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The Upside of Obamanation

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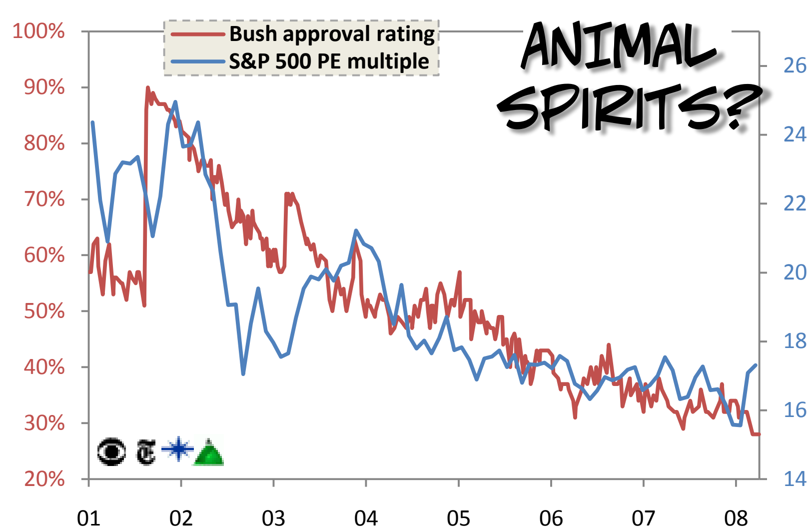
Amidst a nasty correction in stocks, a (sort of) bullish take on an Obama presidency.

Update to strategic view
US STOCKS: Stocks are in the correction we forecasted two weeks ago. We still think a correction is all that it is. We are considering a scenario in which an Obama presidency could have a positive effect on stocks and the economy at first, but we maintain our long-term cautious position in light of the negative effects of a near-inevitable anti-growth policy shift.
[see Investment Strategy Dashboard]

The stock market correction we anticipated two weeks ago is in full swing (see "The Next Thing to Worry About" May 8, 2008). There are a lot of issues in immediate play, and we'll cover all of them in a subsequent report. But for the moment, here is a longer-range -- and perhaps strangely optimistic -- idea that has captured our imagination over the last couple of days.

As we warned of a short-term correction two weeks ago, we also officially shifted our long-term position on stocks to one of caution and said we would be looking for a post-correction exit point, in light of the anti-growth policy risks implicit in a Barack Obama presidency (see, again, "The Next Thing to Worry About" and "Obamanation" February 5, 2008). But in such a call, timing is everything -- where, exactly, will be that exit point? It's worth considering the possibility that Obama himself will provide it.



Suppose that he is elected president in a landslide, and takes office with his current cult status intact -- that is, he would be widely perceived as a man of destiny, a fresh uncorrupted leader capable of restoring national unity, pride and optimism. For a while, such perceptions would be self-fulfilling, and the resultant general sense of confidence might have a positive effect on earnings multiples, which are themselves a direct reflection of confidence.

It's not as crazy as it sounds. The same thing has been running in

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reverse for the last eight years. Over George W. Bush's presidency, multiples have closely tracked his falling approval ratings -- very high right after the terrorist attacks of September 11, 2001, but then generally steadily downward, with a brief rally right after the invasion of Iraq (please see the chart on the previous page). That's a remarkably poor performance for multiples considering that, from the lows in late 2002 and early 2003, we've generally been in a bull market and S&P 500 earnings have more than doubled -- so by most historical precedents, multiples should have expanded. Why didn't they?

Perhaps because, again, multiples are a function of confidence -- *economic* confidence, which can be a function of *general* confidence. Consider as evidence that long before the housing bubble burst, or the credit crisis began, or the present economic slowdown set in, we repeatedly saw seemingly inexplicable polling results showing large percentages of Americans believing the economy was in recession. Such beliefs are barely justified today (see "What Recession?" May 7, 2008), and certainly were not justified for most of the last several years. But for purposes of equity valuation, all that matters is that such beliefs exist, right or wrong. So for a while it won't matter, if Barack Obama is elected president on a wave of high spirits, that his initial high approval ratings will ultimately lead to disappointment (after all, from where he is likely to start, there is nowhere to go but down), or that his economic policies will ultimately lead to slower growth. From where we stand today it's not all that great a distance to all-time highs for stocks, and even a short-lived and entirely undeserved surge in confidence could get us there.

Another element could play into this scenario. An Obama landslide suggests a coat-tails effect that would strongly increase the Democratic majority in congress. That would enable the Democrats so reverse the 2003 tax cuts on incomes, dividends and capital gains in 2009, without waiting for them to automatically sunset in 2011. Ultimately that will be very bad for growth. But a very astute client has suggested the possibility that, anticipating this, economic actors would take steps to accelerate various realizations of income into 2008, so it would be subject to lower tax rates. Capital gains are not counted in personal income as reported, but dividend income and other forms of tax-driven accelerated realizations *are* counted. And personal income is not counted in gross domestic product, but some fraction of the accelerated realizations would find its way into consumption, and consumption *is* counted.

Realizations were accelerated in anticipation of the Clinton tax hikes in 1993, causing disposable personal income in December 1992, the month after Clinton was elected, to grow at an annual rate of 49.7%, the fifth largest monthly jump in the history of the data. The same month real personal consumption expenditures grew at a brisk 8.1% annual rate. Today the effect of income accelerations could be even greater, because of the anticipation of the loss of the current favorable relative tax rate on dividend income, a factor which was not in play in 2002. Microsoft may well elect to declare another extraordinary dividend so that shareholders would be taxed on it at only 15%. Such a dividend would probably not be quite as large as the one paid in 2004, but in the month that one was paid, disposable personal income grew by 58.9% at an annual rate, the third largest jump in the history of the data. If later this year a couple of corporations pay extraordinary dividends, at the same time as other 1992-type income accelerations are taking place, the jump in disposable personal income could set a new record. Consumption could jump accordingly.

Now suppose that, just when confidence is building as Barack Obama is elected by acclamation, tax-driven income acceleration causes reported income and consumption to surge -- and this, if our macroeconomic scenario is right, coming on top of a general economic recovery that will have been in place already. For investors, the confidence spilling over from the Obama landslide will appear to be corroborated by seemingly objective statistics. The results could be electric. Again, this is not as crazy as it sounds. Something very similar happened in the fourth quarter of 2001 and the first quarter of 2002, after the 9/11 terrorist attacks.

Then, President Bush's approval rating soared to 90%, and a powerful sense of confidence, unity and national purpose prevailed. Fitting right into this mood, in December, influential economist Ed Hyman of ISA made the daring prediction of a "super-V recovery," and said that GDP growth in the first quarter of 2002 would top 5%. Other economists soon jumped on the bandwagon. But long before the Bureau of Economic Analysis released the GDP report that would make Hyman appear to be right, we told clients it would be only an illusion, driven not by actual growth, but rather by an artifact of calculation -- simply, that while inventories continued to be liquidated, they were being liquidated at a slower pace than they had been in the previous quarter (see "A Green Eyeshade Recovery" January 9, 2002). But by the time Hyman had made his prediction, the S&P 500 had rallied almost 20% -- and we told clients to sell stocks and buy Treasury bonds (see "Vay Out of Vack -- Even for a 'V'" December 10, 2001). Ultimately, much of the initially reported growth ended up getting revised away, and what was left was mostly the accounting illusion we had described. And stocks collapsed, losing 28% over the second and third quarters.

But while it lasted, it was a great feeling. And a great selling opportunity. Seems to us like many of the same factors that were in place in 2001 and 2002 will be in place again in 2008 and 2009.

BOTTOM LINE: Stocks are in the correction we forecasted two weeks ago. We still think a correction is all that it is. We are considering a scenario in which an Obama presidency could have a positive effect on stocks and the economy at first, but we maintain our long-term cautious position in light of the negative effects of a near-inevitable anti-growth policy shift.