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POLITICAL PULSE

Washington on Hold

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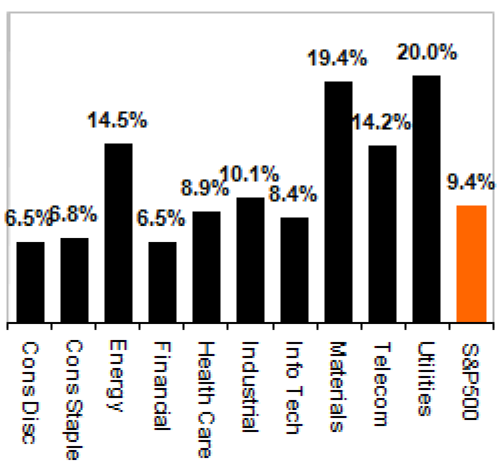
Donald Luskin

The two forces most likely to derail the economy -- the Fed and the Democratic congress -- have both put themselves on the sidelines.

The day after the election last November, when Democrats took control of congress, our advice was "Don't panic," and we predicted that "the Democratic majority will probably be no more successful with anti-growth initiatives than the Republican majority was with pro-growth ones" (see "Don't Panic" November 8, 2007). As it has turned out, congress has been gridlocked even more perfectly than we expected. The Democrats have encountered well-coordinated resistance from the GOP, against which they have mustered far less cohesion as a majority than they had shown when in the minority. What political capital the majority has been able to mobilize has all been invested in embarrassing the White House about Iraq.

Who would have thought, last November, with labor-backed Democrats flush with new-found power, that a modest federal minimum wage hike wouldn't have sailed through within the first couple weeks of the new congress? Instead, that legislation -- augmented with small business tax cuts insisted upon by the GOP -- didn't come to President Bush's desk until it was included in the Iraq funding supplemental, which Bush vetoed last week and is likely to veto again. Who would have thought that a drug reimportation bill would have been defeated? And who would have thought that there wouldn't have been even an attempt to repeal the 2003 tax cuts on dividends and capital gains?

S&P 500 sector returns since election



Update to strategic view

US STOCKS: With the Fed and the Democratic-controlled congress on hold and forward earnings surging, stocks should continue to edge higher. Valuation excesses merit some watchfulness for a short near-term correction.
US TECH STOCKS, US TELECOM STOCKS: With the Democratic-controlled congress on hold, our outlook for these sectors shifts to neutral.
US RESOURCE STOCKS: With the Fed and the Democratic-controlled congress on hold, the forces that could restrain inflation and growth are sidelined -- ideal conditions for these inflation-sensitive and growth-sensitive sectors.

[see Investment Strategy Dashboard]

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Both the Democratic-controlled congress and the Fed are potential hurricanes for the economy, but for now we're in the eye of both of them, and could remain there for a while yet. This benign policy environment helps explain why the S&P 500 has risen 9.4% since the election, and is now within a couple ticks of all-time highs. And it helps explain why, even as overall growth is masked by weakness in the housing sector (see "Two Economies, One Funds Rate" May 1, 1007), S&P 500 forward earnings are surging, with year-ahead estimate upgrades now growing at nearly a 16% annualized pace (see "Earnings to Economy: 'No Recession'" April 20, 2007).

TAXES The best news for the economy is on the tax front, as congress begins to deal with the urgent need for relief from the alternative minimum tax (see "Tax Wars" January 22, 2007). Without another extension of the year-by-year adjustment to the AMT exclusion, 19.9 million taxpayers will be hit by AMT for the first time in 2007, paying $45.9 billion more in federal taxes than they did last year. House Ways and Means Committee chair Charles Rangel has spoken about his intention to offset the static cost of AMT relief by raising the AMT rate from 28% to 35% for taxpayers with incomes above $250 thousand. This would be a brutal anti-growth tax hike levied upon the most incentives-sensitive fraction of the labor force. That said, since it would only affect approximately 3% of taxpayers, Rangel's proposal is not without a potential populist appeal to a few Republicans -- even though AMT most powerfully punishes taxpayers in Democrat-dominated states where state and local taxes tend to be higher. So if this year's budget were to be negotiated in congress under reconciliation procedures -- which would make it exempt from filibuster in the Senate, and thus require for passage only 51 votes -- there would be a decent chance that Rangel's plan would prevail. Then the only hope would be a presidential veto -- which would be risky, since that could lead to *nothing at all* being done on AMT this year. *But here's the good news*: the Democrats have been unable to coordinate themselves sufficiently to organize this year's budget under reconciliation procedures. Thus the threat of a senate filibuster will be a bulwark against Rangel's plan getting to the president's desk in the first place, and it creates a negotiating environment in which AMT relief can be offset with relatively harmless "enforcement" provisions. This area remains an important risk, but we are still quite optimistic.

TRADE We are also encouraged by what's happened on trade. We'd written off the chances of any new pro-trade legislation coming from the Democratic-controlled congress, itself controlled by the anti-trade labor lobby. The risk was that protectionist legislation such as the Schumer-Graham bill -- which would levy a 27.5% tariff on all imports from China -- would become a bipartisan runaway train, in the absence of pro-trade GOP leadership that had put the brakes on in the past. Instead, the Bush administration has taken a series of small and reasonably principled steps within the WTO framework, designed to be seen as putting pressure on China (see "Trade in the Balance" April 5, 2007). These steps have both mollified congress -- with Schumer and Graham saying their bill is now off the table, and promising to work in the future within the WTO framework -- and at the same time moved China, grudgingly perhaps, and not on its preferred timetable, in the direction of reforms it wanted to eventually pursue anyway.

On other policy fronts, stasis in the Democratic-controlled congress has mooted most of the sector-specific effects we highlighted as possibilities shortly after the election (see "Stock Market Exit Poll" November 15, 2007).

- **ENERGY** We expected that all the post-election talk about punishing the energy industry with windfall profit taxes and environmental regulations would come to nothing, and indeed that has been the case. Thus our dominant investment theme over the last year -- inflation -- has had free rein to lift Energy to the position of third best performing S&P 500 sector since the election (14.5% versus 9.4% for the S&P 500). Incidentally, our other inflation sector, Basic Materials, has been second best (19.4% versus 9.4%).

- **HEALTH CARE** We had speculated that there may be a buyable panic in health care if the Democratic-controlled congress attempted to bully the industry with the threat of drug reimportation or Medicare prescription negotiation. The worst congress has done has been a half-hearted attempt at reimportation legislation, which fizzled over nothing more than an amendment requiring the government to quality-assure reimported drugs. So the panic never came, and since the election the S&P 500 Health Care sector has slightly underperformed the market (8.9% versus 9.4%).

- **INFORMATION TECHNOLOGY** We thought tech might get a boost from Democratic enthusiasm for extending the Internet tax moratorium, and promoting other agendas friendly to the giant tech firms located in blue states (including Nancy Pelosi's California), and most of whose CEOs are important Democratic supporters. So far nothing, and since the election the S&P 500 Info Tech sector has slightly underperformed the market (8.4% versus 9.4%).

- **TELECOM** We had expected the Democratic-controlled congress would move quickly to impose so-called "net neutrality" regulations on the telecom industry, which would reduce the expected rate of return on the capital costs of building out next-generation networks. Instead, Congress has been silent on the subject, and the S&P 500 Telecom sector has been the fourth best performer (12.2% versus 9.4%).

BOTTOM LINE: The Fed and the Democratic-controlled congress are on hold and forward earnings are surging, so stocks should continue to edge gradually higher. With the S&P 500 within a couple ticks of all-time highs, despite the earnings surge, the equity risk premium has become slightly narrower than it was in late February at the last interim top. So we are watchful for a strictly near-term correction just ahead.