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MACROCOSM

The Next Thing to Worry About

Thursday, May 8, 2008

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As the credit crisis eases, it's time to turn to the growth risks of the November election.

> **Update to strategic view**
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> **US STOCKS:** The extreme risk premia available in mid-March have been absorbed, as stocks have recovered half or more of the losses accrued at the worst of the credit crisis. A correction here is in order. The recovering economy and still-negative sentiment should lead to more gains in the near term, but the uncertainties of the November election are going to start playing an increasing role. We are moving to a position of caution for the long term, and may look to take advantage of further recovery as an exit point if political developments warrant.
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> [see Investment Strategy Dashboard]

Before the opening on March 17, the first market day after the collapse of Bear Stearns, we hesitatingly said to buy into weakness (see "Bernankruptcy" March 17, 2008). So far so good. Before the sharp correction in stocks yesterday, the S&P 500 had made it better than halfway back to the all-time intraday high made on October 11 2007, sitting 10.0% below that high, and 12.8% above the intraday low on March 17. We also anticipated a sharp recovery in credit markets that had been unnecessarily brutalized by forced deleveraging at the climax of the crisis (see "Inflation Inflection" March 25, 2008). There too, so far so good. The Merrill Lynch High Yield Total Return Index is up 6.3% from its March low, and only 1.1% off its all-time high. The ABX 6-1 index of AAA-rated tranches of CDOs backed by subprime mortgages is up 11.6% from its low, now only off 6.0% from par. The LCDX 8-1 index of leveraged loans is up 6.2% from its low, now only off 4.4% from par.

So some kind of correction or consolidation is certainly due, just on general principle. But for the near term, we think a correction is all it will be. We continue to think that the worst of the credit crisis is over, that the economy will not worsen from here from slowdown to recession, and that overall sentiment is still negative enough to fuel further gains in stocks and risky fixed income markets. That said, at this point the easy money (that was easy?) is out. The snap-back from the extraordinary risk premia offered in mid-March is over. From here, markets are going to have to make it on the merits.

We're not sure exactly what was the trigger for yesterday's drop in stock prices. It seemed to begin in earnest approximately when crude oil prices surged to new all-time highs, in the face of an inventory report that should by rights have been interpreted as bearish. We have not been especially concerned about the macro risks of a rising crude price, seeing it mostly as a self-equilibrating result of reinvigorated global growth prospects (see "There Will Not Be Blood" April 24, 2008). But to the extent that it's a speculative runaway train, it takes on some element of an

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exogenous supply shock, and becomes more worrisome to us. We don't know how to precisely calibrate the balance between those two interpretations, both of which must be to some extent in play. We do know that the more it is generally conceded that oil is a runaway train, the closer we are to that train suddenly stopping. That kind of capitulation top may be closer than anyone thinks.

Also, we can't help but be concerned that Wednesday's drop in stocks was in some way connected to the previous evening's primary election results in Indiana and North Carolina. After Hillary Clinton's narrower than expected win in Indiana, it now seems all but certain that Barack Obama will be the Democratic nominee (the online political futures contracts at Intrade give Obama a 90% probability). That's no revelation -- but it focuses the mind, as the distracting political theater of Clinton versus Obama falls away, and the serious and risky business of Obama versus McCain takes the forefront. At the moment, the baseline expectation has to be that Obama will win. On the face of it, that would likely usher in a new era of risk for markets and the economy, especially if the unique persona of Obama and the drama of the primary season end up strongly increasing Democratic turnout in November, which could produce a "coat tails" effect resulting in filibuster-proof and veto-proof Democratic congressional majorities. It's been over three months since we've opined on any of this (see "Obamanation" February 5, 2008). During that time markets had more urgent matters to worry about. But now that those emergencies seem to be mostly contained, it's time to think again about the election.

It's too simple by half for us just to assert that an Obama presidency would trash economic growth. We've had periods of strong growth under Democratic presidents, and of weak growth under Republican ones (and vice versa). It's a matter of specific policies, and of the particular historical context into which those policies fall. For example, the strong growth during the Clinton years was a matter of both luck and skill. Clinton was lucky to take office just when a very sharp recession was ending and growth was on the upswing anyway. He was also the beneficiary of the continuing percolation through the economy of seismic pro-growth policy shifts that had occurred in the 1980s -- lower marginal tax rates, deregulation and disinflation. And he had an aggressive Republican presence in congress to block his worst ideas and promote his best ones. His surprise tax-hike in 1993 was a mistake, and the GOP couldn't block it in congress, but the economy had enough momentum to absorb it. GOP congressional opposition did block his attempt to nationalize health care. GOP congressional support made possible Clinton's finest hour, when he risked considerable political capital to promote NAFTA. And GOP congressional pressure motivated him to agree to a cut in the capital gains tax rate in 1997.

An Obama presidency seems to us unlikely to benefit either from luck or skill. His stated policies on taxes, trade, regulation, union influence and spending are aggressively opposed to free operation of markets, and if implemented, would almost certainly impose very high incentive and efficiency costs on the economy. Obama 's opposition in congress isn't likely to be as robust as Clinton's was, with the possibility of a strong Democratic majority and with many Republicans today having little commitment to pro-growth policy. The growth costs of Obama's policies would have to be borne against the backdrop of a recovery from the present economic slowdown that is not likely to be outstandingly brisk, because the slowdown itself is not a true recession, and probably isn't going to become one (see "What Recession?" May 7, 2008). And there have been no seismic policy shifts in the previous several years likely to produce exceptional residual growth effects (if anything, policy errors, especially the inflationary errors of the Fed, are likely to be a drag on future growth to some extent).

At this point, the best hope for growth is that Obama doesn't win the presidency. At this moment Obama seems to be a "man of destiny," a political runaway train as unstoppable as the rising price of crude oil. But it wasn't even six months ago that Hillary Clinton seemed unstoppable, too. While the drama of the Democratic primary race has crowded John McCain from public consciousness, and it feels almost as if Obama will run unopposed, November is a long time away and McCain will in fact mount a very credible effort. The Intrade futures put the probability of a McCain win at about 39%.

Another hope is that Obama doesn't really mean all the anti-growth things he says. It is primary season, after all, when candidates tend to sound more extreme than they really are. Also, fate has cast up Obama as a strong presidential contender without his ever having developed strong policy commitments -- he really does seem to be making up policy as he goes along, and remaking it just as easily. On trade, he campaigned in Pennsylvania on "renegotiating" NAFTA. But then it was leaked that his top economic policy advisor had privately told Canadian officials that he didn't actually mean it. He called for a 28% capital gains tax rate, and was embarrassed in a recent televised debate in which he conceded it would be a revenue loser, but was nevertheless necessary on grounds of "fairness." Several days later he called for a 20% rate.

So it's probabilistic. We don't know for sure if Obama will be the next president (he probably will -- the Intrade futures put that probability at about 56%). And we don't know that all his economic policies will be anti-growth (they probably will). We don't know if those anti-growth policies will be implemented (they probably will). And we don't know if, in context, they will in fact be substantively adverse to growth (they probably will). And just as important for investors, we don't know the extent to which markets are focused on any of this, considering everything else there is to worry about (they are probably beginning to be, and to an increasing extent).

All this moves us to a position of caution for the long term. We do expect further gains in stocks and other risky assets after a short correction has played itself out. But we are having a hard time seeing a high probability of avoiding a bad anti-growth policy turn after the November election. As political developments unfold, chances are good we will be looking for an exit point.

BOTTOM LINE: The extreme risk premia available in mid-March have been absorbed, as stocks have recovered half or more of the losses accrued at the worst of the credit crisis. A correction here is in order. The recovering economy and still-negative sentiment should lead to more gains in the near term, but the uncertainties of the November election are going to start playing an increasing role. We are moving to a position of caution for the long term, and may look to take advantage of further recovery as an exit point if political developments warrant.