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POLITICAL PULSE

What Could Possibly Go Worng?

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Donald Luskin

Crisis in Europe avoided. Now we look to the coming year-end tax/debt crisis in the US.

As we talk to clients, we now get pretty complete acceptance of our thesis (see "Europe's Wall of Liquidity" December 21, 2011) that the crisis in Europe would be -- and now actually has been -- forestalled by the ECB's two 3-year Longer-Term Refinancing Operations (LTRO). So now, with the world saved by LTRO, whether it's from shell-shock or just an abundance of caution, the question we hear most often is: *from here, what can go wrong?*

There are many obvious candidates, such as a military event concerning Iran. And there are still some risks in Europe, which we will cover in a subsequent report. But the issue we're thinking most about now is one that isn't a risk at all -- it's sure to happen. Even if it turns out well, the path to a good outcome will be a dangerous one, and just the act of traversing it will likely spook markets.

It's all about US politics. At this point it seems likely that President Obama will be re-elected, that the House will stay under GOP control, and that the GOP will get control of the Senate (please see the chart on the following page). The GOP's prospects have been weakening since the stock market bottomed in October. Since then, as stocks -- and sentiment about the economy -- have improved, the GOP's chances have fallen sharply. Apparently, it's the economy, stupid.

Update to strategic view

US STOCKS, US BONDS, US MACRO: After the election, the lame duck session of congress will have to deal with the expiration of the Bush era tax rates, the onset of new taxes on capital mandated by Obamacare, and -- perhaps most critical -- raising the statutory debt ceiling. Depending on the outcome of the election and the state of the economy, we could face a catastrophic bargaining failure that would result in massive tax increases and a US debt default -- at the same time.

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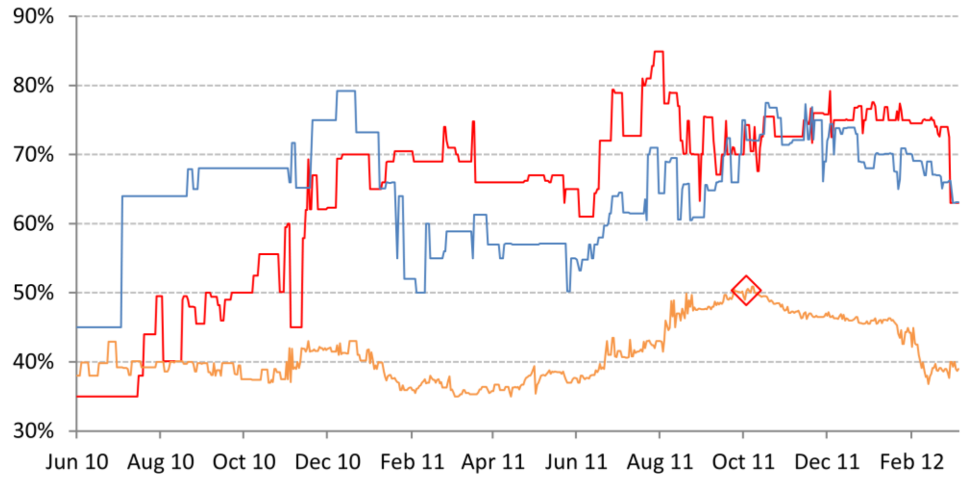
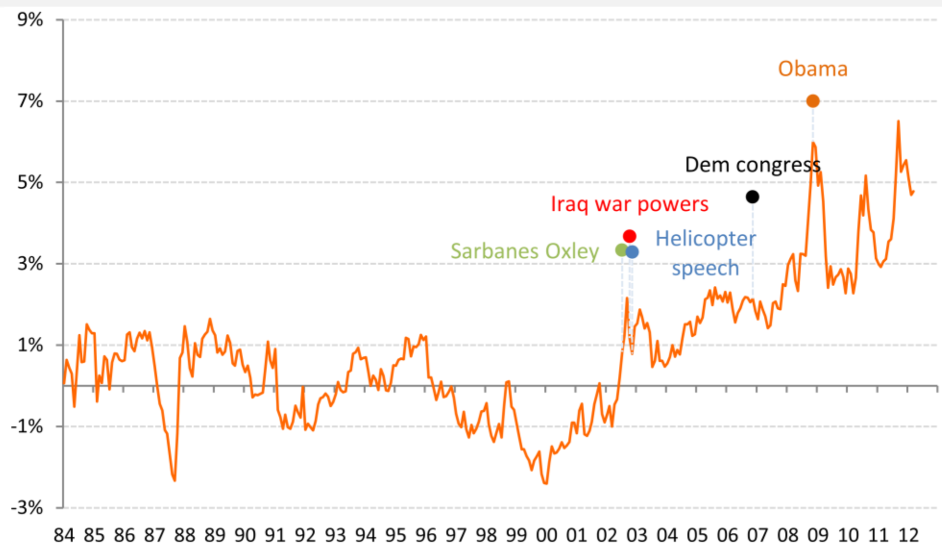
Futures-implied probability of GOP control
Presidency ◇ Stock market bottom Senate House



Source: TrendMacro calculations

- Curiously, the rising stock market will potentially re-elect a president and install a congress whose agenda, including imposing higher taxes on capital, is very unfriendly to the stock market.
- All the more so since Obama's re-election would be seen as the electorate's affirmation that his anti-growth policies have worked -- and a mandate for more of the same.
- This implies an equilibrium level for stocks that would extend the regime of the very high equity risk premium of the past decade of heightened political risk -- which has become especially elevated since the Democrats took congressional control in 2006 and Obama became president (please see the chart below). By the way, we fully acknowledge that the leading GOP contender for the

S&P 500 equity risk premium, at month-end • Political shocks



Source: Various, TrendMacro calculations

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presidency leaves much to be desired in the domain of pro-growth policy.

There are two developments that could turn this situation into a serious market-impacting crisis this year.

- If the GOP fails to gain control of the Senate *and* loses control of the House, it would be a strong negative surprise. We see that as *very* unlikely and therefore not worth worrying about (but that's what "surprise" means).
- What really worries us is how the existing congress and the president will deal with several critical economic issues that will have to be processed after the election in the lame duck session.
- *The more commonly discussed of these issues is that the low Bush era tax rates are set to revert to worse than Clinton era levels at year-end.* Failure to preserve the present rates on dividends and capital gains would be a serious blow to valuation. We would roughly estimate that first-order arbitrage effects alone should be worth about 10% on the S&P 500. Second order impacts on growth are probably worth more. Failure to extend the current income tax rates for the "middle class" would be an immediate catastrophe, without doubt triggering a serious recession (see "The Double-Dip Doomsday Machine" September 21, 2010).
- The Bush era tax rates were extended in the lame duck session of the last congress, in which Democrats controlled both chambers. It could be done because there was a bipartisan consensus that it would be foolish to raise tax rates when the economy is weak, especially for the "middle class." The GOP minority in the Senate used the threat of filibuster to include the "rich" in this analysis, threatening a tax hike for all unless the existing rates were preserved for all.
- The same game theory tactic could be applied this year, with even more force since the GOP now controls the House (it didn't in the 2010 lame duck session). But there could be difficulties. For the GOP it will be a harder case to sell to the extent that the economy is perceived as stronger than it was in 2010.
- At the same time, the GOP-controlled House, in one sense a source of negotiating leverage, is also a source of weakness here because of the obsession with deficits among the freshman members. They may insist not only that the Bush era tax rates be extended, but that they be paid for with spending cuts. That combination may be too big a pill for the Democrat-controlled Senate and the president to swallow, which could lead to a catastrophic lose-lose bargaining failure.
- Raising the stakes is the fact that a 3.8% surtax on dividends and capital gains mandated by Obamacare will kick in on January 1, 2013. This, too, would have first-order and second-order effects on growth -- especially if layered on the failure to extend the Bush era tax rates. It will surely be thrown into the mix of demands by the GOP.

- *There's another issue that we think isn't getting enough focus by investors: the next hike to the statutory debt ceiling will almost certainly have to occur in the lame duck session.*
- To be clear at the outset here, our concern is *not* that the debt ceiling *will* be raised -- it is that it *won't*. The debt ceiling absolutely *must* be raised. It has nothing to do with the necessary and difficult work of cutting government deficits. It is about being able to make good on commitments that already exist, that is, *to avoid the catastrophe of default.*
- Unlike the hikes prior to the election, this one will not be administered under a negative consent regime temporarily established by the Budget Control Act of 2011 -- the so called McConnell mechanism -- that allows the most debt-averse Republicans to vote against it, without actually preventing it. This time, if it is to happen, many House Republicans pledged to vote against it will have to vote for it.
- In August sensible House speaker John Boehner barely held his caucus together to get the debt ceiling raised in exchange for the spending cuts mandated under BCA (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). If the most debt-averse members demand even more spending cuts in exchange for another ceiling hike, we think it's doubtful that a deal can get done.
- Even if it is ultimately done, it will be the result of brinksmanship as reckless as August's. The risk then of a US default -- and the horror that our government would court that risk in a political negotiation -- was surely a factor in launching stocks on what would prove to be a 20%-plus bear market. It was explicitly the reason at the margin why Standard & Poors' downgraded US debt (see "Downgrade: At Least the News is Out" August 8, 2011).
- It is not clear to us whether the fact that all these critical matters will converge at the same moment helps or hurts the chances of cutting this knottiest of Gordian knots. If negotiated all at once, perhaps the threat of failure will be so great that success must emerge -- that said, if bargaining nevertheless fails, the result would be all the worse for having everything fail at the same time.
- This will be an even more dangerous situation if the results of the November election are especially disappointing for the GOP. Facing, worst-case, an incoming House and Senate both controlled by Democrats, with a re-elected Democratic president, could -- would -- GOP leadership prevent its most ideologically driven element from leaving the incoming government with a default to deal with?

With every passing day we will get closer to having to live through this crisis. Now it seems a long way away, but someday it won't be. That said, as the election draws closer, we'll get a better idea of what the political environment and the economic backdrop will be for the lame duck session. We don't see any reason to act on any of this now. But as we learn more, that may change.

And in the meantime, we hope that the Mayans weren't right about December 21, 2012.

Bottom line

After the election, the lame duck session of congress will have to deal with the expiration of the Bush era tax rates, the onset of new taxes on capital mandated by Obamacare, and -- perhaps most critical -- raising the statutory debt ceiling. Depending on the outcome of the election and the state of the economy, we could face a catastrophic bargaining failure that would result in massive tax increases and a US debt default -- at the same time.