INTELLECTUAL AMMUNITION

2009's Economic Chart of the Year

Monday, December 28, 2009

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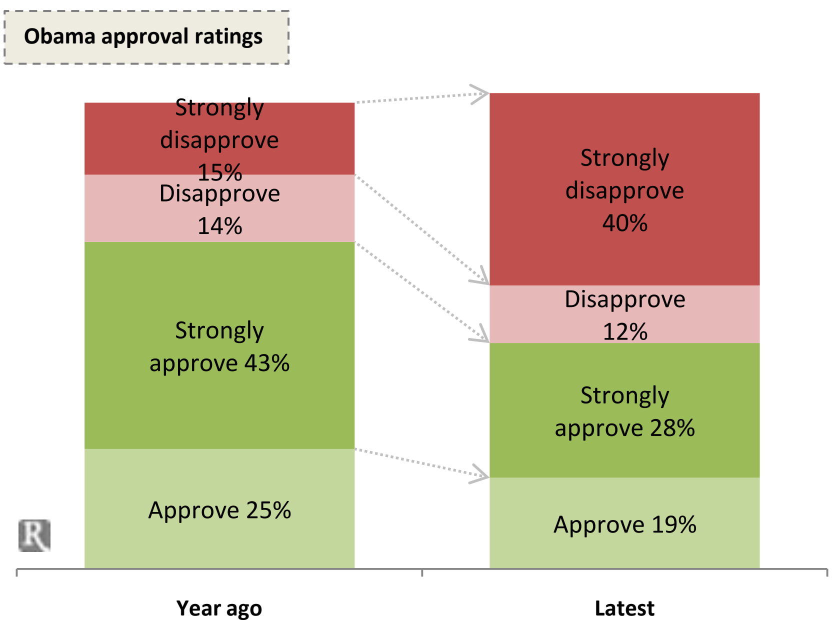
Obama loses his rock-star status, driving an historic comeback for stocks.

There are lots of amazing charts in the amazing year of 2009. But the chart of the year isn't a chart of the stock market, the gold price, the US dollar exchange rate, new jobless claims or consensus forward earnings, even though all of them show dramatic and consequential reversals. The winner is the chart of President Barack Obama's approval ratings, which we think shows the most consequential reversal of all. A year ago 68% of likely voters approved of Obama, 43% strongly. Only a small minority of 29% disapproved, about half of them strongly. Today, the percentage of likely voters who disapprove of Obama has risen by more than two thirds; the percentage who *strongly* disapprove has almost tripled. The percentage who strongly approve has fallen by a third. The percentage who *strongly dis*approve -- 40% -- is now the biggest single segment of the population, approaching the percentage who approve at all -- 47%. This chart, illustrating the fact that Obama has fallen from the status of rock-star a year ago -- to, now, merely that of unpopular president -- is the governing dynamic that underlies all the other charts.

Update to strategic view
US STOCKS: The story of the stock market in 2009 is the story of Barack Obama. First the threat of destabilizing "change" amidst a banking crisis drove stocks to worse-than-Depression lows. At the same time, the administration's brave handling of bank recapitalization set the stage for recovery. Now, Obama's inability to deliver on "change" -- and the collapse of his rock-star status -- has considerably reduced investment uncertainty.
[see Investment Strategy Dashboard]



We say this not because we are conservatives who disagree with Obama's agenda (admittedly, we do disagree with much of it). We say it because *any* economy-impacting policies implemented in haste, goaded by the

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charisma of a very popular president, are likely to be destabilizing and regrettable. Who today doesn't wish that the rush to judgment in 2002 that produced first Sarbanes Oxley, and then the Joint Resolution on Iraq War Powers, had been slowed down and considered more soberly at the height of President Bush's vast post-9/11 popularity?

HASTE MAKES RISK The Obama administration came in with a landslide electoral victory and a mandate for "change." And it was operating against the backdrop of a global economic meltdown that gave rise to the Rahm Emanuel Doctrine -- "you never want a serious crisis to go to waste." Thus, just three weeks after Obama was inaugurated, he signed into a law a record-breaking $787 billion "stimulus" package. It was rushed through Congress so quickly, and was so complicated and lengthy, it's a certainty that not one of the legislators who voted for it actually read the whole thing before doing so. An especially troubling element of it, inserted overnight at the very last minute of negotiations by a single powerful senator, as the final 12 pages of a 1071-page conference report, were draconian restrictions on bonuses at banks that had taken TARP money, whether they needed it or not (see "On the New Bank Bonus Restrictions" February 15, 2009).

With the "stimulus" bill as the template, it seemed then that other economic initiatives would be rushed through just as hastily, including a cap-and-trade carbon tax, mortgage "cramdown," unionization "card check," early revocation of the 2003 tax cuts, and government control of health care insurance. We believe every one of these initiatives is anti-growth, but that's not the point. Anti-growth or pro-growth, the sudden imposition of these initiatives -- without time to deliberate and prepare -- would be terribly destabilizing. All the more so in February and March when the economy was already in the grips of great uncertainty, with a global banking crisis still unresolved. We believe that the prospect of such destabilization was itself destabilizing, and contributed to the otherwise inexplicable collapse of stock prices following the passage of the "stimulus" bill. At the bottom on March 9, stocks had fallen even more since the top in October 2007 than they had fallen over the same number of days in the Great Depression, counting from the top in September 1929 (see "Obama: '…today does mark the beginning of the end.'" February 20, 2009).

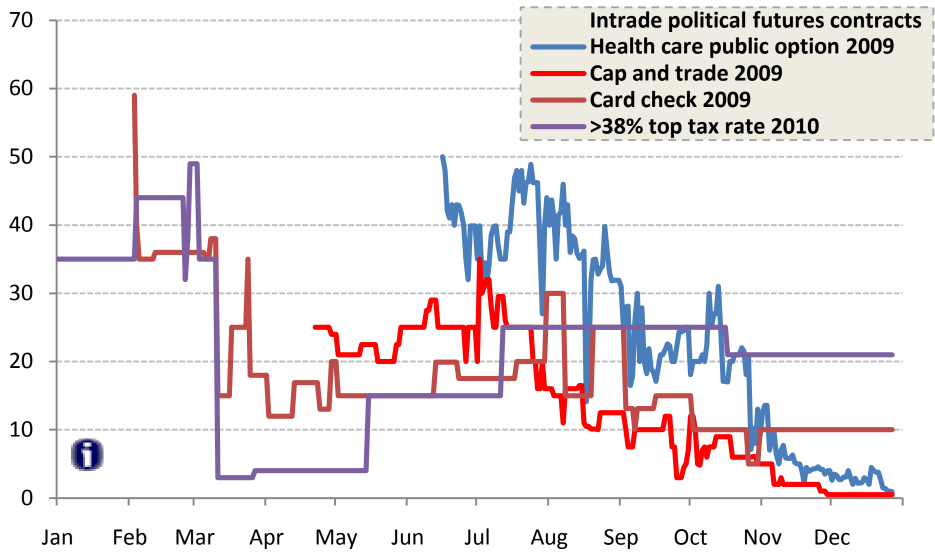
WHAT ABOUT THE BANK CRISIS? We don't mean to ignore the role of the bank crisis in the collapse of stock prices in February and March. But we think at that point it was only a cog in a larger mechanism. It enabled the Emanuel Doctrine by providing the requisite "serious crisis." And at the same time, it was *so* serious, that the hasty political actions it enabled through the Emanuel Doctrine were made all the more dangerous because of their potential interactions with it. For example, if the crisis atmosphere had enabled hasty enactment of mortgage "cramdown" legislation, empowering judges to arbitrarily modify existing home mortgages in bankruptcy, the bank crisis would surely have been made far worse.

And incidentally…

CREDIT WHERE CREDIT IS DUE We have always applauded Obama for appointing Tim Geithner as Treasury secretary. It took wisdom to see that Geithner would learn from his experience in the prior administration's tainted bank rescue efforts (see "Another Rescue, A New Rescue Ranger" November 24, 2008). And it took courage to stand by him and his policies through considerable criticism. That Obama was able to do so should be seen as one very *positive* result of his high popularity early this year.

It's also the case that what proved ultimately to be the solution to the banking crisis was already known by early February, when Tim Geithner first announced the terms of the "stress tests" for systemically important banks. Specifically, Geithner's standby commitment to fund banks that failed the stress tests -- promising to buy securities convertible into common at a known and fixed price -- fundamentally relieved the crippling multiple uncertainties about bank capitalization and the government's role in supporting failing firms (see "The Stress Tests' Hidden Mickey" May 4, 2009).

THE TIDE TURNS At what proved to be the worst of the panic atmosphere in early March, the tide began to turn on the policy initiatives being rushed through Congress. After already clearing the House, mortgage "cramdown" died in the Senate when Blanche Lincoln (D-AR) withdrew her critical support. Same for unionization "card check" when Arlen Specter (D-PA) withdrew his support. Cap-and-trade died when numerous Democratic senators, mostly from energy-producing states, turned against it. Within a matter of weeks, what we had characterized as a "runaway train" of anti-growth legislation (again, see "Obama: '…today does mark the beginning of the end.'") had begun to be brought under control (see "Number of the Beast" March 18, 2009). It was a particularly salient signal because, in all cases, it was not Republican opposition that killed these initiatives. It was Democrats, despite their firm control of both houses of Congress, and despite the popularity of their president (Specter was a Republican when he first turned against "card-check," but shortly thereafter he became a Democrat and reiterated his opposition).

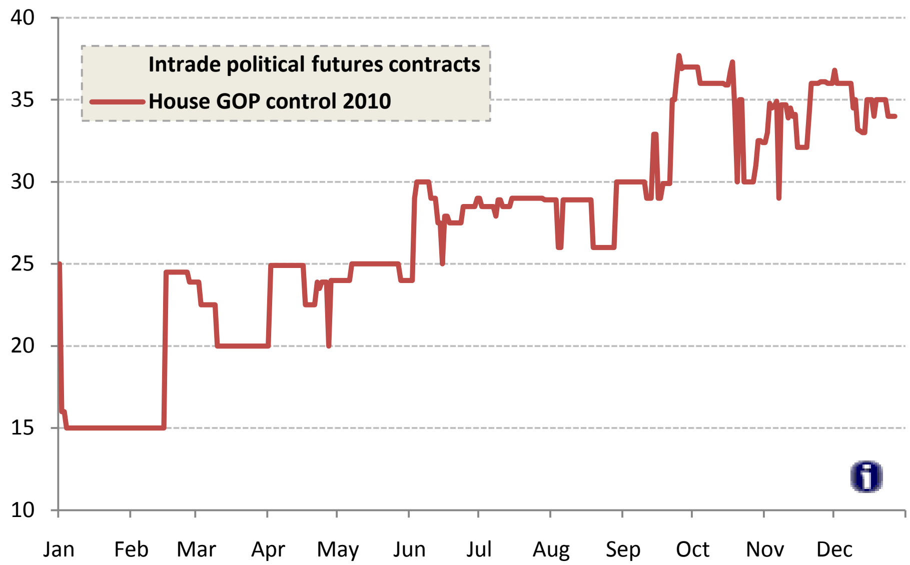


For stocks, there were two inter-related reasons to celebrate. Not only was the risk of a rush to judgment over, but at the same time the bank crisis was visibly solved -- as evidenced by the ability of the banks to raise capital in public markets, thanks to the confidence engendered by Geithner's standby commitment. The successful conclusion of the bank crisis was an end in itself, but in the political context it counted for much more. It rendered the Emanuel Doctrine inoperative, by removing the "serious crisis" that he urged should not "go to waste."

A critical test of this proposition came in July, when the House Ways and Means Committee approved funding the government takeover of health insurance by imposing a 5.4% surtax on high earners -- applied to adjusted gross income, so that it would effectively hike income, dividend and capital gains rates. Though seemingly a powerful anti-growth surprise, this proved to be a positive inflection point for stocks, sending them on their second leg up in the bull market from the March bottom, following a month's correction. For us the clear message was that this represented not so much a threat as another instance of hasty over-reaching in the House, and indeed it was turned back by the Senate (see "Health Care Deform" July 16, 2009).

WHERE ARE WE NOW, AND WHAT'S NEXT? With Obama's rock-star status gone, and the Emanuel Doctrine inoperative, we no longer face the risk of a destabilizing legislative runaway train. For the economy and the market, that's a very big deal, as evidenced by the stock market's rally off the March bottom, with a magnitude and speed not seen since 1933. But this shouldn't lead to complacency. The economy and the markets still face considerable risk from anti-growth policy coming from the Democrat-dominated Congress. For example, the nationalization of health insurance embodied in the bill passed by the Senate last week may be less economically crippling than the one passed previously by the House, but make no mistake about it: either way, it will induce very serious distortions throughout the economy.

With an unpopular president, and without the Emanuel Doctrine, initiatives like this take longer -- and that's an unalloyed good. But regardless of Obama's popularity, the Democrats still control Congress. And as to the Emanuel Doctrine, in some sense it's a blessing of sorts to the Democrats to have it no longer operative. Yes, there is no "serious crisis" with which to justify policy, but at the same time, it may well have been the seriousness of the crisis in March that caused Democrats in the Senate to lose their nerve and slow things down.



The only way to reduce policy risk to the economy and the markets more substantively from here would be for the Democrats to lose control of Congress, and return the federal government to a state of benign gridlock. It would only take one seat in the Senate for the Democrats to lose their filibuster-proof control there. And based on the political futures contracts traded online at Intrade, the Republicans have been facing improving chances of taking back the House of Representatives ever since the panic bottom in February and March.

Whether such a thing is possible depends on *why* Obama's popularity has fallen. If he's lost popularity because he failed to deliver on "change" initiatives demanded by the electorate, then there is no hope -- the electorate will simply install even more agents of "change." But if he lost popularity because he over-reached -- that is, because he tried too hastily to deliver more change than the electorate really wanted -- then there is every reason to expect that gridlock can return in 2010. We favor that explanation. If that is indeed the correct explanation, then another way of framing his drop in popularity is that there was never any *substantive* reason for his high popularity in the first place. After all, as soon as he tried to use it, he lost it.

However one comes down on that judgment call, we think the volatility of the political system has been the dominant economic factor in 2009. With a critical election now just a little more than 10 months away, it will be one of the top drivers of markets in 2010, as well.

BOTTOM LINE: The story of the stock market in 2009 is the story of Barack Obama. First the threat of destabilizing "change" amidst a banking crisis drove stocks to worse-than-Depression lows. At the same time, the administration's brave handling of bank recapitalization set the stage for recovery. Now, Obama's inability to deliver on "change" -- and the collapse of his rock-star status -- has considerably reduced investment uncertainty.