

POLITICAL PULSE

Stand Down

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Donald Luskin

The Gang of Six and the McConnell compromise: paths to peace with honor in the debt war.

At this point our best hope for the drama in Washington over raising the debt ceiling is that a default or shutdown can be avoided, and that the GOP doesn't do too much violence to the cause of pro-growth policy going into the 2012 elections. So far so good on that. The two feasible solutions now on the table -- the Gang of Six program and the McConnell compromise -- are both versions of a mutual stand-down, peace with honor. Though this amounts to a defeat for the most visible GOP spending hawks, based on tracking polls and evidence from online political futures markets, the GOP's chances for 2012 have only been improving (please see the charts below).

Update to strategic view

US MACRO, US STOCKS, US BONDS:

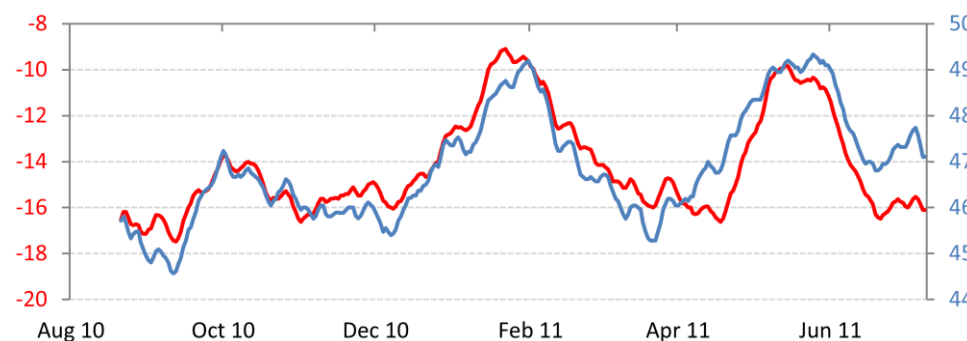
The Gang of Six program and the McConnell compromise have both opened the door to a disengagement from the dangerous game of brinkmanship surrounding the urgent need to raise the debt ceiling. Either way, default and shutdown will likely be avoided, and with the Gang of Six program, a rating downgrade might be avoided too. Now highest on investors' worry list, resolution should break the mood of pessimism that has kept stocks from new recovery highs, and has suppressed Treasury yields.

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— Obama approval index — Obama approval rating

Daily, 21- day moving averages

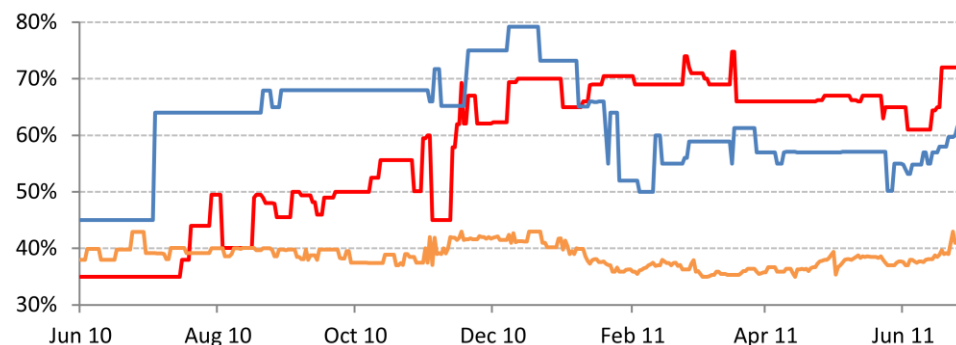
Source:: Rasmussen, TrendMacro calculations



Futures-implied probability, GOP control 2012:

— House — Senate — Presidency

Source Intrade



- The [Gang of Six program](#) so far consists of nothing but [5-pages of bullets](#), a [PowerPoint presentation](#) and [some simple charts](#). It is not entirely without substance, but it is hardly the "grand bargain" that both sides say they want (and that the country ultimately needs).
- It claims to cut deficits by about \$4 trillion over ten years (depending on what baseline is used), But only \$500 billion over three years would be immediately legislated -- and the particulars are only vaguely specified. On the plus side, among the few known particulars would be the repeal of [the CLASS Act](#) within Obamacare. On the negative side, though this isn't proposed explicitly, we infer with confidence that the inflation adjustment for tax brackets would be diluted through use of chained CPI -- a modest tax hike, but one that would compound over time.
- The rest of the program -- what takes \$500 billion to \$4 trillion -- is a set of vague undertakings to figure out how to cut spending in various ways, and to reform the tax code. There is nothing bold or substantive in terms of entitlement reform -- remember, Obama has endorsed it.
- The proposed tax reform has seemingly attractive elements -- such as capping personal and corporate taxes at 29%, and eliminating AMT. But at the same time, it appears -- but it's not crystal clear -- that growth-critical dividends and capital gains would be treated as ordinary income, that is, taxed at a top rate of 29%. Conservative influencers are being told *sub rosa* that the rate will be 20%, but this could be a significant negative in our view. We need to be careful here in any event -- remember, *the purpose here is to raise revenues*: in Congress's framework of static analysis, it's hard to do that without a net tax increase.
- So overall, the Gang of Six program allows everyone concerned to say they've done something significant, but the reality is that the near-term impact would be quite modest -- and it would be unclear whether or not there would ever really be any long-term impact at all, and if so, what it would consist of. This is why we believe, at base, that the Gang of Six program is primarily a way for all the combatants to honorably disengage.
- *That said, the ambitious if hollow claims of the Gang of Six program may be sufficient for Standard & Poor's to withdraw [its threat](#) to strip the US's AAA rating.* We don't see a lot of real-world impact from a downgrade anyway -- but avoiding it would be all to the good.
- [The McConnell compromise](#) is *nothing but* a strategy for disengagement -- and a very clever one. It would vest the president with the power to raise the debt ceiling unilaterally through early 2013, but this power would be subject to congressional disapproval. Congress *would* disapprove -- allowing Republicans to go on record as voting against raising the debt ceiling. Obama would veto the legislation embodying the disapproval, and thus the debt ceiling would be raised, but without GOP complicity.
- This would set up the 2012 election as a referendum on debt and spending, with Obama positioned as the champion of spending, and the GOP positioned as the champion of frugality. While Obama may not relish that prospect, he would be hard pressed now to veto

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a bill that gave him the power to raise the debt ceiling with so few strings attached.

- *Even though the McConnell compromise would probably lead to a ratings downgrade, it is our preferred path.* We'd rather go into the 2012 election with a clean slate, enabling more substantive tax and spending reform after the election with a more pro-growth Congress.

Gone are our hopes for a substantive solution (see ["Chaos in Athens, Progress in Washington"](#) June 20, 2011). But with either of these two options for standing down within grasp, we think we can expect to avoid any of the several train wrecks that have been in prospect.

- Perhaps the worst would have been if the extreme elements of the GOP -- [exemplified by Michele Bachmann](#) -- got their wish and actually prevented the debt ceiling from being raised. Even if default and shutdown were avoided somehow, it would only be with some combination of sudden and drastic spending cuts and tax increases. This path leads to economic and political suicide.
- The other would be if the GOP, even if for the sake of a sincere desire to cut deficits and debt, had acquiesced to a deal significantly raising taxes (see ["The Political Brick in the Wall of Worry"](#) May 27, 2011).
- Finally, it would have been a train wreck if the GOP had blinked -- that is, had agreed to raise the debt ceiling, while getting absolutely nothing for it. That would have shattered the GOP's chances in 2012 -- and sent a signal to markets that there was absolutely no political will to deal with US debt.

The debt ceiling -- with all its intertwining economic and political impacts -- has vaulted to the top of the worry list among our clients. That's quite a statement, as there are a *lot* of things competing for the honor (see ["Tear Down This Wall of Worry"](#) May 20, 2011). From our standpoint as analysts, the situation is worrisome because it is the most opaque political process we have seen in a decade. Yet as we get near the denouement, we are increasingly confident that there will be a satisfactory result. No "grand bargain" -- but no train wreck. The resulting release of tension could go a long way to breaking the pervasive mood of hopelessness that has dogged markets over the last quarter.

Bottom line

The Gang of Six program and the McConnell compromise have both opened the door to a disengagement from the dangerous game of brinksmanship surrounding the urgent need to raise the debt ceiling. Either way, default and shutdown will likely be avoided, and with the Gang of Six program, a rating downgrade might be avoided too. Now highest on investors' worry list, resolution should break the mood of pessimism that has kept stocks from new recovery highs, and has suppressed Treasury yields. ▶