

POLITICAL PULSE

My Way, or the Cliff

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Donald Luskin

Obama sounds like he wants to go over the cliff. But the Petraeus matter is a new wildcard.

We seem to be heading down the very worst branches of the probability distributions we envisioned for the fiscal cliff (see, before the election ["Step by Step, Toward the Cliff"](#) September 25, 2012; and after the election ["Mandate for Volatility"](#) November 13, 2012). Specifically, at the moment, events are hurtling rapidly toward what we've called the "Dr. Strangelove strategy," in which President Obama and the Democrats willfully fail to reach a compromise in the lame duck session of congress, trigger a recession, blame the GOP, and then stampede the GOP into agreeing to a Pandora's Box of anti-growth policy including higher taxes on capital [and energy](#).

- On Wednesday, after meeting with corporate CEOs to discuss the cliff, Obama was asked in [a press conference](#), "Can you envision any scenario in which we do go off the fiscal cliff at the end of the year?"
- The only responsible answer for a president of the United States to give to such a question is: *I will do everything in my power to prevent that from happening on my watch.*
- Instead, Obama said:

...we can all imagine a scenario where we go off the fiscal cliff. If despite the election, if despite the dangers of going over the fiscal cliff and what that means for our economy, that there's too much stubbornness in Congress...

- *His own stubbornness is, apparently, not open to blame. His wishes are, apparently, a fixed point to which all others must adapt. It's my way, or the cliff.*
- If that's the way it is, then we are going over the cliff -- because Obama has bid up his wishes to an extent to which the GOP could not possibly adapt.
- On Tuesday, after meeting with labor leaders to hear their views on the fiscal cliff -- as though anyone couldn't guess them -- [Obama announced](#) he would demand \$1.6 trillion in new revenues as part of a deal on the cliff. This is a sharp snub to the olive branch House Speaker John Boehner (R-OH) [offered last week](#), \$800 billion in new revenues without raising tax *rates*.

Update to strategic view**US MACRO, US**

STOCKS: Obama continues to talk as though he is preparing to willfully go off the fiscal cliff, cause a recession, blame the GOP, and use the crisis to put new taxes on capital and energy into place. The markets have begun to react, and if the reaction becomes severe enough that could pull the Washington negotiators back from the brink. The Petraeus matter is a new wildcard, with the potential to embroil Obama in political risks that might make him more risk averse in negotiating the cliff. However it turns out in the end, for now the volatility in markets is just beginning.

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- \$800 billion is revenue commensurate with the goal Obama has always sought: abolishing the Bush-era tax rates on top earners. For Obama to double it to \$1.6 trillion implies raising taxes well beyond that. If this is not an entirely arbitrary figure, then one has to wonder what all the new taxes will be and who will pay them.
- In the presidential campaign, when Mitt Romney proposed a broader version of Boehner's tax reform idea, it was a standard talking point for Obama to claim that it was mathematically impossible for such a thing to be revenue neutral. He's revived that talking point for Boehner's idea, saying in the press conference that "The math tends not to work."
- But it *does* work. [A study published yesterday](#) by the [Committee for a Responsible Federal Budget](#) -- a non-partisan group that includes [on its board](#) such prominent Democrats as Paul Volcker, Alice Rivlin, Erskine Bowles and Laura D'Andrea Tyson -- proves it beyond the shadow of a doubt, and using only static analysis.
- If Obama's intention were to go over the cliff, and if Boehner's idea *is* credible, then the only thing for Obama can do to poison the deal is to arbitrarily demand an amount that Boehner's approach *can't* satisfy.
- Another tactic to force a breakdown in the negotiations and send us off the cliff is for Obama to give the GOP nothing in terms of spending cuts in exchange for Boehner's offer of additional revenues -- despite Obama's [often repeated](#) claim that his approach is "balanced."
- The only cuts that would be acceptable to the GOP -- or that could ever amount to enough money to matter in any event -- would be measures to reduce the growth of entitlement payments. Such measures were part of the deal Obama and Boehner had agreed to in July 2011 as part of the debt ceiling negotiations.
- This time Obama has [only offered](#) 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 (again, see ["Mandate for Volatility"](#)).
- [Yesterday](#) Senate Majority Leader Harry Reid (D-NV) said that he would reject any changes to Social Security. Assistant Leader Dick Durbin (D-IL) -- who has been [a voice of reason](#) -- added, perhaps with regret, that Reid is "not bringing entitlements to the table."

Is there any reason at all to be hopeful that we can yet avoid going over the fiscal cliff and into a second Great Recession? Yes.

- At this point the negotiations have not formally begun -- it's all been a show trial for the media. The capper will be Obama's [meeting today](#) with civil rights leaders including Al Sharpton to get their views on the cliff.
- The real negotiations start later, when the doors close and Obama, Boehner, Reid and the other principals have their first face to face conversations.

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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

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- But based on how the process has gotten started, even while we can reasonably hope that Obama's apparent willingness to go over the cliff is just for show, we must continue to strongly expect more brinksmanship, accelerating the volatility event in markets that we have long predicted (see, among many, ["Positioning for the Fiscal Cliff"](#) October 3, 2012).
- That volatility is itself one cause for hope. Months ago we predicted that Obama would win re-election thanks to the increased sense of economic well-being engendered by the 30% stock market rally off last year's October bottom (see ["The Fiscal Cliff Bites"](#) July 12, 2012). Now that same ["reflexivity"](#) could come into play in reverse.
- Stocks are already off 8.5% since mid-September (when we called the top: see ["On the September FOMC"](#) September 13, 2012). In two months that's a \$1.04 trillion loss of market value -- more than the \$800 billion in revenues that could be earned over a decade by repealing the Bush-era tax rates for top earners.
- If markets continue to fall, that could remind the politicians of the terrible risks they are taking and force a compromise.
- Even in Washington they must have noticed the sharp drop in stocks Wednesday afternoon *instantly* following Obama's statement that "we can all imagine a scenario..."
- An entirely different factor has suddenly emerged as a wildcard -- the scandal surrounding former CIA Director David Petraeus. Still potentially unknown dimensions of [national security risk](#) are involved -- as are questions of [what the president and the attorney general knew and when they knew it](#), and [its potential connection to the September Benghazi attacks](#) that were at the center of the [second presidential debate](#).
- At minimum, the GOP will make the Petraeus matter as much of a distraction for Obama as possible. If it emerges as presenting serious political risk, that ought to make Obama more risk averse -- lessening the likelihood that he would execute a maneuver as daring as willfully going off the cliff.

So things look terrible. But it's still early days. We don't know, and nobody does -- not even the principals. The only way to deal with this tactically is to live headline by headline. The only thing we know with reasonable certainty is that we are in a period of extraordinary risk. Even if things turn out well for year-end, we still probably haven't seen the worst of the volatility.

Bottom line

Obama continues to talk as though he is preparing to willfully go off the fiscal cliff, cause a recession, blame the GOP, and use the crisis to put new taxes on capital and energy into place. The markets have begun to react, and if the reaction becomes severe enough that could pull the Washington negotiators back from the brink. The Petraeus matter is a new wildcard, with the potential to embroil Obama in political risks that might make him more risk averse in negotiating the cliff. However it turns out in the end, for now the volatility in markets is just beginning. ▶