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POLITICAL PULSE

Last Day

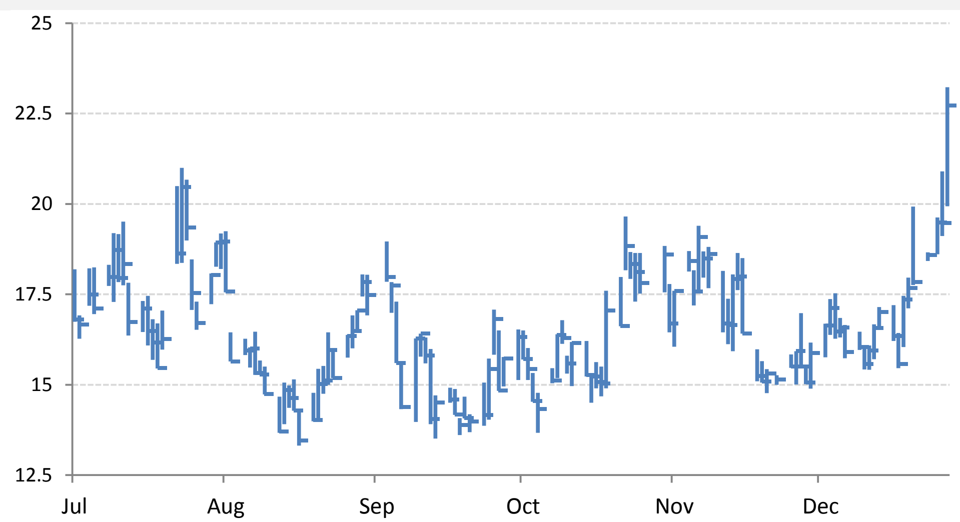
Monday, December 31, 2012

Donald Luskin

Avoid the cliff, damage growth. Go off the cliff, kill growth. Only least-bad outcomes now.

Nine long months ago, when we first highlighted the fiscal cliff as the only serious risk to the bull market that began in 2009 (see "What Could Possibly Go Worng?" March 8, 2012), few believed that we'd ever end up *here* -- the last day of the year, with no legislative solution. Now that we *are* here, most are still fairly complacent that even if we *technically* go over the year-end cliff, surely some solution will emerge soon from the frenzy of last-minute negotiating going on in Washington. For the first time, though, the complacency has started to crack. So far we haven't seen the kind of massive volatility event that we've been warning about (see "Positioning for the Fiscal Cliff" October 3, 2012), but last week volatility spiked to the highest levels seen since the fiscal cliff became a live topic (please see the chart below).

- Can a deal be done today? This morning there are reports that at least Senate Minority Leader Mitch McConnell (R-KY) and Vice President Joe Biden are close to a compromise. It could draw the income line for tax hikes at about $500,000, and potentially preserve top tax rates on dividends and capital gains. Like the "Plan B" of House Speaker John Boehner (R-OH), such a thing



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS: One day before the fiscal cliff, and still no solution. The GOP may yet cave, ushering in anti-growth legislation that will damage our Not So Great Expansion. That would limit the volatility event in markets to what we've already seen, but it's a long-term risk that markets are overlooking now. The volatility probably hasn't seen its worst. We think the political blame game gives the GOP stronger incentives not to cave. We could easily face a bargaining failure that would leave us with a fragile "golden hour" in which to prevent the economy from lapsing into recession. And there is the strong possibility that in setting up the blame game this way, Obama is angling to fall over the cliff on purpose -- and stay over it until the economy substantially weakens. At this point there are no good solutions that have any substantial probability. With so much indeterminacy, dynamic hedging remains the best strategy.

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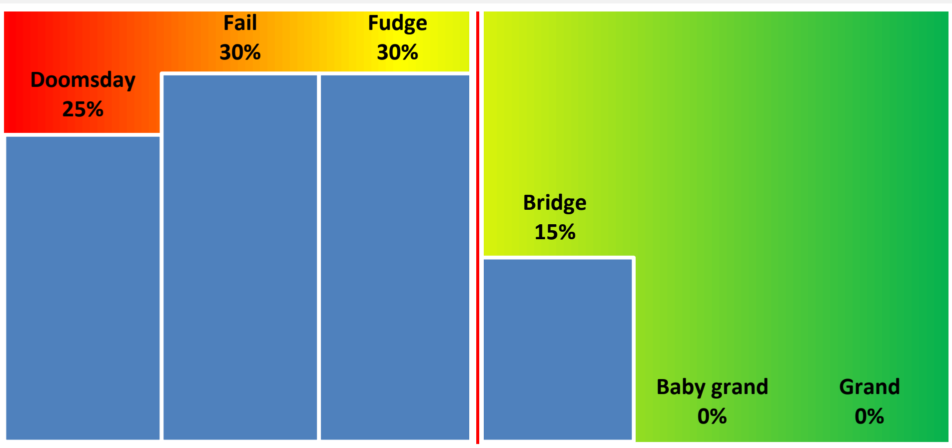
would be a "least bad" solution. But even if McConnell and Biden agree on it, it's not clear Senate Majority Leader Harry Reid (D-NV) would agree, or that it could get through the whole Senate -- or the House GOP, which just last week rejected Boehner's better deal (see "Plan B for Better" December 20, 2012).

- So while it seems hope wants to spring eternal where the fiscal cliff is concerned, we may not have seen the worst. There are so many competing ideological absolutes here -- taxing the rich (or not, and how to define them), cutting entitlement spending (or not), overturning the sequesters (or not), and hiking the debt ceiling (or not), to name the most obvious -- it is difficult to expect that anything could get worked out within a time constraint measured now in mere hours.
- If all that were involved were this tangle of ideologies, the optimal compromise would be quite straightforward -- it is the scenario we have called *bridge* -- and what House Speaker John Boehner (R-OH) proposed a week before the election -- a bill that would simply preserve the *status quo* for a while, creating a post-election cooling-off period long enough for negotiations to start over on a more solid footing.
- But that noble compromise has become quite improbable (please see the chart below). It is nearly ruled out by the fact that the ideological issues are now only instruments in a political blame game in which a "tie" like *bridge* would not be a viable outcome

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



Source: TrendMacro calculations

(see, most recently, "Plan B for Blame Game" December 19, 2012).

- And the dynamics of the blame game have become dangerously unstable. Superficially, the dominant narrative is that President Obama is so completely in control of shaping public opinion that the GOP will have to cave to his every demand or collectively take the blame for falling off the cliff. But *individual* Republican senators and representatives face the reality of being blamed by their voters back home if they cave to Obama. So Obama has given them two

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ways to lose -- cave or don't cave. Since they lose either way, why cave?

- Yes, nevertheless the GOP could still cave this very day, acquiescing in some anti-growth *fudge* that raises taxes on capital and on the most productive workers, and does nothing whatsoever to address America's spending crisis. It wouldn't take any GOP votes at all in the Senate -- just the decision not to filibuster. And it would take only a few in the House. Indeed, in the House it would take no GOP "aye" votes at all. All it would take would be enough Republicans to vote "no" to create a quorum for a vote carried entirely by Democrats (and all the other Republicans could just leave the chamber).
- Right now we think markets are still expecting something like that, by and large. Indeed, it's surely one of the most likely outcomes. But what we think they are ignoring -- having been distracted by the immediate crisis of the cliff -- is that while such a *fudge* would end the crisis it could do great damage to the economy, still struggling with the Not So Great Expansion following the Great Recession. Stocks might briefly celebrate the passing of the crisis, but we think the darker reality of the long-term costs of a GOP cave would soon come to the fore.
- But all that said, if the GOP wanted to cave, would it not have done so already?
- Obama, by playing so aggressively and by being so obvious about it (as he was yesterday on "Meet the Press"), by being so unwilling to give the GOP *anything* -- even after Boehner had caved on tax rates, the debt ceiling, and the amount of revenues to be raised (see "Toxic Fudge" December 17, 2012) -- may have created a situation in which the course of least political resistance is to go off the cliff.
- If this were a mere mistake -- a bargaining failure, the scenario we have called *fail* -- then there would be a chance to recover. The fiscal cliff is not an instantaneous phase-transition that occurs at midnight tonight. Like an oil price shock, it would take some time for its various effects -- mostly higher taxes -- to infiltrate the economy. There would be a "golden hour" in which a solution could still be legislated, before the economy slipped into recession.
- But don't take too much comfort from that. No one knows how long the "golden hour" will last -- a week? a month? a quarter? When it ends: that's the true fiscal cliff, the unknowable moment when it is too late. Markets won't be happy while the politicians bicker underneath a Sword of Damocles.
- We can see many ways out of this mess, but something still haunts us. Obama is not a stupid man. If he has *not* made a mistake -- if *it was his intention* to drive us over the fiscal cliff by making it optimal for the GOP to *not* cave -- then to maximize the GOP's risk and his own power, it would be in his interest to let the "Golden Hour" slip away, and to the economy fall into recession. This is scenario we have called *doomsday*. We wish we could rule it out. Here, on the last day of the year, the last day before the fiscal cliff, we cannot.
- In the face so much short term indeterminacy and long-term risk, we continue to advocate a strategic posture that looks like dynamic

hedging or "portfolio insurance" (again, see "Positioning for the Fiscal Cliff").

Bottom line

One day before the fiscal cliff, and still no solution. The GOP may yet cave, ushering in anti-growth legislation that will damage our Not So Great Expansion. That would limit the volatility event in markets to what we've already seen, but it's a long-term risk that markets are overlooking now. The volatility probably hasn't seen its worst. We think the political blame game gives the GOP stronger incentives *not* to cave. We could easily face a bargaining failure that would leave us with a fragile "golden hour" in which to prevent the economy from lapsing into recession. And there is the strong possibility that in setting up the blame game this way, Obama is angling to fall over the cliff on purpose -- and stay over it until the economy substantially weakens. At this point there are no good solutions that have any substantial probability. With so much indeterminacy, dynamic hedging remains the best strategy.