



Up & Down Wall Street

Crucial Choice

By Randall W. Forsyth
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They are massing at the borders, lying in wait, ready to strike. Some of the most formidable fighting forces ever assembled, numbering in the thousands. They are willing to use whatever tactics necessary to advance their cause. And the mere mention of their name strikes terror in the populace.

Lawyers.

Armies of them have been assembled by the Democrats and the Republicans ahead of Election Day in anticipation of the kind of ballot-box fiasco seen four years ago in Florida. Call them the Coalition of the Hourly Billings.

One estimate has the Dems with some 10,000 lawyers ready to spring into action in the aptly named battleground states. It's inconceivable that the GOP would let themselves be outmanned and outgunned in this, the mother of all election battles. The Democrats clearly want to see that no voter gets left behind, whether they're cast early, provisionally or often. And doubtless the Republicans want to see all those newly registered MTV viewers cast their maiden ballots in precisely the right manner -- so that their next vote might count.

With all the back and forth in the polls in recent weeks, the truth is the candidates are in a statistical dead heat. While one noses ahead in one poll or the other, the gap remains well within the margin of error. So there's no doubt that every vote really does count -- if you live in one of the 10 battleground states. If you live in a state that's solidly in the blue or red fields, however, you might catch a glimpse of a candidate if he's flying over.

New procedures aimed at preventing voter fraud also might have the ironic effect of bringing back some of the hoary abuses of yore. Early voting has proven popular, not surprisingly, in Florida, the home of the early-bird special. So, too, have been absentee ballots. What happens to the votes so cast by those who depart this vale of tears before Tuesday? And you thought the dead voted only in Chicago.

It's well and good, then, that armies of lawyers should be swarming over the polling places. For we are told that this is the most crucial election of our lifetimes. Indeed, we are faced with a fateful choice, and not just in war and peace. Domestically, we must choose between a typical Massachusetts tax-and-spend liberal and a borrow-and-spend Texas conservative.

The fact is, we're going broke, and neither President Bush nor Sen. Kerry has a plan to fix it. After patting himself in bringing the just-ended fiscal year's budget deficit in closer to \$400 billion than the feared \$500 billion, the incumbent promises to cut that shortfall in half. David Stockman two decades ago warned of \$200 billion deficits as far as the eye can see; now that's the rosy scenario. The challenger talks of returning to budget surpluses that prevailed during the Bubba era -- products of a bubble of historic proportions that's gone and never coming back.

In truth, the proposals put forth by both Bush and Kerry would increase the aggregate federal deficit by \$1.3 trillion -- that's with a "T" -- over the next 10 years, according to the Concord Coalition. W would rack up that red ink mainly by making permanent the tax cuts already enacted, which are due to expire down the road. It also assumes spending restraint from an administration that has not vetoed a single spending bill, unprecedented in American history.

This doesn't include Bush's plan to privatize Social Security, which the Concord Coalition says would add another \$1.2 trillion to the deficit. In economic terms, however, that's a wash. Instead of the Social Security Trust Fund getting IOU's from the Treasury for its surplus, the Treasury would sell bonds to the public, which would have that much more to invest.

As for Kerry's plan, most of the increased deficit comes from the extension of the middle-class tax cuts, plus his health-care plan, which the Concord Coalition reckons would cost \$476 billion -- after expected savings of \$300 billion. The budget watchdog group didn't buy the Kerry camp's claims for \$131 billion of various offsets.

The easy target for the deficit mess is the Bush tax cuts, but the fall in revenues had more to do with the recession resulting from the bursting of the tech bubble, which devastated profits. Bush also reversed the two-decade downtrend in federal spending as a share of gross domestic product, from almost 24% in the early 'Eighties to about 18% by 2000. That percentage, now back to 20%, was headed higher even before 9/11, led by ballooning nondefense expenditures.

Even though the problem is spending, the pols will probably see the solution as more taxes. Even Reagan was forced to hike taxes when confronted with unforeseen deficits, notes the perspicacious Amity Shlaes of the Financial Times. While Kerry has promised to repeal the Bush tax cuts for the top bracket, W insists he won't. But the affluent could be hit with higher taxes in other ways, she adds. The estate tax, due to expire in 2010, returns the following year if nothing is done. Social Security taxes, paid on the first \$87,000 of earnings in 2003, could be extended, like the Medicare tax, to all earnings; that could be a bargaining chip for reform. And the tax on dividends, now 15%, could be nudged higher, say to 20%, and still preserve a sizable spread against ordinary income.

All these measures might slow the flow of red ink, but surely won't stanch it. (And they would scarcely touch the likes of Teresa Heinz Kerry, whose income is sheltered well from taxation.) But there is little reason to expect the budget to come under control, since we can borrow so easily.

At this point, everybody knows the U.S. finances its deficits by selling bonds that are snapped up by foreign central banks. Once confined to a footnote on Federal Reserve data sheets, these foreign purchases of Treasuries, especially by Asian central banks, have caught the attention of the media and mainstream economists. They recycle the dollars they receive from exports into the U.S. bond market, which keeps their economies going.

Far from being a cause for so much hand-wringing, some economists see this as a new Bretton Woods system, writes Barry Eichengreen, a professor at the University of California at Berkeley. Under that system in place after World War II until 1971, currencies' values were fixed in relation to the dollar, which in turn was pegged to gold at \$35 an ounce. Now, of course, there's no gold peg, but the dollar is at the center of the system with currencies at the periphery, in Asia and Latin America, informally committed to keeping their exchange rates. They accumulate dollars to keep their currencies stable to spur exports, which funds the U.S. budget and trade deficits.

Eichengreen disputes this revisionist history, noting that the Bretton Woods system fell apart when the rest of the world decided it no longer wanted to keep piling up depreciating dollars. For now, foreign central banks are willing to do so, keeping the U.S. afloat, but cannot be counted on to do so in the future. So the "new Bretton Woods" could unravel just as the old one did.

Martin Jansen of ING Investment sees this situation more starkly. The present system amounts to a Faustian bargain on global scale, he writes. Just as telecom-equipment manufacturers provided vendor financing to the dot-coms, foreign central banks are funding our spending. Jansen hopes the imbalances are corrected before this bubble bursts.

What's that got to do with Tuesday's elections? A breakdown in that Faustian bargain will force the unpleasant choices on the overleveraged U.S. government and American consumer. That will happen regardless of who wins.

So as you enter the voting booth this week, remember what Woody Allen said: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."

Or you could vote Libertarian.

-- A very important week. That's how **Woody Dorsey**, who runs Market Semiotics advisory in Castleton, Vt., dubbed it. And not just because he had nailed the trend change that became evident by midweek.

A couple of days earlier, the Dow touched its low for the year, crude oil set yet another record over \$55 a barrel, the dollar was threatening to take out its spring lows against the euro and the yen while the 10-year Treasury (bad-news-is-good-news) note traded down to the low 3.90s. To Woody, it looked like the end phase of the summer "slopathon" that he had called for earlier in the year, since all these markets had been stretched to extremes.

And things snapped back Wednesday after news of higher-than-expected oil inventories, which sent crude tumbling and other markets moving in domino fashion. In addition, cycle guru Paul Macrae Montgomery from Universal Economics in Newport News, Va., had forecast a cycle date, which he says correlates with market- trend changes, for Wednesday. And, of course, there was a full moon and a lunar eclipse that night that helped the Red Sox finally reverse the Curse. Hey, some traders believe in this stuff.

In any case, Dorsey's psychology indicators pointed to extremes of negativism, be it stocks, the dollar or bonds, leaving those markets ready to pop. "The oil [supply] numbers were just an excuse for a reversal," Woody says.

The market had become "Spitzer-ized," adds Jim Paulsen, chief investment strategist at Wells Capital Management. As such, there was some relief that Marsh & McLennan avoided criminal charges from the hard-charging New York attorney general when the insurance broker named Michael G. Cherkasky to replace Jeffrey Greenberg as CEO.

As for the market's overall psyche, says Jim, "this reminds me of 1962," which saw the Cuban missile crisis bring fears of nuclear war to a peak. The threat of a nuclear confrontation never fully went away, but fears of such gradually diminished. In '04, we've had to worry about terrorist attacks with the conventions, the Olympics and now the elections. "Eventually, it will be like the boy who cried `Wolf!' Some people will realize they can't wait for the next attack, and will have to get invested in stocks or buy that piece of capital equipment," he says. Perhaps, but a few hours after we chatted, Osama bin Laden released a videotape just four days ahead of the U.S. elections.

On fundamentals, Jim remains cheerfully bullish, arguing that the market's price-earnings multiple, based on next year's earnings, is close to its lows before stocks lifted off in October 2002. He figures the S&P fetches about 15 times earnings next year of \$74, in line with its historic multiple. And if the economy's soft patch means GDP growth of 3.3%-3.7%, he says he can't wait to see it overheat.

Perhaps, but \$74 seems steep for S&P earnings next year. And the consumer might be able to absorb \$20 more a week in gasoline costs, but this winter's heating bills will take a hellacious bite out of family budgets. He says job creation will sustain spending, but Jim's a smart and nice chap, so we'll end our disagreement there.

Woody (who's also smart and pleasant) agrees that you should be buying stocks, especially beaten-down things like drugs, for a rally into next year. But that would be an interlude of what he sees as "the repricing of the planet" with real goods such as commodities heading higher and financial assets heading commensurately lower.

Of course, this bear-market rally comes right on time for Wall Street's widely advertised end-of-year buying spree. With profits hard to come by, it shouldn't be surprising if traders jump on the bandwagon. And there's a bit of an appetite for risk, evidenced by blowouts in a slew of initial public offerings last week.

And that assumes no surprises. We might actually know who won Tuesday's vote by Wednesday morning. October's employment number, which comes out Friday, should be better than the recent punk reports, if only for the reversal of the effects of the hurricanes. The Fed will certainly hike rates another quarter-point, all the way to 2% in November. And the surprise rate increase by the Chinese Central Bank only brings it up to zero in real terms in an economy growing 9% and may help that economy avoid a bust after the boom.

So a bear-market advance back to the top of the trading ranges isn't out of the question. Hey, even the Mets had a winning streak this year.