Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

POLITICAL PULSE

What if Romney Wins?

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Donald Luskin

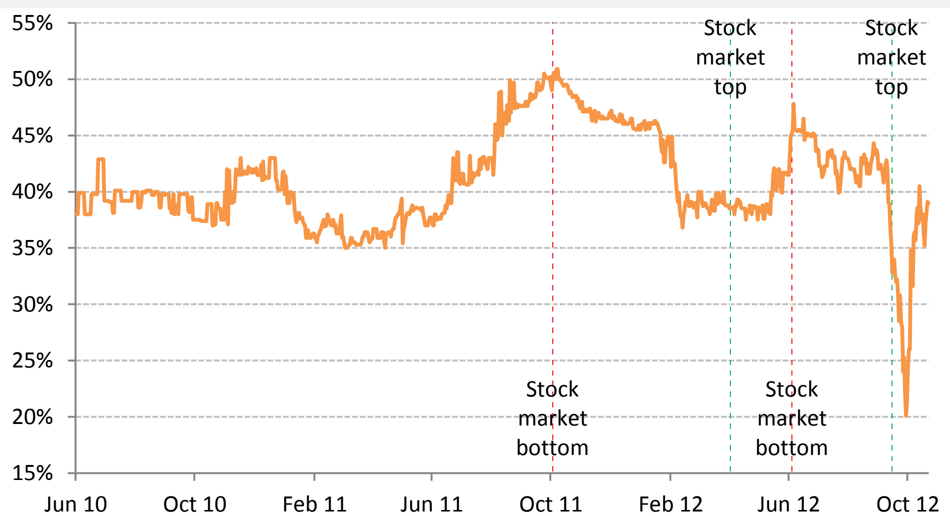
Worst-case cliff scenarios come off the table, but considerable uncertainties would remain.

Our discussions of the large volatility event coming after the election -- as the fiscal cliff and debt ceiling negotiations begin -- have focused on the worst-case scenarios arising from President Obama being re-elected (see "Step by Step, Toward the Cliff" September 25, 2012).

- With an Obama victory, the risk is that a lame duck president, winning an election perceived as a referendum on economic policy, would take the hardest possible bargaining position. Indeed, after a widely read *Washington Post* story made much the same point last Thursday, the White House repeated Obama's pledge to veto any extension of expiring tax provisions if it includes high-earners.

But what if Mitt Romney wins? At this moment he's not the favorite -- neither by the balance of the polls, by the political futures markets, nor by the structural logic of economics and incumbency in our election model (see "TrendMacro's Election Model" September 28, 2012). But he's not a long-shot anymore, either. If -- and it's a big if -- he can maintain the momentum of the last several weeks, he could win. And *maintaining*

Futures-implied probability of GOP White House win 2012



Source: Intrade, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: Romney isn't the favorite, but he's not a long-shot anymore. If he wins, that takes the worst-case scenarios off the table for the fiscal cliff and the debt ceiling. But the negotiation in the lame duck session could still be a considerable volatility event. If we are right that markets have not reflected the risks of the fiscal cliff, then lessening of that risk with a Romney win shouldn't be a cause for a major risk-on rally. If a Romney rally comes, it would more likely be the result of longer-term hopes for an improved policy environment, especially if the GOP takes the Senate too. For now, the correction in stocks is the best candidate for an "October surprise" that could make a Romney win possible.

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momentum -- not taking any undue risk to accelerate it -- seems to be Romney's strategy now, judging by his restrained performance in the third debate last night.

- In what has come to be a close race, even a small "October surprise" could make the difference, and we're running out of time for one (see "October is Half Over -- Where's the Surprise?" October 17, 2012).
- That said, as we noted last month, the best hope for one is a stock market correction (again, see "TrendMacro's Election Model"). We have long argued that the exceptional rally in stocks over the last year may have done much to improve sentiment about the economy, and in the spirit of George Soros's "theory of reflexivity" it could be the factor at the margin re-electing Obama (see "The Fiscal Cliff Bites" July 12, 2012).
- The evidence is that Romney's electoral prospects as judged by the political futures markets have always inflected inversely with stock market tops and bottoms (please see the chart on the first page).
- It's happening. Stocks are now more than 4% off their post-QE3 highs more than a month ago. We said then "stocks won't be at new highs for long" (see "On the September FOMC" September 13, 2012).

The prospect of a Romney win raises immediate questions about how the fiscal cliff and the debt ceiling will play out. It's oversimplifying to say flatly that if Romney wins then they go away as risks. But we think a Romney win would take the worst-case scenarios off the table.

- On the face of it, a Romney win changes nothing. The same players in place today are the ones who will have to forestall the fiscal cliff in the lame duck session, before it arrives at year-end. Obama could still veto, and there's no assurance that the Democrat-dominated Senate and the GOP-dominated House could agree on a bill anyway.
- But that's too simple. A Romney win denies Obama a mandate, and makes it politically costlier to him -- or rather to his party, for whom we assume he would proxy as a lame duck -- to take extreme positions that could be blamed for agitating markets, and for the catastrophic results of deadlock. Romney is already putting his marker down here, positioning himself as a voice of reason, saying he wants temporary extensions of expiring provisions to bring the debate into his first term.
- If Romney wins *and* the GOP manages to get 50 seats in the Senate -- giving it effective control, with Vice President Ryan's tie-breaking vote -- then falling off the fiscal cliff has little risk, as Romney and the new congress could reinstate all expiring tax provisions easily and immediately. And we think the deficit hawks in the GOP would give Romney a pass on the next extension of the debt ceiling.
- With such a clear recovery path in view, Democrats may be emboldened to block extension in the lame duck session as a low-

Contact TrendMacro

On the web at
trendmacro.com

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

Recommended Reading

'Gender Gap' Near Historic Highs
Nate Silver
New York Times
FiveThirtyEight
October 21, 2012

Obama's plan: Push Republicans off the fiscal cliff
Ezra Klein
Washington Post
WonkBlog
October 18, 2012

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cost gesture to their base, trusting that the effects on markets and the economy will be minimal. But markets should be able to look through that.
- If Romney wins without the GOP getting Senate control, the risks would be greater, but we don't see a narrow Democratic Senate majority willing to be the hold-out that would cause a second Great Recession.

So if Romney wins, with worst-case cliff scenarios off the table, at first blush it would seem that there ought to be a major risk-on rally. To some extent, perhaps -- there's a large equity risk premium waiting to be absorbed, and this could be the trigger. But we've argued that markets have not reflected the full risk of the fiscal cliff (see "Positioning for the Fiscal Cliff" October 3, 2012), so having that risk withdrawn shouldn't in and of itself make a large difference.

- And even with worst-case scenarios off the table, there would still be a great deal of uncertainty, and still perhaps a considerable volatiltiy event, while the cliff and the debt ceiling are negotiated in the lame duck session of congress.

If there's a Romney rally, more likely it would be driven by the longer-term prospects of a turn away from the anti-growth policies and anti-business rhetoric that have prevailed during Obama's presidency (see "On the June Jobs Report" July 6, 2012). All the more so if the GOP takes the Senate. That turning *away* ought to be worth a lot, but we are going to curb our full enthusiasm until we learn more about what we are really turning *toward*. Romney's reckless bashing of China and the Fed is worrisome.

- As of this writing the latter may be perversely working in Romney's favor. A story overnight that Ben Bernanke may not seek a third term as Fed chair is contributing to significant weakness in stocks, accelerating what just may be an "October surprise" already underway.
- For the moment, the significance of the stock market is not how it might react if Romney wins, but rather *whether the way it is acting right now will be the factor at the margin that makes that win possible.*

Bottom line

Romney isn't the favorite, but he's not a long-shot anymore. If he wins, that takes the worst-case scenarios off the table for the fiscal cliff and the debt ceiling. But the negotiation in the lame duck session could still be a considerable volatility event. If we are right that markets have not reflected the risks of the fiscal cliff, then lessening of that risk with a Romney win shouldn't be a cause for a major risk-on rally. If a Romney rally comes, it would more likely be the result of longer-term hopes for an improved policy environment, especially if the GOP takes the Senate too. For now, the correction in stocks is the best candidate for an "October surprise" that could make a Romney win possible.