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POLITICAL PULSE

Health Care Deform

Thursday, July 16, 2009

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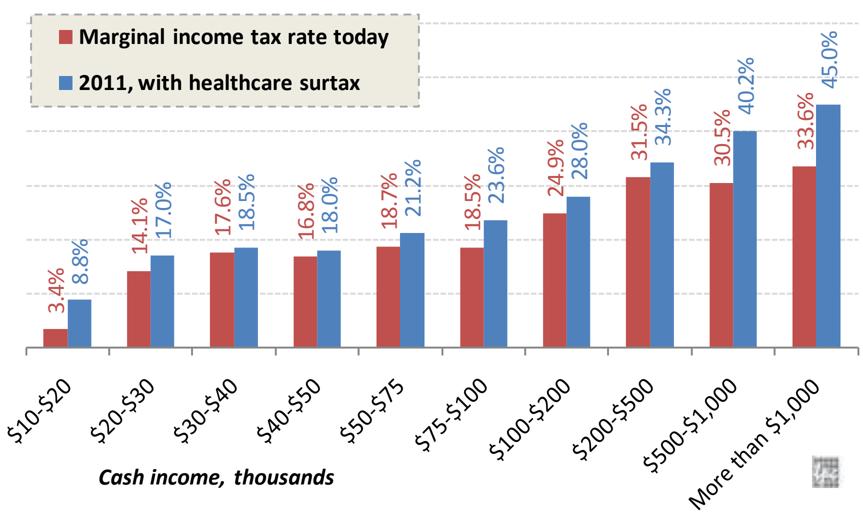
A proposed surtax may be the kind of self-correcting policy over-reach we saw in March.

Update to strategic view
US STOCKS: This week's rally may be due to the bet that the House bill to finance mandatory government health care insurance with a surtax represents self-correcting political over-reach. If it works out that way, it would be a signal that the worst anti-growth policy threats can be avoided, or at least deferred.
[see Investment Strategy Dashboard]

Several clients have come to us with intense concern about the prospect of tax hikes to finance mandatory government-provided health care insurance. No one should be surprised that we view *both* with alarm -- both the tax hikes and the takeover by government of health care insurance. Yet the evolution of this risk may have a lot to do with the strong rally in stocks this week, and the possible end of the deflationary correction they've been in (see "A Deflationary Correction" July 9, 2009).

It's worth considering that the reversal in equities from last week's correction lows is a recurrence of the dynamics we saw in at the bottom in early March. At that time growth was mortally threatened by a runaway train of destabilizing economic policy initiatives, set in motion during the political euphoria following Barack Obama's inauguration (see "Quantum of No Solace" March 10, 2009). The rally off the March lows developed as, one by one, leading legislators signaled that those initiatives would be slowed down, watered down, or taken off the table altogether (see "Wolf in the Fold" May 18, 2009).



Last week, the correction from the June highs accelerated as the Obama administration's health care reform initiative picked up momentum. On Friday the S&P 500 closed at a new

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correction low, as reports leaked out that the House's health care reform bill would include a surtax on high incomes that would hike the top marginal federal tax rate to 45%. The bill also calls for an "individual mandate" enforced by an excise tax on anyone who earns more than 400% of the poverty level, and who chooses to remain uninsured (which, in cases where the excise tax is less than the cost of the insurance, arguably means that some middle-class taxpayers will both remain uninsured *and* pay higher taxes).

Key documents
America's Affordable Health Choices Act ***House:*** * Legislative language * Summary ***Senate:*** * Legislative language * Summary
[Client Resources home]

Then on Sunday on "Meet the Press," influential senator Chuck Schumer (D-NY) said of the surtax that "people weren't going for it; Democrats and Republicans, key Republicans we're negotiating with told [Senate Finance Committee] Chairman Baucus, forget it. So now we're looking at other things." Stocks have been rallying ever since, raising the possibility that the House bill represents the same kind of self-correcting policy over-reach we saw last March.

A Senate version of health care "reform" legislation was passed yesterday by the Health, Education, Labor and Pensions Committee (of which Schumer is not a member), but it was silent on how it is to be paid for. That's up to the Finance Committee (of which Schumer *is* a member). So while "reform" itself is hardly off the table, Schumer's remarks do reveal a lower probability that it will be financed by growth-killing hikes in marginal tax rates for top earners. And ultimately, if there is no way to pay for it, it is unlikely it will happen in the present budget environment. The online political futures markets at Intrade put the probability of enacting a "government option" for health care insurance this year at about 42%, up about 7% from a week ago. But the markets on future tax rates show only a 22% probability of a top marginal rate above 42% in 2011, unchanged for the last several months.

In the short to intermediate term, this is an important test. Passing it -- that is, if the political system rejects a growth-killing tax hike -- would have very positive implications. It would validate our paradigm that the March bottom demonstrated the limits of the administration's mandate for "change" and the Democratic congressional majority's power to make it happen all at once. But longer term, it would only make the policy environment less negative. We will still have to pay the costs and live with the side-effects of the massive government interventions that first exacerbated, and then rescued the world from, last year's credit crisis.

BOTTOM LINE: This week's rally may be due to the bet that the House bill to finance mandatory government health care insurance with a surtax represents self-correcting political over-reach. If it works out that way, it would be a signal that the worst anti-growth policy threats can be avoided, or at least deferred.