TrendMacrolytics

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MARKET CALLS

Four Pillars of Wisdom

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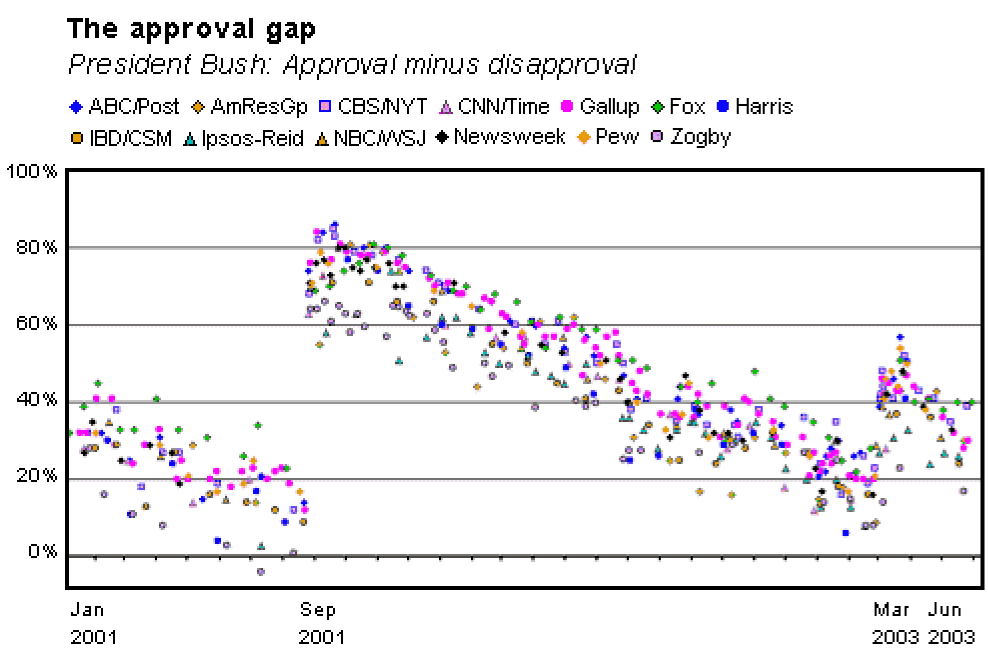
Valuation, monetary policy and tax policy are all in bull-mode. But there's a fourth factor.

We initiated our **Model Position long the S&P 500** just a little over one year ago. It is now our longest-lived Model Position. We started with a notional equity exposure of 25%, noting that stocks were finally fairly valued after years of persistent overvaluation, and explicitly keeping capital in reserve to buy more if stocks became downright undervalued and if favorable macroeconomic factors fell into place. Stocks *did* become downright undervalued -- they still are. And favorable factors *did* fall into place -- specifically the definitive end to deflation risk in monetary policy and the enactment of large-scale pro-growth tax cuts.

As all these reasons have made us increasingly positive on equities and willing to buy on dips, we have gradually built the position up to its current 75% equity exposure. Since its June 11, 2002 inception, the position has returned a *gain* of 3.81% (without dividends or interest income on uninvested cash), or 48.4% on a futures market basis. At the same time, the S&P 500 Index (without dividends) has *lost* 1.86%. The position's positive return and relative out-performance of the benchmark was achieved with an average equity risk exposure over time of only 57%.

We've talked about our equity outlook being based on three pillars -- valuation, monetary policy, and tax policy. All three pillars are in place. So what's holding us back with only a 75% equity exposure in the Model Position? I don't know how to put it except to say that it turns out there's actually a fourth pillar, and it's *not* in place. The fourth pillar is *political risk*.



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We've noted before that three great stock market bottoms of the last year have coincided with a series of "constitutional crises" driven by the narrow and fragile political consensus supporting **President Bush** (see "Another Quarter, Another Crisis?" May 20, 2003). The most recent was in early March when Bush aborted diplomatic initiatives and committed to the invasion of **Iraq**, from a position of approval in the polls that was nearly as low as it has ever been for him. His approval ratings surged as his resolve hardened and the invasion began.

But we warned after the invasion's rapid and successful conclusion that Bush's new-found popularity would be short-lived if weapons of mass destruction -- the putative rationale for the invasion -- were not discovered (see "WMD and the Market" April 10, 2003). Indeed, since then, the failure to find WMDs has been the focal point of opposition campaigns designed to discredit both Bush and **British Prime Minister Tony Blair**. While specific charges of falsifying or misusing intelligence information have not yet definitively stuck, it is nevertheless a fact that Bush's approval ratings have now given back most of their gains from the invasion, and are now back at the levels seen shortly after Bush took office in 2001.

It took every ounce of Bush's political capital to get his tax cuts enacted last month, and he barely made it. While Republican triumphalists like **Grover Norquist** of **Americans for Tax Reform** now crow publicly about eight years of tax cutting under two Bush administrations (see "Step-by-Step Tax Reform" *Washington Post*, June 9, 2000), the reality is that the political consensus that made the last tax cuts possible may very well not be there next time around.

But there is risk beyond that, and that risk is already eventuating. While the Bush administration has gone to the wall to risk its political capital to deliver a tremendous pro-growth tax cut, in other areas of economic policy it has proven all too willing to take *anti*-growth stances in order to shore up its political fortunes. There were the steel tariffs, and the farm bill, and dozens of other less notable -- and mostly non-defense and non-security -- items that have all added up to an enormous increase in government spending, and concomitant government interference in the private sector.

According to unpublished research by **Brian Riedl** of the **Heritage Foundation**, "The federal government will spend $21,000 per household in 2003, up from $16,000 in 1999. Adjusting for inflation, this amounts to the largest four-year expansion of government in more than 50 years" (an earlier published version of Riedl's research can be found here).

I am told that **Jagadeesh J. Gokhale** of the **American Enterprise Institute** -- who, while a consultant to **Treasury**, did the best work on the true actuarial value of **Social Security** and **Medicare** liabilities -- now calculates that the current plan to add a prescription drug benefit to Medicare will have an actuarial present value discounted to perpetuity of $13 trillion.

President Bush is very conscious of the trade-offs being made here. During my April 2 meeting with him at the White House, he reiterated his commitment to reforming Social Security through private accounts, and to ongoing tax cuts -- but the price he knew he would have to pay was to dig the Medicare hole even deeper than it already is (see "Notes from the West Wing" April 3, 2002). As long as Bush's political consensus dangles by a hanging chad, that's the kind of trade-off he will be forced to make.

The only alternative to these cruel trade-offs is to cement the political consensus in Bush's favor. The worst way for that to happen would be for the administration to take on unnecessary military adventures -- we cannot help but note that the issue of **Iran's** nuclear program is suddenly front and center in the public arena. We have no idea whether dealing with that is "unnecessary" -- but we can be sure that the political process required to gear up for it would be extraordinarily divisive, and would therefore have very poor risk/return characteristics if the goal is to cement a consensus.

The best way for a political consensus to be cemented would be for the pro-growth impacts of Bush's tax cuts to take visible effect, and for Bush to be given the credit that he so richly deserves. That implies that there is a powerful form of leverage for the stock market embedded in economic recovery, since recovery will endow Bush with the political wherewithal required to lever that recovery into a real expansion. If that scenario begins to unfold and becomes dominant, we may well increase the equity exposure in our Model Position. But for the time being, we're comfortable that 75% reflects both our optimism and our caution.