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Blamestorm

Tuesday, September 6, 2005

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The post-Katrina risks to markets are mostly political, not economic.

As of this writing **stock prices** are higher than they were pre-**Katrina**, and the **crude oil** price is lower. We're happy with our long-standing call that these markets have been priced for the worst -- stocks ridiculously **undervalued**, and oil ridiculously **overvalued** -- and now that the worst has come, there's potential for a relaxation of the **risk premia** embedded in them (see "Water In The Streets" September 1, 2005). So now let's look at the darker side. What arguments are there that even worse may still be to come, requiring that risk premia be maintained?

The risks here are not directly economic, but instead, political. So we'll move on from our look last week at the mild economic aftermath of 1992's **Hurricane Andrew**. In light of the political blamestorm that has developed in Katrina's wake, we have to worry that a closer parallel might be the aftermath of a 2002 hurricane: **Worldcom**. That hurricane made landfall on June 25, 2002, when the company disclosed massive accounting fraud. The official history is that the stock market nosedived immediately thereafter, as **investor confidence** in *all* **corporate earnings** was shattered. But in reality there was no such loss of confidence -- or at least there was no such market reaction. The reality is that the **S&P 500** was 1.3% *higher* 10 days after Worldcom's revelation. But less than three weeks *later*, the S&P 500 had fallen an astonishing 18.3%. Why? Because a **Category Five** blamestorm united **Congress** in a bipartisan crusade to "get tough" on **"corporate crooks."** The result was the **Sarbanes Oxley Act**, and the market hit bottom on July 24, the day Congress finally stopped building it (see our appropriately entitled report, "Eyeing the Hurricane" July 31, 2002).

The Katrina blamestorm that is currently engulfing the **Bush administration** is largely a matter of cynical political opportunism on the part of the president's opponents. But the Worldcom blamestorm started just the same way. Then, as now, the administration is being blamed for having done too little to prevent a tragedy. And now, as then, the administration's only possible political response is compensating over-reaction. Then the over-reaction was Sarbanes Oxley. What might such over-reaction look like now?

- At minimum there will be **pork** by the barrel-full. If the recently passed **energy bill** can spend $230 million to build a bridge to an uninhabited island in **Alaska**, there is no limit to the billions that can be spent rebuilding a city that, against all sound reasoning, had chosen to locate itself below sea level. As wasteful as that may be, in our model the important risk here is that this inevitable storm-surge of spending comes precisely at the moment when Congress is about to vote on important **pro-growth tax initiatives** -- the permanent repeal of the **federal estate tax**, and the extension of the 2003 cuts on **dividend and capital gains tax rates**. These were fragile initiatives to begin with -- all the more so now that **former President Clinton** is telling **CNN's Larry King** that we should scrap the death tax repeal and give the money to the poor of **New Orleans**.

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- Another risk is the potential regulation of **energy prices** or **energy profits**. The **supply shocks** of the 1970s were surely made far worse by arbitrary **caps** and **windfall profit taxes** that masked price signals and distorted incentives to explore, conserve and substitute. Doing the same things today would have the same devastating effects. Alarmingly, in the weeks before Katrina, the **State of Hawaii** had put in place rules that cap **wholesale gasoline prices** in the islands to an index of mainland prices. And now, after Katrina, the homepage of the website of the **Department of Energy** invites visitors to report incidents of "price gouging" and "price fixing" -- which will be "forwarded to the Federal Trade Commission for investigation, and where appropriate, prosecution."

- The combination of Katrina and the sudden death of **Supreme Court Chief Justice William Rehnquist** has probably put on hold the nomination of a successor to **Alan Greenspan** as **Federal Reserve chairman**. Prior to these events we had expected a nomination by **Thanksgiving**. Now, with so many distractions in **Washington**, the **White House** will probably opt to ask Greenspan to stay on past the January 31, 2006 end of his term (as he is permitted to do under the **Federal Reserve Act**, in the absence of a successor). Clearly, this prolongs the market's uncertainty about the philosophy that will dominantly shape monetary policy in the future. But the more immediate threat is that it might perturb Greenspan's own philosophy with respect to the policy challenges facing the Fed through the end of the year -- what to do about a mounting **inflation** threat against the backdrop of the economic disruptions from Katrina and high energy prices. We have expected Greenspan to keep the Fed on its **"measured"** regime of **rate normalization** through the end of the year. Until now that meant Greenspan would end his career on a fittingly orderly note, with rates at a level approximating a tidy **equilibrium**. If Greenspan finds himself staying in office longer, though, might there be a temptation to stretch out the path to equilibrium? If politically charged data such as **payrolls**, **retail sales**, **home sales** and **consumer confidence** start coming in soft, there will be pressure on Greenspan to pause -- both from political quarters, and from those in the **monetary policy** community who think the Fed's mission is to manipulate **aggregate demand**. Either way, pausing or stopping would be a terrible inflationary error, one which **fixed income markets** seem over-eager to think that Greenspan will make (see "Katrina and the Fed" September 2, 2005).

We point to all these things as risks and threats, and they all merit careful attention. But at this moment we don't actually expect any of them to happen. Indeed, we can point to some *good* things that have *already* happened in the wake of Katrina -- such as the release (albeit annoyingly tardy) of oil from the **Strategic Petroleum Reserve**, and the relaxation of **environmental and safety regulations** on **oil refining** and **transportation**. And there's some evidence that the post-Katrina blamestorm may not quite be getting the traction with the public that opposition politicians and the mainstream media might wish. An **ABC News** poll over the weekend shows a minority of Americans disapproving of **President Bush's** handling of the disaster, with approval/disapproval breaking down almost perfectly along predictable partisan lines.

Bottom line: We find ourselves once again in the position we were in for much of the first half of the year -- waiting out the passing of threats that we deem important yet unlikely. Just basis points away from 21-year record undervaluation, **equities** continue to accrue earnings, and earnings continue to surge. So while we wait for the equity risk premium to relax, stocks remain the king of **carry trades** (see "The King of Carry Trades" June 14, 2005). Today stocks, according to our model, are priced more than 52% below **fair value** -- offering a significant cushion against adverse developments, and significant upside when today's risks pass, as they likely will. By contrast, on the day of Worldcom's revelations in 2002, they were right at fair value, after trading *above* fair value for so many years it seemed as though **overvaluation** was

a permanent feature of equity markets. We knew then it wouldn't be permanent (see "The New High Plateau: The Valuation Conundrum" May 10, 2002), and neither will be the current era of undervaluation. TM