many **critical economic indicators** (such as **payroll jobs**, **stock market returns**, and **federal tax revenues**) running **in the red**. The tax cuts, enacted in May 2003, marked an **inflection point** in which critical indicators **turned positive** and kicked into high gear, where they remain today. Now the scheduled execution of the goose that laid these golden eggs has been deferred by at least two years. If the tax cuts had *not* been extended, we would have had to significantly revise downward our **expectations** for continued growth (see "High Noon" April 25, 2006).

Politically, though it was a long and rocky legislative road to extension, it is good news for the forces of growth to have notched this significant win, and for the **Republican party** to have delivered on a key **mandate** from its pro-growth **base**. At the finish, it wasn't even an especially close vote for this bill that that includes extension of the 2003 tax cuts on dividends and capital gains, a one-year **Alternative Minimum Tax "patch,"** deferred temporary elimination of the **income cap for Roth IRA conversions**, more liberal **expensing provisions for small business** and *no* **windfall profits tax on the energy industry**. In the Senate, the bill passed 54 to 44 with three **Democrats** voting "aye" (and **presidential nomination front-runner John McCain** voting "aye," as well). In the House, the bill passed 244 to 185, with 15 Democrats voting "aye."

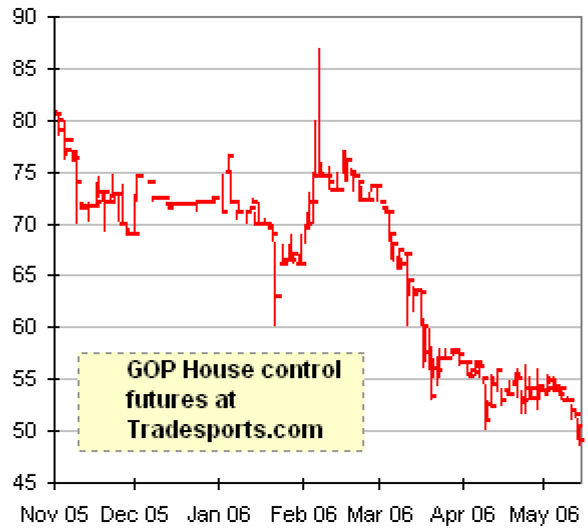
Unfortunately, as we noted early last week, extension of the tax cuts was a **necessary but not sufficient condition** for the **GOP** to hold on to **majority control** of the House in the **November elections** (see "On Extending the Tax Cuts: The Home Stretch" May 9, 2006). Despite passage of the tax cut extension, the party's fortunes continued to erode last week -- with new disclosures about the **Bush administration's domestic spying operations**, and rumors flying

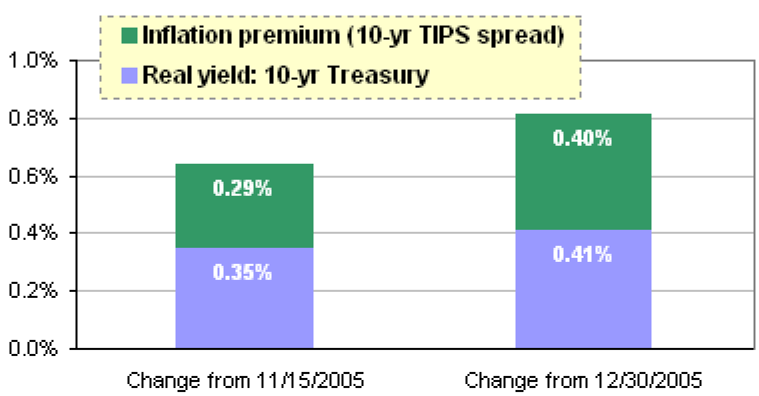
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

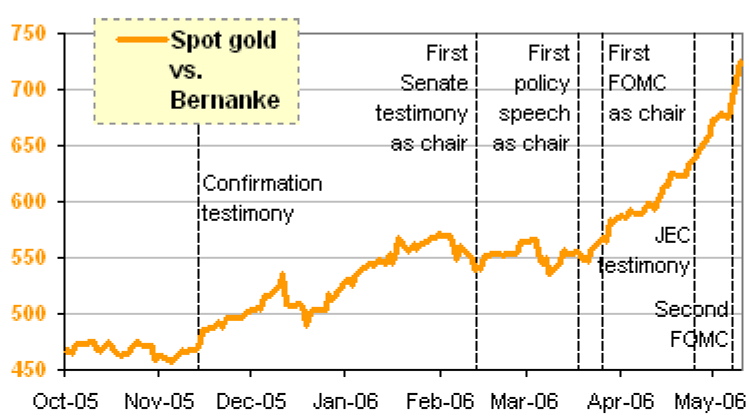
Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

about the imminent indictment of **Karl Rove**. The **futures contracts on Republican House control** traded online at **Tradesports.com** have now fallen to their lowest levels ever, currently giving the GOP only about a 50% probability. We have argued since early this year that a Democrat-controlled House would be bad for the economy and bad for stocks (see ["Election Risk: It's Back"]() January 26, 2006). Among other reasons, today's GOP **leadership** is a **thin red line** holding back dangerous **protectionist** impulses. And **subpoena power** in the hands of Democratic leadership would make for an incomparably bitter and divisive two years leading into the **2008 elections**, during which we can be sure there would be not a single piece of pro-growth legislation. That said, prospects of a Democratic House are less dangerous today than they might have been, now that the 2003 tax cuts have been extended. Without extension, all a Democratic House had to do to kill the 2003 tax cuts was to patiently do nothing until their automatic **"sunset"** after 2008. As parlous as things are for the GOP now, it's hard to imagine an outcome this November so lopsided that the Democrats could actually **repeal** the tax cuts prior to their "sunset" -- so now, no matter who's in control, chances are very good that today's low tax rates on investment income are locked in for almost another five years. In other words, the decline last week in the GOP's political fortunes makes a **bear case** for stocks and the economy more likely -- but at the same time, last week's extension of the 2003 tax cuts pretty much takes the **worst case off the table**.







In our estimation the most likely source of rain on what should have been a tax cut parade for the stock market is **the Fed**. The superficial **media narrative** is that last week's **FOMC statement** was **less dovish** than expected, disappointing investors looking for a **pause** in the present **rate-hiking cycle**, or even an **end** to it. More salient is the increasing sense that the Fed isn't **communicating** its **policy vision** clearly, or perhaps that it does not have a coherent vision in the first place. While it's legitimate in principle to be **"data dependant,"** there's a fine line between that and making it up as you go along -- especially when it doesn't seem that the Fed is looking realistically at the data. If the case for a pause or an end is the expectation that the economy is **slowing**, where's the evidence for that expectation? Almost everything we see points to ongoing rapid growth. And how can the FOMC justify continuing to repeat, as it did in last week's FOMC statement, that **"inflation expectations remain contained"**? Since the day before **Ben Bernanke's Senate confirmation testimony** last October -- which marked his first significant public communication following his nomination as **Fed chair** -- the **10-year Treasury yield** has increased by 64 bps, 29 of which are explained by a widening of the **TIPS spread**. Since year-end, the yield has increased 81 bps, with 40 explained by a widening TIPS spread. **Gold** is up 54% since Bernanke's confirmation testimony, and up 41% since year-end. What is "contained" about *those* inflation expectations?

What is clear in the Fed's present policy vision is a commitment to what Bernanke calls **"gradualism"** -- the idea that, under **uncertainty**, the optimal central bank policy is to move interest rates in **small steps**, judging from experience acquired with each step whether or not to take the next step. In a May 2004 speech, Bernanke likened it to a golfer making a series of small putts to avoid **overshooting** the hole. Bernanke cautioned that there is one case in which gradualism doesn't work: if the hole is uphill from the golfer's current position, a small putt that falls short of the hole will roll back downhill and leave him worse off than when he began. That is precisely the situation in which Bernanke finds himself today. As the economy keeps growing faster than expected, the **"neutral"** or **"normal" rate** required to stop imparting new inflationary impulses into the **pipeline** keeps rising. That's why inflation expectations are growing even as the Fed keeps raising rates -- because it is doing so in steps that are too small. Bernanke didn't mention this in his speech, but what a golfer typically does next when his ball has rolled downhill and into the rough is -- of course -- overshoot. And that is the risk that equities face now as the Bernanke Fed hews to the dogma of gradualism. The good news? With the 2003 tax cuts extended, the economy is more likely than ever to surprise the Fed on the upside. That means that future rate hikes may be gradual, but a "data dependent" Fed sure isn't going to pause for very long (see "On the FOMC Meeting" May 10, 2006).

BOTTOM LINE: Extension of the 2003 tax cuts on dividends and capital gains is good news for the economy and for stocks, even if negative developments last week took center stage. At the margin, extension will help the GOP retain control of the House -- at the same time, it lowers the worst-case risk of a Democratic-controlled House. So the most intense focus of risk shifts to the Fed. By its commitment to gradualism, it is failing to deal with a mounting inflationary threat and increasingly calling its **credibility** into question -- and raising a very real threat of eventual overshoot when it decides it needs to restore its credibility and finally deal with the inflation that everyone but it can see. At the same time as these risks are on the horizon, stocks are now **less undervalued** -- per our **equity risk premium model** -- than they have been in more than a year. Last October the **S&P 500** was an enormous 67% undervalued according to that model. Today, with interest rates having backed up considerably and stocks 10% higher, the S&P 500 is "only" 26% undervalued. That's a good **downside valuation cushion** in absolute terms, but it's a lot less generous than it has been recently. More risk, less cushion -- not exactly the stuff that screaming **bull cases** are made of. That said, a *non*-screaming bull case for stocks is still our central forecast. With the extension of the 2003 tax cuts under our belt, we expect growth to remain strong and a "data dependent" Fed to be moved inexorably to further rate hikes -- forced to do the "right thing for the wrong reason." Fed overshoot is surely a possibility for the future. But in the meantime the course of least resistance for stocks remains higher. TM