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POLITICAL PULSE

Stock Market Exit Poll

Wednesday, November 15, 2006

Donald Luskin

Equity sectors are already responding to the Democratic congressional sweep.

As we expected, after faltering slightly following last week's mid-term elections, stocks have moved to new highs (see "Don't Panic" November 8, 2006). But there has been significant dispersion of returns between sectors, revealing first-blush expectations for policy shifts driven by the new Democratic congressional majority. We can already see that we're going to have a busy time next year tracking these shifts and forecasting their market impacts. Only a week after the election, when admittedly there is little concrete information yet, here are a few quick takes.

HEALTH CARE SECTOR The worst performing sector has been Health Care, off 2.8%. The new Democratic majority is more likely to push for legislation expanding the re-importation of price-controlled American-made pharmaceuticals from abroad, and rescinding the prohibition against the federal government's negotiation of pharmaceutical prices for Medicare. It is not clear that the pharmaceutical industry would not benefit in the end from scale economies arising from lower prices. And fears of regulation are nothing new for this sector. It is tied for worst performance year-to-date through the election, and has persistently been the second most undervalued sector according to our model. With the worst seemingly already discounted, our intuition would be to buy any near-term panic weakness.

INFORMATION TECHNOLOGY SECTOR The best performing sector has been Information Technology, up 3.0%. The new Democratic majority is more likely to extend the Internet tax moratorium that expires next year, which disproportionately benefits companies in "blue states," especially Nancy Pelosi's California. At the same time, Lamar Alexander, a long-time opponent of the moratorium, is likely to be elected Senate minority whip. But of all the Democratic initiatives that the Republican minority will choose to blockade, or that President Bush will choose to veto, we have a hard time thinking that a pro-growth initiative like extending the Internet tax moratorium will be one of them. Tied for worst performer year-to-date through the election, this could be a long-awaited catalyst for the sector.

Update to strategic view
US STOCKS: Health Care and Telecommunications are anticipating a more adverse regulatory environment. An undervalued laggard priced for the worst, Health Care may be a buy on panic weakness. But Telecommunications is priced for the best, and has a long way to fall unless the GOP or the White House blocks "net neutrality" legislation; expect more weakness until and unless this resolves favorably. Info Tech is anticipating extension of the Internet tax moratorium that expires next year, and we think that's a good bet. Energy seems not to be worried about windfall profits taxes. As long as oil, gasoline and gas prices are off their highs, we agree that the threat level is low. If they rise, the threat rises too -- but so do the profits.
[see Investment Strategy Dashboard]

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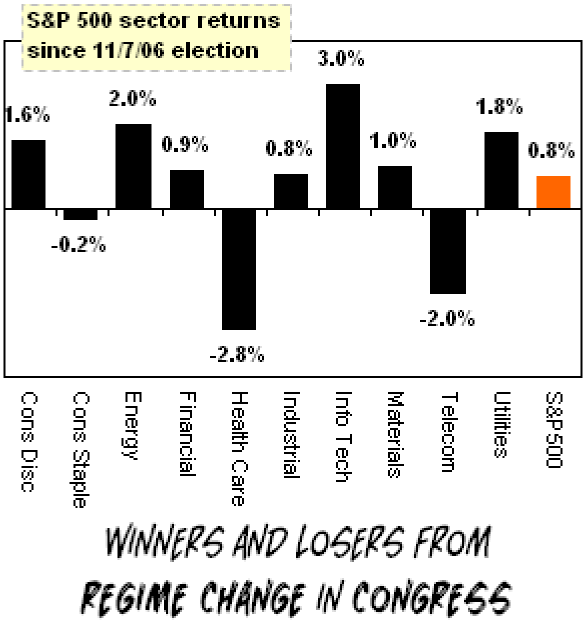

TELECOMMUNICATIONS SECTOR The second worst performing sector has been Telecommunications, off 2.0%. It has been by far the best performing sector year-to-date through the election, up 25.4%. The new Democratic majority is more likely to push for so-called "net neutrality" legislation, which would restrict the ability of telco's to control access to, and pricing of, their next-generation networks. Content providers such as Microsoft and Google have lobbied extensively to promote this legislation, partnering with liberal advocacy groups such as Move-on.org. Because next-generation networks require telco capital investment of many billions of dollars, this legislation could delay or altogether abort their build-out, which could have adverse consequences for growth across the entire economy. Considering the sector's spectacular performance this year, we see it as very vulnerable to the kind of negative surprises that may be developing here. We expect weakness until there is more clarity on these regulatory risks.

ENERGY SECTOR The second best performing sector is Energy, up 2.0%. This is a seemingly anomalous result, considering that the new Democratic majority is more likely to impose windfall profits taxes and environmental regulations on energy producers. With crude oil, gasoline and natural gas prices well off their peaks, it may be the case that there is no particular impetus for adverse legislation at this time. With the Fed still somewhat accommodative and still imparting inflationary pressures into the economy, we think it unlikely that energy prices will fall much from here, and in fact may well move higher, perhaps even challenging the highs before it's all over (see "The Frustrated Fed" September 28, 2006). If that happens, the threat of adverse legislation will rise, and probably only a presidential veto could head it off. But profits would rise at the same time.

BOTTOM LINE The final vote hasn't been tallied, but our quick take would be to buy the laggard Health Care sector on panic weakness and avoid the leading Telecommunications sector until we get better visibility on regulatory threats. Extension of the Internet tax moratorium could be a catalyst for the laggard Information Technology sector, and the threat of windfall profits taxes is probably not material at this time for the Energy sector. TM