TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

POLITICAL PULSE

Extending Visibility

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Donald Luskin

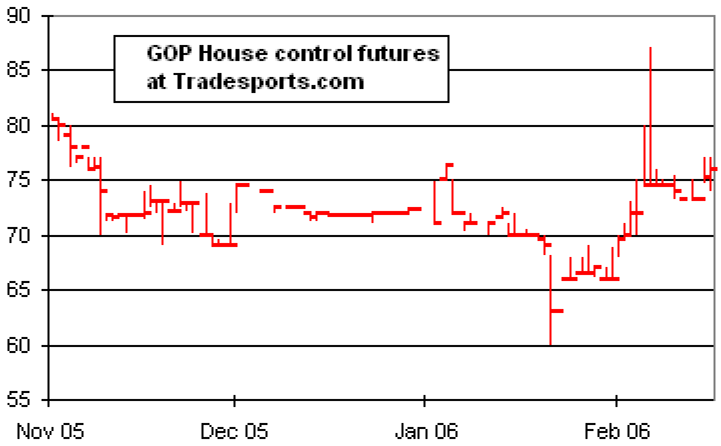
Chances for extension of the 2003 tax cuts have gotten better -- and markets are beginning to see it.

There have been two very positive developments this week that have improved the probability of the extension of the **2003 tax cuts on dividends and capital gains** under the **filibuster**-proof **2006 tax reconciliation** process.

- A **Senate** resolution instructing the **House/Senate conference committee** to include extension in the conference report -- even though it had been conspicuously excluded in the Senate's own version of the legislation -- passed by a 53/47 vote on Monday. While the resolution itself is non-binding on the conference committee, it is an important straw poll that validates our out-of-consensus call two weeks ago that there *are* enough votes in the Senate to approve extension (see "Quick Takes" February 7, 2006. Only three **Republicans** voted against -- **Lincoln Chaffee**, **Olympia Snowe**, and **John Warner**. As we expected, bellwether **GOP** moderate **John McCain** voted for the resolution (though he had voted against the tax cuts originally in 2003). .Also as we expected, a single **Democrat**, **Ben Nelson**, voted in favor.

- On Wednesday Republican **leadership** announced the appointment of the House/Senate conference committee that will craft the final legislation. The House appointed three Republicans and two Democrats; and the Senate appointed two Republicans and one Democrat. The lopsided number of conferees from the two chambers gives the House -- whose version of the legislation already includes extension -- a negotiating advantage (though approval of a conference report requires both a majority of Senate conferees and House conferees -- not a majority of the total). It was no surprise that **Ways and Means Committee chair Bill Thomas**, an extraordinarily talented negotiator and extension advocate, would be on the House team. It was an unexpectedly positive signal, though, that **John Kyl** of **Arizona** would be on the Senate team. Kyl is without doubt the single best informed and most passionate evangelist for extension in the Senate.

Extending the 2003 tax cuts still must overcome a Democratic point of order under the **Byrd Rule**, which forbids tax provisions under reconciliation from having negative revenue effects beyond the reconciliation instructions' budget window, in this instance five years. Under the perverse methodology of the **Joint Committee on Taxation**, extension to 2010 is "scored" as a revenue loser in 2011 and 2012 (see "On the Byrd Rule and Extension of the 2003 Tax Cuts" February 8, 2006). Sources continue to flatly assure us that the conference committee will craft a bill that will be in compliance with Byrd -- but no one so far has been willing to tell us exactly how it will be done.



All in all, prospects for extension have become substantially brighter. That, and the tangible commitment of GOP leadership that has made it possible, improve in turn the prospects that the GOP will hold on to control of the House in the **November elections**. Conventional bottoms-up race analysis now shows 21 GOP seats that are either **"toss ups"** or **"leaners,"** a seeming deterioration from 18 just one month ago (the current GOP margin of control is 14 seats). But the market-based forecast embodied in the **political futures contracts** at **Tradesports.com** shows the probability of continued House control having recovered back to better than 75%, matching the year-to-date highs established in the first week of January. As progress toward extension of the 2003 tax cuts has become more positive and more visible -- and the GOP majority, now energized by **John Boehner's** new leadership in the House, is coalescing around a pro-growth agenda -- it's surely no coincidence that **stocks** have recovered to match *their* year-to-date highs as well (see "Election Risk: It's Back" January 26, 2006).

Bottom line: Stocks have been remarkably resilient in the face of a sudden and significant shift in consensus toward our view that **the Fed**, under new chairman **Ben Bernanke**, will continue to hike the **fed funds rate** to at least 5%. We'd like to think that, at least in part, that's due to a dawning acceptance of the fact that there's nothing prohibitive about such rates, and that indeed they are necessary to address **inflation risks** imparted by the Fed having stayed so extremely easy for so very long. At the same time, stocks are being buttressed by improving prospects for extension of critical pro-growth tax policies directly affecting the after-tax return on invested capital, and the political implications of a Republican congressional majority that has decided to rally around extension in a time of serious electoral uncertainty. We face the very real possibility that monetary, tax, and political risks will all resolve positively at the same time. Great news for **equities**, and terrible news for **bonds**. Dare we speculate that this confluence of events is what it will take to finally collapse the near-historic **equity risk premium**? TM