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POLITICAL PULSE

Back to the Cliff

Wednesday, November 28, 2012

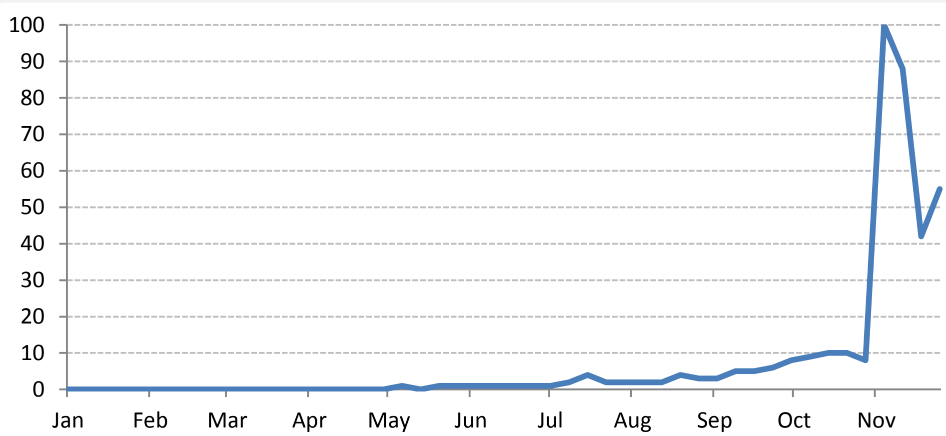
Donald Luskin

Markets gave Washington a pass for Thanksgiving. Now, the battle of the cliff begins.

Just as we predicted early Monday ten days ago (see "Photo-Op at the Cliff's Edge" November 19, 2012), stocks rallied all Thanksgiving week while the fiscal cliff receded in public consciousness (please see the chart below).

- No one should take comfort from the fact that there were fewer headlines about the fiscal cliff last week. That was only because there was so little substantive engagement among the negotiators.
- The two best outcomes -- the grand bargain we have called the *grand* scenario, or the down-payment on it we have called *baby grand* (see "Mandate for Volatility" November 13, 2012) -- take time to negotiate, and a now a precious week has been squandered. So we now must downgrade our estimate of the already small probabilities of those two scenarios (please see the chart on the following page).
- As time shortens, our *fudge* scenario of a basket of trivial changes becomes less probable, too.
- More probable now are the *bridge* scenario, some form of freezing existing policy for a while; *fail*, in which we fall off the fiscal cliff because bargaining breaks down; and *doomsday*, in which we fall

Google Trends: interest during 2012 in "Fiscal Cliff"
100 = peak search volume



Source: Google, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS: Stocks rallied Thanksgiving week with the fiscal cliff out of the headlines, as negotiations in Washington went nowhere. Time is running out for the best outcomes involving real tax and spending reforms. What's left is temporarily extending the status quo, or an accidental or deliberate fall off the cliff. To the good, Geithner is a pragmatic point-man for the White House. But Boehner's olive branch on revenues has been snubbed, and not reciprocated on spending. Harry Reid is emerging as the most divisive player, raising the stakes by insisting on co-negotiating the debt ceiling and the cliff, and threatening to blunt the GOP's filibuster power. As the clock ticks and the political noise amps up, we expect stocks to give up last week's gains and make new post-election lows.

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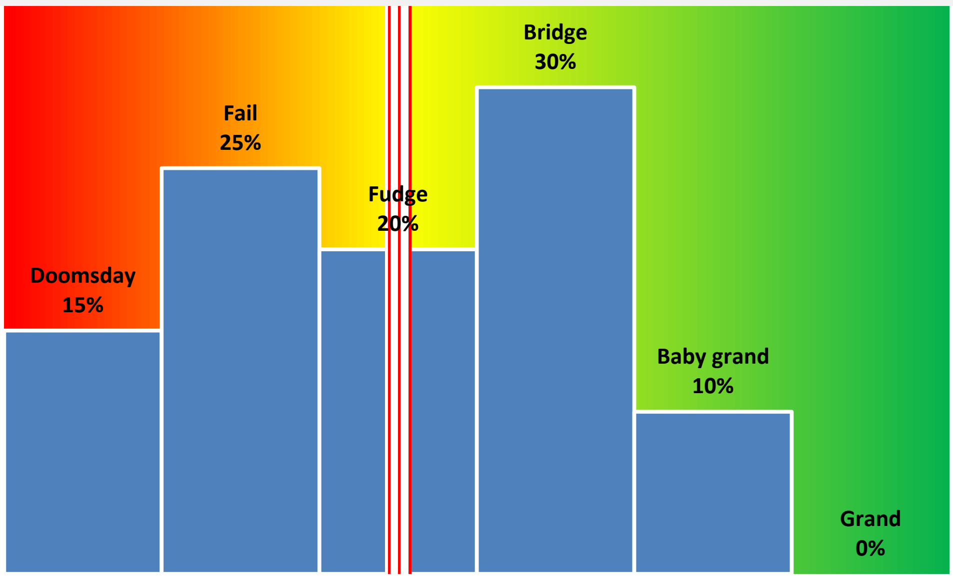
off because one party or the other willfully blockades a solution for real or imagined political advantage in the aftermath.

- The negotiations will soon begin in earnest, and will become increasingly public. It will become increasingly apparent how little agreement there is between the parties.
- We think it's very unlikely that stocks can get much above their highs during Thanksgiving Friday's low-volume half-session. As the clock runs out and it appears that no compromise is emerging, we think it's more likely that stocks will extend their post-election losses.

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

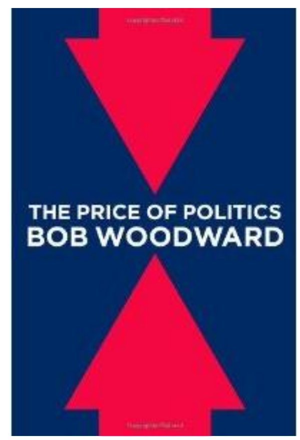


Source: TrendMacro calculations

Yes, we can point to certain developments that are indeed potential positives.

- We were encouraged to hear that Treasury Secretary Tim Geithner has been named by the White House as its point-man in the negotiations.
- We think Geithner is a pragmatic technocrat, who has proven himself in the banking crisis of 2008 and 2009 to be capable of finding effective solutions even when they are politically difficult.
- If nothing else, at least the role was not given to White House Chief of Staff Jack Lew. According to Bob Woodward's *The Price of Politics*, in the failed debt ceiling negotiations of 2011 when Lew was head of the Office of Management and Budget, he was especially unconstructive.
- On the face of it, appointing a man *capable* of finding a solution -- instead of a man *incapable* of finding a solution -- would seem to indicate the White House's *intention* to find a solution (or at least to *appear* to have that intention).

Note to clients



Two weeks ago we sent copies of Bob Woodward's *The Price of Politics* to individuals in client organizations who we thought would be especially interested.

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 following page.

- Another positive is a White House report issued Monday -- the joint product of the National Economic Council and the Council of Economic Advisors -- warning that failure to extend the "middle class" component of the Bush-era tax rates would reduce consumer spending by $200 billion in 2013.
- The bleak report is constructive because it puts the White House on record as agreeing that there would be sharply recessionary consequences to falling off the fiscal cliff. Indeed, the report has earned the wrath of liberal ideologues who have sought to minimize the economic risks as cover for daring to execute the *doomsday* scenario (see "Step by Step, Toward the Cliff" September 25, 2012).

That's about it for the positives. Sadly, they are at least counterbalanced by negatives.

- The White House continues to snub the olive branch offered the day after the election by House Speaker John Boehner (R-OH), to include higher revenues in a compromise solution -- derived from tax reform such as capping or eliminating deductions, but not from higher tax *rates*.
- President Obama has often spoken of a "balanced approach" to deficit reduction, including both spending restraint and higher taxes. But on Monday, CEA Chair Alan Krueger clarified what the White House *now* means by that: "a balanced approach of both higher tax rates as well as reduction in deductions."
- Democrats are floating a revenue proposal that appears to preserve Boehner's condition of not raising *rates*, but is a self-evident non-starter seemingly designed to be rejected. Rather than raising the top 35% bracket, filers with incomes above the threshold at which that bracket kicks in would pay that rate on their entire income, not just the portion above the threshold. That puts a virtually infinite marginal tax rate on the dollars just above the threshold.
- At the same time, the Democrats have not reciprocated Boehner's olive branch on revenues with one of their own on spending. On Sunday, Assistant Senate Majority Leader Dick Durbin (D-IL) -- a deficit hawk who broke ranks with his party to sign on with the Simpson-Bowles proposal -- took Social Security reform off the table claiming rather preposterously that "It doesn't add to the deficit," but was open to reforms in Medicare and Medicaid. But yesterday he changed his mind, saying they shouldn't be negotiated as part of the fiscal cliff.
- A new demand from Senate Democrats is that the debt ceiling be tied into the fiscal cliff negotiation. Yesterday Majority Leader Harry Reid (D-NV) said, "We would be somewhat foolish to work out something on stopping us from going over the cliff and then a month or six weeks later Republicans pull the same game they did before…" Durbin made similar remarks, and Reid indicated that Obama takes the same position: "I agree with the president, it has to be a package deal."

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Jim DeMint
November 20, 2012

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- Indeed, reportedly Obama made that demand to Boehner in their brief White House meeting two weeks ago. Yet for Reid, this is a change. Reid said the day after the election that he expected the debt ceiling to be negotiated separately, in January.
- But we have long predicted that raising the debt ceiling would become intermingled with the fiscal cliff (see "On Ryan as VP Nominee" August 13, 2012), and now it's official.
- This substantially raises the stakes -- or at least the noise level. That said, a joint negotiating failure at year-end for both the cliff and the ceiling would, in fact, only pertain to the cliff. The expiration of tax provisions and the onset of spending sequesters begin, by law, on January 1. A government shutdown and Treasury default, for failure to raise the debt ceiling, would not occur until February. So there would be more recovery options.
- Finally, Reid -- who is emerging as the most divisive figure in the negotiations -- has enflamed matters further by threatening to amend Senate rules next year to make GOP filibusters less effective. He would execute what has always been called the "nuclear option" through a parliamentary maneuver that is being politely called the "constitutional option."
- Obviously this threat is an affront to Senate Minority Leader Mitch McConnell -- much as was McConnell's similar threat to Reid in 2005, when McConnell was majority leader. The difference is that this time the affront is aggravating the already very contentious negotiation for the fiscal cliff -- and taking valuable time from it. McConnell has said it would "poison" party relations, and said it would be "to throw a bomb" that could "blow up" fiscal cliff talks.
- Other than risking a bargaining failure by raising tempers, it's difficult to see what Reid hopes to achieve with this. The overriding reality of the fiscal cliff negotiation is that it is game with the structure of a three-person Prisoners Dilemma, in which the best outcome occurs only when all three cooperate. The GOP's leverage from threatening to blockade the best outcome isn't enhanced by its filibuster power in the Senate -- considering that it enjoys a majority in the House, and an overwhelming majority in the House Ways and Means Committee in which all tax bills must originate.

We conclude with one final development, of unknown significance at this time. Yesterday Representative Tom Cole (R-OK), a five-term congressman with strong fiscal conservative credentials, told *Politico* that he would favor the GOP bowing to Obama's demand to extend the "middle class" component of the Bush-era tax rates, and separately negotiating extending the rates for the so-called "rich." He told the *New York Times* that "We'll get some credit for that, and it's the right thing to do." But it is clear to us that this would be to surrender a great deal of negotiating leverage. If this idea gains adherents -- we don't think it will, but *if* -- it would signal the *good short-term* development that falling all the way off the fiscal cliff would be avoided. At the same time it would signal the *bad long-term* development that anti-growth and anti-capital tax and spending policies were to be imposed on an already insufficient business cycle recovery. Again, we don't think this will get any traction, but trial balloons must always be watched.

Bottom line

Stocks rallied Thanksgiving week with the fiscal cliff out of the headlines, as negotiations in Washington went nowhere. Time is running out for the best outcomes involving real tax and spending reforms. What's left is temporarily extending the *status quo*, or an accidental or deliberate fall off the cliff. To the good, Geithner is a pragmatic point-man for the White House. But Boehner's olive branch on revenues has been snubbed, and not reciprocated on spending. Harry Reid is emerging as the most divisive player, raising the stakes by insisting on co-negotiating the debt ceiling and the cliff, and threatening to blunt the GOP's filibuster power. As the clock ticks and the political noise amps up, we expect stocks to give up last week's gains and make new post-election lows.