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Economic Commentary

A New Direction for America

The title of this piece is the slogan that the first female Speaker of the House, Nancy Pelosi, used as an overarching theme to push last week's historic Democratic takeover of the US House of Representatives. When the dust finally settles Democrats will likely pick up 29 seats and have a 232-203 majority. Since 1955, this is only the second time control of the House has switched between parties.

Harry Reid, the new Senate Majority Leader says, "it's time for a change," now that the Senate has switched back to Democratic control 51-49. Since 1980, this is the seventh time control of the Senate has switched between parties.

Politics is a hot button issue and it seems that the more evenly divided the electorate becomes the more flammable the environment. As a result, it is important to discuss policy, not personality or party. It is the direction of policy that is important for financial markets and the economy.

First, I must offer a mea culpa. After watching the pollsters get it wrong so many times, I believed that Republicans would fare much better in the 2006 elections than polling suggested. Not only was the economy doing well and Republicans had raised more money, but actual votes from the March 2006 primary in IL-6, pitting Peter Roskam (R) against Tammy Duckworth (D) to fill the seat vacated by Henry Hyde (R), showed Roskam in better shape than the polls suggested.

As it turned out, the polls, which showed Roskam down by as much as 14%, were way off the mark. Congressman Roskam won the election with slightly more than 51% of the vote. While I was right about IL-6 and Roskam, I was obviously wrong in assuming that other polls throughout the country were also wrong. The Democrats ran a great campaign.

The war in Iraq was a key frustration factor for voters. The immediate resignation of Donald Rumsfeld as Secretary of Defense was the response. Immigration was also another divisive issue, which led to the defeat of J.D. Hayworth, a "tough on immigration" incumbent Republican Congressman from Arizona.

What is less clear is any mandate for Democrats on economic policy. A Club for Growth poll of 800 likely voters, taken two days before the election in 15 swing districts, found a significant shift in how the electorate views Republicans. The small government, fiscal discipline "brand," that Ronald Reagan earned for Republicans seems to have disappeared. The poll found that by an 11% margin, voters thought that Republicans were "the party of big government."

When asked which party is doing a better job "eliminating wasteful spending," the Democrats led 39 percent to 25 percent. Pat Toomey, the president of the Club for Growth said that, "by a margin of over 2 to 1, voters in these swing districts favored keeping the Bush tax cuts in effect on income-tax rates. The margin was 5 to 2 in favor of keeping the capital gains and dividend rates low, and people supported making the repeal of the death tax permanent by almost 3 to 1."

It's not surprising that there is concern about spending. Along with a new prescription drug benefit, and much more federal spending on education, the past six years have seen a huge expansion in earmarks and pork barrel projects. Between FY-2000 and FY-2006, federal government spending grew by 48.4%, while GDP grew just 35.1%. The government share of GDP has climbed from 18.4% to 20.3%. Even though Democrats voted for much of this spending, and in fact complained in some cases that the government was not generous enough, the Republicans were held responsible.

Despite this, the election was not all that extraordinary. Since 1938, the opposition party has experienced an average gain of 38 seats in the sixth year of a two-term presidency (see table below). The 29 seat swing in the 2006 election was not all that huge.

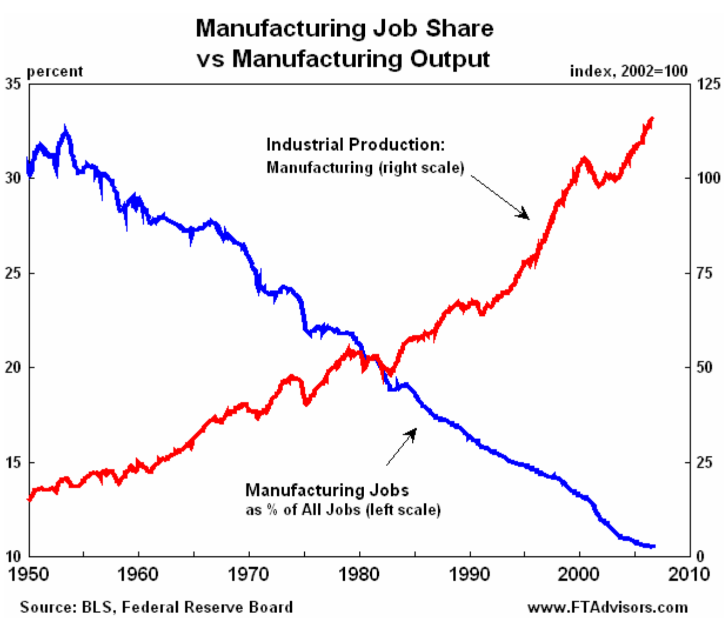
		Gain/Loss		
Two-term Presidents	**Year**	**GOP**	**Dem**	**President's Party**
George W. Bush	2006	-28	**29**	Republican
William J. Clinton	1998	**-5**	5	Democrat
Ronald Reagan	1986	-13	**13**	Republican
Dwight Eisenhower	1958	-62	**63**	Republican
Harry Truman	1950	**33**	-33	Democrat
F.D. Roosevelt	1938	**88**	-79	Democrat
Two-term Administrations				
Nixon/Ford	1974	-52	**53**	Republican
Kennedy/LBJ	1966	**50**	-51	Democrat

Voters sent a message, but that message did not call for a major shift in the direction of economic policy. In fact, many of those elected have been labeled "blue dog" Democrats, a group who often supported Ronald Reagan's fiscal policy.

This is very important for investors. For example, repealing the 15% tax rates on long-term capital gains and qualified dividends and pushing them back to levels that existed prior to May 2003 would likely reduce US equity valuations by approximately 20% because they would raise the cost of capital. At the same time, protectionism and excessive interference in the energy markets could reduce economic growth and increase inflation.

As a backstop, administration insiders say because Democrats and not Republicans are in control of Congress, the President will be free to veto legislation, such as tax hikes, excessive spending or overly meddlesome regulation. These insiders say that the President never used his veto pen in the past because it would have made his own party look bad. Now things are different. As a result, while policy may not move solidly in a free market direction, it is unlikely to veer sharply the other way either.

Most importantly, it's not clear what politicians could do, even in a perfectly bipartisan atmosphere to "fix" what many perceive as problems. Take the loss of manufacturing jobs for example. While it is true that the US has lost more than 3 million manufacturing jobs in the past six years, it is also true that manufacturing output this year has climbed to an all-time record high.

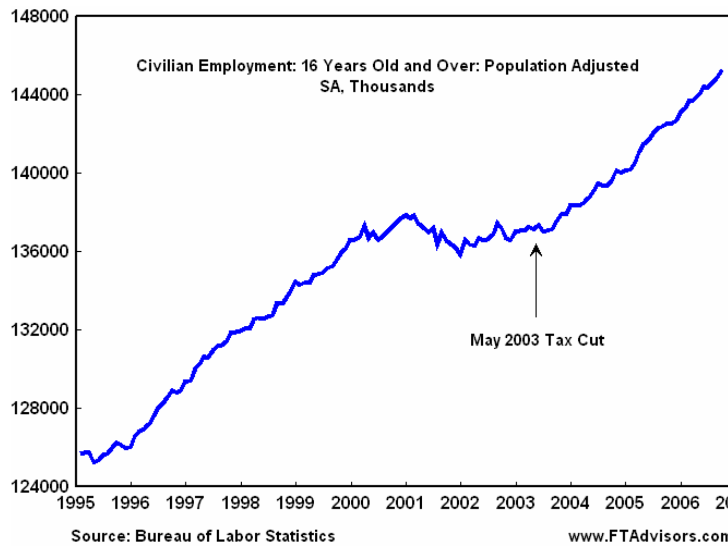


This is not a new phenomenon. Manufacturing jobs made up 30% of all jobs in 1950, while they make up just 10% today. On the other hand, manufacturing output (adjusted for inflation) is up more than 7-fold since 1950. The US is the second largest exporter of goods in the world (Germany is #1), and the US leads the world in exports when both goods and services are counted.

The 1980s and 1990s saw the invention and proliferation of technology, while the 21st century is about implementation. And the resulting productivity boom means that US companies are producing more with fewer people. While this is unambiguously good for the economy as a whole, it is a clear negative for those who have their lives disrupted.

High tax rates on capital act like a wall between old and new investment and reduce the mobility of capital, impeding progress and reducing the momentum of "creative destruction." Low tax rates on capital are a positive in the sense that they allow resources to be moved from less productive to more productive areas of the economy.

With the US unemployment rate at 4.4% it would seem that this process of moving resources has gone well. New small business starts are soaring, and 8.2 million new jobs have been created since the tax cut of May 2003. Job growth accelerated sharply once the tax cuts were passed.



While it is understandable that many people who have had their lives disrupted by technological change are upset and wish something could be done, it is not at all clear what politicians can do differently to help them without harming the economy and creating even more pain than they relieve. Tax hikes and protectionism would slow the economy. Spending has already soared.

In the end, Democrats ran a magnificent campaign and Republicans clearly lost a great deal. However, while there may be a new direction for Iraq, we find it hard to believe that the election signals anything but minor shifts in the direction of economic policy. The stock market is still undervalued, inflation is still on the rise and the Fed is still on hold.

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