Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

POLITICAL PULSE

Toxic Fudge

Monday, December 17, 2012

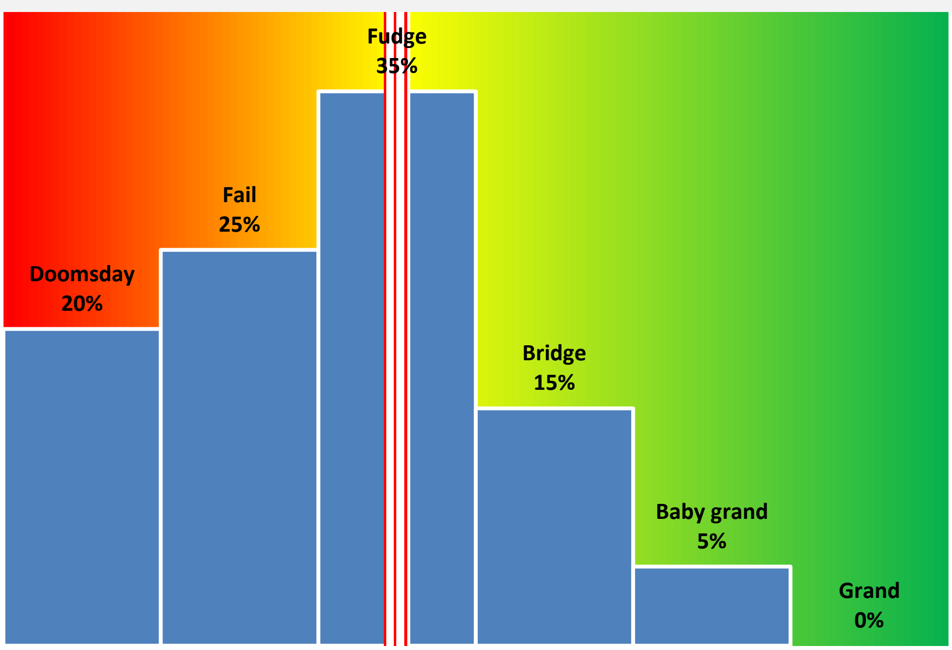
Donald Luskin

Boehner offers hikes to tax rates and the debt ceiling. Where's the upside in *that*?

The fiscal cliff negotiations have moved closer to our most-probable *fudge* scenario (see the chart below, and "What If the GOP Caves?" December 3, 2012) -- a messy compromise of tax hikes, borrowing, stimulus, spending cuts and spending increases. On Saturday it was reported that House Speaker John Boehner (R-OH) offered to compromise by putting on the table hiking tax *rates* for incomes over $1 million -- possibly entailing 10-year revenues of $1 trillion -- to be met by entitlement reforms of similar value. This is a version of the trade-off that has been advocated by Senator Bob Corker (R-TN) (see "How the GOP Could Survive the Cliff" December 10, 2012). Then on Sunday it was reported that Boehner put on the table a one-year increase in the statutory debt limit to sweeten the deal.

- If such a *fudge* could be quickly concluded, it would avoid a year-

New 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: Boehner has reportedly conceded on hiking tax rates for incomes over $1 million, and has offered to hike the debt ceiling for one year -- in exchange for spending cuts. This moves us closer to a messy version of our *fudge* scenario. Maybe it averts a year-end volatility event -- but that's far from a sure thing. Even if it does, then we'll be in the same Not So Great Expansion but with higher taxes. We don't see much upside for stocks in that -- and we urge quick action if things start to go terribly wrong by year-end.

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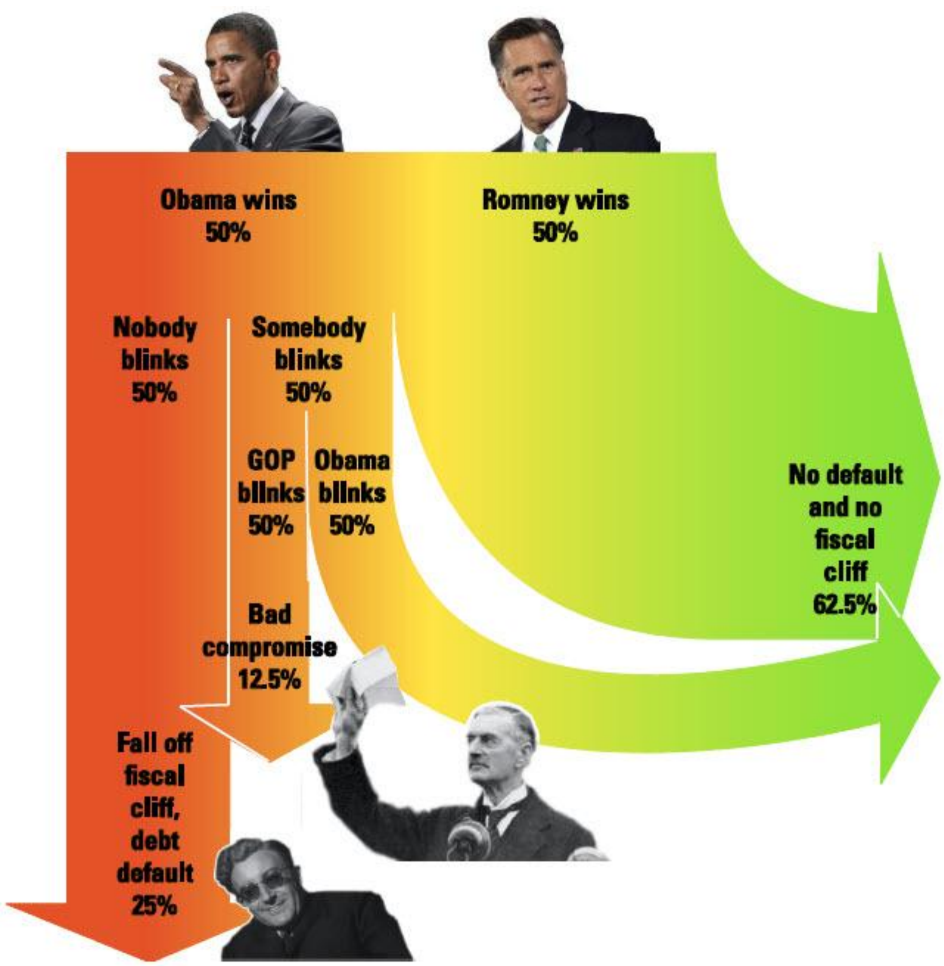
end crisis and the significant volatility event we've been warning about (see "Step by Step, Toward the Cliff" September 25, 2012).

- Indeed, if even this *fudge* fails, there is reportedly another one being developed by Senate Minority Leader Mitch McConnell (R-KY) -- a "two bill strategy" that would extend the Bush-era tax rates for only the so-called middle class, while allowing most Republicans to go on the record as voting to extend them for everyone. This would be a poor version of the legislative maneuver we described last week (again, see "How the GOP Could Survive the Cliff"). We don't see how it's different than the House acceding to the July Senate bill that lets the Bush-era tax rates expire only for the so-called rich -- the strategy of Representative Tom Cole (R-OK) (see "Back to the Cliff" November 28, 2012).
- Before the election, we used to talk about this scenario occurring *if* Obama won re-election, *if* somebody blinks in the crisis, and *if* that somebody is the GOP. It's an appeasement scenario, which we symbolized with the image of Neville Chamberlain, the British

Process probability map: fiscal cliff and debt ceiling
From presidential election to negotiation to conclusion



Source: TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
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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

[About us]

Prime Minister who appeased Hitler (please see the chart on the previous page, and again "Step by Step, Toward the Cliff").

- But the last cards have not been dealt in this hand of poker. Remember, it seemed that a deal was agreed in August 2011 in the debt ceiling crisis -- and then suddenly it wasn't. Do Obama and Boehner play together today any better than they did then?
- There remains a very real possibility of what we now call the *doomsday* scenario -- in which Democrats willingly take us off the fiscal cliff to gain political advantage in the aftermath, confident that the electorate will blame the GOP. Before the election we symbolized it with the image of Dr. Strangelove (again please see the chart on the previous page).
- And there's the possibility that Boehner's seemingly appeasing moves are just feints designed to make the GOP appear conciliatory, so that it can avoid blame when negotiations fall apart over entitlement cuts -- a version of our *fail* scenario.
- The optimal investment posture continues to be a form of dynamic hedging: stay alert for sudden event-driven developments, and act swiftly if things start to go terribly wrong (see "Positioning for the Fiscal Cliff" October 3, 2012).
- We really don't see any way from here that things could go terribly *right*. The best case is that we simply don't fall all the way off the fiscal cliff, and thus we avoid a double-dip Great Recession.
- We don't think that relief offers an upside for markets comparable in magnitude to the downside threatened by falling off the cliff in our *fail* or *doomsday* scenarios. That's because this is approximately what markets are already expecting. *And once they get it, we'll still be in a Not So Great Expansion -- but with higher taxes.*
- And we doubt the spending reforms that the Democrats will agree to will be substantive. They may be offset by deferring or eliminating the sequesters agreed in 2011's Budget Control Act (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). And renewal of the job-killing extended unemployment benefits could be included, too.
- The only argument for a substantial upside from such a deal is that business activity has been suppressed by fear of a cliff-dive, and with that fear abated, there would be a surge of pent-up spending and investment. We don't doubt one bit that more policy certainty would be a boost to confidence. But in the *fudge* likely to come out of the negotiations, there will be precious little certainty -- except that taxes are going up on the most productive people and on their investments.
- Objectively, the only hard evidence of anticipation of the cliff is the surge in dividend payments and other income accelerations. They'll make Q4 2012 personal income look like a boom, and they might add a little fillip to Q1 2013 consumption -- just as such maneuverings in Q4 1992 and Q1 1993 did, ahead of the Clinton tax hikes. And, briefly, they will create the illusion that hiking tax *rates* causes tax *revenues* to rise.
- Other than that, the Not So Great Expansion has looked to us over the last several months, as the cliff approaches, pretty much as it has looked all along.

- We don't see how raising taxes -- and achieving little or nothing on out-of-control entitlement spending, the true driver of long-term deficits -- can do anything but make it worse.

Bottom line

Boehner has reportedly conceded on hiking tax *rates* for incomes over $1 million, and has offered to hike the debt ceiling for one year -- in exchange for spending cuts. This moves us closer to a messy version of our *fudge* scenario. Maybe it averts a year-end volatility event -- but that's far from a sure thing. Even if it does, then we'll be in the same Not So Great Expansion but with higher taxes. We don't see much upside for stocks in that -- and we urge quick action if things start to go terribly wrong by year-end.