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MACROCOSM

The Fiscal Cliff Bites

Thursday, July 12, 2012

Donald Luskin

Wall Street, Main Street, the C-suite, and the Theory of Reflexivity turned inside-out.

The question we get most often from clients in meetings and calls is: *when will the year-end fiscal cliff start mattering for stock prices?* The answer is: *now*.

- In the many dozens of client conversations we've had on the subject, we haven't heard a single client say he is selling stocks because of it.
- Yet investors *are* acting -- by *not* acting. The fact that the question is so pervasive suggests a widespread caution that has kept the correction that began in early April from resolving itself, though stocks were objectively quite undervalued even on the day of the highs (see "Sell in May and Go Away -- Volume 3?" May 10, 2012).
- We think it's beginning to show up in stock market dynamics.
- A strong rally began in the first week of June -- when a weak jobs report (see "On the May Jobs Report" June 1, 2012) forced President Obama to admit that the economy is "not fine" (see "Light at the End of the Cliff?" June 11, 2012). This reality and its admission deprive Obama and the Democrats of their claim of a strong economy, a prerequisite for letting tax rates rise after year-end.
- That rally has now stalled out, with Obama emboldened by the Supreme Court's Obamacare decision (see "On the SCOTUS Obamacare Decision" June 28, 2012), daring to boldly reaffirm Monday his commitment to a showdown with Republicans over extending today's tax rates for high-earners. This seems recklessly political, following on a fourth-in-a-row weak jobs report (see "On the June Jobs Report" July 6, 2012).
- It's not just Wall Street that is acting in response to all this, even if by not acting -- it's the C-suite, too. Caution about the fiscal cliff is holding back corporate hiring and investment activity.
- Yesterday's minutes of the FOMC's June meeting mentioned it no less than seven times. The key language is:

> …the possibility of a sharper-than-anticipated fiscal tightening in the United States…pose[s] a downside risk. …an agreement on a credible longer-term plan that put the federal budget on a sustainable path over the medium run

Update to strategic view

US STOCKS, US MACRO: The year-end fiscal cliff is now visible on the horizon. Stocks and the economy are being moved by it, in both directions, as caution drives investors and corporate capital allocators. It puts us in a trading range defined by a variant of Soros' Theory of Reflexivity: improving growth and stock prices defeat themselves by increasing fiscal cliff risk, and deteriorating growth and stock prices save themselves by decreasing it. For stocks, for the rest of the year, it's all about politics.

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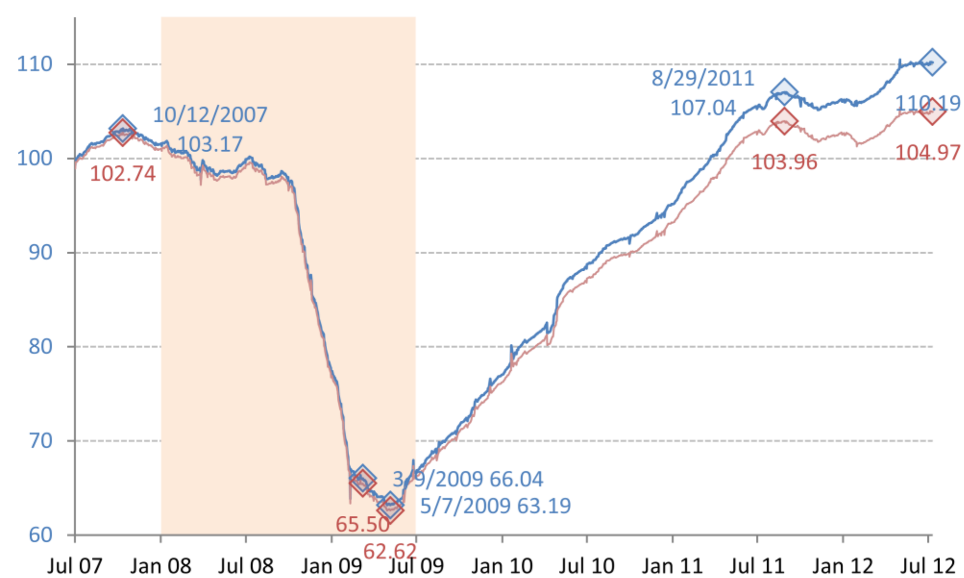
in a way that removes the near-term fiscal risks to the recovery would help alleviate uncertainty, likely would have positive effects on consumer and business sentiment, and so could spur an increase in business investment and hiring.

- This C-suite caution flows to Main Street through the channel of poor job creation. This is exactly what we were talking about last week (again, see ["On the June Jobs Report"]) when we discussed failure of business capital investment -- driven by policy uncertainty -- as the governing dynamic of our present L-shaped recovery (more precisely, we are in the flat stage of the square root sign-shaped recovery we predicted three years ago precisely at the bottom of the Great Recession; see ["The Square Root of Recovery"] July 2, 2009).
- And it flows to Wall Street through earnings. Stocks would be *more* undervalued -- and thus more attractive even to cautious investors -- if caution about the fiscal cliff weren't holding back corporate investment activity that would imply higher future earnings.
- In fact, year-ahead forward earnings per share -- our single favorite business cycle indicator -- have flattened out again, having briefly touched new highs after their stall-out in the second half of last year (please see the chart below).

Year-ahead forward EPS **S&P 500** **Snapple (S&P no Apple)**
Recession Consensus, bottom-up, cap-weighted



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

For the remainder of the year stocks will move in a trading range driven by shifts in the political winds that will marginally change expected outcomes of the year-end fiscal cliff -- just as they rose in June and are falling now. This notion is subtler than it may seem at first blush, thanks to an inside-out variant of [George Soros' "theory of reflexivity."] As [originally posited by]

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Recommended Reading

The Pre-FOMC Announcement Drift
David O. Lucca, Emanuel Moench
Federal Reserve Bank of New York Staff Reports
June, 2012

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Soros, mutually reinforcing factors in the financial markets and the real economy create accelerating positive feedback loops. In this case, we believe such factors create a *negative* feedback loop that caps the upside and puts a floor under the downside -- a trading range.

- Improvement in growth and rising stock prices heighten the riskiness of the fiscal cliff. They embolden the president and Democrats to permit tax rates to rise. And they increase the chances that the president will be re-elected, and that the Democrats will retain their Senate majority, thus aggravating the risk of another showdown on the debt ceiling getting folded into the fiscal cliff debate (see "What Could Possibly Go Worng?" March 8, 2012).
- The heightened risk reverses the very factors that created it -- growth will slow, and stocks will fall.
- But deteriorating growth and falling stock prices lower the riskiness of the fiscal cliff. They deprive the president and Democrats of the prerequisite to permit tax rates to rise. And they lower the chances that the president will be re-elected, and raise the chances that the Republicans will gain control of the Senate. This both reduces the risk of another showdown on the debt ceiling, *and* creates an option for January 2013 to quickly recover from a bargaining failure on the fiscal cliff in the lame duck session of congress.
- The lowered risk reverses the very factors that created it -- growth will improve, and stocks will rise.
- And so on…

So what we feared would happen has happened (see "Time Is Our Frenemy" May 24, 2012). The correction that began in April lasted too long, and has now joined up with the growing realization that year-end, and the fiscal cliff waiting there, isn't an eternity away -- we can see it now on the horizon. So now the US is just like Europe -- an economy and a financial market held hostage to the vagaries of politics (see "For Europe, It's the Politics, Stupid" June 27, 2012).

Bottom line

The year-end fiscal cliff is now visible on the horizon. Stocks and the economy are being moved by it, in both directions, as caution drives investors and corporate capital allocators. It puts us in a trading range defined by a variant of Soros' Theory of Reflexivity: improving growth and stock prices defeat themselves by increasing fiscal cliff risk, and deteriorating growth and stock prices save themselves by decreasing it. For stocks, for the rest of the year, it's all about politics.