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

POLITICAL PULSE

Now What?

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Donald Luskin

The election is over -- but the battle for the Senate and the Treasury is still being fought.

Update to strategic view
US STOCKS: With credit conditions easing, stocks deeply undervalued, and the election out of the way, the charismatic Obama is in a position to trigger a sentiment-driven short-term rally. But uncertainties about the size of the Democratic majority in the Senate, and doubts that Obama is really a "post-partisan" moderate who can deal effectively with a Left-leaning Congress have gotten the post-election stock market off to a bad start.
[see Investment Strategy Dashboard]

If this stock market sell-off is Barack Obama's honeymoon rally, it's going to be a very unhappy marriage. Though there was little in the election results that should have come as a surprise to investors, it seems to be acting as the catalyst for a test of the double-bottom for stocks made in mid- and late-October. At this point, the outpouring of recessionary economic statistics and earnings revisions shouldn't be a surprise, either (see "How Bad An Earnings Hit?" October 23, 2008). With credit conditions visibly easing, stocks still at generational levels of undervaluation, and a sentiment environment starved for good news, there's still a decent chance that the relief of having the election over with, and a tide of good feelings about our history-making new president, could power an intermediate-term rally of significance. What comes after is another matter (see "Bearack Obama" October 31, 2008).

Still, stocks are definitely not off a good start post-election, and we can speculate on several reasons why. One troubling element is the fact that it became clear as yesterday wore on that Democratic Senate control was going to remain uncertain for weeks. There are still three Senate races to be decided (three, assuming the Oregon race still being tabulated goes to the Democrat, as predicted by local media). If the Republicans lose them all, they will have 40 seats in the Senate, giving the Democrats a filibuster-proof 60-seat supermajority for the first time since the Carter administration. That would leave no effective check on anti-growth policy, either by the Republican minority or by a new president who has styled himself as a moderate. On the plus side, a Republican win in any of the three unresolved Senate seats would block the Democrat's super-majority. On the plus side, in all three cases the Republican candidate is the likely winner. But we won't learn the final outcome of any of these situations for weeks. So if the hope was that least we'd know the lay of the political land by now, the sad reality is that uncertainty still prevails.

In Minnesota, the vote was close enough to trigger a mandatory manual recount. In Georgia, none of the three candidates earned the 50% of votes required to avoid a two-way run-off. In

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

Alaska, it's still too close to call -- and if the Republican incumbent Ted Stevens prevails, he faces likely expulsion from the Senate for his recent felony conviction. Then there would have to be a special election. There is the intriguing possibility that Sarah Palin would choose to run -- her victory, highly likely, would move her to Washington for four years of seasoning while awaiting a potential role in the 2012 presidential election.

Another straw in the political wind yesterday was the announcement of Rahm Emanuel as Obama's chief of staff, and of a list of other people who will serve in various transition capacities. Everyone on the list is either an Obama insider -- either by virtue of a significant campaign role or a Chicago connection -- or a former Clinton administration figure. Nothing particularly surprising there. But especially considering Emanuel's reputation as a take-no-prisoners partisan, anyone who believed the promise that Obama was an "inclusive" and "post-partisan" politician must have been disappointed yesterday. It's still early days, but these first appointments are at least a clue that the Obama administration will be every inch a conventionally Democratic one. Until we know more, uncertainty prevails.

Finally, markets were reminded yesterday of the intense risks associated with the vast new powers vested in the Treasury secretary by virtue of the Troubled Asset Relief Program (TARP). Within the S&P 500, the financial sector very much led the downside yesterday, off 8.8%. The names of Lawrence Summers, Paul Volcker and Timothy Geithner were floated as potential Obama Treasury secretary appointments. Summers and Volcker are iconic figures, but none of the three is particularly a Wall Street insider, at least not in the template of Henry Paulson or Robert Rubin. And Geithner's appointment would raise issues about the potential continuation of failed policies that led to this year's series of botched rescues, in which had a prominent role (see, among many, "AIG: Rescue or Bag Run?" September 17, 2008).

The worst risk in this vein is that, in an Obama administration, the Treasury secretary will effectively be Barney Frank. He would seem to be bidding for the job, choosing yesterday of all days to say in an interview that the investment of TARP funds to recapitalize banks would stop unless "they will redouble their efforts to get it lent out." Frank said, "If the money isn't being lent out, then I suppose there's no harm done if it's cut off." This threat follows upon his utterly unfactual statement last week that "Any use of the these funds for any purpose other than lending—for bonuses, for severance pay, for dividends, for acquisitions of other institutions, etc.-- is a violation of the terms of the Act."

Frank's saber-rattling is cause for alarm in any event. But to crank it up like this the day after the election is especially troubling, because it amounts to a public challenge to the president-elect with respect to the future control of TARP, and of financial regulatory policy in general. Ideally, Obama would find a way to signal his intention to deal reasonably with the banks. Until he does, should his silence be interpreted as the putatively moderate Obama admitting he can't effectively rein in anti-business zealots like Frank? Or worse, interpreted as his not wanting to? And how will Paulson play it, while he still controls the checkbook? A Treasury report to Congress yesterday suggested that Paulson himself still doesn't know. But potentially he will want to deploy as much TARP money as possible, as soon as possible. Uncertainty, again, prevails.

BOTTOM LINE: With credit conditions easing, stocks deeply undervalued, and the election out of the way, the charismatic Obama is in a position to trigger a sentiment-driven short-term rally. But uncertainties about the size of the Democratic majority in the Senate, and doubts that Obama is really a "post-partisan" moderate who can deal effectively with a Left-leaning Congress have gotten the post-election stock market off to a bad start.