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POLITICAL PULSE

Is the Inevitable Inevitable?

Wednesday, December 19, 2007

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A GOP victory on taxes and spending, and the emergence of Ron Paul, lowers the chances of a growth catastrophe in the 2008 election.

AMT RELIEF AT HAND In the nick of time for the 2007 tax year, it looks like a "patch" to the Alternative Minimum Tax will be passed by congress and signed by the president -- thus preventing approximately 20 million taxpayers from paying an additional approximately $2,500 in income taxes. The White House and the GOP minority in congress have succeeded in turning back Democratic attempts to "offset" AMT relief with higher taxes on hedge fund and private equity managers.

Failure to come to agreement and enact the "patch" at all would have been very bad news for growth. "Offsetting" it with taxes on investors would have been a chilling sign of the GOP's inability or unwillingness to stand against anti-growth initiatives, of which there are surely more to come. The enactment of the "patch" with no anti-growth "offsets" relieves uncertainty and avoids a catastrophe, but we think it was generally expected -- we ourselves have predicted it since spring (see, for example, "Washington on Hold" May 10, 2007). So while it's very welcome news, we don't see it as an especially powerful short-term news catalyst for equities.

Update to strategic view
US MACRO: The credit crisis and the Fed's reaction to it still holds center-stage, but in the background some long-term positives are developing. The now highly likely enactment of an AMT "patch" with no "offsets" in the form of new taxes means that catastrophic tax-hikes have been averted. This accomplishment by the White House and the GOP minority in congress, and the emergence of Ron Paul as a likely third party candidate, reduces the inevitability of a strong anti-growth mandate coming out of the 2008 elections. **US STOCKS:** The enactment of an AMT "patch" with no "offsets" was generally expected, so it's not likely to be a short-term news catalyst for equities. We continue to see stocks as absurdly undervalued in relation to low interest rates and to forward earnings which, outside the financial sector, continue to make all-time highs.
[see Investment Strategy Dashboard]

Longer term, we note that the White House and the GOP congressional minority have, at the same time, succeeded in turning back Democratic initiatives to increase spending and expand the scope of federal funding for children's health care. And they've done it without causing interruptions to existing programs, or shutting down the government overall (doing so was a political disaster for the GOP in 1995). Core conservative voters who turned away from the GOP in 2006 because of its fiscal profligacy ought to be impressed by the party's performance this year. If the GOP can continue to display this kind of commitment and skill, and earn back the

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respect of its core constituency, it might be time to start lessening the sense of inevitability of anti-growth Democrats controlling the White House and both houses of congress after the 2008 election.

THE PAUL FACTOR Congressman Ron Paul (R-TX) is emerging as a force to be reckoned with in the 2008 election. His economic philosophy is a strong version of Reaganomics, emphasizing smaller government, lower taxes, less regulation, free trade and sound money. On Sunday Paul raised $6.1 million dollars, the largest amount ever raised in a single day by any presidential hopeful during a primary season. This stands in seeming contrast to Paul's low poll numbers, which trail those of most of his Republican opponents in the Iowa caucuses and the New Hampshire primary. The explanation is that a large component of the support for Paul evidenced by his fund-raising performance is among Democrats, thanks to Paul's status as the most avidly anti-war candidate of either party. So while he is unlikely to win the GOP nomination, he will have the crossover appeal and fund-raising prowess required to mount an effective third party candidacy, and could well play a role in 2008 similar to the one played by H. Ross Perot in 1992. Paul has a ready-made vehicle for such a move, in the form of The Libertarian Party -- which is already on 26 state ballots for the 2008 election, and has officially invited Paul to seek its nomination (he ran for president on the Libertarian ticket in 1988).

Paul officially maintains that he won't pursue a third party run, but highly placed sources indicate to us that he is almost certain to embrace the opportunity when the time is right. A third party run by Paul would likely deny either major party candidate the mandate of a majority of the popular vote. And his free market economic philosophy would shift the center of gravity in the debate between the major party candidates in the pro-growth direction. The Paul factor adds uncertainty to the 2008 election, and on the face of it that's bad for markets. But in this case, uncertainty -- which includes the probability that anti-growth policy ideas won't get a popular mandate -- surely beats the inevitability of an anti-growth outcome.

BOTTOM LINE: The credit crisis and the Fed's reaction to it still holds center-stage, but in the background some long-term positives are developing. The now highly likely enactment of an AMT "patch" with no "offsets" in the form of new taxes means that catastrophic tax-hikes have been averted. This accomplishment by the White House and the GOP minority in congress, and the emergence of Ron Paul as a likely third party candidate, reduces the inevitability of a strong anti-growth mandate coming out of the 2008 elections. The enactment of an AMT "patch" with no "offsets" was generally expected, so it's not likely to be a short-term news catalyst for equities. We continue to see stocks as absurdly undervalued in relation to low interest rates, and to forward earnings, which -- other than the financial sector -- continue to make all-time highs.