

POLITICAL PULSE

A Scott Heard 'Round the World?

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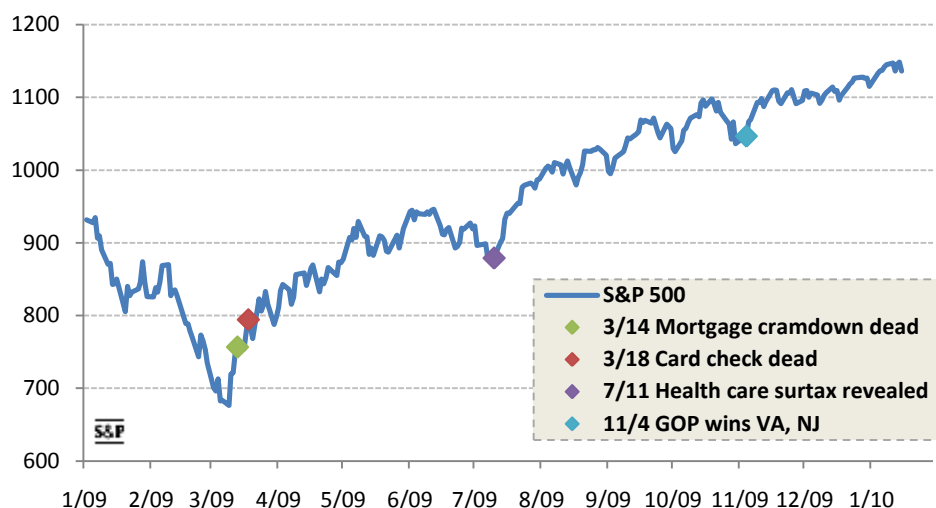
A GOP Massachusetts win today would be another step down the bullish road toward political equilibrium.

An upset win by Republican Scott Brown in Massachusetts's special US Senate election is far from certain, but it seems likely. As of this writing, the online political futures markets at Intrade give him a 70% probability of winning. As dramatic a narrative as this is -- an unknown Republican even coming close to taking the Senate seat held for years by Teddy Kennedy in the bluest of blue states -- in an important sense it is only a new chapter in an ongoing story. It fits right into one of our key bullish themes driving the present historic rally in stocks. It's another step in the long march back toward political gridlock, from the state of extreme partisan lopsidedness that destabilized markets early last year (see ["Obama: '...today does mark the beginning of the](#)

Update to strategic view

US MACRO, US STOCKS: An upset win, or even a close call, by Republican Scott Brown in today's Massachusetts special US Senate election would move Congress one step closer to gridlock, where growth-retarding policy uncertainty is minimized. Short-term, it makes passage of health care "reform" increasingly unlikely. Longer term, loss of the Democrats' filibuster-proof Senate super-majority is all but assured for November's mid-term election. The GOP taking the Senate or the House is still a stretch. The move to gridlock has been a bullish factor operating already for many months, as Democratic "change" initiatives have all come to naught. So we don't see a Brown win, or a close call, having a substantial immediate effect on stocks, especially in what we expect will be a difficult earnings season.

[\[see Investment Strategy Dashboard\]](#)



[end."](#) February 20, 2009). Especially in a time when neither party is promulgating pro-growth policies, gridlock is the best outcome for the economy and for markets because, if nothing else, it minimizes uncertainty.

The move to gridlock began in mid-March, when key Democrats began dissenting against the

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headlong rush to "change" -- slowing down and deferring initiatives that had seemed just weeks earlier certain to be enacted into law almost instantly (see ["Number of the Beast"](#) March 18, 2009). This followed within days the bottom in stocks that launched the present bull market. And though there were other very important positive developments at the same time, the return to political equilibrium is a long thread woven deeply through the tapestry of recovery from recession (see ["2009's Economic Chart of the Year"](#) December 28, 2009). The bull market's big second leg up commenced in July the day that the House Ways and Means Committee voted to fund health care "reform" with a 5.6% surtax on adjusted gross incomes, effectively killing the Democrats' signature initiative by making unmistakable how much it would cost (see ["Health Care Deform"](#) July 16, 2009). The third leg up began in early November when Republicans in Virginia and New Jersey won off-year gubernatorial elections (see ["On GOP Wins in New Jersey and Virginia"](#) November 4, 2009). Will a Republican win, or a close call, in Massachusetts today trigger a fourth leg higher? Maybe, but each of these successive legs has had less power, as the gridlock narrative -- and the simultaneous recovery from recession and credit crisis -- becomes increasingly stale (see the chart on the previous page).

For the short-term, a Massachusetts victory would be very positive in that it will deny the Democrats their present filibuster-proof majority of 60 (counting the two independents who caucus with the Democrats). Even a close call would probably kill health care "reform," which we regard as a significant anti-growth policy initiative. With a Scott win, the Democrats will try to push the Senate's bill through the House *verbatim*, so it could go directly to the president's desk for signature without another Senate vote. But the House barely passed its own version last November, by a narrow [220 to 215](#) margin. With the Senate version's more liberal abortion provisions, it's doubtful that the Democrats could get 220 "ayes" again. If Scott loses, but it's a close call, then "reform" would have to be reconciled between House and Senate versions. With Obama having made the tactical blunder of campaigning over the weekend in the Massachusetts Senate race, and explicitly making it a referendum on health care, the fragile Democratic consensus that barely got "reform" through the House and Senate in the first place could easily come unglued. But markets may have already figured out that health care "reform" is dead, if the relative performance of the health care sector is any indication. Since the end of the third quarter, it's the best-performing sector in the S&P 500.

Longer-term, a Massachusetts win, or close call, would certainly show that there is more wind at the GOP's back than anyone would have thought just a couple weeks ago. But it remains quite a challenge for the GOP to retake control of either the House or the Senate at the November mid-term election, and thus deeply institutionalize gridlock. In the House, the GOP would have to pick up 40 seats. To do so, it would have to win all 15 Democratic seats [deemed by the respected conventional wisdom of the Cook Political Report](#) to be toss-ups, all 23 deemed Dem-leaning, 2 deemed GOP-leaning, and the 1 seat deemed GOP-likely. At the same time, the GOP would have to successfully defend all 25 seats now deemed only GOP-likely, GOP-leaning, or Dem-leaning. In the Senate, the GOP would have to pick up 11 seats. To do so, it would have to win all 8 Democratic seats [deemed by Cook](#) to be toss-ups, the 1 deemed Dem-leaning, the 1 deemed GOP-leaning, and 1 seat deemed GOP-solid. At the same time, the GOP would have to successfully defend all 7 seats now deemed toss-ups or only GOP-likely or GOP-leaning. To be sure, a Massachusetts win for the GOP, or even a close call, would defy conventional wisdom, so maybe the Cook benchmark here is too cautious. Yet to get at the probabilities by less conventional and perhaps more penetrating means, as of this writing, Intrade gives the GOP only a 10% shot at the Senate, and a 37% shot at the House. These have only moved slightly higher as the Massachusetts story has unfolded over the last month. But sometimes it pays to bet on a miracle -- after all, Intrade's GOP House control contract showed only a 15% chance on inauguration day about a year ago.

Let's say the GOP does take both the Senate and the House in November. By setting up a government divided between the legislative and executive branch, it would enhance confidence by making more secure the gridlock that was only perilously obtained in 2009. But it would hardly indicate the dawn of a new age of pro-growth policy. At this point, Republicans seem as bereft of pro-growth ideas as Democrats. Indeed, while out of power, conservatives have adopted many of the dangerous populist themes usually held by liberals. Ever since the battle to enact TARP legislation last year, in which a Democratic majority had no choice but to support it while the Republican minority had the luxury of opposing it, the GOP has been the loudest voice demonizing Wall Street. It is Republicans, not Democrats, who are imperiling Ben Bernanke's confirmation for a second term as Fed chair. Their populist grandstanding has the consequence of exposing markets to a potentially destabilizing period of weeks or months in which there is [no clear statutory basis](#) for determining with legitimacy exactly who the Fed chair is. Then assuming Bernanke is ultimately confirmed, he will have to operate under the cloud of having had a significant number of senators vote against him, eroding the public confidence that a Fed chair needs in order to be effective and independent.

So while we see a Republican win or close call in Massachusetts as bullish, we temper our enthusiasm by remembering that it is only the marginal extension of a well-established theme -- the return to political equilibrium. That's a very good thing *per se*, as historically stocks have performed best, on average, in periods of gridlock (see ["Divided Government Is Best for the Market"](#) September 12, 2008). But we mustn't wishfully mistake this as the harbinger of a return to the kind of pro-growth policies that powered the great bull years of the 1980s and the 1990s. The reality is that we face a backdrop of a grudging economic recovery, and a stock market at peak multiples that is very vulnerable to correction as this earnings season finds itself challenged to meet over-ambitious consensus expectations (see ["Under-Seasoned"](#) January 15, 2010). So against a generally encouraging longer-term framework, we continue to hold our short-term cautious stance on stocks.

BOTTOM LINE: An upset win, or even a close call, by Republican Scott Brown in today's Massachusetts special US Senate election would move Congress one step closer to gridlock, where growth-retarding policy uncertainty is minimized. Short-term, it makes passage of health care "reform" increasingly unlikely. Longer term, loss of the Democrats' filibuster-proof Senate super-majority is all but assured for November's mid-term election. The GOP taking the Senate or the House is still a stretch. The move to gridlock has been a bullish factor operating already for many months, as Democratic "change" initiatives have all come to naught. So we don't see a Brown win, or a close call, having a substantial immediate effect on stocks, especially in what we expect will be a difficult earnings season. ▶