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MACROCOSM

What If the GOP Caves?

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Donald Luskin

At least we wouldn't fall off the cliff. But don't kid yourself -- we'd still end up in the ditch.

We're surprised that stocks hung in there last week, despite a tightening deadlock over the fiscal cliff and the debt ceiling. We continue to expect, as we did last week (see "Back to the Cliff" November 28, 2012), that as the second hand gets closer to midnight -- and the negotiating factions *don't* get closer to each other -- stocks will have to fall sharply to discount a bargaining failure that could swiftly lead to recession.

Always respectful of markets, our purpose here will be to try to understand and reality-test the market's apparent optimism. Let's begin with a quick review of where matters stand now in Washington.

- Treasury Secretary Tim Geithner met separately on Thursday with House Speaker John Boehner (R-OH), Senate Minority Leader Mitch McConnell (R-KY), Senate Majority Leader Harry Reid (D-NV) and House Minority Leader Nancy Pelosi (D-CA). We have characterized these negotiations as a Prisoners Dilemma, and Geithner is taking the metaphor quite literally -- by negotiating with each of the principals in isolation from each other, preventing them from intercommunicating.
- McConnell rejected the deal structure proposed by Geithner -- he said he "burst into laughter" -- and so did Boehner -- he said he was "flabbergasted."
- Indeed, there is no way to objectively regard the White House proposal conveyed by Geithner as serious. Even House Minority Whip Steny Hoyer admitted that it was little more than a Democratic "wish list." The White House proposal demands $1.6 trillion in new tax revenues, from *both* raising tax *rates* on top earners *and* limiting their deductions. It offers $400 billion in spending cuts, none from entitlement benefit reform -- and demands a new $50 billion stimulus program.
- The ratio of $4 of revenue to $1 in spending cuts totally reverses President Obama's position less than three months ago, calling for $1 of revenue to $2.5 in cuts.
- Furthermore, the White House demands making permanent the president's temporary authority to unilaterally raise the debt ceiling, limited only by the congress's veto override powers.

Update to strategic view

US MACRO, US STOCKS: As the fiscal cliff deadlock worsens, markets are weirdly calm. What are they counting on? We agree that deadlock could lead to the harmless bridge scenario in which today's policy is temporarily continued. But the dominant narrative is a version of the fudge scenario -- that the GOP will cave: taxes for top earners will rise, but at least we won't fall off the cliff. We see that as less likely than the bridge, but either way would avoid a short term crisis. But caving would lead to a significant longer-term blow to growth. The economy is not as well equipped to absorb such a tax hike as it was in 1993. And either way, the next couple weeks of brinksmanship should still produce a great deal of volatility.

[Strategy Dashboard home]

- Whatever the merits of the White House's proposal, the Democrats' position now is that it is up to the GOP to put specific proposals on the table.
- But the GOP already has. On Friday McConnell took the daring step of being the first to openly speak of specific reductions in entitlement benefits. His proposal shouldn't be controversial -- it is nearly identical to the reforms President Obama agreed to last year in the debt ceiling crisis, as documented in Bob Woodward's *The Price of Politics*.
- As early as the day after the election Boehner put new revenues on the table. He's since made it clear that he's talking about $800 billion, to be achieved by "reform" that doesn't raise marginal rates. Obama claims that the "math tends not to work." But last week his own economic team published statistics proving that simply capping deductions for top earners at $25,000 is enough -- it's just not enough to get to $1.6 trillion.

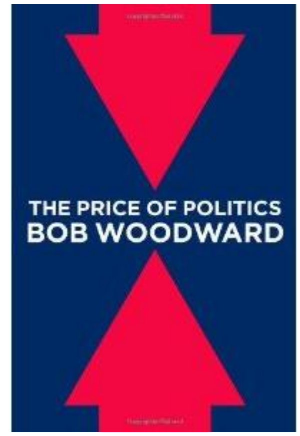
So, where matters stand in Washington is, as Boehner puts it, "we're nowhere, period." *What is there about this that markets are taking comfort in?*

- At the simplest level, markets must believe -- as we have maintained they have believed for months -- that this is all just political theater and, in the end, somehow it will all turn out just fine (see "Positioning for the Fiscal Cliff" October 3, 2012).
- As we said last week (again, see "Back to the Cliff"), the complete deadlock we're seeing now makes the scenario we've called *bridge* the likeliest possibility -- the extension of existing policy for a number of months in order to buy more negotiating time (see "Mandate for Volatility" November 13, 2012). *Bridge* is by no means a stable long-term solution to America's fiscal challenges, but it does get us through the short-term crisis of the year-end cliff, so it is one of the more benign outcomes.
- So in an important sense we agree with complacent markets -- the mostly likely single outcome isn't that bad. *However*, even if *bridge* is the year-end outcome, we'll be astonished if we get to it without a great deal more brinksmanship. That brinksmanship will necessarily flirt with the two worst scenarios -- *fail* and *doomsday* -- in which we fall over the fiscal cliff, either accidentally or willfully. So we still expect a major volatility event.

Another theory of what the market is expecting here is that the GOP will cave. Specifically, fearing blame for falling off the cliff, the GOP will accede to the expiration of current tax rates for top earners, dividends and capital gains, and will concede congress's power to determine the statutory debt limit. This would be a version of the scenario we have called *fudge* (again, see "Mandate for Volatility").

- We think the expectation that the GOP will cave is the dominant narrative, a thought contagion able to thrive in the afterglow of Obama's reelection. Strong evidence for this expectation is the rush

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.

by companies to move dividends into calendar 2012, and to pay extraordinary dividends, in anticipation of higher tax rates next year. We think this narrative is so strong that markets expect it to lead to the *fudge* scenario with relatively little brinksmanship.

- We don't think that will prove to be correct. But even if it is, it's only a good outcome in the limited sense that the alternative -- falling off the cliff -- would have been far worse. Yes, a *fudge* in which the GOP caves would be a relief in terms of short-term risks. But having focused so much on those, the market is blinding itself to some very bad long-term consequences.
- First, a positive. We think it would be a good thing if the GOP caved on debt ceiling authority, delegating it to the president under the "McConnell compromise" created in last year's crisis (see "Stand Down" July 21, 2011). We've never seen withholding debt authority as a practical weapon to force spending reform -- carrying out the threat of not raising the debt ceiling would be worse than the spending the threat was meant to curb.
- That said, the GOP caving on higher taxes cannot in any way be construed as anything but a major long-term negative.
- It won't make a significant difference to America's long-term fiscal profile. Ten years of higher taxes on top earners won't offset even a single year's deficit. The problem is too much spending, not too little taxing.
- So we don't accept the idea that settling the great debate over tax rates will set the stage for renewed confidence. Quite quickly taxes will simply have to be debated again, because deficits will only get worse until entitlement spending is addressed.
- *Most pointedly -- and we think this should be obvious -- higher taxes on top incomes, dividends and capital gains will be harmful to growth in what is already a Not So Great Expansion.*
- Democrats frequently point out that all that will happen is we go back to tax rates prevailing in the prosperous Clinton years. Granted, it is difficult to see in the data any obvious economic damage done by the Clinton tax hikes of 1993.
- But historical economic data is difficult to draw clear lessons from, because so many factors are always at work simultaneously. And no two moments in time -- 1993 and 2013 -- can ever be sufficiently alike to draw simple conclusions about any single common factor. To upend the old cliché, *this time is always different*.
- From first principles, we have to expect higher taxes to damage growth. How can it not hurt to increase disincentives to capital investment for those with capital, and labor contribution by the segment of the population demonstrated to be the most productive?
- And if any comparisons at all can be drawn, we would argue that the damage ought to be worse now than it was in 1993.
- First, the economy is weaker now, in almost every dimension.

    - When the Omnibus Budget Reconciliation Act of 1993 was passed, real GDP was growing at the above-trend rate of 3.0% YOY after a mild recession (currently, it's growing at the below-trend rate of 2.5% after the Great Recession).

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[About us]

Recommended Reading

The Crisis of American Self-Government
Sohrab Ahmari
Wall Street Journal
December 1, 2012

Diving Off the Fiscal Cliff: An Economy on the Rocks
Stephen J. Entin
Tax Foundation
November 27, 2012

[Reading home]

- The output gap was 2.7% (currently, 6%).
- Housing starts were 1.3 million SAAR (currently 892 thousand).
- S&P 500 forward earnings growth was 9.2% YOY (currently, 4.4%).
- Unemployment was 6.0% (currently, 7.9%).
- The labor force participation rate was 66.6% (currently, 63.8%).

- Second, while the magnitude of personal income tax hikes in 1993 is roughly comparable to what we can likely expect for 2013, the tax hikes on investment income will be larger.
- In 1993, the top dividend tax rate was hiked from 31% to 39.6%. According to our simple valuation model based on after-tax yields (see "The 2013 Fiscal Cliff Could Crush Stocks" May 5, 2012), that reduced the value of the stock market for taxable investors by 12.4%. If in 2013 the top rate goes all the way to 39.6% plus the Obamacare surcharge of 3.8% -- a total marginal tax rate of 43.4% -- then the value of the stock market would fall by 33.4%. If, on the other hand, the top dividend rate is capped at 20% plus 3.8% -- a level we think would be a likely compromise -- the value of the stock market would fall by 10.3%.
- Most important, in 1993, the capital gains tax rate was not changed. In 2013 it would be hiked from 15% to 20% plus the Obamacare surcharge of 3.8%, for a total of 23.8%. This is a substantial hike in a critical disincentive to capital formation at a time when we can ill afford it. In 1993 fixed investment was 14.0% of GDP, and now it is only 12.7%, having risen only feebly from all-time lows just two and a half years ago.
- Finally, in 1993, there were other developments that offset the tax hikes. Specifically, the North American Free Trade Agreement (NAFTA) -- effectively a large tax cut -- was ratified by congress just three months after it passed the tax hikes. More generally, the US economy was enjoying two significant peace dividends -- a technology boom engendered by the end of the Cold War, and a drop by a third in the price of crude oil in the aftermath of the first Gulf War.
- Are there comparable economic tailwinds at work today? We think not. Housing is something of a bright spot -- at least the brightest spot in the Not So Great Expansion (see "It's Okay You Didn't Build That" July 20, 2012). Other than that, the best we can point to amounts to just shifts in sentiment -- an increasing confidence that China won't experience a hard landing, and that Europe's debt problems won't trigger a systemic banking crisis. All to the good, to be sure, but pretty low-powered stuff compared to what was happening in 1993.
- The greatest hope for a truly countervailing growth accelerant would be the unleashing of the technology revolution in domestic oil and gas extraction. Sadly, the same administration that intends to impose higher taxes is unlikely to offset that by permitting significantly more rapid exploitation of energy resources. Indeed, the Obama administration is already preparing a move in the opposite direction, in the form of a new global climate change initiative.

Again, we don't think the GOP caving is the likeliest scenario. But even if the market is correctly discounting the GOP caving -- and thus avoiding the worst fall off the fiscal cliff -- remember that this, too, will likely not happen without a great deal of destabilizing brinksmanship. Abstracting from the very negative longer-term consequences, the next several weeks should still be very difficult.

Bottom line

As the fiscal cliff deadlock worsens, markets are weirdly calm. What are they counting on? We agree that deadlock could lead to the harmless *bridge* scenario in which today's policy is temporarily continued. But the dominant narrative is a version of the *fudge* scenario -- that the GOP will cave: taxes for top earners will rise, but at least we won't fall off the cliff. We see that as less likely than the *bridge*, but either way would avoid a short term crisis. But caving would lead to a significant longer-term blow to growth. The economy is not as well equipped to absorb such a tax hike as it was in 1993. And either way, the next couple weeks of brinksmanship should still produce a great deal of volatility.