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Obamacare: Do Markets Care?

Friday, March 26, 2010

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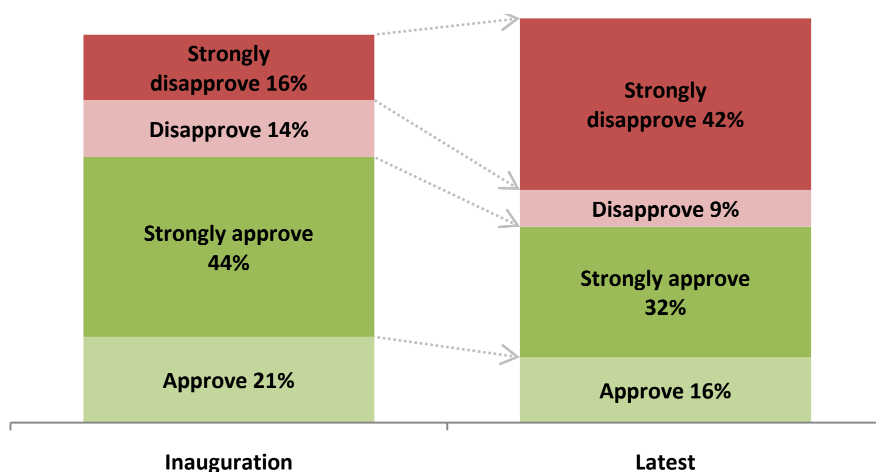
So many anti-growth long-fuse tax bombs, and so little reaction.

For all the anti-growth implications in Sunday night's passage of Obamacare, it seems strange at first blush that markets pretty much haven't reacted at all. But why should they have? They've had a year to get used to the idea of something like this happening. And from the perspective of new recovery highs in stocks, we would say markets have reacted by expressing their satisfaction that it took a whole year. However distasteful the smoky-room processes that were ultimately required to achieve enactment, far worse would have been the legislative blitzkrieg that seemed inevitable a year ago. As we've said so many times since Barack Obama became president, at least bad policy made at leisure is far better for markets than bad policy made in haste (see "Quantum of No Solace" March 10, 2009, and "2009's Economic Chart of the Year" December 28, 2009). We might extend this to say that the fact that Obamacare's enactment took so long, became in the end so unpopular, and required such unseemly procedural ploys, that the road has now been definitively paved for even slower policy processes in the future, thanks to the increasingly likelihood that Republicans will take control of one or both houses of Congress in November. It could be the fulfillment of our

Obama approval daily tracking poll



Source: Rasmussen Reports

Update to strategic view

US STOCKS: Stocks didn't react to the growth-killing taxes in Obamacare because they were already fully expected, and because there is a significant hope that they can be repealed before they take effect in future years. Forward earnings continue to grow as the economy recovers, but the growth rate is slowing dramatically, and the February quarter earnings season is going poorly.

US BONDS: The 10-year Treasury has moved toward the top of the trading range between 3.5% and 4.0%. With the Fed's open-ended commitment to a zero short-rate still very much intact, we expect the trading range to hold.

HIGH YIELD BONDS: The Fed on hold indefinitely continues to be a salutary gusher of liquidity that lowers default expectations and makes even today's below-average spread to Treasuries looks attractive.

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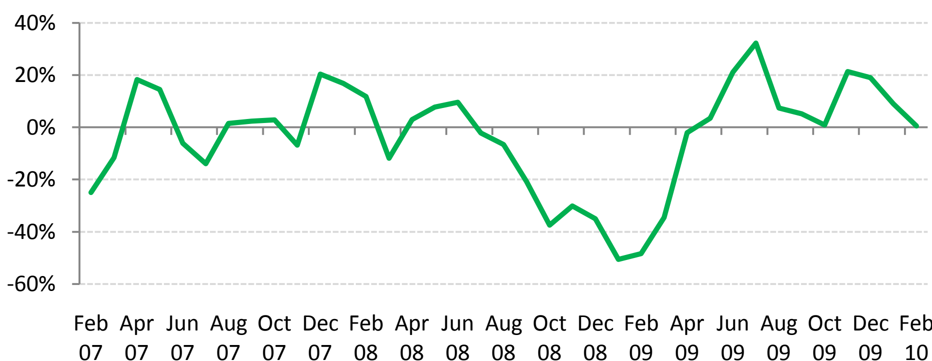
prediction of political re-equilibration made last July (see "Health Care Deform" July 16, 2009) when the growth-killing tax costs of Obamacare first became public. Recall that when House Ways and Means Committee chair Charlie Rangel first proposed a 5% surcharge on AGI for the wealthiest households, that was the starter's pistol for the second big leg up in the bull market for stocks off the March 2009 bottom.

A Republican-led Congress could do much to reverse or blunt the worst anti-growth elements of Obamacare. These are long-fuse tax bombs that won't explode for years. The 0.9% tax on wages and the 3.8% tax on interest, rents, dividends and capital gains of single-filers above $200,000 AGI and joint-filers above $250,000, not indexed for inflation -- Obamacare's worst growth-killers -- don't kick in until 2013. But that doesn't mean that they won't have a chilling effect on investment decisions being made right now (after all, the tax rate you pay on any investment income in the future is dictated by the law in effect in the future). In 2013, with the 2003 tax rates having expired, the dividend tax rate will be 40.8% and the capital gains rate will be 23.8% (both up from today's 15%). Straightforwardly, a higher expected tax rate on investment income lowers after-tax expected returns, and that -- axiomatically -- lowers the present value of any investment asset. But that calculus is affected by the degree of certainty about the future tax rate. If markets were highly confident that the new 3.8% investment tax hike will be repealed before it takes effect in 2013, then there would be no present reaction.

- If we had to torture this week's market action until it confessed *some* kind of reaction to Obamacare, then it would be something along such lines. Stocks at new recovery highs indicate the expectations that (1) the worst growth-killers in Obamacare will be repealed, (2) A Republican-led Congress in 2011 will gridlock any new growth-killers. The back-up in bond yields indicates the expectation that repeal of revenue provisions in Obamacare will add substantially to deficits. But truly, this strikes us as a sterile exercise. The most credible interpretation is that markets fully

Orders, non-defense capital goods, ex-aircraft
3-month annual rate



Source: Census Bureau, TrendMacro calculations

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[About us]

Recommended Reading

The Story of the CDO Market Meltdown: An Empirical Analysis
Anna Katherine Barnett-Hart
Thesis, Harvard College
March 19, 2009

Timeline of Tax Provisions in the House Health Care Bill
Tax Foundation
March 21, 2010

How to compete and grow: A sector guide to policy
McKinsey Global Institute
March 2010

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Key documents

Patient Protection and Affordable Care Act

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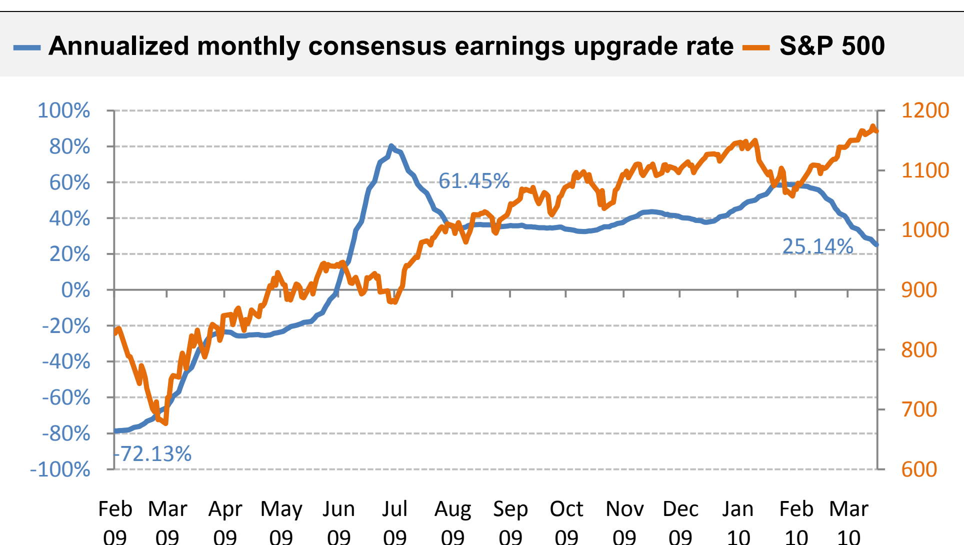
expected what they got.

The behavior of stocks doesn't need all that much explanation in the first place. Stocks have crept to new recovery highs because the economy itself is in recovery. But they've *only* crept because the economy is *only* in recovery, not expansion. The macro data this week was uninspiring. We were especially disappointed by the tepid growth in orders for non-defense capital goods ex-aircraft (please see the chart on the previous page). Capital spending is always a critical causal precursor to robust growth. But in this business cycle it is something more: crushed to all time lows as a fraction of GDP in the recession, it is the sector of the economy most likely to generate a true V-shaped recovery from a very low base. But so far it's not happening. Though with this morning's third revision to Q409 GDP we see fixed investment revised upward to a 0.61% contribution to real growth -- the first positive contribution in ten quarters -- it remains at an all-time low as a fraction of GDP.

For stocks, the main event continues to be the ongoing rise in consensus forward earnings. After a 39% drop in the recession, the third worst since 1900, forward earnings have already rebounded 29%, requiring a further 26% improvement to recapture the all-time high in 2007. By coincidence, right now the consensus is being upgraded month-over-month at an annual rate almost exactly at the required 26% (see the chart below). In other words, *if the present rate of forward earnings upgrades is maintained for a year, earnings will be at the old highs again in March 2011.* Yet this seems unlikely, because the upgrade rate is rapidly falling, having held at enormous levels the likes of which we've never seen before for the better part of a year. We expect it to keep falling.

Some evidence that expectations have gotten ahead of themselves is the bland performance of companies reporting earnings in March for the quarter ended February. Most companies report in January for the quarter ended December. This earnings season that majority beat expectations by



Source: Source: S&P, Zacks, TrendMacro calculations

13.1% on an cap-weighted basis -- a good showing, but down a little from their 14.2% beat the prior earnings season. Now the companies reporting February quarters have hardly beaten expectations at all, just 1.1% on a cap-weighted basis. We don't see how stocks can continue to drive to new recovery highs in an energetic way until an element of upside surprise can reassert itself. Not seeing where that element is going to come from in a slow macro environment, we continue to expect correction or at least consolidation in stocks.

For bonds, there are several main events, and we have no deep conviction about what combination of them explains this week's back-up in long-term Treasury yields. We don't seriously point to Obamacare. And we aren't especially moved by the idea that sovereign risks in the lesser regions of Europe are poisoning the well for sovereigns in general -- if anything, dollar-based Treasuries should benefit from such turmoil. We do give some credence to the growing risk of trade tensions with China as a possible explanation for Treasury jitters (see "No Protectionism Threat: Yuan To Bet?" March 18, 2010), but there's no particularly compelling evidence that China is behind this week's less than stellar auctions. We still think the prime mover is the Fed, and in this slow macro environment we continue to see a reliably easy policy environment for the indefinite future. So we continue to expect that long-term Treasury yields wills stay range-bound, with the 10-year between 3.5% and 4.0%. We don't see Treasuries as an attractive investment, but with yields at the upper end of the range, they might be worth a trade.

As we have expected, the Fed also continues to be the prime mover in a relentless drive lower in credit spreads (see "Easing -- As in Appeasing" November 23, 2009). The promise of easy policy for the indefinite future lowers expected default risk, and makes even what are no lower than average spreads to Treasuries seem attractive. Until we are ready to make the call that the Fed is going to tighten, we still like high yield bonds as both income and total return plays.

Bottom line

Stocks didn't react to the growth-killing taxes in Obamacare because they were already fully expected, and because there is a significant hope that they can be repealed before they take effect in future years. Forward earnings continue to grow as the economy recovers, but the growth rate is slowing dramatically, and the February quarter earnings season is going poorly. The 10-year Treasury has moved toward the top of the trading range between 3.5% and 4.0%. With the Fed's open-ended commitment to a zero short-rate still very much intact, we expect the trading range to hold. The Fed on hold indefinitely continues to be a salutary gusher of liquidity that lowers default expectations and makes even today's below-average spread to Treasuries looks attractive.