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Date with Destiny

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Donald Luskin

Risking the errors of 1937 and 1930, this is where we either learn from history or repeat it.

For months we've been following the chart that tracks the eerie near-perfect correspondence of the stock market today and the stock market in late 1937 (see our *Wall Street Journal* op-ed "Why This Isn't Like 1938 -- At Least Not Yet" July 9, 2010). Then as now, there had been a huge rally as the economy struggled to recover, then from the Great Depression and now from the Great Recession. But in 1937 a series of monetary, tax, regulatory, and political mistakes aborted the recovery, creating 1938's "depression inside the Depression," and launching the longest-lasting bear market in American history. On the chart (please see below), we are precisely now at the point where that bear market began in earnest. We are optimistic that we won't be repeating history here. But this is the week to watch, just in case. The fact is we are facing the risk of similar policy

Update to strategic view

US STOCKS, US MACRO: Failure to extend the Bush-era tax rates in this session of Congress, and Wednesday's House vote for protectionism against China, raise the specter of the policy…

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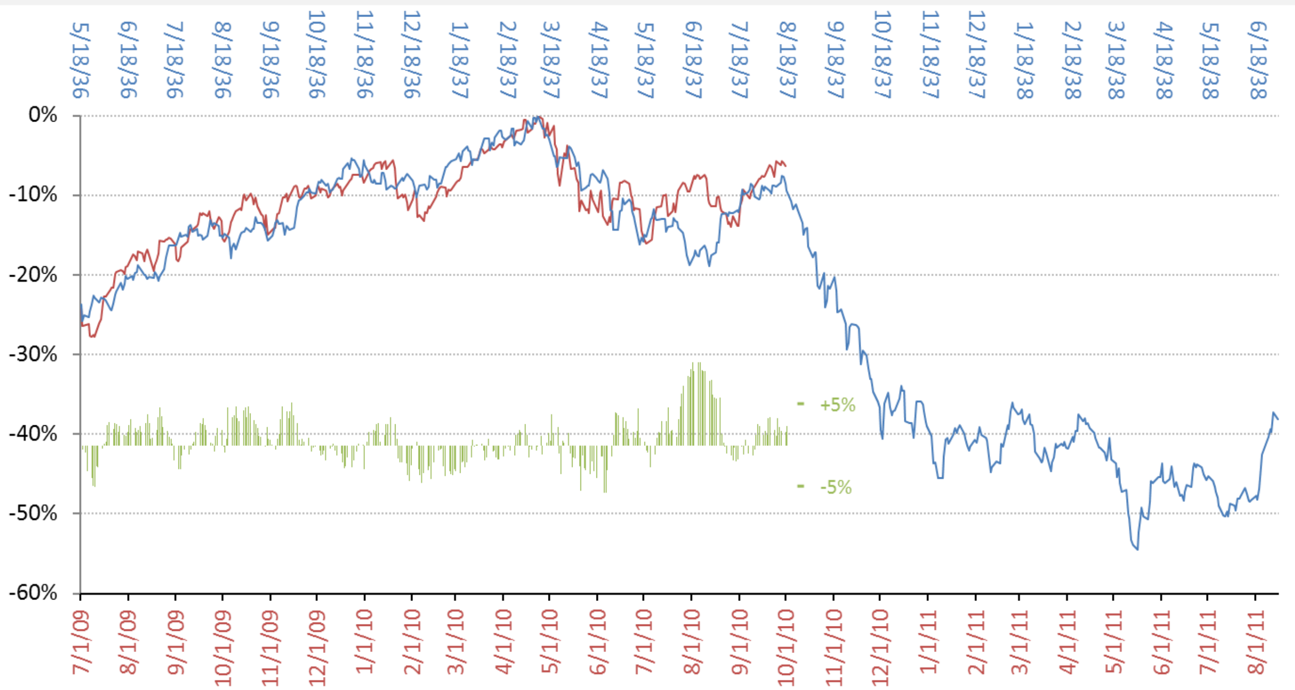
S&P 500 in post-1936 "recession in the Depression" S&P 500 today Difference

Percentage change from respective recovery peaks



Source: Standard & Poor's, TrendMacro calculations errors today -- in addition to one big error beyond the ones made in 1937.

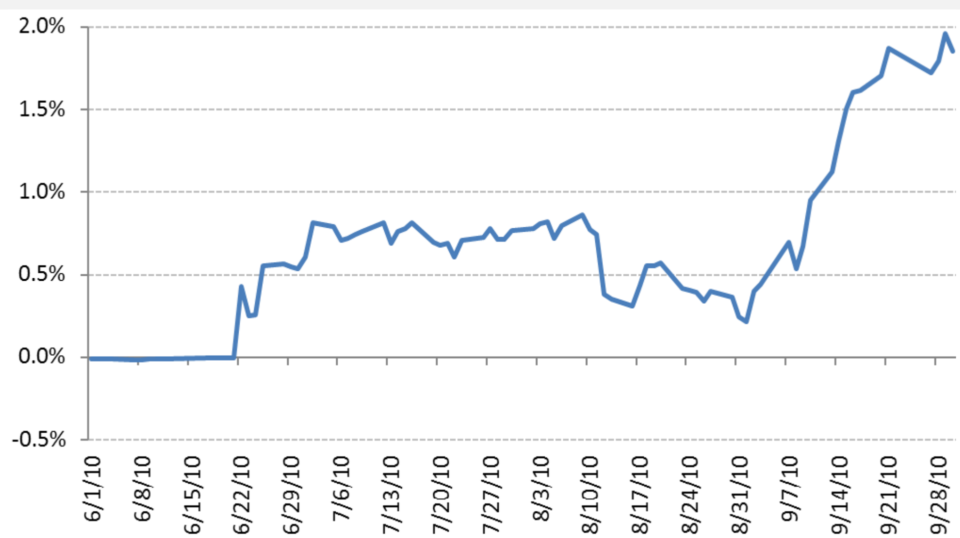
The House resurrects Smoot-Hawley

The Smoot-Hawley Tariff Act, signed into law in early 1930 by Herbert Hoover, was the proximate cause of the Great Depression. By 1937, Franklin Delano Roosevelt had succeeded in defanging its most punitive provisions, and the global trade war of the early 1930s was over. So here we are now at risk of repeating an error of 1930, not an error of 1937.

A bill that passed the House of Representatives on Wednesday, aimed at punishing China for alleged currency manipulation, adds dangerous new protectionist powers to Smoot-Hawley, which is still on the books after all these years. As we have already explained (see "No Protectionism Threat: Yuan To Bet?" March 18, 2010), the "Currency Reform for Fair Trade Act" would empower the Commerce Department to estimate the degree to which a foreign currency is undervalued, and apply that to the cost basis used in determining whether exports are being sold below cost. If China's RMB were found to be 40% undervalued, then virtually every single export from China would become subject to countervailing duties under Smoot-Hawley's "dumping" provisions. This is the stuff of a nuclear trade war.

In June China resumed the gradual revaluation of the RMB -- which had been suspended at the onset of the credit crisis in July 2008 -- specifically to avert the threat of this legislation (see "On RMB Revaluation" June 20, 2010). But China made a key error in this US election year, by revaluing the RMB too slowly, mere basis points cumulatively from late June to early September. Then, as the bill gained momentum in the House, the pace of revaluation picked up, moving about 1-1/2% in just four weeks (please see the chart below). But it was too little too late, and the bill ended up passing

RMB revaluation versus USD
Cumulative, June 18 = zero



Source: Reuters, TrendMacro calculations

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…errors that triggered the great bear market beginning in 1937. But we think that these are mostly pre-election atmospherics. We expect the anti-China bill to go nowhere in the lame duck session, while it is now likely the Bush-era tax cuts will be fully extended. It's a blow to confidence in the short term, but ultimately likely an upside surprise. We continue to expect sluggish growth, and a gradual ascent for stocks back to the April highs.

GOLD: We reaffirm our $1500 price target for gold, based on the Fed's avowed desire for a higher level of inflation.

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[About us]

with a bipartisan landslide vote of 378 to 79.

We believe there is enduring bipartisan political will in the US to keep bullying China to continue to gradually revalue the RMB -- which is to say, to permit the US to keep devaluing the dollar (see "Geithner and the Dollar: That's Not My Job" October 15, 2009). But we don't think there is the will to foment a nuclear trade war, and we'd be surprised to see this bill voted in the Senate in the lame duck session, especially as Congress changes its composition more toward Republicans who are generally more free-trade oriented. Yes, 99 Republicans in the House voted "aye" on Wednesday. But 74 voted "no," and on that roll of honor are the names that we think best represent the political and intellectual leadership of the coming GOP majority -- Boehner, Cantor, Ryan, Pence, Issa and Paul.

- Our call is that this bill will not be enacted into law, but will succeed in prodding China to further revaluation. We predict that this will cost American jobs at the margin, by raising prices of consumer goods in the US, and empowering China to be a stronger competitor for the import of scarce global resources such as oil and copper.

Bush-era tax cuts at risk

Democratic leadership in the Congress has opted to not tackle the extension of the Bush-era tax cuts in the pre-election session, leaving it for the lame duck session. This was a no-win political situation. They couldn't hold a vote because they would lose -- in the House there are now more than enough Democratic dissidents who would reject a bill that didn't extend tax relief to *all* Americans, including the highest-earners. On the other hand, failure to hold a vote leaves Democrats visibly accountable for placing the economy in jeopardy by prolonging uncertainty about a potentially catastrophic tax increase.

- No question about it, the GOP won this round, and will now head into the elections able to campaign on a promise to extend tax relief that Democrats denied. Democrats in tight races were so scared of this prospect that on Wednesday a resolution permitting the House to adjourn without dealing with the extending tax relief passed by only a single vote, with 39 dissident Democrats opposing.
- This increases the chances of extension of the Bush-era tax rates to *all* Americans by changing the narrative of the mid-term campaigns. It makes tax relief for all less contingent on the exact party composition of the House after November. That's because in narrow races, if Republicans don't win, it will only be because Democratic opponents joined the dissidents in promising tax relief.
- The Democratic dissidents are doing more than pandering to the demand-side economics of consumers who face a sudden loss of disposable personal income if today's tax rates are allowed to sunset (see "The Double-Dip Doomsday Machine" September 21, 2010). Last Friday 47 Democratic representatives signed a letter to Speaker Nancy Pelosi calling for extension of today's low dividend

and capital gains tax rates, sounding for the life of them like rock-ribbed supply-siders.

- We acknowledge the blow to confidence in requiring the economy to wait until the lame duck session for resolution, listening to the ticking of a doomsday tax clock all the while. And we acknowledge the ongoing risk of deadlock, in which the ideological battle over extending tax relief to "the rich" ends up extending tax relief to no one. But at this point, we think it's probable that today's tax rates will be extended for all, middle class and "rich" alike.
- This is an upside surprise for the economy, to be sure, but of modest proportions. If the high-earner tax rates are only extended for, say, two years, their potential positive effect will be significantly blunted -- especially in the domain of capital gains, where a one-year holding period is required. Its importance will be more in the symbolism that the war on capital conducted in Washington over the last eighteen months may be over -- and capital just might win.
- We note a key and growth-favoring distinction between this election year and 1936, the election year that set the stage for the policy errors of 1937. The Democratic congressional majority swept into power in 1932 with FDR got stronger and stronger in 1934, 1936 and 1938, not eroding at all until 1940 (after the 1936 election, the one most analogous to the present, Democrats increased their dominance to 322 House seats and 69 Senate seats, having been in the minority three elections earlier). Today, the re-equilibration from strong Democratic dominance back to a more balanced political playing field is happening in half the time.

A note on gold at new highs

Gold has broken through our old price target of $1300, and we stand by our revised price target of $1500 (see "More Upside for Gold" June 10, 2010), with all the usual ups and downs along the way. This call is not contingent on a strong form of new quantitative easing by the Fed, although that would certainly accelerate gold. The key is that the Fed has made perfectly clear that it wants more inflation, and other major central banks are doubtless of similar mind. However, whenever, and wherever that is achieved, gold is going to be driven higher (see "On the September FOMC" September 21, 2010).

Bottom line

Failure to extend the Bush-era tax rates in this session of Congress, and Wednesday's House vote for protectionism against China, raise the specter of the policy errors that triggered the great bear market beginning in 1937. But we think that these are mostly pre-election atmospherics. We expect the anti-China bill to go nowhere in the lame duck session, while it is now likely the Bush-era tax cuts will be fully extended. It's a blow to confidence in the short term, but ultimately likely an upside surprise. We continue to expect sluggish growth, and a gradual ascent for stocks back to the April highs. We reaffirm our $1500 price target for gold, based on the Fed's avowed desire for a higher level of inflation.