

POLITICAL PULSE

Chaos in Athens, Progress in Washington

Monday, June 20, 2011

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A more pro-growth tone in the spending debate, and the oil peace dividend comes closer.

The world's eyes are focused on political chaos in Greece (see ["Black Wednesday in Greece"](#) June 16, 2011), and rightly so. But it would be a mistake to let that crowd out the recognition of constructive political developments on the home front.

- The soft-patch in the US economy and the correction in US stocks have corresponded with a period of political retrogression. The GOP has been single-mindedly obsessed with deficit reduction -- turning a blind eye to growth, handing Democrats an engraved invitation to insist on tax hikes, and seemingly willing to court disaster by playing chicken with Treasury debt default (see ["The Political Brick in the Wall of Worry"](#) May 27, 2011). With the GOP portraying itself as a reckless party of pain, the probability of its retaining House control fell from a high of 79% at year-end to just 50% two weeks ago, and the probability of gaining Senate control fell from a March high of 75% to just 60% one week ago (please see the chart below).
- GOP congressional control has been a linchpin of the second leg up in this bull market in stocks. It began at mid-year last year,

Update to strategic view

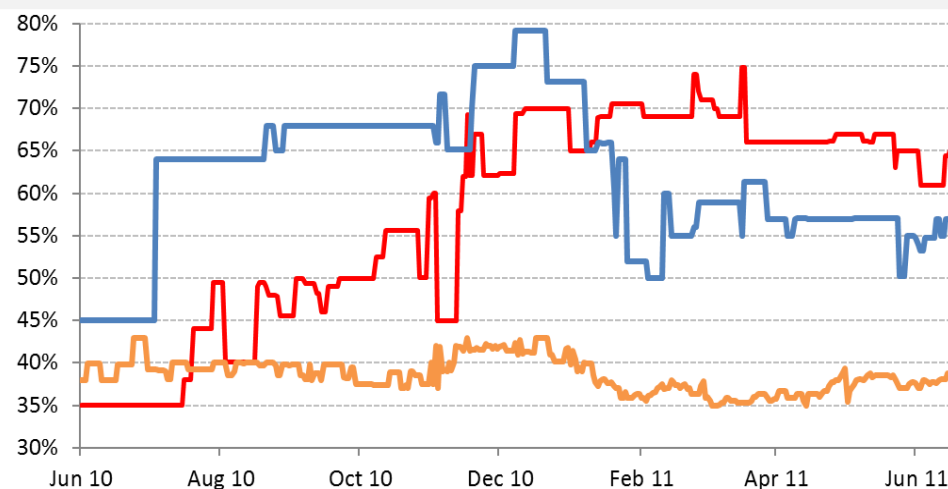
US MACRO, US BONDS:

Last week's symbolic breakthroughs on ethanol subsidies, entitlements and defense symbolize a new and more mature phase of negotiations over federal spending, and reduce the risk of a catastrophic bargaining failure that would result in a Treasury debt default.

OIL: The GOP's embrace of rapid withdrawal from Afghanistan points to a secular peace dividend in the form of lower oil prices -- we're already getting a taste of it, with oil prices down more than twice as much as stock prices in this correction.

Futures-implied probability of GOP control in 2012

— House — Senate — Presidency



Source: Intrade, TrendMacro calculations

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precisely at the same time as the GOP's chances for congressional control took a quantum leap higher (see ["Good Week for Growth"](#) July 26, 2010).

- The GOP's probability of congressional control recovered significantly last week, on the strength of several seemingly small but nevertheless positive developments. They are important in substance and as symbols, because each one represents a breakthrough in grappling with various "third rails." These are the issues thought to be politically untouchable -- some for the left, some for the right -- but all necessary to be put on the table for any useful headway in a pro-growth solution to the deficit and the debt.
- The Senate [voted overwhelmingly](#), on a bi-partisan basis, in favor of eliminating subsidies for ethanol, and of eliminating import tariffs on foreign ethanol.
 - This issue has usefully forced Republicans to reiterate their commitment to not raising taxes -- ironically, because the ethanol subsidy is currently structured as a tax credit, so raising it would [technically be a tax hike](#).
- The AARP, the powerful seniors' lobbying group, [let it be known](#) that it would no longer oppose all Social Security benefit reductions. Dick Durbin (Dem-IL) [said](#) he was in favor of making changes to Medicare.
- The administration [said](#) it believes that al Qaeda has become significantly weakened in Afghanistan by Osama bin Laden's death, and now the US [is in negotiations](#) with the Taliban. In the GOP debates, front-runner Mitt Romney [said](#) he would support the earliest possible withdrawal of US troops from Afghanistan, and he has since been [joined](#) in that view by fellow aspirant Jon Huntsman. This puts cuts in defense spending on the table, leading to the peace dividend we have predicted (see ["The bin Laden Commodities Crash"](#) May 6, 2011).

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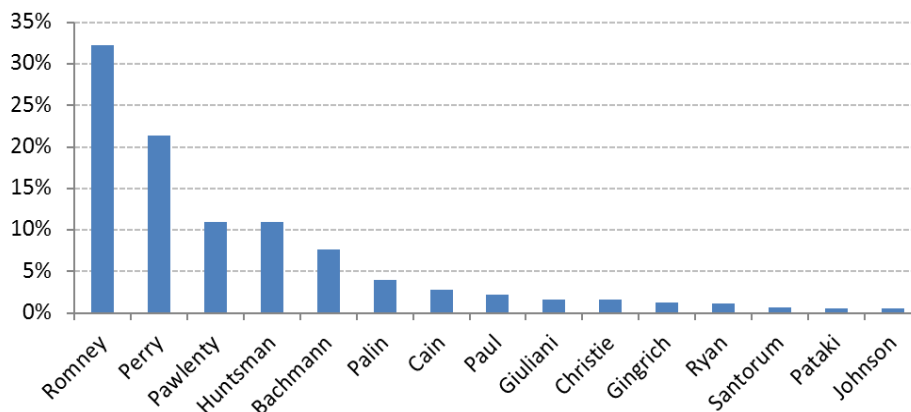
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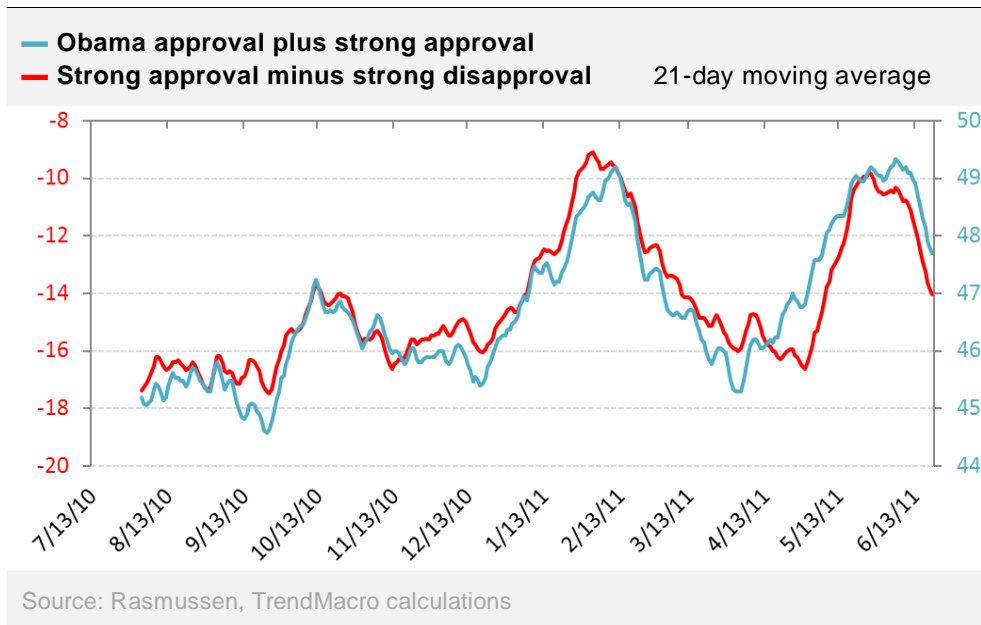
■ Futures implied probability of GOP presidential nomination



Source: Intrade

- A GOP embrace of withdrawal from Afghanistan is especially significant because it requires the GOP both to implicitly give credit to Obama for "winning the war on terror," and to pull back

from full utilization of a signature policy position that is presumably very popular among its base. Perhaps the GOP is willing to move in this direction because, after a brief bump, Obama's approval ratings have fallen back to about where they were before the death of Osama bin Laden (please see the chart below).



- This has key growth implications because, we believe, reduction in US combat presence in the Middle East would be a catalyst for a secular decline in the oil price, as the geopolitical risk premium is gradually reduced -- leading to a double peace dividend, one in defense spending and another in energy prices (again, see ["The bin Laden Commodities Crash"](#) May 6, 2011).
- Starting exactly on the day of the announcement of bin Laden's death, the oil price has now already fallen all the way back to pre-"Arab spring" levels. This has coincided with a general back-up in "risk-on" trades overall (see ["The Post-Osama Slow-Motion Drip-Down"](#) June 10, 2011) -- suggesting oil's drop has been driven by growth risks. Thus, at least directionally, the oil price has been endogenous (that is, an effect of growth, not a cause). But in terms of magnitude, with oil falling more than twice as far as equally growth-sensitive stocks -- it would seem it has been exogenous, too (a cause of growth, not an effect). We think this will be revealed further when stocks find their bottom and recover -- with the oil price recovering less.

Last year, after the GOP took control of the House, we argued that while political gridlock would not likely produce strong pro-growth policy outcomes, it at least assured an end to the onslaught of large-scale destabilizing (and anti-growth) policy initiatives the economy had to endure in 2009 and 2010. Not ideal, but an important difference -- and in economics and markets, differences make a difference (see ["Stock Outlook: Differences Make a Difference"](#) November 10, 2010). And the GOP, even only with control of the House, can use its ability to threaten to

block must-pass legislation to achieve important pro-growth results -- that's how the Bush-era tax rates got extended (see ["Tax Cut Endgame"](#) December 13, 2010).

Last week's developments recounted here appear to signal a new phase in the negotiations over spending, where the game of chicken matures into a serious negotiation. That in and of itself is a good thing, because it would serve no one if bargaining were to break down catastrophically, resulting in a Treasury debt default. Instead, we will likely end up with baby-steps down the long road to spending reduction -- a disappointment to those who feel that salvation lies in immediate and drastic cuts, and a relief to those who fear that such cuts would cripple the already weak economy (we have many clients who feel adamantly about both views).

Bottom line

Last week's symbolic breakthroughs on ethanol subsidies, entitlements and defense symbolize a new and more mature phase of negotiations over federal spending, and reduce the risk of a catastrophic bargaining failure that would result in a Treasury debt default. The GOP's embrace of rapid withdrawal from Afghanistan points to a secular peace dividend in the form of lower oil prices -- we're already getting a taste of it, with oil prices down more than twice as much as stock prices in this correction. ▶