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POLITICAL PULSE

The Political Brick in the Wall of Worry

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An upset NY election, and no credible GOP presidential bid: political risk is on the table.

We continue hear extreme levels of pessimism from clients. Judging from their tone, you'd think we were in a grueling bear market. But in fact as of this writing stocks are just off 2.4% from the new recovery highs they posted less than a month ago. Last week we discussed the economic factors that seem to be feeding into this pessimism (see "Tear Down This Wall of Worry" May 20, 2011"), but we left out one macro driver that has come into focus in client conversations this week: *politics*.

- We think a major driving factor in the present second leg up in the bull market in US stocks has been the turn away from the anti-growth policies and demonization of capital that marked the first two years of the Obama administration (see "The Pendulum Swings Back" November 2, 2010).
- It was a tangible positive that the political environment *stopped getting worse* -- it gave the economy a more stable base on which to grow.
- But taking control of the House by a Republican party with a mandate to cut federal spending is not a sufficient condition to actually *make things better*.
- The intense focus on cutting spending is a legitimate response to the mandate of an activist base -- and a very worthy long-term policy goal. However, right now, with a 3.08% yield on the 10-year Treasury, the bond market is making a fool of the GOP spending cutters, no less so than it is doing to Bill Gross and Standard & Poor's. Self-evidently, the US Treasury does not face an imminent funding crisis, regardless of the pending completion of QE2 (see "Will the World End when QE2 Does?" April 4, 2011).
- Tuesday's upset win by the Democratic candidate in a special congressional election in a GOP-leaning upstate New York district potentially sends the message that cutting spending is not a durably winning message. Democrats are portraying their win as a reaction against the supposedly draconian cuts to Medicare proposed in the Paul Ryan budget. The online political futures contracts traded at Intrade are now giving the GOP only about a 50% probability of retaining House control in 2012, down from about 80% late last year (please see the chart on the following page). As embarrassing as it was for newly-declared presidential

Update to strategic view

US MACRO, US BONDS, US STOCKS: The Treasury market is making a fool of deficit-obsessed Republicans no less than it is of Bill Gross and Standard & Poor's. The drop in the 10-year yield is about falling growth expectations, which easily trump worries about US solvency. With cutting spending crowding out true growth initiatives, the most we can expect is that last year's political sea-change shifts the economy out of first gear and into second, and enables only a slow-motion melt-up in stocks -- in neither case the race back to trend that we would normally expect.

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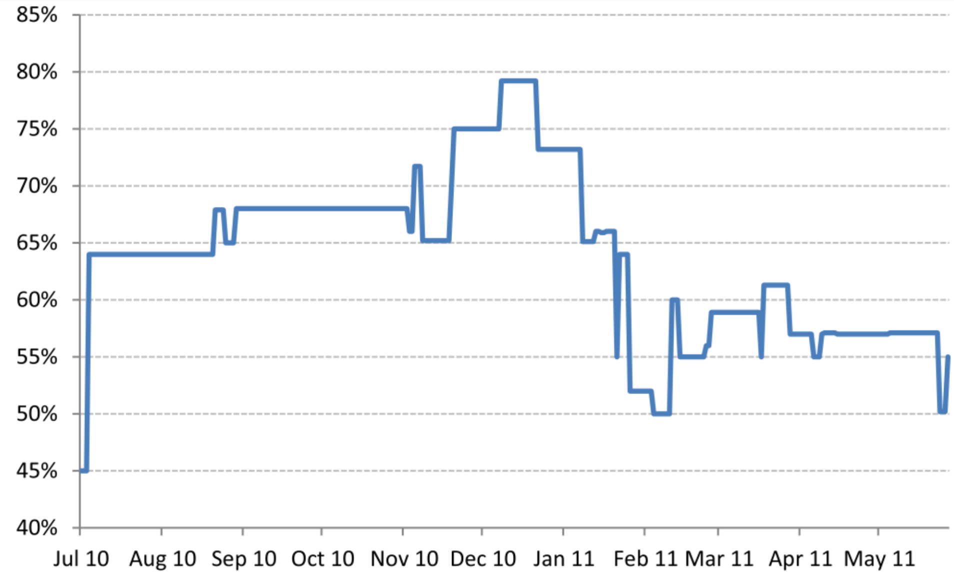
In Memoriam

We note with great sadness the passing of John Delaney, the founder and CEO of Intrade, the online prediction market. He died Saturday at age 42 during an ascent of Mt. Everest. We offer our condolences to his wife, Orla, and his three children.

Futures-implied probability of 2012 House control by GOP



Source: Intrade

candidate Newt Gingrich to have [publicly criticized] Ryan for his budget plan's radicalism, it seems there's a plausible case that he was correct.

- The GOP has quickly responded, [attempting to reset the debate] by mobilizing House spokespersons such as Eric Cantor to emphasize the GOP's jobs and growth initiatives. Stocks made their lows for this correction (at least so far) on Tuesday, the day of that election. They've perked up since the GOP has shown some signs of learning its lesson.
- The difficulty of reducing US fiscal deficits has been high on the worry-list among our pessimistic clients all year, and it's a legitimate issue. But in the last week, conversations have been dominated by the failure of the GOP to produce a presidential candidate for 2012 who is both credible and can convey a powerful pro-growth message. This pivot in political sentiment, in our view, represents a more evolved view of the challenge in the US policy environment -- the realization that rapidly growing the economy is the *sine qua non* of a durable solution to deficits. Spending is a side show -- and cutting it won't in and of itself create growth.
- It is also a more pessimistic view, because right now all the GOP can do is opportunistically use its control of the House to threaten to block must-pass legislation. It did so in December, in the lame duck session even before it had House control, to extend the Bush tax cuts (see ["Tax Cut Endgame"] December 13, 2010). And it can do so again with raising the debt ceiling to win at least some spending concessions. It's not enough to put in place any number of tax, regulatory and trade initiatives that would give the US economy a chance to get back to trend levels (we're already about back to trend *growth rates*, but it would take much more to get back to trend *levels*). It's not even enough to undo the damage of the first

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two years of the Obama administration, by repealing Obamacare or Dodd-Frank.

- We see the most likely political outcome in 2012 being the GOP holding the House and taking control of the Senate, but failing to take the White House. That is not a bad configuration, if the late 1990s is any evidence. The risk is that an obsession with spending cuts -- at the expense of growth -- causes the GOP to miss the opportunity to campaign against an incumbent president and Senate that has been impotent to improve a catastrophically high unemployment rate. That should be a lay-up -- but this year the GOP has only started to talk about it in the last couple days. The election will be won only by swaying the mass of ordinary people in the political middle who personally feel the pressure of high unemployment -- not the conservative activists who are sensitive to budgetary matters.
- But as we have in the past, we urge clients not to let the perfect be the enemy of the good (see "The Enemy of the Good" December 2, 2010). The policy environment is not presently set up to actively make things better, but things have stopped getting worse. That alone makes a much better economic and investment environment than the one we faced a year ago. For the economy, it means we should be able to get out of last year's first gear and into second -- but not up to full speed. For stocks, in the context of rampant pessimism, it augurs for a continued slow-motion melt-up. We don't see that as a wildly optimistic thing to say. In fact, considering how far the economy and the stock market are below long-term trend levels, it's only cold comfort.

Bottom line

The Treasury market is making a fool of deficit-obsessed Republicans no less than it is of Bill Gross and Standard & Poor's. The drop in the 10-year yield is about falling growth expectations, which easily trump worries about US solvency. With cutting spending crowding out true growth initiatives, the most we can expect is that last year's political sea-change shifts the economy out of first gear and into second, and enables only a slow-motion melt-up in stocks -- in neither case the race back to trend that we would normally expect.