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POLITICAL PULSE

Trumped!

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Donald Luskin

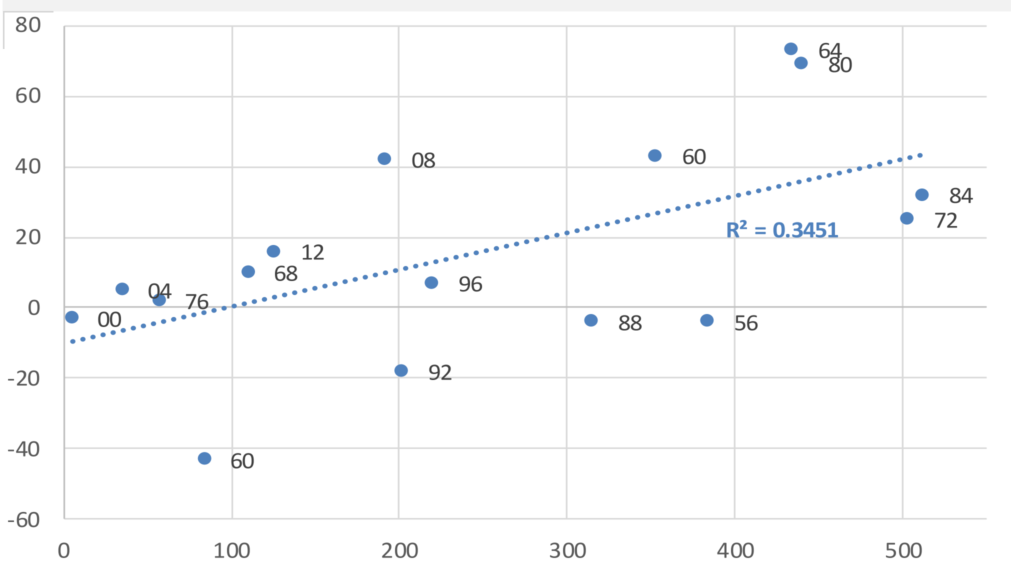
Win or lose, Trump is a risk for markets, a Black Swan that's not just going away.

The conventional wisdom is now catching up to what we've been telling clients in meetings and on calls for two months now – that Donald Trump isn't going to just go away. Markets need to get real about the perfectly feasible scenario that Trump will be the Republican nominee for president. Then, win or lose, we believe the impact will possibly be quite significant. Indeed, we have to wonder whether the jitters in global equities last week were due to the dawning awareness that Trump may be a true Black Swan, as a story leaked on Thursday revealed the GOP establishment is now preparing for a "brokered convention."

WHAT IF HE LOSES? *The biggest risk is that Trump will be the nominee, and lose in a Goldwater- or Carter-class landslide. The "coat-tails effect" could cause the GOP to lose control of both the Senate and the House.*

- As solid a lock on the House as the GOP may seem to have, thanks to careful districting by GOP governors, history shows that a landslide could get the Democrats the 30-member swing that they need to get control (please see the chart below).

Swing in House seats (vertical axis) Presidential elections 1952-2012
Same-party Electoral College margin of victory (horizontal axis)



Source: US Congress, National Archive, TrendMacro calculations

Update to strategic view

US MACRO, ELECTION MODEL: As we've been telling clients for months, Trump is not going to just go away – he may be the GOP nominee. The establishment and the conventional wisdom are just beginning to see it, and last week's market jitters may in part have been caused by it. If Trump is the GOP nominee, and loses by a landslide, the GOP could lose the Senate and the House – despite gerrymandering – which would usher in two years of anti-growth policy such as we had in 2009-2010. Our election model still forecasts a win for the GOP. If it is Trump, the risk is that he would impose protectionist measures against China and US multinationals.

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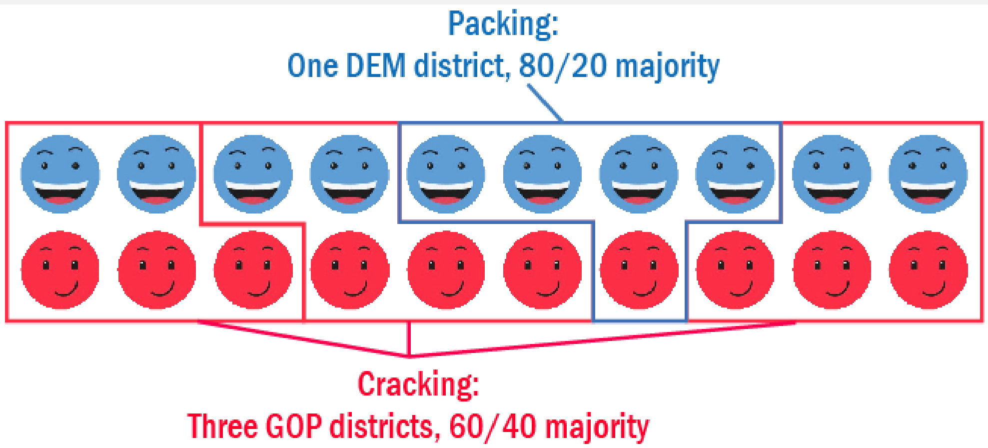
- *How can this be?* It's because in the science of gerrymandering congressional districts, there is a trade-off: if you make districts extremely safe, you get fewer districts; if you are willing to take at least some risks, you get more districts.
- In the lingo of the districting business, it's a trade-off between "cracking" and "packing." A GOP governor "cracks" districts by creating GOP majorities in them, but *not totally dominant* majorities, because that uses up a finite number of GOP votes. He then "packs" the remaining districts with all the Democratic votes ruled out of the "cracked" districts, creating a small number of districts that are extremely safe for Democrats, but which waste Democratic votes in obtaining that safety.
- With optimal "cracking" and "packing," it is simple to allocate an electorate made up of a precisely equal number of Democrats or Republicans into districts that will send to Washington – *most of the time* – a strong majority of members from whichever party gets to do the gerrymandering (please see the chart below).

How optimal districting can turn a 50/50 purple state into a 75/25 red state



Source: TrendMacro calculations

- We say "optimal" and "most of the time" because of the trade-off between risky "cracking" and riskless "packing." That trade-off means that, under extreme conditions, the "cracked" districts could still lose for the GOP. Our concern is that a sufficiently disastrous Trump candidacy could be precisely such an "extreme condition."
- The Senate is at risk anyway, even if Trump loses by a narrow margin. The natural six-year cycle of Senate seats puts the GOP more at risk than the Democrats in 2016 – not such an extreme imbalance as the Democrats themselves faced in 2014, but nevertheless a risk to the GOP.
- *So if Trump runs and loses, then the GOP almost certainly loses the Senate in all cases, and the House too in landslide cases.*
- *With single-party control of government, it is highly likely that the Democrats would rush to implement a host of long-favored initiatives. Remember what happened in the two-year window of control enjoyed by the Democrats in 2009 and 2010 -- the massive "stimulus," Obamacare and Dodd-Frank.*

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Recommended Reading

GOP preparing for contested convention
Robert Costa
Washington Post
December 10, 2015

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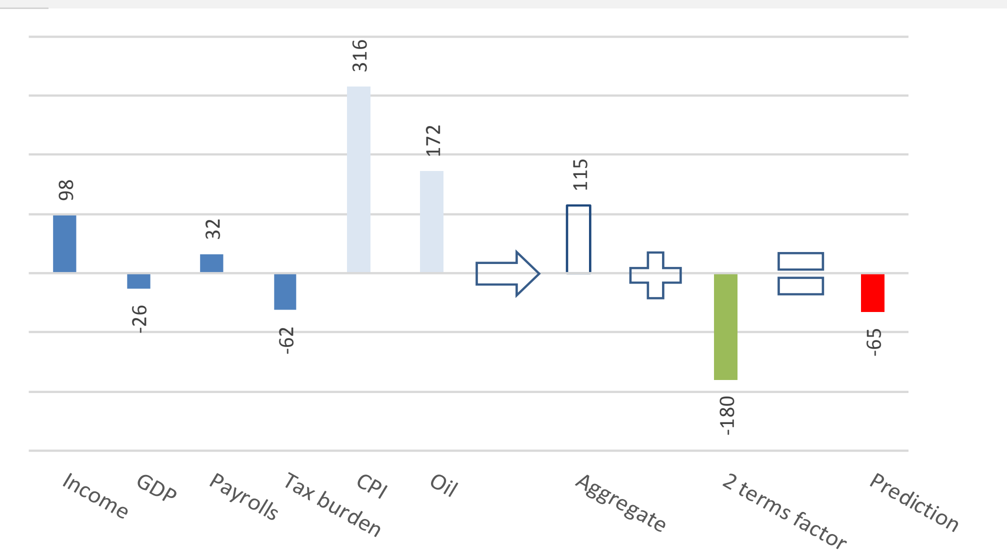
- *Whatever truly noble aspirations or intentions might be attached to those initiatives, or view – purely as observers and forecasters of the markets and the economy – is that all three of those initiatives were, and remain, anti-growth.*
- *We are concerned that other anti-growth initiatives, of similar scope and complexity – such as converting Obamacare into a single-payer system, putting price controls on prescription drugs, imposing strict carbon-emission controls or taxes, more regulation and taxation of the Internet, limiting the growth of fracking, making it easier for labor unions to gain more influence – or something as simple as higher taxes on the most productive among us, and our capital – would be imposed upon a US economy that has never, in some sense, really recovered from the Great Recession.*

It's easy enough to visualize that Trump would lose in a big enough landslide to trigger our scenario in which the GOP loses the White House, the Senate and the House.

- Obviously, his extreme positions may alienate whole voting-blocs.
- And the media, who already see Trump as a golden ticket to high ratings for normally dead-air political programming, will be eager to portray even his mainstream views as extreme. The Democrats will be glad to help.
- So far, the Republicans have, too. Mainstream GOP candidates and opinion media have been as harsh on Trump as they usually are on Democrats. If he is the GOP nominee, the establishment will have to decide whether to bite its tongue and get on his team – if it will even be able to so do, given how many quotably poisonous things they've already said.

WHAT IF HE WINS? Our election model (please see the chart below)

TrendMacro presidential election forecasting model
Electoral College vote-spread for incumbent party
■ **Strong inputs** ■ **Weak inputs** ☐ **All inputs** ■ **Dummy variable** ■ **Output**



Source: BAML, TrendMacro calculations

predicts that a Republican will win (see "Modeling the 2016 Presidential Election" November 12, 2014). In backtesting, our model has correctly predicted every election from 1952, and in real-time it perfectly predicted Obama's re-election in 2012 – forecasting his winning margin within just four Electoral College votes (see "On the 2012 Election" November 7, 2012).

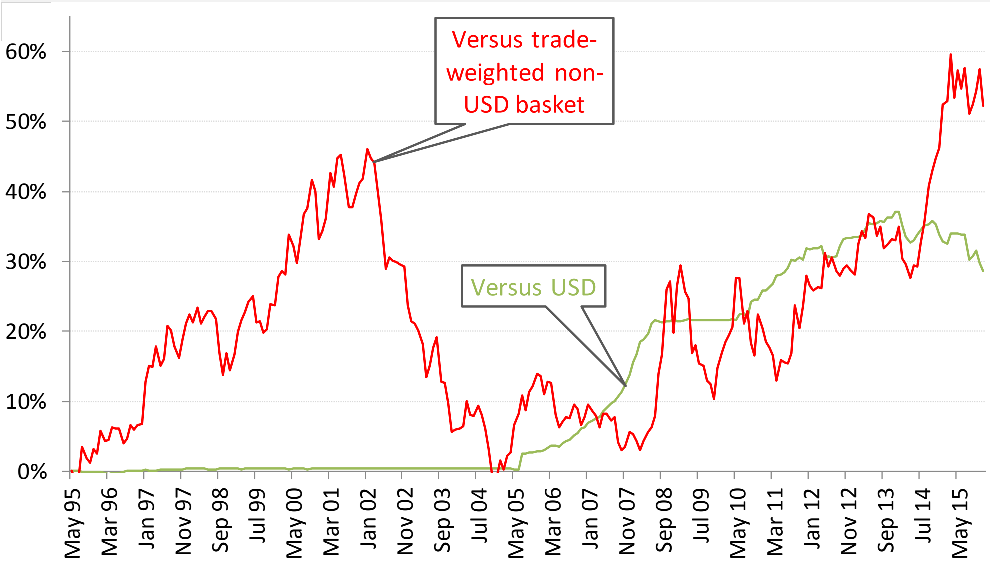
- The problem is, our model isn't calibrated for the GOP candidate being Donald Trump.
- But as unlikely as it seems now that he could win – and remember, just a couple months ago it was seen as virtually inconceivable that he could have stayed in the race this long – the GOP does have the edge in 2016.
- The model weights heavily the fact that, since the FDR/Truman Democratic streak, no party has been able to hold the White House for more than two terms, with the single exception of George H. W. Bush following two terms for Ronald Reagan. So whatever else, Trump has going in his favor that the Democratic party is tired and lazy after the Obama years, as evidenced by its inability to produce exciting challengers to an old war-horse like Hillary Clinton.
- The present configuration of economic factors in our model favors the Democrats – at least if the election were held today. But there's almost a year to go till the election. Even abstracting from our expectation that we are in for a short, shallow recession, it's highly unlikely that oil prices or inflation will have improved (from the voters' perspective) a year from now as much as they have over the last year – and right now, those two factors are tilting mightily toward the incumbent party.

The problem with anticipating what a Trump presidency would mean for policy that moves markets is that Trump has not left a long record of actual positions or accomplishments. In their absence, we are left with the fool's errand of trying to extract his intentions from his campaign promises. And with only a few exceptions, Trump's promises are long on attention-getting extremes and short on policy content.

- *We do probably know with some confidence that Trump is an isolationist and a nativist.*
- *These are fundamentally anti-growth policy postures.*
- It is an axiom of economics that productivity is a function of the scope of the market – the extent to which persons, goods and capital can freely sort themselves into the places and forms in which they are most productive.
- The scope of the market is reduced when the free flow of persons, goods and capital is constrained – as by arbitrary immigration restrictions, or by protectionism. Productivity – and the wealth and well-being that flows from productivity – is commensurably reduced.
- You'd think the world would have learned that lesson once and for all after the Smoot-Hawley Tariff Act ushered in the global Great Depression of the 1930s.

- Yet populist politicians – and certain businessmen whose narrow short-term interests would be helped by particular protections – can't seem to resist.
- So we have Trump threatening to put "tough countervailing duties" on China, a "currency manipulator" whose "yuan is undervalued by anywhere from 15% to 40%."
- Trump is literally parroting claims made over ten years ago by Senator Chuck Schumer (D-NY), when he and Senator Lindsay Graham (R-SC) threatened countervailing duties. Since then, a decade of gradual revaluation by China as strengthened the RMB by 29% against the USD, and 52% against a trade-weighted basket of non-USD currencies (please see the chart below).

Strengthening of the RMB from May 1995



Source: Bloomberg, TrendMacro calculations

- As China tries to rebalance its growth model from infrastructure to consumption and net exports, it is going to need to weaken the RMB, which we believe has become among the most over-valued in the world – not strengthen it. The work began in August with a small devaluation (see "On the RMB Devaluation" August 11, 2015), and we believe it will continue over years, as part of a gradual de-dollarization. This is very delicate work – like defusing a bomb. That work will be downright dangerous in a global diplomatic environment in which President Trump revives protectionist arguments from over a decade ago, long after the world has moved on.
- We can see other elements of Trump's nativist tendencies in his tax plan, one of the few policy domains for which there is a detailed policy document available on his website.
- Reportedly, Arthur Laffer, the father of Reaganomics, said on Fox News that Trump's tax plan is "better or pretty close to as good" as Reagan's.
- There are certainly elements of it that we see as very pro-growth,

such as lowering the top personal marginal rate to 25%, and the top corporate rate to 15%. But there are parts at smack not only of Smoot-Hawley (which ushered in the Great Depression), but also of Franklin Roosevelt's toxic retained-earnings tax imposed in 1937 (which ushered in the longest bear market in stocks in US history).

- Trump's plan seeks to impose a one-time 10% tax on the "deemed repatriation" of US corporate cash held overseas.
- In other words, it is a one-time 10% wealth tax on overseas tax, whether or not it is moved to the US – ignoring the fact that this cash is already the residual left over after paying taxes in whatever jurisdiction it was earned.
- After that, profits earned overseas by US companies will be taxed in the US, whether or not it is repatriated.
- The idea is that, under this regime, companies will "bring their cash home and put it to work in America." We don't see how taxing it will coax it home – more likely, more US companies will find ways not to be US companies any more.
- But more practically, the idea completely misunderstands the nature of businesses that operate globally. It assumes that all overseas cash is kept there for no other reason than to shelter it from US taxes. Surely that is one of the reasons, but at the same time US multinationals need to keep cash overseas just as they keep factories and workers overseas – to better serve overseas markets. It makes no more sense to command the Coca-Cola Company to bring its, say, Spanish cash back to Atlanta than it does to command it to bottle its product for Spanish consumption in Atlanta.

For what it's worth, we find ourselves attracted to Trump's aspirational and irreverent campaign. But as things stand now, we have no choice but to see Trump as a non-negligible risk to the markets and the economy, win or lose. As we struggle with what we continue to think is the first-ever recession caused by too-low oil prices, for now we have to count Trump as another negative.

Bottom line

As we've been telling clients for months, Trump is not going to just go away – he may be the GOP nominee. The establishment and the conventional wisdom are just beginning to see it, and last week's market jitters may in part have been caused by it. If Trump is the GOP nominee, and loses by a landslide, the GOP could lose the Senate and the House – despite gerrymandering – which would usher in two years of anti-growth policy such as we had in 2009-2010. Our election model still forecasts a win for the GOP. If it is Trump, the risk is that he would impose protectionist measures against China and US multinationals.