

TRENDMACRO LIVE!

On Treasury Secretary Paulson

Tuesday, May 30, 2006

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On first blush, Henry Paulson would seem to be quite a catch as Treasury secretary for a lame-duck administration with all-time low approval ratings. His credentials are, on the surface, most impressive. He is no Bush crony, and he isn't yet another executive from a declining smokestack industry (as were his two predecessors). We have no reason to think he's any kind of pro-growth firebrand, but neither do we think he holds with the dangerously anti-growth ideologies of the last Treasury secretary to have once led Goldman Sachs, Robert Rubin.

So why the negative reaction in markets (stocks down, bonds down, dollar down, gold up)? One possibility is that this seemingly impeccable nominee will turn out to be a liability for the administration in the Senate confirmation process. Paulson could end up being yet another embarrassment for an embattled Republican party struggling to hold onto control of the House of Representatives in the November elections.

It will surely come out that Paulson was at the center of the controversy over former New York Stock Exchange CEO Richard Grasso's enormous pay package in 2003. Paulson was an NYSE board member at the time, and a member of the board's compensation committee. It has been reported that he failed to attend the committee meeting at which the controversial pay package was approved, being instead in Brazil on a bird-watching safari. Later, after the controversy erupted into public view, Paulson led the charge to dismiss Grasso, and was instrumental in his replacement by Paulson's Goldman colleague John Thain. The administration's opponents will have no trouble painting Paulson as negligent, profligate, and Machiavellian all at the same time. Further embarrassment could come from the fact that the Grasso matter is still the subject of ongoing prosecution led by Democratic New York State attorney general Eliot Spitzer. The trial is set for October 30, just days before the election.

BOTTOM LINE: At this point the two big risks overhanging stocks are (1) whether a "data-dependent" Fed will conquer inflation risk without inducing a slowdown in the rapidly growing economy; and (2) whether the pro-growth Republican majority can hold onto control of the House in November. The nomination of Henry Paulson aggravates the second risk by exposing the administration to the embarrassment of a controversial Senate confirmation process. The good news is that the worst consequence of that risk is already off the table, with the extension of the 2003 tax cuts on dividends and capital gains having been enacted (see ["Rain on the Tax Cut Parade"](#) May 15, 2006). And we continue to see stocks as deeply undervalued relative to forward earnings and Treasury yields, though not as extremely as they have been over the last year (see ["Today and 1987: Ominous Parallels? Part 1"](#) May 25, 2006). So while we don't have great fears about the downside for stocks, the full upside is held hostage until we can get better visibility on the Fed and the election. **TM**

Update to strategic view

STOCKS: The nomination of Henry Paulson for Treasury secretary is bad, at the margin, for stocks. It increases the risk that the pro-growth GOP majority may be turned out of the House of Representatives in the November election.