

TRENDMACRO LIVE!

## On Plan B for Busted

Friday, December 21, 2012

**Donald Luskin**

The volatility event may have arrived, and the *doomsday* scenario rears its very ugly head.

The volatility event we've been warning about for months may be at hand (see, among many, ["Step by Step, Toward the Cliff"](#) September 25, 2012). We warned yesterday that while "Plan B" from House Speaker John Boehner (R-OH) was a least-bad tax hike with some attractive pro-growth elements, its passage in the House would be problematic (see ["Plan B for Better"](#) December 20, 2012). Last night it was withdrawn without a vote because, [according](#) to a [distraught](#) Boehner, "it did not have sufficient support from our members to pass." With that, the House has adjourned until after Christmas -- and now expectations for how the fiscal cliff crisis might be resolved have to be significantly downgraded. If last night's volatility in stock index futures is any indication, it's probably time to deploy dynamic hedging strategies that will keep apace of any further weakening (see ["Positioning for the Fiscal Cliff"](#) October 3, 2012).

- We now believe there are equal probabilities for four scenarios for year-end (please see the updated chart below, which now looks rather like a cliff): *bridge*, in which the status quo is briefly extended to buy more negotiating time; *fudge* in which a hodgepodge of

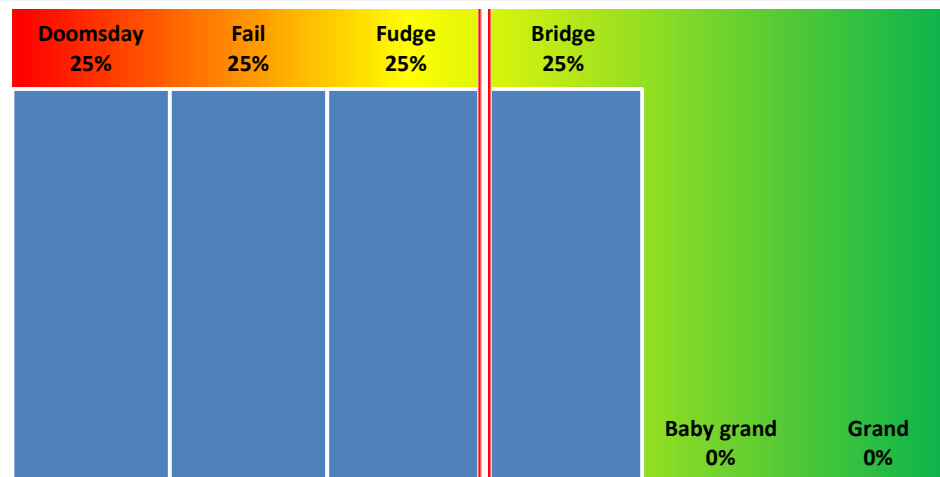
### Update to strategic view

**US MACRO, US STOCKS:** Boehner's "Plan B" has failed, and the House has adjourned until after Christmas. The blame game will now amplify tremendously, and both sides will flirt with the *doomsday* scenario of willfully falling off the fiscal cliff. The volatility event in markets we've been warning about may be at hand, in which case it's time to deploy dynamic hedging strategies. A disruption in markets could drive the politicians back to the negotiating table, but from here we don't see how a *fudge* could emerge that is any better than "Plan B" would have been. It looks like, at best, 2013 will be another year in the Not So Great Expansion, but with higher taxes. At worst, we go over the cliff and into another Great Recession.

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### New estimated probabilities of fiscal cliff outcomes by year-end

■ Bad ■ Good ||| Bad/Good divide



Source: TrendMacro calculations

compromises is thrown together (see ["Toxic Fudge"](#) December 17, 2012); *fail*, in which no deal can be done and we fall off the fiscal cliff; and *doomsday*, in which the blame game intensifies to such a pathological level that the politicians willfully leap off the cliff (again, see ["Step by Step, Toward the Cliff"](#)).

- 75% of our estimated probabilities now are bad, some seriously bad. And the 25% that are good aren't very good.
- The *doomsday* scenario has to be taken seriously now. "Plan B" was a smart finesse by the GOP designed to restore itself to equal footing in the political blame game around the fiscal cliff (see ["How the GOP Could Survive the Cliff"](#) December 10, 2012, and ["Plan B for Blame Game"](#) December 19). With the GOP unable to execute "Plan B," it is now more vulnerable than ever to blame by Democrats, and it will be tempting for Democrats to maximize that advantage by going all the way off the cliff. For their part, conservative Republicans appear, by not supporting "Plan B," to have chosen to willfully fall off the cliff, too. And don't forget that those same Republicans will get to do it all over again when it's time for the debt ceiling to be raised.
- The [first statement](#) from the White House last night was, on the surface at least, moderate. But we think the blame game will amplify tremendously in the coming week. That could make it very difficult for the negotiators to come back together constructively, which would lead to a *fail* scenario.
- Perhaps a very bad reaction in markets will scare both sides off the *doomsday* scenario, and drive them to the negotiating table with urgency, and a *fudge* will emerge -- if not in time for year-end, then early enough in January to avoid a recession. Surely the Republicans who blocked "Plan B" will think that their show of firm resolve will help them in negotiations. But we doubt it. The Democrats must see the failure of "Plan B" as a schism in the GOP, a sign of weakness to be exploited, not strength to be feared. We'll be amazed if any *fudge* that might yet emerge will be any better for GOP ideals than "Plan B" would have been.
- Sadly, the best we can hope for now is a *bridge*. This was [Boehner's](#) first negotiating position, taken a week before the election -- and it has been proposed at various times by [Bill Clinton](#), [Larry Summers](#) and [Dick Durbin](#) (D-IL). [Obama](#) has always said he would veto such an approach. In any event, it would be little more than a short-term can-kicking exercise. It will kick the can into a new congress in which the GOP will have fewer votes in both chambers -- yet a new congress that will also have to deal with hiking the debt ceiling. That sounds like us to a recipe for even more volatility.
- Incidentally, the new House may well have a new speaker. [Press reports](#) to that effect, recriminating Boehner, are rife this morning -- that's the blame game heating up. But from sources we believe that Boehner will not be *forced out* as speaker -- nevertheless, he is considering setting down the gavel out of frustration with the President and his own party. We may learn more on that in a press conference scheduled for 10:00 this morning. A new lead negotiator next year might press the reset button constructively --

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but putting him or her in place will consume valuable time. Once we're over the fiscal cliff, every second will count.

Short-term, a volatility event seems very likely now. Longer term, the hopes that we had for the pro-growth aspects of "Plan B" (again, see "[Plan B for Better](#)") seem dashed. At best, 2013 will be another year in the Not So Great Expansion, but with higher taxes. At worst, it will be a year at the bottom of the fiscal cliff -- that is, another Great Recession less than five years since the last one.

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### **Bottom line**

Boehner's "Plan B" has failed, and the House has adjourned until after Christmas. The blame game will now amplify tremendously, and both sides will flirt with the *doomsday* scenario of willfully falling off the fiscal cliff. The volatility event in markets we've been warning about may be at hand, in which case it's time to deploy dynamic hedging strategies. A disruption in markets could drive the politicians back to the negotiating table, but from here we don't see how a *fudge* could emerge that is any better than "Plan B" would have been. It looks like, at best, 2013 will be another year in the Not So Great Expansion, but with higher taxes. At worst, we go over the cliff and into another Great Recession. ▶