Higher Taxes And Good News In The Same Sentence?

One of the rewards of research in any field is finding the unexpected. Last week's discussion of the relationship between futures on the presidential election, the strength of the stock market and the price of oil was not only worthy of a "harrumph!" or two and an unattributed repetition on *Wall Street Week*, but it was intuitively pleasing. Who, after all, would have expected the President's popularity to soar in a bear market or with crude oil prices surging skyward?

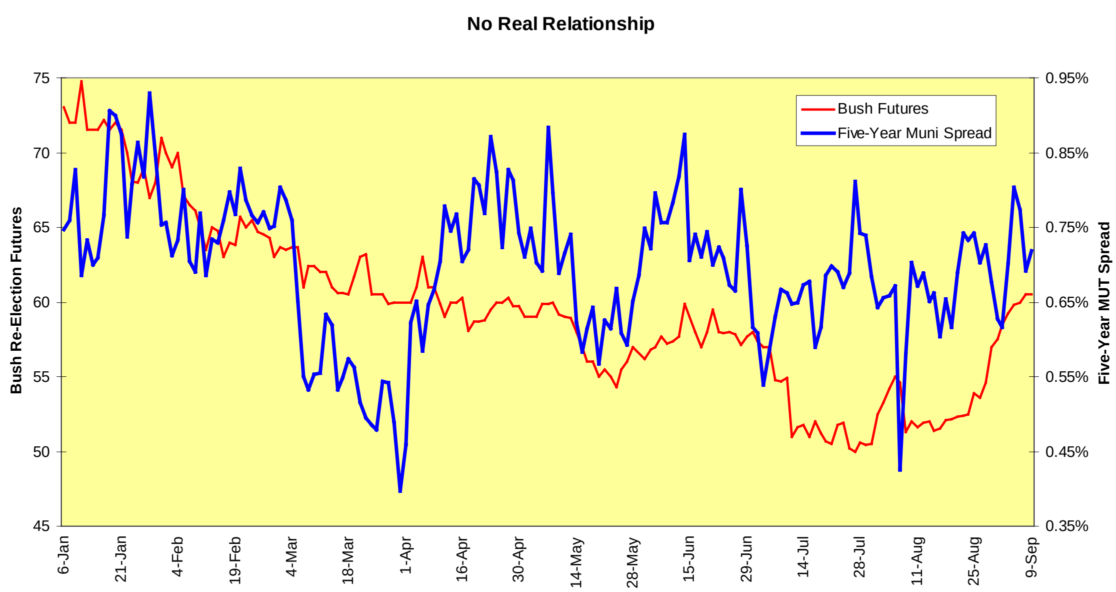
As promised at the end of that column, this scribbling will address how well spreads between municipal bonds and Treasuries deal with the relative political fortunes of the two major parties. John Kerry has made rescinding the Bush-era reductions in top marginal tax rates one of the few hard and fast distinctions of his campaign. President Bush, on the other hand, not only believes in tax cuts, but has acted on this belief more and with greater consistency than did Ronald Reagan, a president forever identified with supply side economics. The Reagan administration pushed through tax cuts in 1981, but then acquiesced to tax increases in 1982, 1983 and effectively in 1986. The Bush administration cut taxes in 2001 and 2003, and to date has resisted the temptation to invite any lip readers to the garden party.

So if the municipal-over-bond and municipal-under-ten-year (MOB and MUT, respectively; please see an earlier post from March 2004 on details) spreads move largely as a function of investors' expectations for tax rates, then it should stand to reason these spreads would constitute an effective barometer of relative political fortunes.

As one candidate might spell it, R-O-N-G!

You Cannot Find What Is Not There

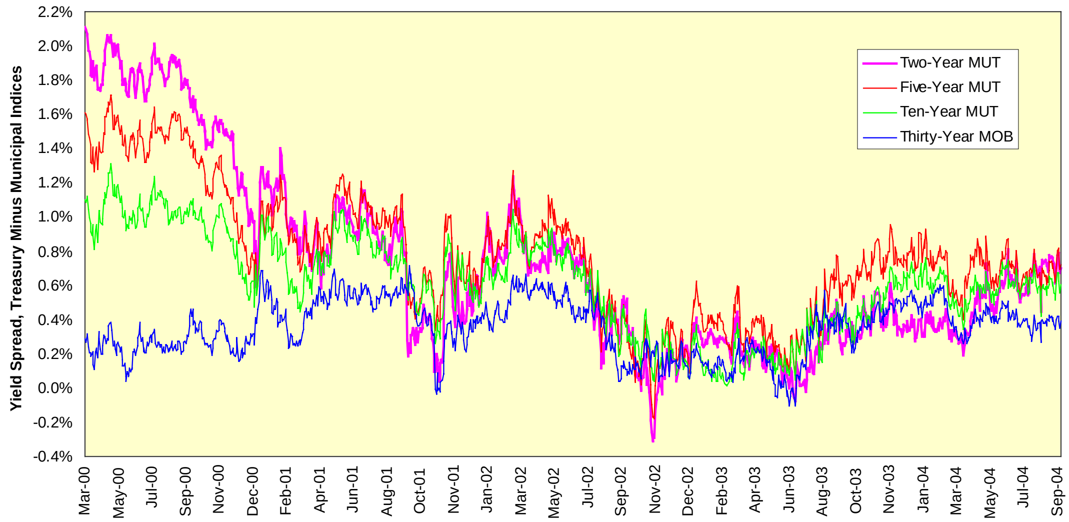
The MUT spread, depicted here as the yield differential between five-year Treasury notes and a Bloomberg generic index of AAA-rated option-free municipal bonds, should expand on the expectations of higher marginal tax rates. A taxable investment will have to yield more to be equivalent to a tax-free investment if Uncle Sam helps himself to a greater share. Why, then, did this spread contract with the Tradesport.com Bush re-election futures earlier in the year and expand along with the President's re-election chances?



Putting It Into Perspective

A *non sequitur* such as this, my friends, can quicken the pulse of a middle-aged economist like nothing else. Step One: See whether there is anything particularly unique about the five-year MUT and expand the range of inquiry from the January 2004 peak of Bush re-election futures back to the March 2000 stock market peak.

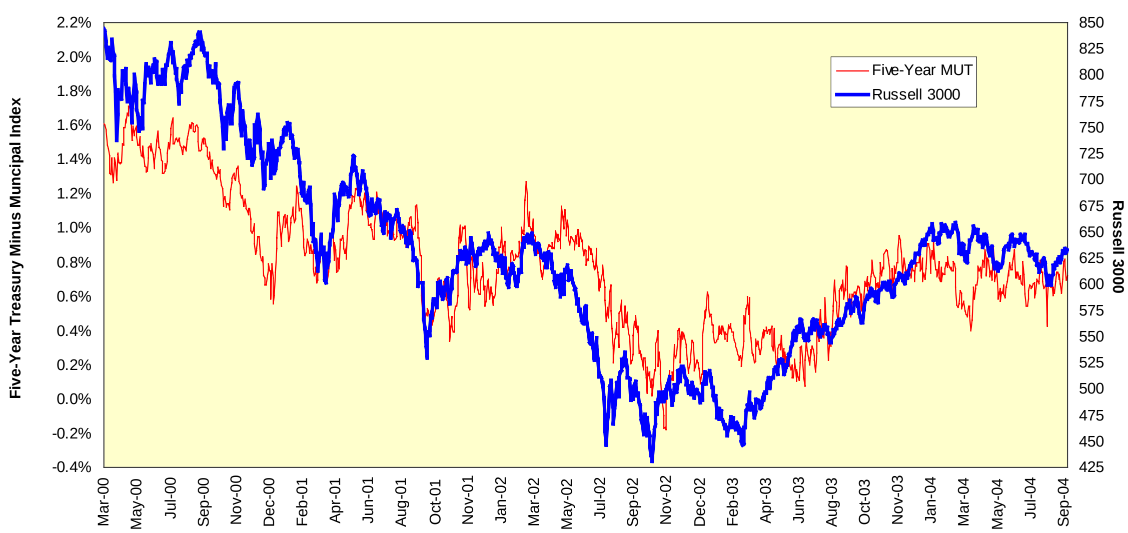
The Excitement's In The Chase



Nothing unusual shows up so far. The two- and five-year MUT spreads contracted most rapidly during the 2000 election season when it appeared that George Bush would defeat Al Gore, which he did after a five-week detour into Constitutional law. The 30-year MOB, interestingly enough, rose through this period as if to say that any tax reductions would endure for less than 30 years. The MUT spreads rose again into 2002 and then collapsed abruptly midway through that year only to recover in 2003.

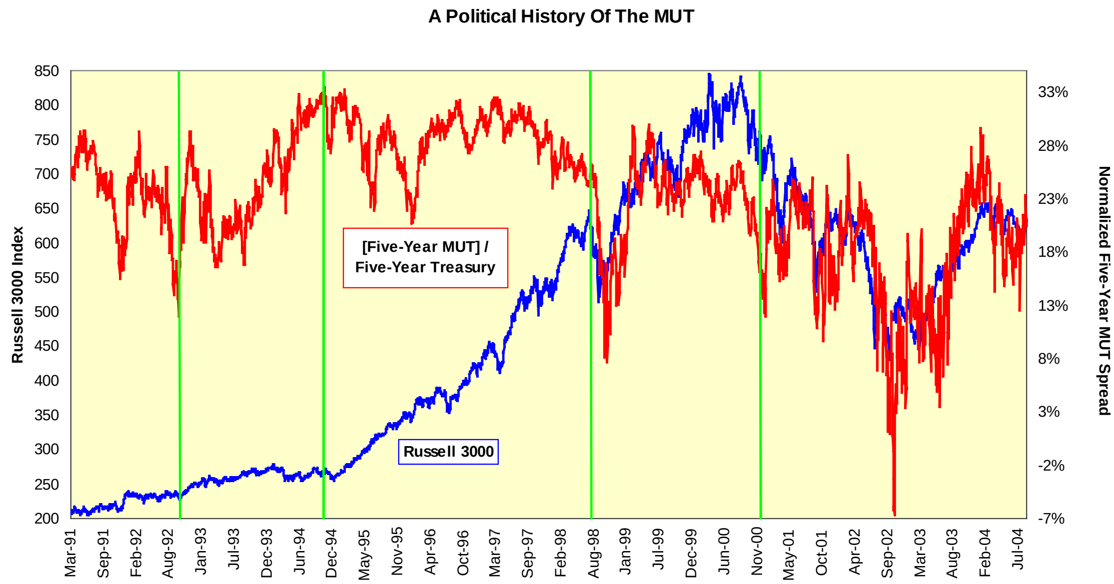
Step Two: Ask what else in your life got trashed during 2002 and recovered in 2003. Let's plot the five-year MUT against the broad-based Russell 3000 index from March 2000 onwards.

Stocks Look Like A MUT



Those two lines look more alike than the Bush twins, no? But just because two economic time series look alike does not mean a causal relationship exists, even if they have more than 1,100 data points, a statistically significant number, in the sample.

Step Three: We need to expand the history of these two series and see whether a politically consistent narration can be overlaid upon them.



Five different regimes can be identified in this history. The first, ending when Clinton's election became apparent in October 1992, was the end of the George H.W. Bush administration and its period of declining MUT spreads. The second was the first two years of the Clinton administration, which did in fact see a tax increase in 1993. This period ended with the Republican Congressional victories of November 1994.

The next period, that of divided government, saw both declining MUT spreads and the ascent of the Russell 3000 to - are you ready for this? - today's levels in July 1998. It ended on July 20, 1998, the day when Monica Lewinsky agreed to cooperate with Kenneth Starr; all further potential for fiscal initiatives out of the Clinton administration died on that day. The combine Russian/Long Term Capital Management crises caused a quick collapse in the MUT as investors fled into Treasuries.

The fourth period, characterized by federal surpluses and the final stock market boom, saw the MUT decline once again as no one expected any federal tax increase in such as environment.

The current period, that of the entire Bush administration, has seen the near-perfect correlation between the MUT spread and the stock market. The same weakening economy that hurt stocks led to both tax cuts and massively lower interest rates. The rebound in the economy since early 2003 has supported stocks, led to the current measured pace of interest rate increases and has increased expectations for higher federal marginal tax rates regardless of the election's outcome. Federal deficits approaching $500 billion have to be addressed somehow.

So, if the good news of a stronger economy and stock market materialize, so will the bad news of higher marginal tax rates. That is about as much reality as you are going to hear between now and November 2nd.