

TRENDMACRO LIVE!

On the Debt Ceiling Deadlock

Monday, July 25, 2011

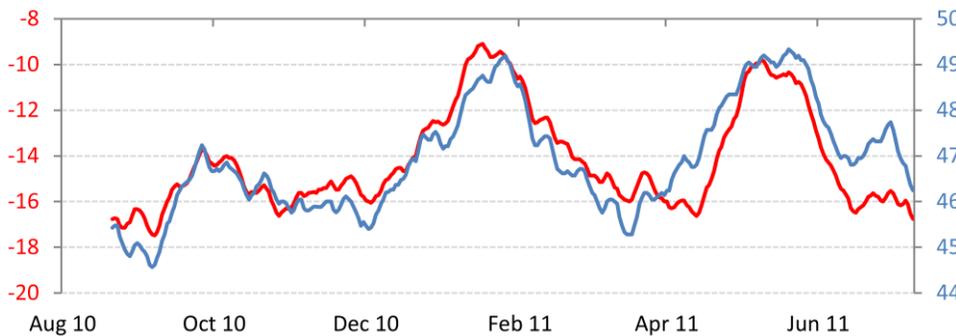
Donald Luskin

The bargaining asymmetries are clear now -- a favorable resolution is within reach.

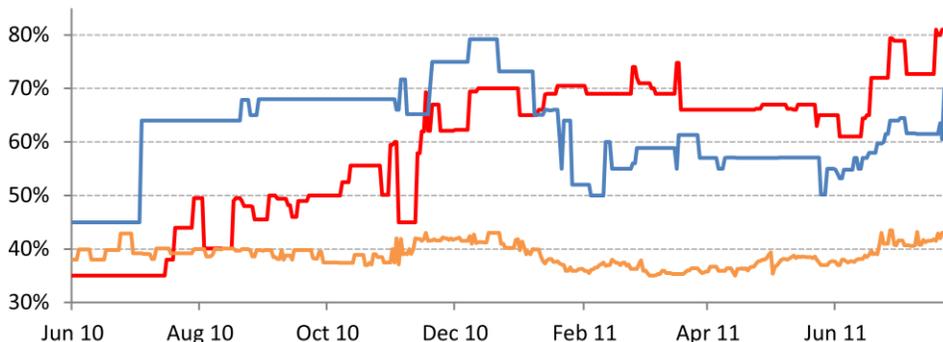
As of this writing stocks are lower in reaction to Friday's deadlock in Washington over raising the debt ceiling. Yet we see the most recent political developments pointing more, not less, toward a mutual standing down (see "[Stand Down](#)" July 21, 2011). Indeed the game theory dynamics suggest something slightly better -- not only the avoidance of default or shutdown, but also modest spending cuts and no new taxes.

- The key is that this process is proving to be a loser for President Obama. *He needs to get out of it.* Polls (please see the charts below) show clearly that it was a mistake for him to involve himself

— 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



Update to strategic view

US MACRO, US STOCKS, US BONDS:

Friday's apparent breakdown of bargaining in the debt ceiling negotiations reveals the underlying game theoretics. At this point Obama is stuck in a negative-sum game where his highest result is simply to get out. Boehner and the GOP are still playing a positive-sum game where he will score points with his base, come what may. This bargaining asymmetry means that a mutual standing down should be achieved, avoiding default or shutdown, and with modest spending cuts and no new taxes. 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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in these negotiations so deeply -- or that his involvement is not seen as constructive.

- The process has often been called a [game of "chicken."](#) But from Obama's perspective, it has turned instead into another game theory construct -- [the "dollar auction"](#) -- a negative-sum game in which the best you can do is get out as cheaply as possible.
- Thus Obama's [unseemly anger](#), and his insistence over the weekend, [through Treasury Secretary Geithner](#), on a debt ceiling hike that will carry across the 2012 election (even though most debt ceiling hikes, [historically](#), have in fact been much shorter-term than that). *This means that, at this point, Obama's definition of winning is just not having to play this game again.*
- If this is all that Obama wants -- *needs* -- at this point, then House Speaker John Boehner is correct to do what he said he'd do in [his statement](#) Friday evening -- carry on future negotiations with Senate leadership. Obama will agree to anything they come up with.
- From Boehner's perspective, this is not the same negative-sum game that it is for Obama. Win, lose or draw, he is representing the deeply held views of his party's base, and he will at least get credit for that. To be sure, at the same time he runs the risk of being blamed for a default or shutdown -- but on that score he is on even footing with Obama.
- *With this net imbalance of bargaining power, we would expect a resolution this week that extends the debt ceiling in time to avoid default or shutdown -- in exchange for modest spending cuts, and requiring no new taxes beyond a few symbolic loophole-closers (see ["Chaos in Athens, Progress in Washington"](#) June 20, 2011).*

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Bottom line

Friday's apparent breakdown of bargaining in the debt ceiling negotiations reveals the underlying game theoretics. At this point Obama is stuck in a negative-sum game where his highest result is simply to get out. Boehner and the GOP are still playing a positive-sum game where he will score points with his base, come what may. This bargaining asymmetry means that a mutual standing down should be achieved, avoiding default or shutdown, and with modest spending cuts and no new taxes. 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. ▶