

POLITICAL PULSE

Step by Step, Toward the Cliff

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As Romney flails, trial balloons from Washington point to volatility and bad compromises.

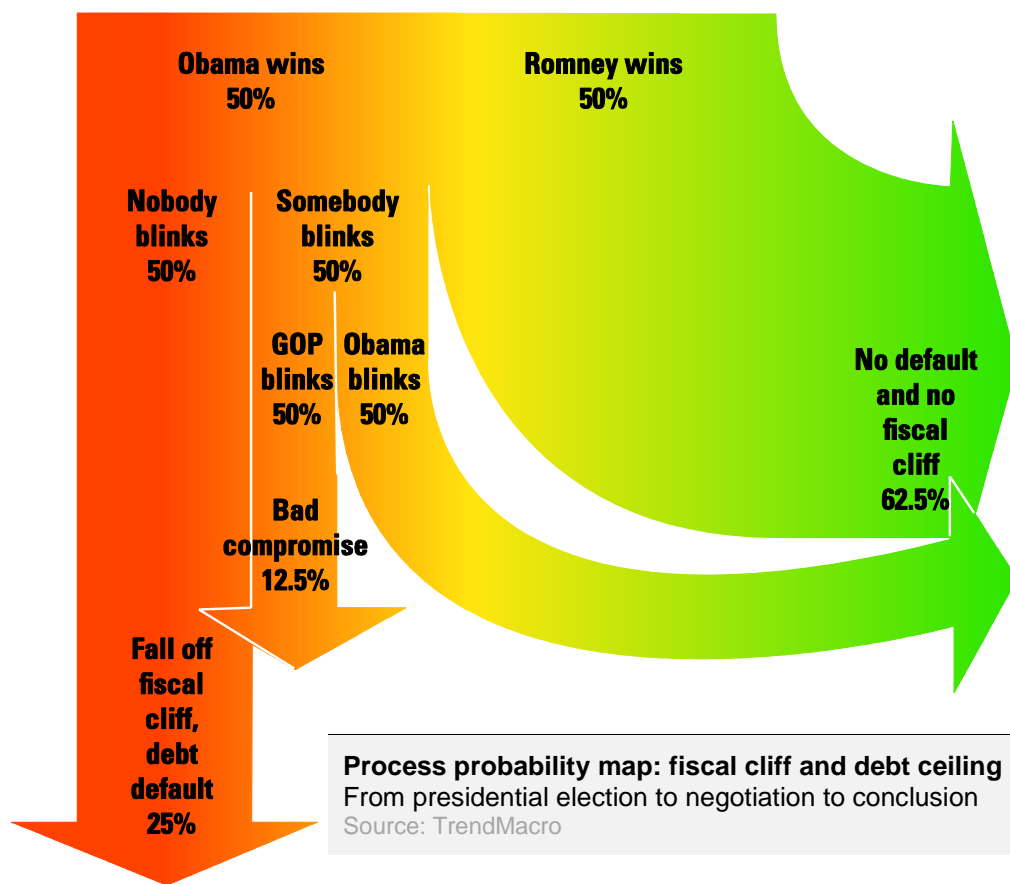
Stocks flirt with new recovery highs as the virtual impossibility of Romney/Ryan winning the election becomes the dominant narrative. There is debate about whether [President Obama's prospects are lifting stocks](#), or [vice versa](#). We are positive it is the latter. [Step by step, inch by inch](#), we are moving closer to our nightmare scenario: a rising stock market re-elects Obama, gives him a mandate, and then risks the fat-tail outcome of catastrophic bargaining failures -- or bad compromises -- over the fiscal cliff and the debt ceiling (please see the chart below; and, originally, ["The Fiscal Cliff Bites"](#) July 12, 2012; and most recently, ["On the September FOMC"](#) September 13). So last week we saw the sudden launching from Washington of a multitude of trial balloons testing ideas on how to deal with the coming crisis, some of them downright frightening.

Update to strategic view

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STOCKS: Rising stocks have bolstered approval for President Obama and diminished prospects for Romney, bringing us closer to a bargaining failure when the fiscal cliff and the debt ceiling must be negotiated post-election. A confusing flight of trial balloons last week from Washington point only to the difficulty of the negotiations. Even if a solution is found, that solution could involve very costly compromises, and in any event there will likely be enormous uncertainty along the way. We urge preparedness, in expectation of a major volatility episode.

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- Assistant Senate Majority Leader Richard Durbin (D-IL) -- usually stridently liberal, and now among of the ever-changing membership of the so-called "[Gang of Six](#)" -- is [reportedly](#) "floating a six-month extension of current [tax] rates combined with budget cuts so lawmakers have time to reach a grand bargain deal early next year." Durbin is also [advocating](#) that the Senate deal now with a plethora of "extenders" -- tax provisions for corporations that expire each year.
- That's about as optimistic as the news got last week. Durbin's procedural suggestions fall far short of the strong pro-extension position that leading Democrats took in 2010, the last time the Bush era tax cuts were facing expiration. And Durbin was immediately contradicted by the White House [repeating](#) Obama's [promise](#) to veto any bill extending the Bush era tax rates for "the rich."
- The [extremist](#) Democratic view calling for a deliberate jump off the fiscal cliff was endorsed last week by [Laura D'Andrea Tyson](#), a mainstream economist who was CEA and NEC chair during the Clinton administration.
- A *Washington Post* story [reported](#) that "Senior Republicans say they will be forced to retreat on taxes if President Obama wins..." The story was based on a single contextless quotation from a single GOP senator -- and House Speaker John Boehner (R-OH) [responded](#) immediately with a strong refutation.
- At the same time, a different "Gang of Six" senators has sent [a letter](#) to Majority Leader Harry Reid urging cancelling the automatic budget sequestrations beginning in 2013, agreed under last year's Budget Control Act (see "[Debt Ceiling Crisis Over -- Now What?](#)" August 2, 2011). The letter warns of the "devastating impact" of "indiscriminate across-the-board defense cuts" -- even though real defense spending today is higher than the peak of Reagan's Cold War build-up. Signed by John McCain (R-AZ) and Lindsey Graham (R-SC) -- among the GOP's least reliable supporters of low tax rates -- the letter's call for a "balanced" approach to "deficit reduction" can be [decoded](#) as a call for the GOP to cave on extending the Bush era tax rates.

We don't see any of these trial balloons -- some pointing to good compromise by Democrats, some to bad compromise by Republicans, and others to a clash of absolutes -- as conclusive, one way or the other. *Indeed, the confused and contradictory nature of them highlights the magnitude of the negotiating challenge ahead.* Nevertheless, these are the kind of emanations that we are forced to study in real time and in depth, to make an actionable call on how the coming crisis of the fiscal cliff and the debt ceiling will play out.

- Bear in mind that none of this will matter as much if Romney wins in November. To a large extent, we are bracing for what might happen if he doesn't. It's still too early to tell -- but at the moment it looks like he won't, so preparedness is sensible.
- Also bear in mind that even if Obama wins, there remains a chance that everything will work out fine -- as a strong majority of our clients indicate they expect.

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[Putting a Face on America's Tax Returns](#)
Tax Foundation
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[Economic Freedom of the World](#)
2012 Annual Report
Fraser Institute

[A time of hoarding and inflation fears, 1930s edition](#)
Izabella Kaminska
ft.com/alphaville
September 24, 2012

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- However, we still urge caution and preparedness.
- Things might work out -- but not work out "fine." If the GOP compromises on expiring tax rates on dividends and capital gains, that would keep us from flying headlong off the fiscal cliff but would still be very bad for equity valuations in the short term (see ["The 2013 Fiscal Cliff Could Crush Stocks"](#) May 5, 2012) and growth in the long term.
- Even if things truly work out fine, the process of getting there will likely be drenched in brinksmanship. *So even a successful ultimate conclusion could entail a dangerous episode of volatility along the way.*

Bottom line

Rising stocks have bolstered approval for President Obama and diminished prospects for Romney, bringing us closer to a bargaining failure when the fiscal cliff and the debt ceiling must be negotiated post-election. A confusing flight of trial balloons last week from Washington point only to the difficulty of the negotiations. Even if a solution is found, that solution could involve very bad compromises, and in any event there will likely be enormous uncertainty along the way. We urge preparedness, in expectation of a major volatility episode. ▶