Trend Macro

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

MACROCOSM

Bearack Obama

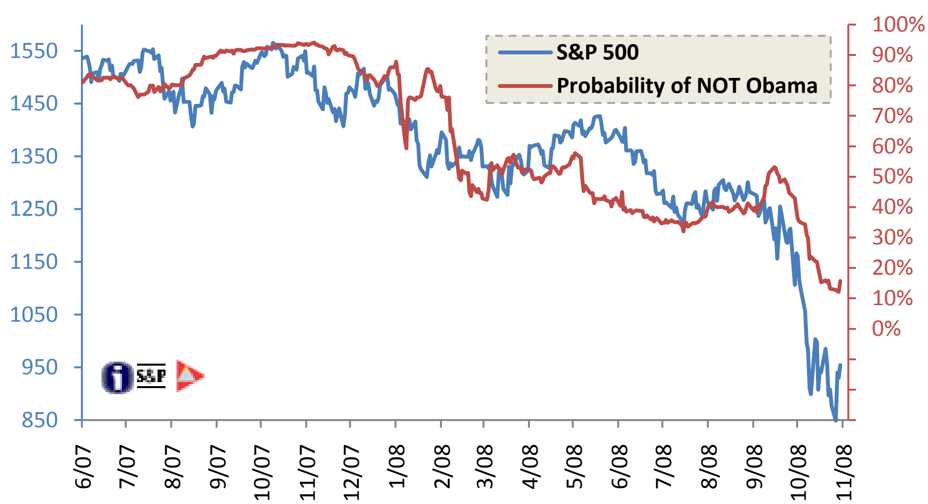
Friday, October 31, 2008

Donald Luskin

He could usher in a capital-unfriendly "Left decade," but in the near-term Obama's election could be a plus for stocks.

Update to strategic view
US STOCKS: Stocks have now probably more than fully discounted the election of Barack Obama as president, pricing for a growth-adverse environment similar to that of the 1970s. This argues for there being not much room on the downside, but it also caps the potential for sustainable recovery. In the near-term, stocks are trading at a generational undervaluation, and Obama's election might trigger a substantial rally.
[see Investment Strategy Dashboard]

Barring a miracle or a catastrophe, Barack Obama will be elected president next Tuesday, and the Congress will have a stronger Democratic majority, perhaps even a filibuster-proof majority in the Senate. It's become commonplace lately to see charts relating the stock market's fall this year to the increasing probability of Obama's election. Our version is below, updated from when we first published it in February, putting out a long-term cautionary signal based on a potential lurch to the political Left, fueled by the rise of Obama as a messianic figure (see "Obamanation" Tuesday, February 5, 2008). In our chart, we track the S&P 500 against the probability that Obama will *not* be elected (derived from the prices of political futures contracts traded on Intrade). There's more art than science to this analysis, to be sure, but based on the pattern of nesting cycles established over the last year, we could say the S&P 500 price that fully discounts Obama's election is about 1,025. We're below that now, thanks to other factors.



We think that the policies likely to come from Obama's administration and the Democratic-dominated Congress will be negative for stocks and for growth in the longer term, and that limits the potential for recovery from

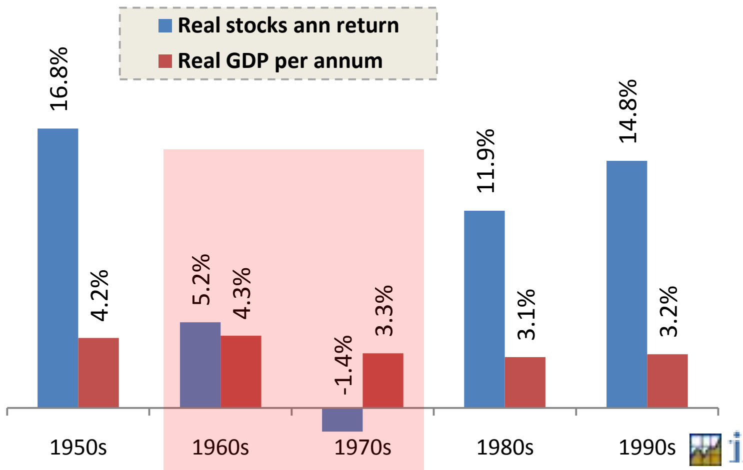
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

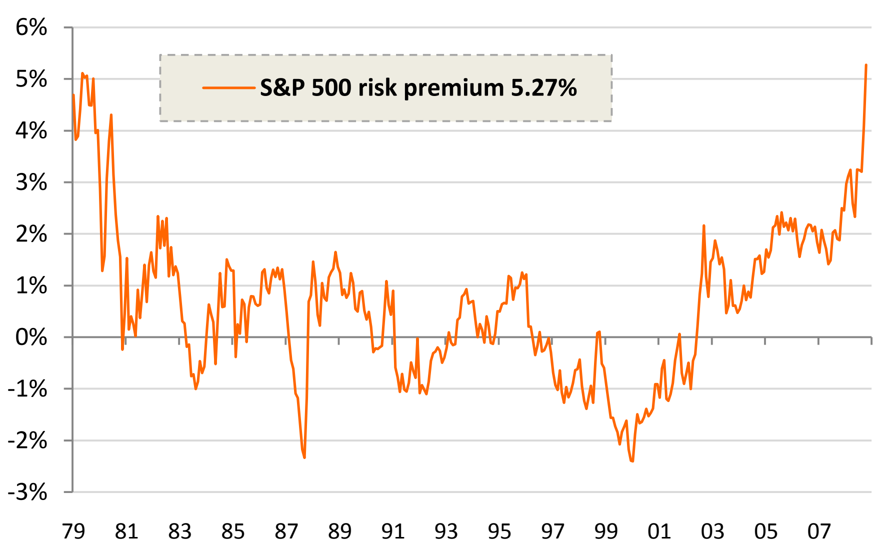
Phone:
650 429 2112
973 335 5079
704 552 3625

recession, and what would otherwise seem to be a stellar buying opportunity in undervalued equities. But in the intermediate term, the value opportunity in stocks is very real, and a credible case can be made that Obama's election would actually help to catalyze it.

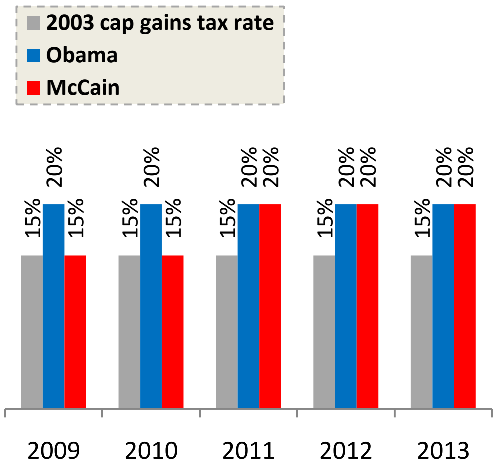
To scale the long-term risk potential of a sustained lurch to the left -- by which we mean more government, more regulation, higher taxes, more union power, more welfare, more inflation and more protectionism -- let's look at the last five complete decades, from the 1950s to the 1990s. We'll characterize the 1960s and the 1970s as Left decades, and the 1950s, the 1980s and the 1990s as the Right decades. In both Left and Right decades, the Democrats and the Republicans each occupied the White House half the time. But during the Left decades, the Democrats controlled Congress for 20 years straight, and had a filibuster-proof Senate majority in 14 out of 20 years. Across Left and Right decades, real GDP growth has been constant -- that is, in a constant gradual decline, settling in after the post-war boom had run its course. But real equity returns are distinctly different -- far higher in the Right decades than in the Left decades. Since growth is roughly constant while and real equity returns are highly variable, the clear message would seem to be that in Right decades more of fruits of growth are returned to capital, and in Left decades more of the fruits are returned to labor. Surely this is what Obama means when he speaks of "fairness," "sharing the wealth," and "redistribution." Setting aside one's personal views about whether such policies are really fair, or are socially desirable whether fair or not, the fact that investors must consider is that they are not friendly to real equity returns going forward.

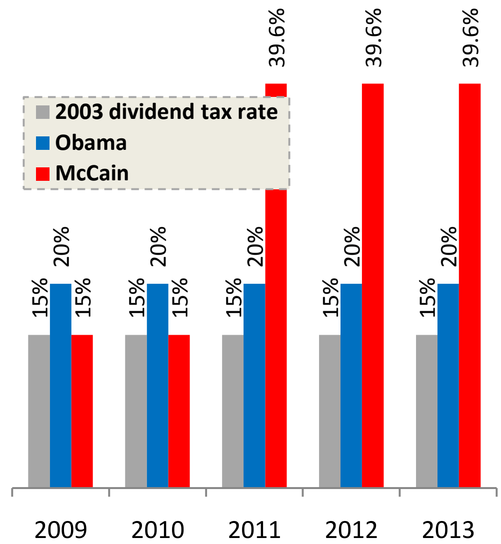


Obama has made no secret of his intentions along these lines, nor have the Democratic leaders of Congress. And McCain shares many of these intentions, styling himself more as a Teddy Roosevelt Republican than a Reagan Republican -- and in any event, he'd have to work with a Democratic Congress. That means the decision that will be made in Tuesday's election has little capacity to surprise -- which is to say that a return for some period of time to an equity-unfriendly policy environment is potentially pretty thoroughly discounted. So we see the equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the 30-year Treasury yield -- at levels not seen since



the chaotic "malaise" of the late 1970s, when there was a Democratic president and Democratic Congressional control, with a filibuster-proof majority in the Senate.





Stock prices have surely discounted the loss of the low 2003 tax rates on dividends and capital gains. Even if McCain is elected president, and even if he sincerely wishes to extend the 2003 rates, he'd never get it past Congress -- the low rates will automatically sunset after 2010. So under McCain, after two more years of capgains rates still at 15%, they would revert to 20%. After two more years of dividend rates at 15%, they would revert to 39.6%. Obama has said he wants both rates at 20% immediately, and presumably he could get a friendly Congress to agree. That means, for a window of say five years, overall tax rates on capital would be lower under Obama than they would be under McCain. That's not to say that Obama's tax program is anything to celebrate -- it's less capital-friendly than the status quo, and his proposed tax rates on capital are only a small part of an overall plan that would punish work and risk-bearing incentives at every level of the economy. The point is that, Obama or McCain, the tax picture looks grim either way -- and stocks have already had ample opportunity to absorb that fact.

While the onset of a Left decade ushered in by Barack Obama is objectively worrisome for stocks -- and taxes are just one part of it -- there is one subjective element that cuts the other way. This is a different potential silver lining to the Obama cloud than we discussed in late May (see "The Upside of Obamanation" May 22, 2008), hinging on the deep risk aversion that has beset global markets over the last couple months. Stocks today are not only priced for an Obama presidency, or a very deep and protracted global recession, or a historic drop corporate earnings (see "How Bad an Earnings Hit" October 23, 2008). Beyond all that, stocks are priced now by the animal emotion of sheer panic. With massive and likely effective safety nets deployed across the global financial system -- *finally!* -- we're in a position now to work through the challenge of mounting an economic recovery (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). What that takes, as much as anything else, is a restoration of *confidence*. And setting aside his many faults in economic policy, Obama definitely inspires confidence.

Military history is full of generals who were deeply flawed strategic thinkers, but who so deeply inspired confidence in their troops that they managed to win battles anyway. Such generals may be defeated in the long run (one thinks of George Custer), but in the short run they can be quite effective. Suppose Obama, shortly after he is elected, were to convene an economic summit. It would be staged in a place steeped in the mythology of a bygone financial order, say Bretton Woods -- attended by the great and the good, men of probity and reputation such as Paul Volcker, Warren Buffett, Robert Rubin and Alan Greenspan, icons of nostalgically remembered better times in the market. The communiqué that would be issued at the end would be contentless, but it would be clear that these men had imparted to our earnest new president, so eager to learn, the simple secrets of restoring stability to the world financial system that had somehow eluded the Bush administration. With investors desperate for an emotional catalyst to give them the courage to invest in securities trading at generational lows, a public ritual such as this could be the start of a deeply wished-for restoration of confidence -- a resurgence of pent-up animal spirits -- that could quite quickly mean a half-way retracement of the S&P 500's losses since the all-time highs in October 2007. If that happens, with some of the extreme undervaluation of stocks taken out, we'd have to think about whether it would be an especially opportune time to get out of stocks for a while. At that point in won't be about confidence anymore. It will be about the reality of a coming policy environment that might be quite adverse.

BOTTOM LINE: Stocks have now probably more than fully discounted the election of Barack Obama as president, pricing for a growth-adverse environment similar to that of the 1970s. This argues for there being not much room on the downside, but it also caps the potential for sustainable recovery. In the near-term, stocks are trading at a generational undervaluation, and Obama's election might trigger a substantial rally.