Trend Macro

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POLITICAL PULSE

The Pendulum Swings Back

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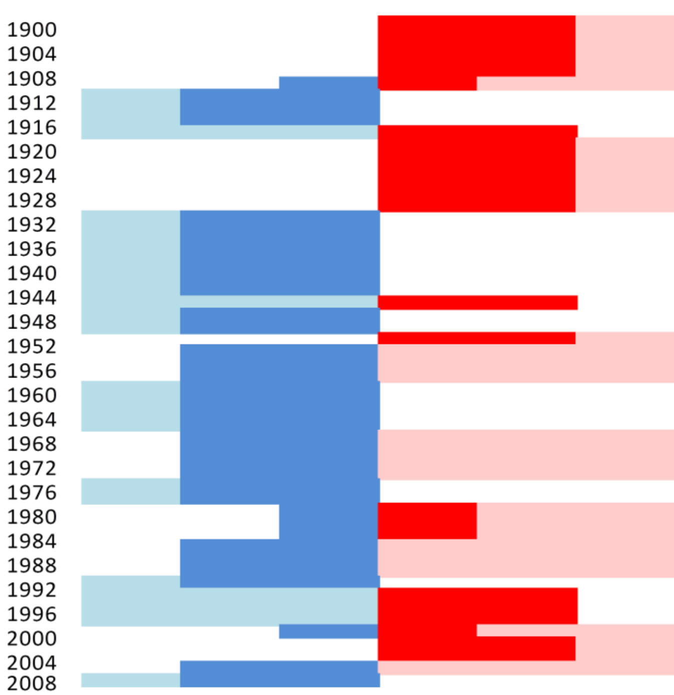
The battle to extend Bush-era tax rates will be the first test for a new political alignment.

No matter the precise outcome of today's mid-term elections, it will be an important further step toward political stabilization -- a long march back to the center after an extreme swing to the anti-growth left (see "2009's Economic Chart of the Year" December 28, 2009). A critical post-election test of this proposition is just weeks away, when the lame duck session of Congress debates extension of the Bush-era tax rates. Depending on how the White House adapts to the message of today's elections, it could be lethal game of political "chicken" which, if it goes wrong, will without doubt trigger a new recession (see "Tax Cut Chicken" September 9, 2010). We think now that the Bush-era tax rates will be extended for all, including "the rich," thanks to what we see as mounting evidence that Barack Obama intends to "tack to the center" as Bill Clinton did after the Democrats lost Congress in 1994.

Senate or House: Democratic Republican
Presidency: Democratic Republican



Source: Clerk of House, Clerk of Senate

Next year the US will have a divided government, after two years of Democratic rule. Of the 111 years since 1900, 42 have had divided government, 40 have had Democratic rule, and 29 have had GOP rule (please see the chart at left). There is no precedent for the

Update to strategic view

US MACRO, US STOCKS: Today's election is an important political stabilization, and a downpayment on a major realignment. It points to the likely full extension of expiring Bush-era tax rates, taking a major short-term risk off the table. We're still worried about "sell on the news" risk -- stocks fell 5% after the GOP sweep in 1994. But we'd buy the dip, as the cessation of anti-growth policy risk -- along with "QE2" coming tomorrow -- takes two significant drags on growth out of the picture.

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exact nature of the split we seem likely to get, if in next year's Congress the GOP controls the House but the Democrats continue to control the Senate (as of this writing, the over-under in the Intrade online political futures market for GOP House seats is 240, and for GOP Senate seats is 49). There has never been a Congress divided this way under a Democratic president. In fact, you have to go back to Grover Cleveland's administration from 1885 to 1889 to find a Democratic president with any kind of mixed congress, and that one was mixed the other way.

So we cannot do the empirical exercise of measuring how stocks have performed under this particular partisan configuration, because it has never existed before. But here is what we do know from history, covering the modern era from 1948 to the present (please see the chart below). It's not especially positive.

- The combination of a GOP House and a Democratic Senate gives the worst of all results, the only configuration with a negative average return. But this is based on only a single session of Congress -- the 107th, from 2001 to 2002.
- One-party rule, no matter which party, has been better for stocks than divided government. Democratic rule has produced an average return of 14.3%, GOP rule has produced average return of 17.5%, and divided government has produced an average return of 10.4%.
- GOP Senate control is key to all the best results. Unfortunately, that's what it looks like we won't get today.

Such empirical exercises are interesting, but we think there is more salience to a more qualitative approach to history, in this case keying off another unusual element in this election. Given this particular moment in history, the unusually short time we spent with Democratic rule before switching to divided government -- just two years -- is encouraging. We say

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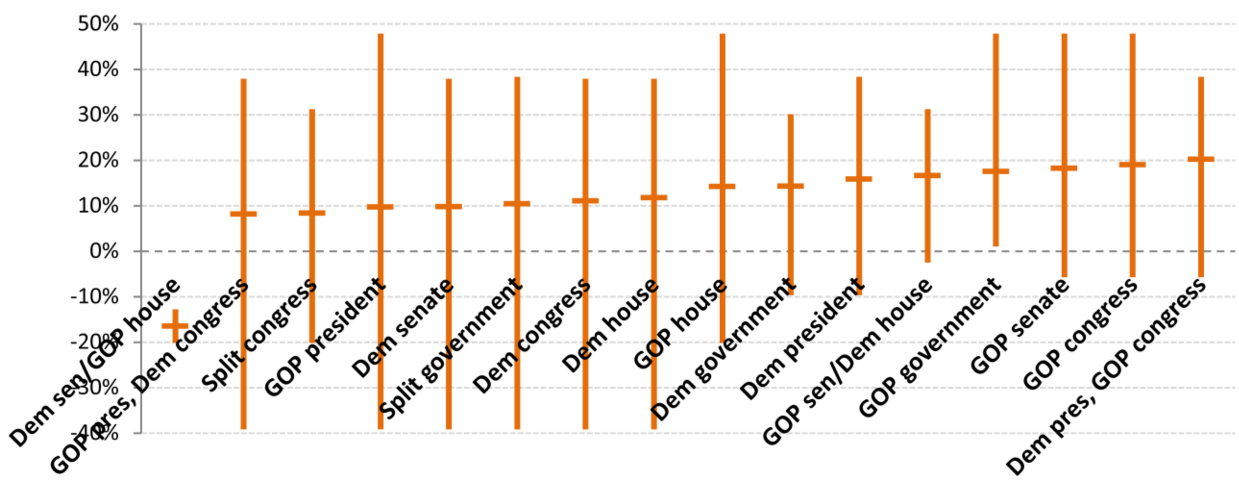
Recommended Reading

What the Government Purchases Multiplier Actually Multiplied in the 2009 Stimulus Package
John Cogan and
John Taylor
Working Paper
October 2010

[Recommended Reading

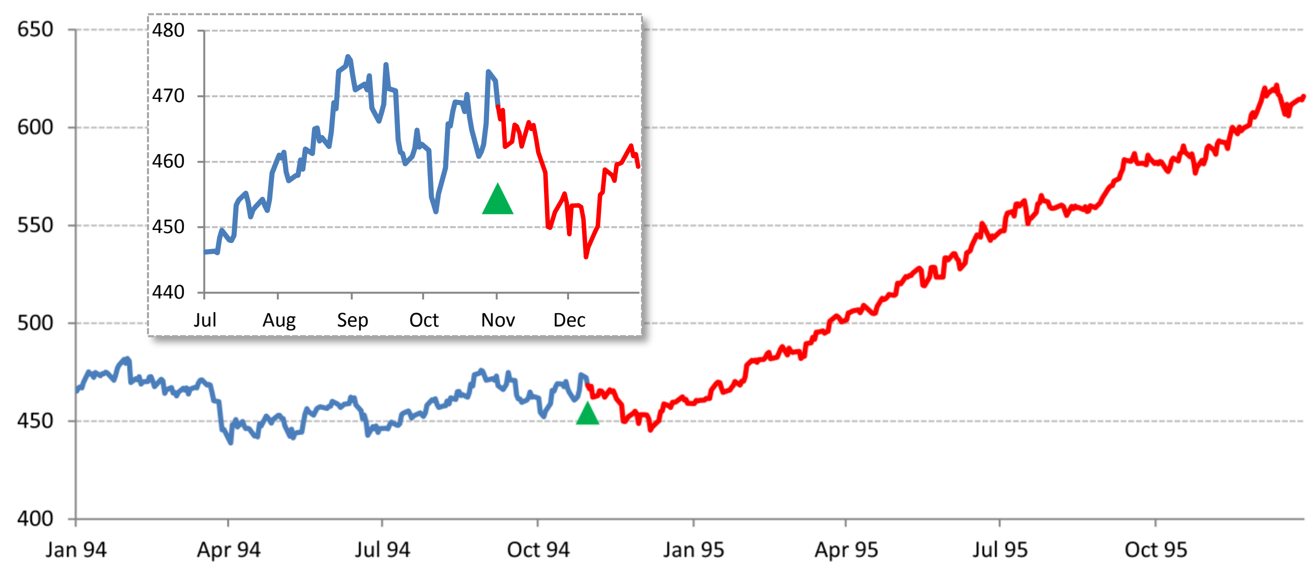
S&P 500 total return: best, worst, average, based on party control of government, 1948 to present



Source: Clerk of House, Clerk of Senate, Standard and Poor's, TrendMacro calculations that not just because the last time it happened -- only the second time since 1900, when the GOP swept Congress in 1994 while Clinton was president -- the results for the economy and the stock market were spectacularly positive.

- A note of caution on that. Right after the GOP sweep in 1994, stocks -- which had been rallying from mid-summer just as they have this year -- fell 5% (please see the chart below).
- It was a perfect opportunity to sell the news, and then buy the dip. Stocks had one of their best years on record -- +39.4% -- the next year, in 1995.

S&P 500 and the 11/1/1994 election — before election — after election ▲ election day



Source: Standard and Poor's

More important, we find encouragement in this rapid realignment because our era is often compared to the Great Depression, out of the depths of which Democrats enjoyed one-party rule for 14 years. At the apex of their power in 1937 and 1938, Democrats had 334 seats in the 435-seat House and 76 seats in the 96-seat Senate. They profoundly remolded the American economy by dramatically increasing the size and scope of government. When Obama became president, and less than a month later a stimulus bill representing more than 5% of GDP was enacted so hastily that no one in Congress who voted for it could have possibly read it, it looked like the Democrats were going to get a chance to remold the economy once again, and along lines very inimical to growth. Now it seems they will not get that chance.

The realignment may have been rapid, but it remains incomplete, with the GOP only taking control of the House. Yet the change in the *zeitgeist* is palpable. We've already seen numerous Democratic incumbents and candidates tack to the right on the flash-point issue of extending the Bush-era tax rates for "the rich." It began in July when four incumbent Democratic senators, none of whom were running in the then-upcoming election, came out in favor of extension (see "Good Week for Growth" July 26, 2010). By September, 47 Democrats in the House had come out in favor of extension, enough to assure passage -- and force Democratic leadership to not hold a vote prior to the election (see "Date with Destiny" October 1, 2010).

At this point it really looks to us like extension is going to happen. The original dissident Senate Democrats have now been joined by another incumbent, Robert Menendez (D-NJ), and two front-runner candidates for open seats, Joe Manchin (D-WV) and Chris Coons (D-DE), who would be seated immediately in the lame-duck session. Front-runner Republican Mark Kirk (R-IL) would also be seated immediately, meaning that in the lame-duck session we'll be starting with 49 votes for extension in the Senate -- and the debate will be conducted knowing that in January there will be 56 votes, and that it's a lock in the House either way.

Would Obama veto a bill for extension for all taxpayers, including "the rich"? Since the dissident Democrats first raised the issue, he's repeatedly not said he would, when asked. Now, over the weekend, an "according to sources familiar with the matter" story appeared in the *Washington Post*, saying that Obama's strategy would be "decoupling" -- a bill making the Bush-era tax rates permanent for the middle class while extending them for two years for "the rich." This is exactly the strategy we predicted last month that he'd take (see "The Double-Dip Doomsday Machine" September 21, 2010). It bows to the inevitable in the short-term, while teeing up another debate two years in the future, one in which the GOP won't be able to play chicken -- to hold the middle class tax rates hostage -- because they will have already been made permanent.

- If it plays out this way, we will have dodged a huge bullet. A bargaining failure in which none of the Bush-era tax rates were extended would have definitely triggered a new recession (again, see "The Double-Dip Doomsday Machine").
- More than the avoidance of a negative, it would be a pro-growth positive to extend favorable tax treatment for returns on capital and for top incomes.
- But the ostensibly temporary nature of the extension would significantly cut against its pro-growth power.

The most bullish thing that can be said about extension of the Bush-era tax rates under "decoupling" is that it will be a highly visible demonstration of the rapid political stabilization we will have undergone. In the Democratic catechism, the "Bush tax cuts" have been second in their loathsomeness only to the invasion of Iraq. For a Democratic Senate and a Democratic president to extend them will speak volumes about the vast new solution-space that has opened up for pro-growth economic policy.

Obama's trial balloon in the *Washington Post* is only one piece of evidence over the last month that he intends to "tack to the center."

- Three weeks ago, Obama ended the moratorium on offshore oil drilling in the Gulf a month before it was to expire.
- On the same day, when "forclosuregate" was first breaking into the headlines, a White House spokesman announced that Obama would not demand a moratorium on foreclosures, citing the risk of "unintended consequences."
- Last week it was reported that the Treasury will relax its tight restrictions on banks paying dividends and doing stock buybacks.

We think the election's impact on the economy and the markets will be very much like the impact of the Fed's "QE2," to be announced tomorrow.

- The economy acts like the Fed is too tight -- now the Fed is going to loosen, but we don't know if it will be enough.
- Similarly, the economy acts like it is besieged by anti-growth policies -- now a major political realignment is going to stop such policies, but we don't know if it will be enough.
- In neither case are we talking silver bullets, or even outright positives of any significant magnitude. We're talking about the cessation of major negatives.
- But in logical space, the cessation of major negatives is a major positive.
- The bullish wildcard is that a new vector has been set in motion. We're headed in the right direction, at last.

Bottom line

Today's election is an important political stabilization, and a downpayment on a major realignment. It points to the likely full extension of expiring Bush-era tax rates, taking a major short-term risk off the table. We're still worried about "sell on the news" risk -- stocks fell 5% after the GOP sweep in 1994. But we'd buy the dip, as the cessation of anti-growth policy risk -- along with "QE2" coming tomorrow -- takes two significant drags on growth out of the picture.