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Bulls await an extension of Bush tax cuts

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There has been a fierce tug of war between the bulls and the bears in the US stock market since the beginning of the year with no clear winner so far. All that the bears and the bulls know for sure is that they have rope burn. It might continue to be this way through the end of this year and into next.

Nevertheless, I am pulling for the bulls. Indeed, my S&P 500 targets are 1,250 by the end of this year and 1,400 by the end of 2011. This month, the bulls regained the ground they lost during the spring and summer. The S&P 500 is now up 1.8 per cent since the start of the year after being down as much as 8.3 per cent on July 2. That's quite impressive given widespread concerns about a double-dip recession in the US, a sovereign debt crisis in Europe, and a property bubble in China.

The eventual winner of the tug of war will depend on whether deleveraging puts the brakes on the global economic recovery or whether global economic growth has enough momentum to ease the burden of all the debt that has been accumulated in recent years. In past recoveries, growth bulls have always triumphed over debt bears.

Today's pessimists foresee a grim 3D scenario for the global economy: debt, deflation, and depression. In their opinion, private sector debts have become too burdensome forcing consumers and businesses to retrench. In this scenario, a deflationary debt spiral is likely. That could lead to a depression and debt defaults. Governments can't do much to avert this outcome because they've borrowed too much and risk a sovereign debt crisis if they try to borrow much more. The major central banks are also stymied since official interest rates are near zero, and can't go lower.

The naysayers believe that the current economic recovery isn't likely to evolve into an economic expansion. Recoveries morph into expansions when economic growth is self-sustaining and does not require government stimulus to keep them going. The bears rightly observe that it took extraordinary fiscal and monetary stimulus to avert a global depression in 2008 and 2009 and conclude that there is little more governments can do.

The bulls see a 3P scenario: productivity, profits, and prosperity. Companies responded to the recession by boosting their productivity. This has resulted in a remarkable rebound in corporate profits. Corporate cash flow is at a record high and corporate balance sheets are extraordinarily liquid. The global economic recovery, which started in 2009, has been led for the first time by rapidly growing emerging economies. The proliferating prosperity in these "New World" economies is boosting global economic demand, and more than offsetting subpar growth in the "Old World", that is, the heavily indebted social welfare states of Japan, the US, and Europe.

The optimists contend that recoveries usually morph into self-sustaining economic expansions as rebounding profits stimulate business spending and hiring. As employment expands, fiscal and monetary policies can turn less stimulative without threatening the expansion. Recessions are usually caused by credit crunches, which depress final demand. The downturns are exacerbated by inventory liquidation. That is what happened in 2008 and 2009. But that is not happening now.

Of course, bank lending remains depressed in Japan, the US, and Europe. However, companies with access to capital markets are raising plenty of money at record low interest rates. Sales growth may remain subpar in the Old World economies, but that won’t require another wipeout of inventory stocks.

On the other hand, sales might continue to improve as the global economy continues to rebound from the previous recession. The key driver is profits. It is profitable companies that hire workers and expand capacity.

During August, the bears seemed to be winning the tug of war because the US economic indicators released that month, for June and July, increased the credibility of the double dip scenario. However, tax incentives to buy homes and appliances expired in the spring, and census workers finished their jobs during the summer. Naturally, the pace of economic activity dropped steeply, but it is already showing signs of reviving according to September’s batch of economic indicators.

The big challenge for the bulls will be the expiration of the Bush tax cuts at the end of this year. The November 2 mid-term congressional elections will have a significant impact on whether or not all or some of the cuts are extended for at least another year. There is an increasing likelihood that the elections will result in a more conservative Congress with lots of new legislators who will be in favour of policies that are better for profits, the economy, and the bulls.

The political cycle is on the side of the bulls: the S&P 500 was up 20.9 per cent, on average and without exception, during the past 12 periods spanning mid-term elections to the end of the third year of presidential terms.

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