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POLITICAL PULSE

Down to the Wire, and Beyond

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Donald Luskin

Almost there: another 2013 risk-event with no contagion -- plus the GOP gets a do-over.

With hours to go until the dubious deadline for the not-really-first-ever Treasury debt default, a compromise solution to the shutdown and debt limit crises emerged in the Senate yesterday afternoon. This morning House leadership going to make a counteroffer. It's in the interest of the two-party duopoly to maximize this shakedown by taking it right down to the wire and maybe a little beyond. But we still think a solution will emerge, much along the lines we have expected (see, among many recently, "On Yellen for Fed Chair" October 9, 2013).

- The Senate compromise is only a stop-gap measure, appropriating funds to operate the government only to January 15, 2014 at sequester levels -- and raising (or perhaps just suspending) the debt limit only to February 7, with limits on the extraordinary measures Treasury might employ to extend that date.
- There is a bicameral budget reform committee that must report by December 13, 2013.
- There are minor tweaks to Obamacare, including income verification for subsidies (to please conservatives) and a one-year delay to the transitional reinsurance tax on self-funded plans (to please liberals, by pleasing unions).
- Reportedly the House will shoot back a counteroffer today adding suspension of Obamacare's medical device tax, and some version of repealing the Obamacare subsidy for congressional employees and cabinet members.

The give-and-take between the two chambers takes time, and time is something we don't have much of. But it strikes us that nothing the House is talking about adding here has to be a poison pill.

- The governing dynamic is that both parties and both chambers are being "jammed," by each other and by the clock -- forced to make an unpalatable decision because the alternatives are worse. It's a replay of January's American Taxpayer Relief Act (ATRA) which ended the fiscal cliff crisis (see "Tax Hikes Have Consequences" January 2, 2013).

Let's treat this as the base case, and look to the aftermath. What would all

Update to strategic view

US MACRO, US STOCKS, US BONDS, US FED: A solution to the shutdown and debt limit crises is in view, with the Senate and the House hammering out specifics as we go down to the wire and probably a little beyond. We wouldn't expect much short-term market bounce-back response when the dust settles, as markets didn't correct much as the crisis unfolded. But this will have been a learning experience for markets, in which 2013 proves be the first year in seven in which risk-events do not have to be globally systemic. That would lower the mean expected equity risk premium and enhance growth expectations, which could move stocks prices higher. Bond yields should continue to normalize higher, even if the resolution of this crisis removes a reason for the Yellen Fed to defer tapering. Long-term we think this would be a strategic win for the GOP, improving its chances in the 2014 mid-term, and in turn further enhancing expectations for pro-growth policy.

[Strategy Dashboard home]

this mean for markets short-term, and for the intersection of markets and politics longer-term?

- Short-term, probably fairly little. The reaction in markets even to extremely reckless statements by politicians -- continuing from the White House yesterday even as a deal came together in the Senate (see "Let's Hope the Politicians are Lying" October 7, 2013) -- has been quite muted.
- The drop in stocks and Treasury yields has been a small fraction of the outright bear market we saw during the 2011 US debt limit crisis -- when it was intertwined with one of the worst episodes in the euro area's debt and currency crisis (see "Once More unto the Debt Crisis, Dear Friends" September 25, 2013).
- So the passing of the crisis shouldn't trigger a significant recovery effect.
- That said, getting through this crisis would be yet another Pavlovian conditioning experience for markets in 2013, learning over and over that risk-events no longer must be assumed to be globally contagious (see "No Guns this August" August 19, 2013). Each increment of that learning lowers the mean expected equity risk premium, and sets the stage for a resurgence of entrepreneurial risk-taking that should accelerate growth and earnings considerably in 2014 (see "A Major Upgrade to our Strategic Outlook" September 12, 2013).
- *Stocks may indeed respond positively in the coming weeks to that second-order dynamic, and bonds yields should continue to march higher, back toward and beyond 3% on the 10-year.*
- Longer-term, there's another positive driver. We think that as we get a little distance on this crisis, we'll move on from today's dominant narrative that the crisis has been a setback for the GOP. It's already starting.
- *We think the crisis will in fact turn out to be a positive for the GOP. If true, the rising probability of Republican congressional gains in next year's mid-terms, and more pro-growth policy, will be additional factors contributing to more entrepreneurial risk-taking and accelerating growth*.
- It won't hurt the GOP if it turns out that a deal passes the House with predominantly Democratic votes, breaking the so-called "Hastert rule" (the House GOP can only countenance bills that command "a majority of the majority"). That "rule" has already been broken many times, indeed three times already this year with no apparent harm to the GOP or Boehner's speakership.
- Indeed, passing ATRA this way in January to end the fiscal cliff crisis was a huge win for the GOP -- raising taxes on higher incomes less than they were scheduled to rise absent the legislation, and depriving Obama of leverage in future negotiations by taking all the automatic tax hikes out of the US tax code. All the greater a victory, because in the process of collecting that win most GOP House members got to go on record voting against a tax hike.
- Compromises generally like what is currently on the table would similarly be a win for the GOP.

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Associated Press
October 14, 2013

Japan Rising: Shinzo Abe's Excellent Adventure
Barry Eichengreen
Milken Institute Review
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Krugtron the Invincible: Part 1, Part 2, and Part 3
Niall Ferguson
Huffington Post
October 8, 9, 10, 2013

Obamacare's Financial Unraveling: Predictable, and Predicted
Charles Blahous
Real Clear Politics
October 9, 2013

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- To be sure, the GOP will have come out with only trivial policy gains. But it will have gotten a few. And it will have played to its base, stayed unified, scared the president off his "we won't negotiate" position," and given away nothing -- extending government funding at sequester levels, and the debt limit, for mere weeks (with most House members able to vote against it).
- *The big win is that, unlike Obama did with ATRA, the GOP will not have given away any of its leverage.*
- *We continue to believe that the sequesters are the GOP's trump card here. In a world in which an increasing majority of government spending is entitlements on autopilot, what little is left of discretionary spending is of paramount importance for politicians looking to bring home the bacon to their districts -- and the sequesters, while small in the grand scheme of things, importantly effect that discretionary spending.*
- *In mere weeks the GOP will get a do-over. Unified through this experience and wiser for it, they can avoid the mistake of focusing on Obamacare, and instead play the trump card that is still tucked safely away in their hands - the sequesters. The goals for which the sequesters can be traded: pro-growth tax reform, and a down-payment on entitlement reform.*
- Don't think it's impossible. This is basically how the Gingrich GOP congress got a capital gains tax cut out of Bill Clinton in 1997.

How about the Fed?

- The Fed's tapering plans, whatever they are now that chair designate Janet Yellen is taking the reins, don't have to be changed by this. Deferral of tapering at the September FOMC was rationalized in part by the belief that the "fiscal debate" would trigger fears of systemic risk (see "On the September FOMC" September 18, 2013). But with a deal, that rationale expires.
- But if incoming chairman Yellen doesn't wish to begin tapering, that's her call regardless of the resolution of the present crisis.
- Either way, we continue to believe that the Fed is very far down the diminishing returns curve for quantitative easing (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). Whatever Yellen decides won't matter to markets -- yields have been normalizing higher since mid-year 2012, before QE3 even started. They will continue to normalize higher now.

Bottom line

A solution to the shutdown and debt limit crises is in view, with the Senate and the House hammering out specifics as we go down to the wire and probably a little beyond. We wouldn't expect much short-term market bounce-back response when the dust settles, as markets didn't correct much as the crisis unfolded. But this will have been a learning experience for markets, in which 2013 proves be the first year in seven in which risk-events do not have to be globally systemic. That would lower the mean expected equity risk premium and enhance growth expectations, which could move stocks prices higher. Bond yields should continue to normalize higher, even if the resolution of this crisis removes a reason for the Yellen Fed to defer tapering. Long-term we think this would be a strategic win for the GOP, improving its chances in the 2014 mid-term, and in turn further enhancing expectations for pro-growth policy.