

TRENDMACRO LIVE!

## On the 2012 Election

Wednesday, November 7, 2012

Donald Luskin

**Onward toward the fiscal cliff. The fat tail risk has just gone way, way up.**

Our election model called it on the nose. We predicted President Obama would be re-elected by 122 Electoral College votes (see, for our final model update, ["On the October Jobs Report"](#) November 2, 2012). Assuming Obama wins Florida, the Electoral College spread will be 126 (please see the chart below).

More of a surprise to us is the Democrats' two seat gain in the Senate, holding all five of their own incumbent toss-up seats (VA, WI and CT, with MT, ND still officially undecided), with the GOP losing three of its five incumbent toss-ups (IN, ME, and MA). The GOP took only one previously Democratic seat (NE). We assume that Maine's senator-elect will caucus with the Democrats.

This is offset somewhat by the GOP's retention of strong control in the House.

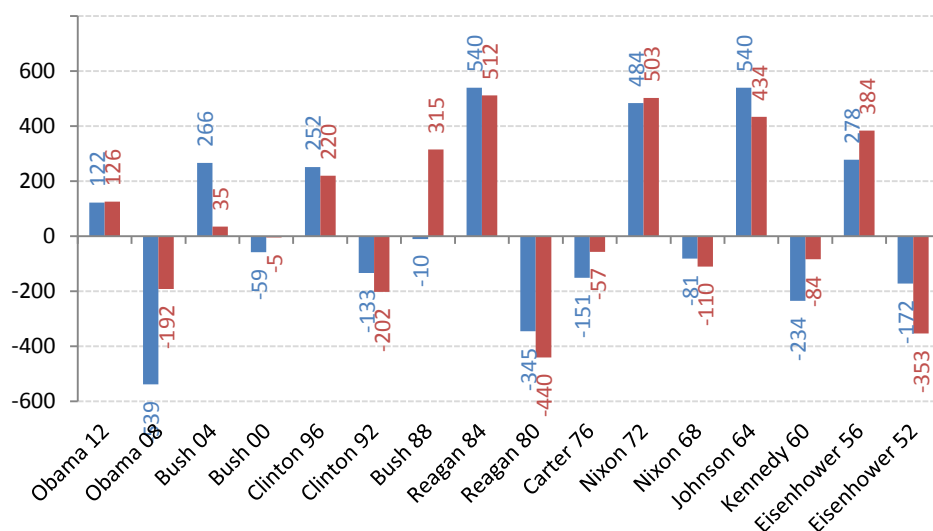
### Update to strategic view

#### ELECTION MODEL, US MACRO, US STOCKS:

Obama wins, by almost precisely the Electoral College margin our model predicted. The surprise is that the Democrats gained two seats in the Senate. This forecloses the rosier scenarios for the negotiation of the fiscal cliff and the debt ceiling in the lame duck session of congress, intensifying the expected volatility event for markets it will produce, and expanding the fat tail risk of a catastrophic bargaining failure. We have been urging caution and preparedness for months -- now, all the more so.

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**TrendMacro's election prediction model** ■ Prediction ■ Actual  
 Margin of Electoral College votes for incumbent party



Source: Various, TrendMacro calculations

- The US government remains very much divided.
- This produces stalemates, so it is ideal for preventing large pro-active partisan policy errors such as Obamacare.
- But it is uniquely ill-suited to dealing with the fiscal cliff and the debt ceiling. In both cases, very dangerous consequences are embedded in existing law. Pro-active steps are required to avoid them, and those steps require cooperation, which divided government does not easily produce.

With Obama re-elected, most of the rosier scenarios for negotiating the fiscal cliff and the debt ceiling in the lame duck session of congress are off the table. The expected intensity of the volatility event coming up in a fractious negotiation has to be seen as going way up, and the fat tail risk of a catastrophic bargaining failure way up, too.

- The key question coming out of the election is the extent to which Obama and the Democrats interpret it as a strong mandate, justifying a hardline position in the negotiations.
- A very strong mandate would have both emboldened Obama and discouraged the GOP. In that political environment the negotiations would have produced bad policy, but at least the brinksmanship might have been kept to a minimum.
- But a win by 126 Electoral College votes is not a very wide margin. Since 1952 the average margin has been 256, more than twice Obama's in this election,
- Obama's win was narrower than it was in 2008, when he won by 192. 4.7 million fewer Americans voted for him this year than in 2008. So on the face of it his mandate is less than it was for his first term.
- So he has less than a strong mandate. But we argued yesterday that this may be the worst possible case as we head toward the cliff (see "[What If Obama Wins?](#)" November 6, 2012). Obama may nevertheless *think* he has a strong mandate, and act like he does -- after all, he was re-elected. [As he told](#) House Majority Leader Eric Cantor (R-VA) at the outset of last year's catastrophic negotiations over the debt ceiling, "Elections have consequences and Eric, I won."
- If Obama acts like that again and the GOP doesn't accept Obama's mandate -- and they didn't last year -- that will maximize brinksmanship in the coming negotiation and produce the largest volatility event for markets.
- Already House Speaker John Boehner (R-OH) [said](#), commenting last night on the GOP's retention of strong House control, "With this vote, the American people have also made clear that there is no mandate for raising tax rates." [He will release](#) a more complete statement on the cliff later today.
- The strongest argument for a mandate is the Democrats' gains in the Senate. That may embolden Obama, but it's not clear it will make much difference in the Senate's own calculus in the negotiation.

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## Recommended Reading

[5 Reasons Why Obama and Romney Will Get No Mandate](#)

Ron Fournier  
*National Journal*  
November 6, 2012

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- For starters, in the lame duck session, it is the existing players who will make the decisions -- not the newly elected senators.
- And among the existing players who will be there in the next session of congress as well, there ought to be significant risk-aversion about taking a hardline negotiating position that could throw the stocks into a bear market and the economy into a recession. 20 Democratic senators will have to defend their seats in just two years, and six of them come from solidly red states (AK, AR, LA, MT, SD, and WV).

So now we wait. [Reportedly](#) Obama will very shortly reveal his new plan for the fiscal cliff and the debt ceiling. Our expectation is that his new plan will look like his old plan -- increase taxes on so-called "rich folks" now, and promise weak entitlement reforms for the distant future. The GOP will likely come back demanding more substantive reforms, and willing to agree only to revenue raisers that do not increase tax rates. Note that Boehner's marker on taxes, last night [and over the weekend](#), is about *rates*, not *revenues*. In that distinction is hope for sensible compromise.

- A key risk to watch for is whether the Democrats adopt what we've been calling in client meetings "the Dr. Strangelove strategy." It is [best expressed](#) by Senator Patty Murray (D-WA): *to deliberately let all the current tax provisions expire so that Democrats can come back and replace only the ones they like.*
- As she puts it, "If the Bush tax cuts expire, every proposal will be a tax cut proposal, and the [Grover Norquist no tax hike] pledge will no longer keep Republicans boxed in and unable to compromise."
- [Reportedly](#) some Democrats are talking about working climate change legislation into the solution next year, when presumably the GOP would be powerless to resist.
- The Dr. Strangelove strategy would cause a recession. Watch for more "studies" offered by Democrat-leaning think tanks that rationalize that risk away -- [such as](#) the Center on Budget and Policy Priorities' claim that the fiscal cliff is really just a "slope."
- Obama has never overtly embraced this strategy. Indeed, in his [victory speech last night](#) he said, "I am looking forward to reaching out and working with leaders of both parties... Reducing our deficit. Reforming our tax code."
- But he has repeatedly [threatened to veto](#) even the shortest extension of expiring tax provisions if it includes top earners.
- And most ominously, in [his interview](#) with the *Des Moines Register* last month when asked about the fiscal cliff, he said, "...we're going to be in a position where I believe in the first six months we are going to solve that big piece of business. It will probably be messy."
- Sounds to us like Obama is willing to go over the cliff -- to *not* resolve the negotiation in the lame duck session of congress. Now the question is whether he really feels he has the mandate to do so.

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**Bottom line**

Obama wins, by almost precisely the Electoral College margin our model predicted. The surprise is that the Democrats gained two seats in the Senate. This forecloses the rosier scenarios for the negotiation of the fiscal cliff and the debt ceiling in the lame duck session of congress, intensifying the expected volatility event for markets it will produce, and expanding the fat tail risk of a catastrophic bargaining failure. We have been urging caution and preparedness for months -- now, all the more so.

