

POLITICAL PULSE

Best Behavior

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It's not the economy, stupid. For now, Democrats have no reason to rock the growth boat.

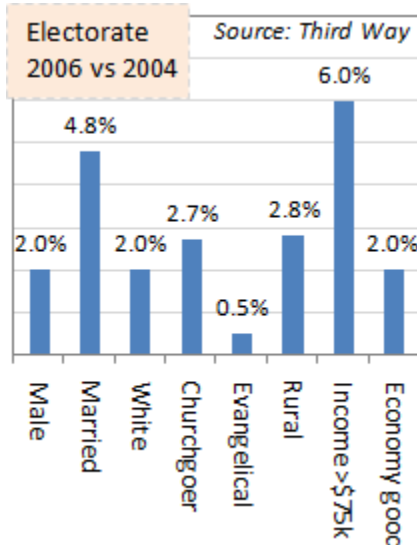
We have commented that while we expected no radical anti-growth policies from the new Democratic-controlled congress (see ["Don't Panic"](#) November 8, 2007), we have been happily surprised by just how benign the political environment has been (see ["Washington on Hold"](#) May 10, 2007, and ["Upside Surprise on Trade"](#) May 22, 2007). By way of explanation, we have noted how effectively Republican minority leadership has acted as "goalies" to block Democratic initiatives. And as a more theoretical proposition, we have noted that the Democratic majority has acted efficiently in producing "cheapest to deliver" policy outcomes, the least extreme outcomes sufficient to command the loyalty of the most polarized elements of its base.

With stocks at new highs, forward earnings rising at double-digit rates and the economy poised to reaccelerate, it's well worth asking how durable this state of affairs is. One analysis of voter behavior in the 2006 election implies that the Democratic majority has a strong incentive to stay on best behavior through the 2008 election. In a nutshell, *the new Democratic majority was elected by Republicans*, and to a considerable extent it will be obliged to act accordingly if it wishes to be elected by them again.

Update to strategic view

US STOCKS: The current benign congressional policy environment is likely to stay in place through the 2008 election, creating a supportive backdrop for stocks and the economy. Very short term, we continue to keep a wary eye on valuations.

[\[see Investment Strategy Dashboard\]](#)



An examination of national exit poll data in the last two elections conducted by Third Way, a centrist-liberal think tank, shows that the composition of the electorate shifted in 2006 toward attributes typical of Republicans and away from attributes typical of Democrats. Compared to 2004, the electorate in 2006 was more male, more married, more white, more religious, more rural, more rich, and more happy about the economy. Conversely, the electorate in 2006 was less African-American, less Hispanic, less urban, and less low-income.

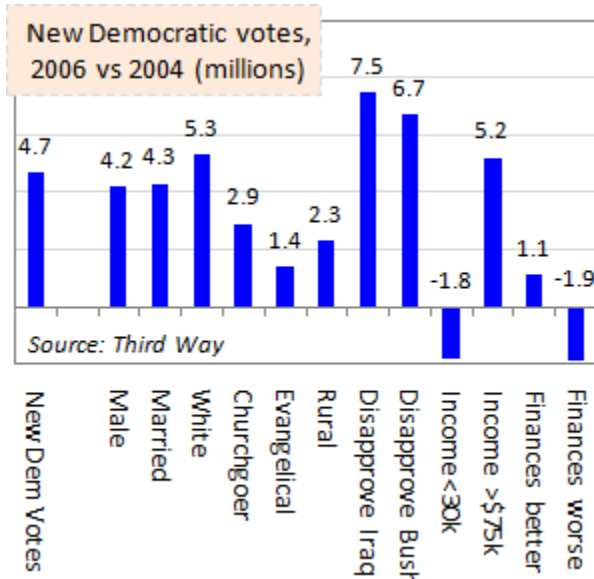
The electorate became more Republican-like, yet it voted more Democratic. There are two reasons, closely related to

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each other. The 4.7 million voters shifting from Democratic to Republican between 2004 and 2006 are more than explained by, first, the 7.5 million who went from approving of the war in Iraq to disapproving; and second, the 6.7 million who went from approving of President Bush to disapproving. The Third Way work does not address the issue of corruption in these terms, because there is no exit poll data from 2004 on that subject. However, it notes that 74% of 2006 voters were strongly concerned about corruption, and among them Democrats won by a 13% margin.



Economics had nothing to do with it. The 4.7 million gain in Democratic voters is more than explained by the 5.2 million with annual incomes above \$75 thousand (most of that coming from those with incomes above \$100 thousand); Democrats *lost* 1.8 million votes among their traditional base with incomes below \$30 thousand. Among whites, the household income above which an individual was likely to vote Democratic rose from \$23,700 in 2004 to \$40,300 in 2006. 1.1 million new Democratic voters said their personal financial situation was better in 2006, and the Democrats lost 1.9 million votes among those who said their situation was worse.

With new Democratic voters both richer and more satisfied with the economy, Democrats seem to have concluded that they won in 2006 *despite* their emphasis on class warfare and "economic insecurity," not because of it. So it makes sense that there has been a minimum of both talk and action from the Democrats in the economic domain, with surprising progress on free trade. Emphasis has been put on opposing the war in Iraq, and on embarrassing and discrediting the Bush administration. Thus the new majority in congress has been acting pretty much in accordance with the apparent preferences of the swing voters who made the Democrats' 2006 victory possible. With 22 Republican senate seats up for election in 2008 (versus only 11 Democratic seats), and the Republican presidential field in disarray, Democrats have everything to gain in the next election by continuing to be on best behavior in economic policy.

BOTTOM LINE: After the 2008 election, it's another story. But for the time being, with the Fed apparently on hold indeterminately -- while we harbor very short-term concerns with valuations -- we believe that the political environment sets a surprisingly supportive backdrop for the economy and the stock market. ▶