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POLITICAL PULSE

Light at the End of the Cliff?

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Donald Luskin

If the economy is "absolutely not fine," then Congress must absolutely not let taxes rise.

It's still too soon to make the call, but last week saw a serious potential first step down a path that would avoid the year-end "fiscal cliff" (see "What Could Possibly Go Worng?" March 8, 2012). This may go some way toward explaining the stock market's 5%-plus rally from the lows of the present correction.

It all hinges on a single word: *not*.

- Friday morning, responding to a question at a press conference following a statement on the economy, President Obama said "the private sector is doing fine."
- It was predictable that this would draw ridicule from the Romney campaign.
- The surprise was that later the same day, answering the single questions asked after a joint statement with Philippine President Benigno Aquino, Obama said, "Listen, it is absolutely clear that the economy is not doing fine."
- The wrong-footedness of the initial statement -- and the fact that it would be so maladroitly reversed the very same day -- reflects Obama's disorientation in the wake of Wisconsin Governor Scott Walker's landslide recall victory on Tuesday. We note that the next day, when the results of the recall election were known, the stock market had it's biggest one-day gain year-to-date.
- But for our purposes today, the significance of this embarassing public reversal is that it deprives Obama of an absolutely critical argument that supported his insistence on the expiration of the low Bush-era tax rates for high earners -- and the imposition of further taxes on investment income for high earners under Obamacare (see "The 2013 Fiscal Cliff Could Crush Stocks" May 5, 2012).
- *Specifically, Obama cannot get away with arguing for higher taxes if he has conceded that the economy is not strong -- because the Democratic party won't let itself be blamed for taking the risk of making a weak economy even weaker.*
- We saw this factor in play in 2010 when we faced a version of the fiscal cliff in the year-end expiration of the Bush-era tax rates. *It was Democrats -- who then controlled both houses of Congress*

Update to strategic view

US STOCKS, US MACRO, US FED: Last Friday's confession by President Obama that "the private sector is absolutely not fine" is potentially an important down-payment on Democratic concession on extending the Bush-era tax rates. That he would be forced to confess it -- and that it is true -- raises the chances of a GOP sweep of the White House and both houses of Congress in November. It's far too early to be sure, but all this points toward lowering the risk of the year-end "fiscal cliff." And it's one more reason -- though none is needed -- for the Fed to ease at the June FOMC meeting. If we see more hints from Democrats that a weak economy forbids taking the risk of raising taxes, then as the fog of war in Europe begins to clear, stocks will be able to completely recover from the present correction.

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and the White House -- who led the charge for extension, precisely because the economy was seen as too weak.

- As early as July 2010, well before the mid-term election, a few centrist Democrats started making this argument in press statements (see "Good Week for Growth" July 26, 2010). It quickly became a thought contagion among Democrats in Congress. Obama conceded he would agree to extension on election night, after the GOP won control of the House (see "The Pendulum Swings Back" November 2, 2010). By early December, when Congress formally voted to extend the Bush-era tax rates for two years -- and Obama signed it into law -- it wasn't a surprise, except for a few details (see "Tax Cut Endgame" December 13, 2010).

Obama's "not" on Friday came *after* a flurry of statements by Democrats that threatened to reawaken the same thought contagion about the riskiness of tax hikes in a weak economy.

- Kent Conrad (D-ND), the chair of the Senate Budget Committee, told *Politico* that "it might make some sense" to extend all the tax rates while Congress works on a long-term fiscal solution -- "on a short-term basis…I think something like that is going to have to be done." We take this especially seriously, because he was among the very first Democrats to come out in favor of extension in 2010.
- Former President Bill Clinton told Maria Bartiromo in a CNBC interview last Tuesday that he favored extension -- or so CNBC claimed on its website -- and this was eagerly repeated by various GOP spokespersons. According to the transcript of the interview, he did not in fact quite say it. He only said "they will probably have to put everything off until early next year." Within hours Clinton's office had released a denial and clarification.
- Similarly, on Wedesday former White House National Economics Council Chair Lawrence Summers told MSNBC that "the real risk to this economy is on the side of slowdowns…we've got to make sure that we don't take the gasoline out of the tank at the end of this year." He, too, subsequently offered a denial and clarification.
- But it was on Wednesday, after the Clinton and Summers statements -- and despite their denials -- that the stock market had its best year-to-date gain.
- For Clinton and Summers to have had to issue denials -- Bartiromo maintains that Clinton was "bullied by the White House" -- we can conclude that the administration is very afraid of having pro-extension flags run up the flagpole. That is, the White House is afraid that people will start gathering around and saluting those flags, as they did in 2010.

Now, with Obama's "not" part of the political mindscape, we'll see if the thought contagion will start multiplying. If it does, we will feel less fearful about the year-end fiscal cliff -- but we won't feel entirely safe.

- It's uncertain how a Democratic concession on the tax extension would impact the *other* equally perilous elements of the fiscal cliff --

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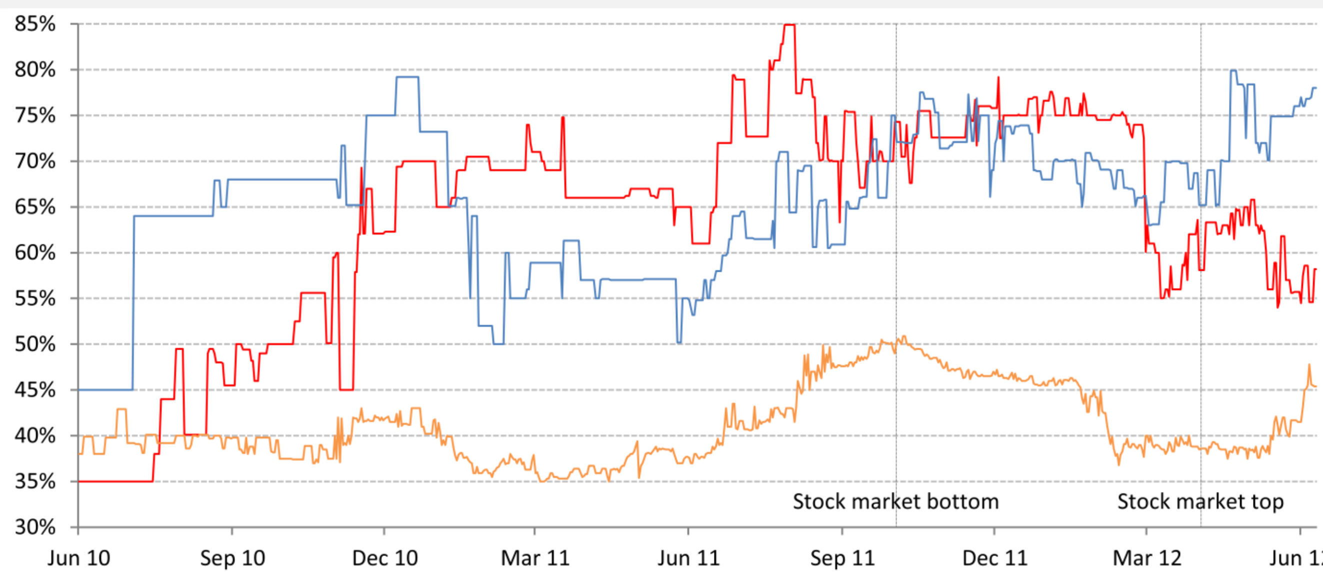
the need to raise the statutory debt ceiling, and the risk that a bargaining failure will result in a Treasury default and a government shutdown.

- On the face of it, there may be no reason to think a Democratic concession on tax extension would help. After all, tax extension wasn't on the table last August when the debt ceiling was negotiated (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). Then the political process was so bitter and so chaotic that, even after it had successfully concluded with an agreement to reduce planned spending by $1.2 trillion, Standard & Poor's neverthless downgraded the US's credit rating (see "Downgrade: At Least the News is Out" August 8, 2011).
- But there are reasons for us to speculate that the same thought contagion that would assure extension of the Bush-era tax rates might make the GOP more likely to concede on the debt ceiling.
- The debt ceiling debate hinges on the risk of blame. Neither side wants to be seen as responible for the economic effects of a government shutdown or a debt default. Having forced the Democrats to concede that the economy is weak, the GOP will be less likely to risk being seen as reckless with the debt ceiling. Especially so since the GOP will insist that spending be cut dollar for dollar with any hike in the debt ceiling -- the self-styled "Boehner principle" (see "Time Is Our Frenemy" May 24, 2012) -- and Democrats will credibly argue that spending cuts weaken the economy.
- Furthermore, thought contagion or no thought contagion, the economy is in fact weak (see "On the May Jobs Report" June 1, 2012). That itself has far-reaching political consequences: the weaker the economy, the less likely President Obama will be reelected, and the more likely the GOP takes control of the White House and both houses of Congress (please see the chart below).

Futures-implied probability of GOP control, 2012 election — **Senate** — **House** — **Presidency**



Source: Intrade, TrendMacro calculations

- It seems a reasonable guess that *if* the GOP is in control of the federal government in 2013, it will be more concilatory on the debt ceiling in the lame duck session at the end of 2012. After all, the GOP won't want to begin its turn at bat with a debt default.
- For that matter, it will be in the GOP's interest to forgo a decision on the debt ceiling in the lame duck session altogether, and take it up instead in January when it assumes control. At that point the risk of catastrophic bargaining failure would be significantly reduced.
- But Democrats could potentially force the negotiation into the lame duck session, using the Treasury's effectively arbitrary control in determining exactly when it runs out of cash. The only value for Democrats here would be to embarrass the GOP by forcing it to concede on the debt ceiling. Under the circumstances we are positing -- a GOP sweep -- the Democrats may find some value, or at least some satisfaction, in that. But it wouldn't raise the risk of a catastrophic bargainng failure very much, because the GOP would likely concede, knowing it could come back just weeks later and set things right.

Bottom line

Last Friday's confession by President Obama that "the private sector is absolutely not fine" is potentially an important down-payment on Democratic concession on extending the Bush-era tax rates. That he would be forced to confess it -- and that it is true -- raises the chances of a GOP sweep of the White House and both houses of Congress in November. It's far too early to be sure, but all this points toward lowering the risk of the year-end "fiscal cliff." And it's one more reason -- though none is needed -- for the Fed to ease at the June FOMC meeting. If we see more hints from Democrats that a weak economy forbids taking the risk of raising taxes, then as the fog of war in Europe begins to clear, stocks will be able to completely recover from the present correction.