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POLITICAL PULSE

Upside Surprise on Trade

Monday, May 14, 2007

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A Democratic congress finds a way to keep the globalization train on the track.

We interpret the trade compromise announced last Thursday night between the Bush administration and committee leadership in congress as another upside surprise in the continuing failure of Democratic congressional control to produce anti-growth policy (see "Washington on Hold" May 10, 2007). Immediately after the election last November, we predicted that there would not be a chaotic lurch toward protectionism, but we conceded that neither would there be any forward movement on trade (see "Don't Panic" November 8, 2007). Happily, perhaps we were too pessimistic: this agreement paves the way for potential approval of pending bilateral Free Trade Agreements, and perhaps the extension of the President's "fast track" authority for trade negotiations. While free trade purists have denounced the compromise as enshrining intrusive labor and environmental requirements, labor interests have denounced it, as well -- because they want nothing at all that will enable any further trade with nations with cheap labor supplies.

Update to strategic view
US STOCKS: Thursday's compromise on trade, paving the way for new bilateral Free Trade Agreements, is an upside surprise from a congress in which protectionism is a danger. The relatively narrow risk premium raises the possibility of a short near-term correction, but the trade compromise is part of a trend toward diminishing political risk that should support the continued move higher in stocks.
[see Investment Strategy Dashboard]

It's been reported that the trade compromise was brokered by powerful Ways and Means Committee chair Charles Rangel over the objections of House speaker Nancy Pelosi. This is further welcome evidence of internal disorder within the new Democratic majority -- with Rangel telling one reporter "I don't report to her." And it is a welcome victory of the pragmatic center of Democratic politics over its ideological fringes. It demonstrates that Democrats in congress are willing to give Big Labor far less than that key constituency wishes -- just as the Bush administration has consistently disappointed its analogous constituency, the "religious right." To borrow the language of bond futures, efficient politicians will always provide only "cheapest to deliver" policy to their most polarized and most loyal political bases -- just enough to keep them loyal, and not enough to betray the interests of mainstream voters. In this case, the Democrats need Big Labor's money, and they need Big Labor's feet on the street at election time. But when it comes time to actually making trade policy, the Democrats apparently appreciate that only 12% of the US labor force is unionized -- yet 100% of the US population enjoys cheap foreign-made goods at Wal-Mart (and trade is not

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without resources on K Street). So Big Labor gets just what it needs to stay politically mobilized, and no more.

We saw similar logic at work last December in the decision of the two Democratic members of the Federal Communications Commission to not stand in the way of the AT&T merger with BellSouth. A well-funded lobby working through radical left advocacy organizations such as Move-on.org was insisting that the merger be blocked unless AT&T were required to adopt "net neutrality" regulations, which would have gutted the economics of the company's next-generation network build (see "Net Neutrality Not Neutered" December 14, 2006). Ultimately, AT&T agreed to regulations so limited and temporary as to have virtually no economic effect, just sufficient to permit Move-on.org to feel that it had at least accomplished *something*.

Thursday's trade compromise is an especially good thing. With trade flows now a record 28% of GDP, and exports running at $1.5 trillion annually (see "Trade in the Balance" April 5, 2007), trade has become an indispensable cornerstone of the US economy. The value of that cornerstone has been shown in especially high relief this last year as US residential investment has sharply contracted. The deep global diversification of the overall economy has so far kept it immune from infection from the collapse of a single and highly locally-oriented sector (see "Two Economies, One Funds Rate" May 1, 2007).

BOTTOM LINE: Thursday morning we wrote that we were on alert for a short-lived correction in stocks (again, see "Washington on Hold" May 10, 2007), and by Thursday afternoon it seemed that a correction was already underway. News of trade compromise, released after the close on Thursday, may explain why there was no downside follow-through on Friday. We still think, based only on the narrowing of the equity risk premium to levels similar to those that obtained at the interim top in February, that there could still be a short-term correction in the cards. But Thursday's trade compromise is part of a salutary trend toward diminishing political risk which, in concert with a resurgence in forward earnings growth, should prolong the move higher in stocks -- at least until the Fed is eventually drawn back into rate-hiking mode.