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

POLITICAL PULSE

Don't Panic

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Donald Luskin

The Democrats did better than expected, but it's not a lurch toward anti-growth policy.

We expected the Democrats to take control of the House of Representatives, but are surprised by the margin of victory (see "Speaker Pelosi" October 12, 2006). We expected the Republicans to hold the Senate, and while as of this writing the outcome remains unknown, it looks like we might be surprised there, too. But don't panic. A shift toward Democratic power suggests the risk of anti-growth policy. But other than the 2003 tax cuts, we can't say that Republican dominance produced very much pro-growth policy. And we don't disagree with the frequently heard observation that divided government can itself be good for growth. That said, there's no denying that the election constitutes a surprise at the margin, and equity markets may get disturbed somewhat here from the sheer uncertainty of it all. Our quick take would be that any significant negative reaction in stocks would be a short-term buying opportunity, given the larger macroeconomic context (see "Gut Check for Growth" November 2, 2006).

Update to strategic view
US STOCKS: The stronger than expected win by Democrats in yesterday's election doesn't represent a lurch toward anti-growth policy, but does present uncertainties that may disturb stock prices. Any significant negative reaction is probably a buying opportunity, considering the overall macroeconomic backdrop.
[see Investment Strategy Dashboard]

The election was *not* fought primarily on economic issues, so we don't interpret the results as a mandate for a Left-leaning anti-growth economic agenda. We note that in California, ballot proposition 87, which would have imposed a tax on oil production within the state to fund a bureaucracy devoted to developing alternative energy sources, was soundly defeated. And a number of victorious Democratic challengers are moderates, so within the Democratic party itself this election may represent a net move to the right in economic policy terms. Also, the Democrats will probably not command a majority in the House significantly larger than the GOP did in the last term, and will command an even smaller majority in the Senate if they get a majority at all. So anti-growth initiatives coming from a Democratic leadership -- which is likely to be more left-leaning than the rank-and-file -- will likely be defeated by a coalition of Republican opposition and defecting Democratic moderates. In a nutshell, the Democratic majority will probably be no more successful with anti-growth initiatives than the Republican majority was with pro-growth ones. And, of course, the GOP still controls the White House -- and a veto pen.

Nevertheless there will be challenging tests ahead. No doubt there will be various protectionist measures that will have to be fought back, and certainly no pro-trade measures will stand any chance at all. But we are not terribly worried that draconian initiatives like the Schumer-Graham tariff -- a 27.5% tax on all goods imported from China, which would have had catastrophic effects on global trade -- could now sail through the Senate with a veto-proof bipartisan majority. That initiative was promoted by its sponsors only because they knew it would never be enacted. It was a showpiece, a bluff if you will, designed to nudge policy and diplomacy -- in a protectionist direction, to be sure, but not all the way over the protectionist cliff. There will be more nudges now, and that's not good for growth. And yes, each nudge moves us closer to the cliff. But this election doesn't create a mandate to jump off.

On the tax front, the first challenge will be the extension of the "patch" on the Alternative Minimum Tax exemption, failing which more than 15 million taxpayers will face higher marginal tax rates for tax-year 2007. Loss of the "patch" would be a blow to growth, as it would create marginal disincentives for contribution of labor to the economy. Since the incidence of AMT falls mostly on "blue states" with high state and local tax rates, Democrats are actually more likely than Republicans to support extension of the "patch." But our guess is that Democrat-sponsored legislation extending the "patch" may at the same time seek to repeal or limit the 2003 tax cuts on dividends and capital gains. The GOP minority and the White House would face having to nix the AMT "patch" for the sake of prolonging dividend and capital gains relief. That would be a game of chicken in which growth could well be the loser if the "patch" ends up not being extended.

All this will put pressure on the GOP and the White House to articulate a compelling pro-growth narrative that will justify what will seem to be relentless obstructionism, and to make a case for a return to power -- and for holding the presidency -- in 2008. Based on their poor track record, we are not convinced that such a narrative will be forthcoming. But perhaps the GOP and the administration will, from the position of opposition, find the voice that eluded them when in the position of control. Absent that, it may well be that the best case for growth will be made inadvertently from the Left, in reverse. A strident Democratic leadership embodied by such polarizing figures as Nancy Pelosi may cause even a poorly articulated GOP growth agenda to seem at least reasonable by comparison. It is especially urgent that the case for growth be made to the electorate, one way or the other. Under current law, today's low tax rates on dividends, capital gains and wage income enacted in 2003 automatically expire after tax-year 2010. Without new legislation to extend those tax rates, they will revert to pre-2003 levels in what will amount to a massive *de facto* tax hike. The worst risk to further extension of today's low tax rates isn't a new Democratic congressional majority -- it's the absence of a strong pro-growth Republican presidential hopeful. Yesterday's election doesn't make that absence any worse than it already was. The rigors of opposition status may be the GOP's best hope for finding the right candidate.

BOTTOM LINE: Don't panic. The election produced a surprisingly strong result for Democrats, but does not represent a lurch to the Left that suggests the inevitability of anti-growth policy. But this shift of power toward the Democrats does present uncertainties which may disturb stocks in the short term. Given the overall macro environment we'd expect that any sharp correction in stocks here would be a short-term buying opportunity. TM