

Greg Valliere: The U.S. Political Outlook

October 29, 2010

by Robert Huebscher

Three questions dominate the political landscape, according to Greg Valliere, and the big one is what will happen to the Bush tax cuts. Valliere is the chief political strategist at the Potomac Research Group, and he was a keynote speaker at the Schwab IMPACT conference on Wednesday.



Despite significant challenges, Valliere said the fundamentals in Washington are “better than they have been in several years.”

We previously reported on Valliere’s forecasts in January 2009, when he predicted (correctly) that the economy would grow in the second half of that year, and (incorrectly) that healthcare reform would be tabled.

The first question Valliere explored was whether there is any “medicine” left to stimulate the economy. He said markets have already factored in the likely results of the mid-term elections, and he offered an analysis of the post-election fallout. He also speculated on the fate of the Bush tax cuts.

A double-dip recession, Valliere said, has perhaps 15-20% likelihood, “but we are out of ammunition” to revive economic growth:

No “shock and awe” will be announced at next Wednesday’s Federal Reserve meeting, he said. Most likely, the Fed will do a “little more” quantitative easing. There is great dissent within the Fed over the possible benefits of further rate reductions. The Fed will keep Fed Funds Rate at zero for at least another year.

Additional government spending is now “radioactive,” he said, and nobody wants to endorse it. TARP, introduced and supported by Republicans, is now viewed as “wasteful and immoral” by both parties. TARP and the stimulus are considered failures, Valliere said, and this will be a dominant political theme.

The Bush tax cuts will be extended before Christmas, but that is not a new economic stimulus, he said; it just avoids a negative one. The economy would have to dramatically weaken before support for further tax reductions emerges, and if so it would be a payroll tax cut.

“We better hope we don’t have a double-dip recession,” Valliere said, “because there’s not much Washington can do.”

There are policy options that give him cause for optimism, Valliere said, and they depend on two big factors – the election results and the likelihood of predictability on taxes. If things work out as he hopes they will, Valliere said it will get businesses to “loosen their wallets.”

According to the closely-followed election handicapper Charlie Cook, Valliere expects a “tidal wave” of 48 to 60 (and as many as 65) new Republican House members, which would be more than Newt Gingrich’s 52 new members in the last Republican takeover in 1994. In the Senate, Valliere said it would be a “stretch” to think Republicans could get to their “magic number” of 10 to gain control. They will lose Connecticut, West Virginia, California and two or three others, but will gain seven to nine seats.

“Post election,” he said, “the balance of power will shift and it will be a plus for the markets.”

A big question for Valliere is how Democrats will react. The audience applauded when he said that, within 72 hours of the announcement of the election results, Nancy Pelosi will step down from her leadership role. She will be replaced by Steny Hoyer, a pro-business Democrat and a personal friend of Republican majority leader John Boehner. “The temperature will go down,” Valliere said, as acrimony between the parties will abate.

The bigger story, according to Valliere, is that the finger pointing at Barack Obama will start on election night. Will he pivot as deftly to the middle as Clinton did in 1994, he asked? That would be very unlikely, he said, because Clinton had many centrist views that Obama does not share. If Obama does not “look like he got the message,” Valliere said, he will be challenged for the nomination in 2012 by someone in his own party. It will not be by Hillary Clinton, who Valliere predicted

will step down as Secretary of State after the election. Someone like Evan Bayh (D-IN), a centrist, could step in, he said. In today's electoral climate, Obama could not win Indiana, Ohio, North Carolina, or Florida – key states he won in 2008 – according to Valliere.

The Tea Party has been a blessing, Valliere said, except in Delaware, where Christine O'Donnell is unlikely to win in her Senate race. It helped in Nevada and Kentucky, but going forward Republicans must decide whether to position themselves in a "Mitt Romney Chamber of Commerce" image, or possibly go down the Sarah Palin path. In the short-term, how aggressive will they be legislatively is the main concern, and the big fight will be over spending (although not over a possible healthcare reversal, which Obama would veto). Valliere expects outlays to be frozen over the next two years, but does not foresee a shutdown of the government.

The most interesting post-election story is for investors, he said. Markets overwhelmingly like gridlock, and the market does well in year three of the presidential term. Cap-and-trade and card check legislation will not move forward and there will be no "punishing" of the Chinese through trade sanctions; Valliere said this lack of action will be favorable for the markets.

He added some words of caution. Obama will have his veto power, which will be sustained by Congress, and regulators will stay very active, Valliere said, including Elizabeth Warren, the EPA – which may introduce carbon emission restrictions, and an active Medicare overseer. "These will be a big irritant for markets," he said

Valliere's biggest concern is that the uncertainty over taxes will persist until mid-December, and he said this is a bigger issue than the election itself. The Bush tax cuts will be extended for everyone, he said. If not, the most ominous impact will be from the dividend tax rate going from 15% to 36%. Most economists, he said, concur that this is "a stupid time to raise taxes on anyone." More importantly, politically a "big chunk" of moderate Democrats want to extend it; 47 Democrats rebelled against Nancy Pelosi to say they wanted to keep dividend tax rates where they are now.

In mid-December, a deal will come into shape, Valliere said, brokered by Senators Collins and Snowe of Maine. Republicans will drop their demand to extend the tax cuts permanently and settle for extending them just for two to three years. Democrats will accept this. Valliere assigned a 70% likelihood to this outcome, but that leaves a 30% chance negotiations will break up in acrimony.

The estate tax will not remain at zero, he said, and will probably rise to the high 40% with an exemption of around \$4 million.

Valliere identified a couple of more things to worry about. "We are swimming in a sea of red ink," he said, in reference to budget deficits. Spending could be frozen at the previous year's level, he said, but the reduction in deficits would be minimal because the discretionary part of budget is just 16%. He said there is no chance substantive reform will emerge from the deficit reduction commission. Valliere is not sure the country is willing to go through the process of entitlement reform or increasing taxes. A VAT, an elimination of the mortgage deduction, or other radical moves are out of the question, he said.

"The deficit will stay extraordinarily high for the next two or three years," he said, "even with a freeze on spending. The bond market couldn't care less for now, but this will not end happily."

His final worry, and what he called the greatest threat, is from fundamental radical Islam. This is still an acute problem in three areas.

Pakistan is unstable, corrupt, and its relationship with the U.S. is deteriorating. It has nearly 100 nuclear bombs, Valliere said.

In Washington, support for the war in Afghanistan is deteriorating, even among Republicans. "It is a corrupt, illiterate, and untamable country," Valliere said. "Even the military thinks that war is unwinnable." No peace dividend is coming, he said, because the unwinding from Iraq and eventually Afghanistan will be slow.

The last – and most ominous – threat from fundamental radical Islam is at what point Israel says "enough is enough" with the Iranian nuclear policy. Valliere cited a recent article in the *Atlantic* which said that Iran will have two dirty bombs by next summer. He said Israel will be "inclined to move" by the fall 2011. "More people in Washington are telling me this is intolerable," he said, adding that most Arab countries would like to see action. "Consensus is growing toward action."

Despite his many concerns, Valliere was clearly optimistic that progress can be made on the political front, particularly in respect to long-term issues such as deficit reduction and stimulating economic growth. His optimism stems, in large part,

from a belief that a new generation of political leaders will gain power and will be willing to tackle problems that have been neglected for many years. Valliere cited New Jersey Governor Chris Christie, who has been confronting the labor unions, as a role model among many in Washington. His prediction for the “next big superstar” is Florida’s Marco Rubio, who has talked about cutting Social Security benefits – a surprising move, considering Florida’s demographics. “We will need some new thinking politically.”