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POLITICAL PULSE

## Oh What a Relief It Is

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### The GOP lays down its nuclear option of debt default. What can Washington do for an encore?

The problem with relief rallies is that when the relief is old news, the rally runs out of steam. We still think this is just a relief rally for US stocks, but as we noted early last week, "it feels like stocks want to keep melting up" (see ["2013 Outlook: Think Globally, Shrink Locally"](#) January 14, 2013). Now stocks have made new recovery highs, because fresh relief just keeps on coming.

- It appears now that the statutory debt limit will be suspended for three months without any political brinkmanship involving the threat of a Treasury default.
- The political logic is very much as we've been explaining to clients all month. President Obama has learned to use the threat of public opinion to neutralize the GOP-controlled House's power to block must-pass legislation with various "nuclear options" (see ["What If the GOP Caves?"](#) December 3, 2012). Reeling from its defeat in the fiscal cliff crisis, the GOP needed a face-saving way to lay down the nuclear weapons it didn't dare to use anyway, and fight a more conventional political war.
- The GOP [came to terms](#) with this new reality at its off-site huddle in Williamsburg last week. Speaker John Boehner (R-OH) made it official Friday when [he announced](#) that the GOP would endorse a three-month debt ceiling suspension without demanding any spending cuts in return.
- Instead, the GOP House would use this short-term suspension to force the Democrat-controlled Senate into making a politically embarrassing vote in favor of debt, tax hikes and spending -- in this case, passing the first Senate budget in four years -- while the House passes an austere budget written by Paul Ryan (R-WI). Every three months, the GOP could demand another embarrassing Democratic vote, right up to the 2014 elections. And should it become necessary or desirable, the GOP's nuclear option would never be more than three months away.
- Yesterday while stocks drifted up to new recovery highs, the White House [officially stated](#) it would go along with GOP's approach, and Senate Democrats [signaled similarly](#).
- At the same time, the highly influential anti-spending Club For Growth [stated](#) it would not negatively grade Republicans who vote for the short-term suspension. So the House's short-term debt

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#### Update to strategic view

##### US STOCKS, US

**MACRO:** A new lease on life for the relief rally in stocks as the GOP lays down its nuclear weapons in the debt ceiling debate. But it's just for three months at a time, and the nuclear option will still be available in some subsequent round. In the meantime, it's warfare with the conventional weapon of the threat of government shutdown. And until the sequestrations and the continuing resolution are settled, there will be the threat that the GOP will agree to higher taxes in a fool's bargain for various ideological aims. The only relief is that nothing at all will happen -- no spending reform, but no new taxes. This rally is built on such relief. We don't see that much upside or durability in it.

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ceiling bill [H.325](#) is highly likely to pass today, and then to become law.

- Assuming it does, then the nuclear threat of a debt default is off the table for at least three months.

That is some relief, to be sure. But let us not jump to the conclusion that stability is busting out all over. What can Washington do for an encore? Suspend the debt ceiling for *another* three months, and then *another*? Hard to see how that could keep powering stocks higher.

- In the meantime, the debate about taxes and spending will continue, and it is unlikely to be comforting or constructive. The threats may not be nuclear now, but in some sense that is worse -- nuclear weapons are so horrible they are virtually never really used, but less horrible conventional weapons *are*.
- The most conservative members of the GOP House [will insist](#) that leadership be especially aggressive in the coming debates over the sequestrations and the continuing resolution, as the price for supporting the present debt ceiling bill.
- Democrats in the Senate will be very aggressive too, countering every Republican spending initiative with new tax hikes -- as Senator Chuck Schumer (D-NY) [signaled very explicitly](#) on Sunday.
- The worst risk that the most ideological sects within the GOP -- those obsessed with *cutting entitlement spending*, those obsessed with *increasing defense spending*, and those who are obsessed with the *dream of a grand bargain* -- could drive agreement to further tax hikes on top of the ones just imposed (see "[Tax Hikes Have Consequences](#)" January 2, 2013).
- A lesser risk is that *no agreement* between Democrats and the GOP could lead to a government shutdown when the continuing resolution expires on March 27. This is not a nuclear option like a debt default -- there have been [shutdowns before](#) -- and the economic impacts need not be catastrophic. But a government shutdown isn't exactly the kind of event that extends a relief rally.

We think we can pretty much rule out anything really good happening here -- the kind of agreement that would cut spending without raising taxes. So relief is the best we can realistically expect -- the relief of muddling on with no progress on spending, but at least no new taxes. Happily that's the most likely single outcome, in our current view. Enough to keep this relief rally fueled? For the moment, stocks still feel like they want to keep melting up. But we still don't see that much upside or durability.

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## Bottom line

A new lease on life for the relief rally in stocks as the GOP lays down its nuclear weapons in the debt ceiling debate. But it's just for three months at a time, and the nuclear option will still be available in some subsequent round. In the meantime, it's warfare with the conventional weapon of the threat of government shutdown. And until the sequestrations and the

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