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POLITICAL PULSE

Mandate for Volatility

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Donald Luskin

The fiscal cliff negotiations begin -- worlds collide. The market is finally waking up to the risk.

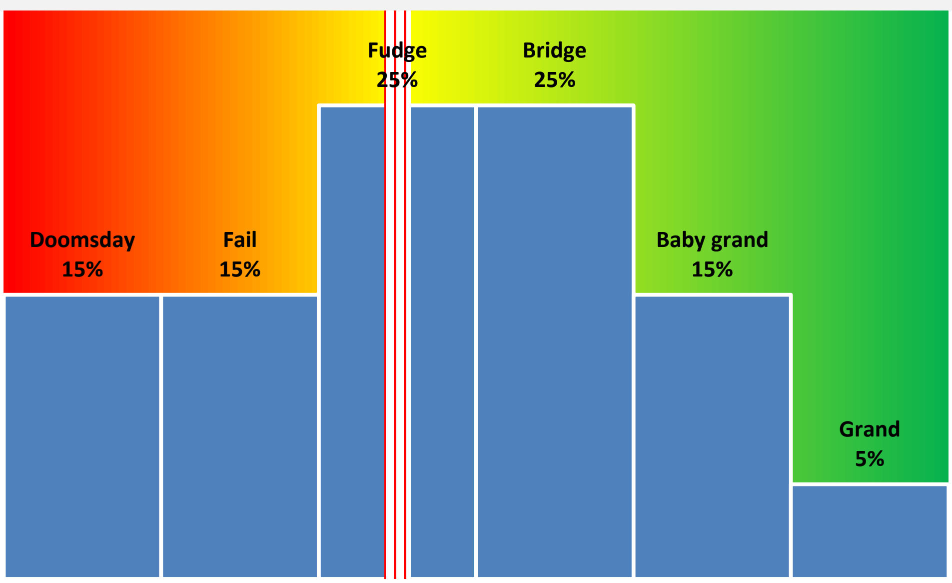
The time of denial is over. With the election settled, the candidates and the markets -- both of whom should have been more attentive all along -- are suddenly focused on the dangers of the coming fiscal cliff.

The Washington negotiating game is afoot. We see six basic possible outcomes for year-end. Slightly more than half the cumulative probabilities range from tolerable to good (please see the chart below). Outcomes from bad to horrible are slightly less likely, cumulatively. But when intensity is integrated with probability, the distribution has a strongly negative bias. That is, the slightly less likely bad things are much more bad than the slightly more likely good things are good.

Here are the six possible outcomes, going from the best to the worst.

- ***Grand*** -- a transformative grand bargain such as Simpson-Bowles -- is not impossible given the crisis atmosphere we expect to build

Probabilities of various fiscal cliff negotiation outcomes by year-end
Bad Good ||| Bad/Good divide



Source: TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS: Obama and Boehner have assumed their opening positions for the negotiation of the fiscal cliff -- and it's a clash of absolutes. Obama insists on raising tax rates, Boehner insists on not raising them. The even more contentious matter of reining in spending with entitlement reforms has barely been raised yet. Obama appears to be making all the same mistakes he made in the debt ceiling negotiation in 2011 -- failing to problem-solve with his counterparty, exaggerating the power of the presidency, and claiming a mandate his counterparty has no reason to agree he has. There are still good likely outcomes. But there are also bad outcomes that are only slightly less likely, and they are intensely bad. Markets have finally snapped out of their utter denial of the risks -- there's more to come.

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up by year-end. Pressure *can* create diamonds. But given the complexities involved and the short deadline, we assign *grand* only a 5% probability.

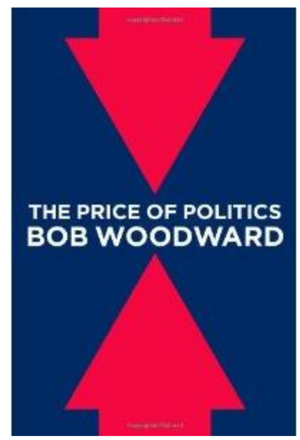
- ***Baby grand*** -- a limited suite of tax and spending reforms -- is more probable because it is less ambitious than *grand*. And a template already exists -- President Obama and House Speaker John Boehner (R-OH) came very close to implementing such a program in 2011 in the debt ceiling negotiations. It was a serious down-payment on entitlement reform without anti-growth tax rate hikes. But the deal fell apart in 2011, and that bitter experience is likely to polarize the principals in the present negotiation, as we will discuss in more detail momentarily. So we assign *baby grand* only a 15% probability.
- ***Bridge*** -- a short-term extension of the status quo -- would move the negotiation beyond the lame duck session and buy the negotiators more time to one of the better outcomes. Boehner has proposed this, echoing similar past proposals by key Democrats Dick Durbin (D-IL), Bill Clinton and Lawrence Summers (see "Light at the End of the Cliff?" June 11, 2012). This is a noble concession for Boehner, considering that the GOP will have fewer votes in both the Senate and the House next year. Less generously, Obama has said he would veto any extension that includes the top earners. But it's hard for us to say definitively that, if push came to shove and the deadline were bearing down, Obama would not concede just a few months of breathing room. Because this is an outcome without huge political costs to either party, we give *bridge* a probability of 25%.
- ***Fudge*** -- a face-saving compromise entailing only minor changes to the status quo, or unenforceable promises of future reform -- can be either good or bad depending on the changes. If the fudge is a two-year extension of all the expiring tax provisions, larded with extended welfare programs -- such as the deal struck in 2010 -- the worst anti-growth impacts would be avoided, but nothing would have been done to deal with America's ever-worsening fiscal mess. On the other hand, if tax rates on top earners or investment income are raised in exchange for relief from the defense spending sequester, the anti-growth impacts would be considerable. *Fudge* is not as free from political cost as *bridge*, but it is a time-tested fallback modality -- a version of it was employed to resolve the 2011 debt ceiling crisis. So taking the good and the bad versions together, we give *fudge* a probability of 25%.
- ***Fail*** -- an honest negotiating breakdown -- would see the expiration of all expiring tax provisions, the triggering of spending sequesters, and possibly a debt default. It would be the result not of a willful intention to cause these harms, but out of a sheer inability to negotiate a solution before the year-end deadline. We would expect that negotiations could resume quickly in 2012, probably in time to forestall the worst recessionary effects -- but the damage to confidence would be considerable nevertheless. Given the bitter resentments between the principals after the 2011 debt ceiling negotiations, and their highly polarized positions taken so far, we give *fail* a 25% probability.

- ***Doomsday*** -- a deliberate dive off the fiscal cliff for the sake of political advantage by Democrats, what we've called the "Dr. Strangelove strategy" (see "Step by Step, Toward the Cliff" September 25, 2012) -- is by far the worst outcome. Unlike *fail*, there would be no immediate resumption of negotiations. Democrats would let the resulting recession deepen, blame the GOP, and then stampede the GOP into a tax and spending program. As advocated by Senator Patty Murray (D-WA), "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." We'd like to think this idea is limited to the idiot fringe of the Democratic party, but perhaps it is not. We have interpreted some of Obama's remarks as subtly pointing toward this direction (see "On the 2012 Election" November 7, 2012). As crazy as it sounds, we assign *doomsday* a 15% probability.
- So cumulatively, we assign to *doomsday* and *fail* -- both of which entail falling off the fiscal cliff in one way or another -- a probability of 30%. Considering their intensity, that is *a very fat tail* on the negative side of the distribution, one which we think markets have only just begun to take on board.

The negotiating positions taken so far are not encouraging.

- Boehner has gotten out in front of the issue first, beginning to stake out his position as early as the weekend before the election. He had further remarks on election night, gave a speech the day after, and a press conference Friday.
- Boehner's irreducible minimum is that he will not agree to raise tax *rates*. However, he has said he would agree to tax reform that would increase *revenues*, through a combination of reduced deductions and economic growth. In exchange he would expect substantive spending reform.
- This is exactly the deal that Boehner and Obama had on the table in July 2011 when the debt ceiling was being negotiated -- but they failed to achieve it. Boehner had agreed to $800 billion in new revenues, and Obama had agreed to substantive cuts in entitlements including raising the Medicate eligibility age and reducing the COLA adjustment in Social Security (the deal memo with all the particulars was leaked yesterday).
- As chronicled in Bob Woodward's *The Price of Politics* -- a detailed eyewitness history of the negotiations -- the deal fell apart when Obama demanded another $400 billion in revenues, and Boehner walked away in frustration. Thus was killed a potential *baby grand* -- and taking its place was the *fudge* of the Budget Control Act of 2011 with its poorly designed sequesters.
- Obama claims that he was misunderstood by Boehner, and that they still could have done their deal. Yet Obama now is showing no willingness whatever to join Boehner in resurrecting it.
- In remarks Friday, Obama was clear that *his* irreducible minimum was to raise the tax burden of top earners. He didn't overtly say he insisted on higher *rates* as opposed to merely higher revenues. But

Note to clients



We have sent copies of Bob Woodward's *The Price of Politics* to individuals in client organizations who we thought would be especially interested. The books should start arriving today.

We would be happy to provide additional copies to any client to whom we mistakenly have not already sent one. If you have not received a copy and wish to have one, please email us immediately at any of the addresses on the previous page.

White House spokesman Jay Carney made it clear later the same day, stating "The President would veto…any bill that extends the Bush-era tax cuts for the top 2 percent of wage earners in this country."

- *So we have a clash of absolutes. Obama insists on raising rates, Boehner insists on not raising rates. Worlds collide -- it blows up.*
- On the spending side, Obama expressed on Friday no willingness to reduce entitlements as he had agreed in 2011 -- only to "bring down the cost of health care so we can strengthen programs like Medicaid and Medicare." That just means paying Medicaid and Medicare providers less -- an approach that was explicitly rejected in the 2011 deal.
- What's worst in our view is Obama's public posture coming into the negotiations. He appears to be repeating all the same mistakes Woodward says he made in 2011.
- We would have expected Woodward's account of events to put Obama in a flattering light, yet he portrays the president as a disastrously incompetent negotiator. According to Woodward,

> *The failure was one of human relations. There had been no sincere contact, no inclusiveness, no real listening… Obama talked, then seemed to listen, but…he was really just waiting to talk again, to make his points, to win the argument.*

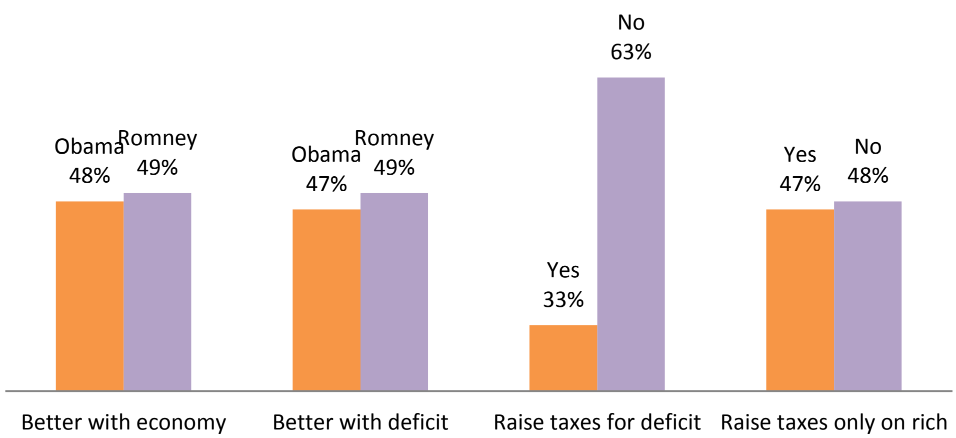
- And, again according to Woodward, he has an exaggerated estimation of the ability of the personal prestige of a sitting president to command desired outcomes from unwilling counterparties. At one point Obama dramatically stalked out of a negotiating session with Boehner and other Republicans, saying, "Do you think Ronald Reagan sat here like this?"
- Sadly, all of this was on display in his remarks on Friday. The greatest risk to the negotiations falling apart lies in Obama's exaggerated claim of a mandate to raise taxes on top earners. He said,

> *And I just want to point out this was a central question during the election. It was debated over and over again. And on Tuesday night, we found out that the majority of Americans agree with my approach -- and that includes Democrats, independents, and a lot of Republicans across the country, as well as independent economists and budget experts*.

- Even leaving aside the concluding claim that Republicans, economists and experts voted for him to support raising taxes on top earners, this is a great exaggeration. If it were true, perhaps it would cow Boehner and the GOP. But since it is not, it will only anger them, as similar posturing did in 2011, according to Woodward. Worst of all, if Obama himself believes it, he will render himself incapable of bargaining coherently.

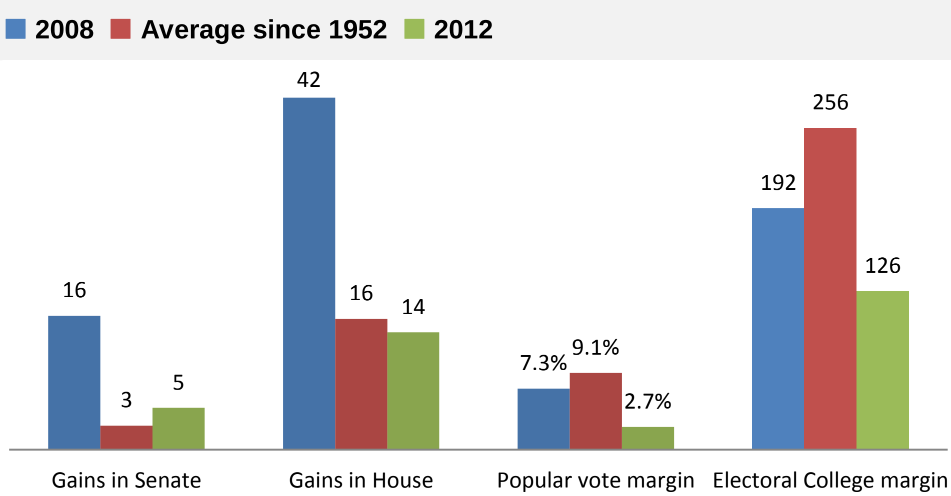
- *This is the worst-case scenario we warned about on election day -- Obama believes he has a mandate and the GOP doesn't* (see ["What If Obama Wins?"]() November 6, 2012).
- Make no mistake about it. Obama has no mandate for this.
- According to exit polls, the majority of voters overall rated Romney higher on his ability to handle the economy and the deficit, and the majority rejected raising taxes for deficit reduction or raising taxes only on the rich (please see the chart below).

National exit polling result, overall voters



Source: CNN, TrendMacro calculations

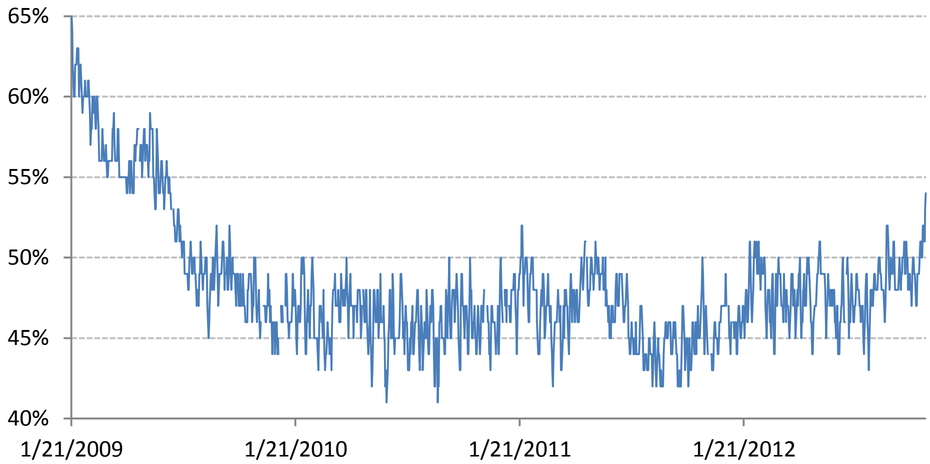
- Obama's 2012 margins of victory in both the Electoral College and the popular vote were lower than in 2008 -- and his margins in 2008 *and* 2012 were both lower than the average since 1952. His party's relative gains in congress were lower than in 2008, and in the House were lower than the average since 1952 (please see the chart below).



Source: Various, TrendMacro calculations

- The closest thing to a mandate Obama has is his approval rating. At 50% on election day, the level at which it has maxed out since late 2009, it has inexplicably spurted to 54% *after* the electorate approved of him by electing him (please see the chart below).

Obama approval rating



Source: Rasmussen, TrendMacro calculations

- We very much fear that this probably fleeting evidence of adulation will reinforce Obama's worst traits as a negotiator, and will make the upcoming bargaining about the fiscal cliff extremely difficult -- and extremely volatile for markets. The volatility we saw last week after the election is just the beginning.

Bottom line

Obama and Boehner have assumed their opening positions for the negotiation of the fiscal cliff -- and it's a clash of absolutes. Obama insists on raising tax rates, Boehner insists on not raising them. The even more contentious matter of reining in spending with entitlement reforms has barely been raised yet. Obama appears to be making all the same mistakes he made in the debt ceiling negotiation in 2011 -- failing to problem-solve with his counterparty, exaggerating the power of the presidency, and claiming a mandate his counterparty has no reason to agree he has. There are still good likely outcomes. But there are also bad outcomes that are only slightly less likely, and they are intensely bad. Markets have finally snapped out of their utter denial of the risks -- there's more to come.