

MACROCOSM

## Back from the War

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Donald Luskin

### It's back to business for the economy and for President Bush.

The conventional wisdom was that with the risks of war in **Iraq** receding into the background, the market would turn its attention to an earnings season that would reveal an economy that had slumped badly in the first quarter. Just as a year ago corporate earnings reports and guidance failed to validate "super-V" recovery hopes (remember *those?*). This time around they've failed, so far, to confirm any significant collateral damage from the war. Our daily work with aggregate earnings forecast data suggests that consensus growth expectations remain very much intact, including expectations for the late-recovering and still vulnerable technology sector.

We stand by our forecast that as the fog of war lifts, the economy will continue to mount a slow and steady -- but still sub-par -- recovery (see ["Better Than It Looks"](#) April 4, 2003). So we should expect a continuing absorption of the deep risk premium that was impounded in market prices, and look for higher equity and high-yield bond prices and lower Treasury bond prices. As a rough-and-ready estimate based on our stock/bond valuation work, benchmarked against the extremes in mid-March just before the onset of war, more than one half of the risk premium remains to be absorbed in order to return the markets to normal equilibrium.

The major factor now inhibiting the complete absorption of the remaining risk premium is uncertainty about whether **President Bush's** high wartime approval ratings will persist, whether his popularity will translate into domestic political effectiveness, and just how much of a difference it makes to have the president himself personally engaged in selling his economic agenda to the electorate and to hold-outs in the **Senate**. Yesterday's Rose Garden speech in support of his pro-growth tax-cuts marked the beginning of Bush's new "back from the war" mode, and signaled that these uncertainties can now start to be resolved.

The degree of uncertainty about the political prospects for the president's economic agenda is reflected in the completely contradictory ways the media found to speak ill of his Rose Garden speech. The [lead editorial in the \*New York Times\*](#) portrayed it as triumphalist no-limit gambit in which a victorious president "has come out fighting for this disastrous plan...including 'at least' the \$550 billion, 10-year cut pending in Congress." But a [Washington Post story](#) portrayed it as a confession of defeat, in which Bush "signaled to small-business leaders yesterday that he will accept as much as a 25 percent reduction in his tax cut proposal." Did these guys even attend the same speech?

The good news implicit in *both* stories is that Bush has locked in at least \$350 billion in tax-cuts no matter what -- so now we're just arguing about *how much more*. So why isn't the market delighted? Because at \$350 billion, it's going to be hard to hang onto the pro-growth centerpieces of the Bush plan -- the elimination of the double taxation of dividends and retained earnings, and the acceleration of deferred reductions in personal income tax rates. The worst of all worlds would be to end up with \$350 billion in populist, feel-good, demand-side welfare

disguised as tax-cuts, designed to "put money in people's pockets" and "keep the consumer spending."

Our sources in the Bush administration say that the president is committed to an all-out effort to get the biggest tax-cut possible, and to preserve the best pro-growth features. Senators **Olympia Snowe** and **John McCain** are the administration's best hopes for critical converts at the margin from within the **Republican** party. Several **Democrats** have been targeted by the Bush administration as well. Republican **George Voinovich** has been given up for brain-dead.

In last week's efforts to line up converts before the congress's Easter recess, McCain was not a possibility because he would not even consider supporting any tax-cut during the war. Now, with the war effectively ended, the possibility of converting him may turn out to be an important peace dividend. **TM**