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POLITICAL PULSE

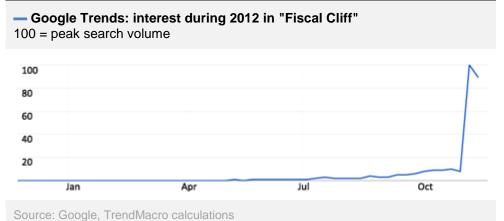
## Photo-Op at the Cliff's Edge

Monday, November 19, 2012 **Donald Luskin** 

Friday's White House Kumbaya makes a prettier media narrative, but the reality is still ugly.

The media narrative around Friday's White House meeting -- the first face-to-face fiscal cliff negotiations between President Obama, House Speaker John Boehner (R-OH) and other principals -- is that a constructive bipartisan process is now underway, pointing toward compromise and resolution. But we don't think comity is busting out all over in Washington.

- Friday's meeting, a mere hour to deal with an issue of potentially vast importance to the economy, was little more than a photo-op engineered by the White House to make Obama look like a conciliator, following a week of the most polarizing remarks imaginable (see "My Way, or the Cliff" November 16, 2012).
- We agree with Treasury Secretary Tim Geithner's <u>characteristically</u> <u>sarcastic take</u>: "they said what you'd hope for them to say at this point." After all the smiles and handshakes, as Geithner put it, the negotiators "have the hard stuff ahead."
- Obama himself, now in Thailand touring ancient temples, told his monk guide, "We're going to need a lot of prayer."
- Republicans are standing by <u>Boehner's offer</u> to put revenues on the table. But <u>higher tax rates are still off the table</u>, and the higher revenues on offer must be matched by entitlement reform.
- Democrats are standing by their diametrically opposed positions. In an interview Friday after the White House meeting, House Minority Leader Nancy Pelosi (D-CA) confirmed her party's insistence on higher tax rates for top earners, and on no reductions in



Update to strategic view

US MACRO, US STOCKS: Friday's meeting at the White House, the first face-toface negotiation about the fiscal cliff for Obama, Boehner and other principals, had a surface gloss of comity. And with Petraeus and Israel crowding into the headlines, and Obama in Asia, the fiscal cliff will be less in the news this week. Stocks may enjoy a small countertrend rally. But this will be a head-fake. Hard positions on both sides have not softened. Some form of resolution by yearend, hopefully benign, is still the single most likely outcome. But horrific outcomes are far more than fat tails in the distribution. And even if the best happens, there will be much brinksmanship, and much market volatility by yearend.

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- entitlements. Senate Assistant Majority Leader Dick Durbin (D-IL) <u>ruled out one possible compromise</u>, raising above \$250,000 the income threshold at which Democrats demand tax rates must rise.
- We noted last week that the scandal surrounding General David Petraeus could helpfully serve to vent political energy from the cliff negotiations (again, see "My Way, or the Cliff"). Rising tensions in the Middle East, and Obama's absence for his Asian tour, point in the same direction. Serious negotiations among principals won't resume now until after Thanksgiving.
- All this dials down the tension, and also plays to the GOP's political advantage. The Democrats' positions have been highly aggressive since the election, trading on a self-perceived mandate and a bump in Obama's approval ratings (see "Mandate for Volatility" November 13, 2012). The GOP wants to move the negotiations as far as possible into the future, away from the rosy afterglow of the election and nearer the debt ceiling's expiration. This underlies Boehner's call just before the election for a "bridge" to delay decision-making into early next year, and his proposal Friday for a "framework" for "targets" to be agreed now and finalized in 2013.

The cliff will be somewhat less in the news for the coming week (please see the chart on the previous page). With stocks having fallen 8.9% from the mid-September high tick (the day after we called the top; see "On the September FOMC" September 13, 2012) to the low tick Friday, we may now be in for a brief countertrend rally.

- But a rally here will likely be a head-fake. We still think stocks will
  make lower lows by year-end. Though our most likely scenarios for
  the fiscal cliff do involve some form of relatively benign resolution
  by year-end, there are others -- somewhat less likely but still
  entirely possible -- that involve catastrophic bargaining failures that
  would hurl the US economy off the cliff and into a back-to-back
  Great Recession (again, see "Mandate for Volatility").
- With that risk as the backdrop, even ultimately successful negotiations will involve a great deal of brinksmanship along the way, and so too a great deal of volatility for markets.

## **Bottom line**

Friday's meeting at the White House, the first face-to-face negotiation about the fiscal cliff for Obama, Boehner and other principals, had a surface gloss of comity. And with Petraeus and Israel crowding into the headlines, and Obama in Asia, the fiscal cliff will be less in the news this week. Stocks may enjoy a small countertrend rally. But this will be a head-fake. Hard positions on both sides have not softened. Some form of resolution by year-end, hopefully benign, is still the single most likely outcome. But horrific outcomes are far more than fat tails in the distribution. And even if the best happens, there will be much brinksmanship, and much market volatility by year-end.

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Democrats Unlikely to Regain House in 2014 Nate Silver New York Times FiveThirtyEight November 16, 2012

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