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TRENDMACRO LIVE!

On the First Presidential Debate

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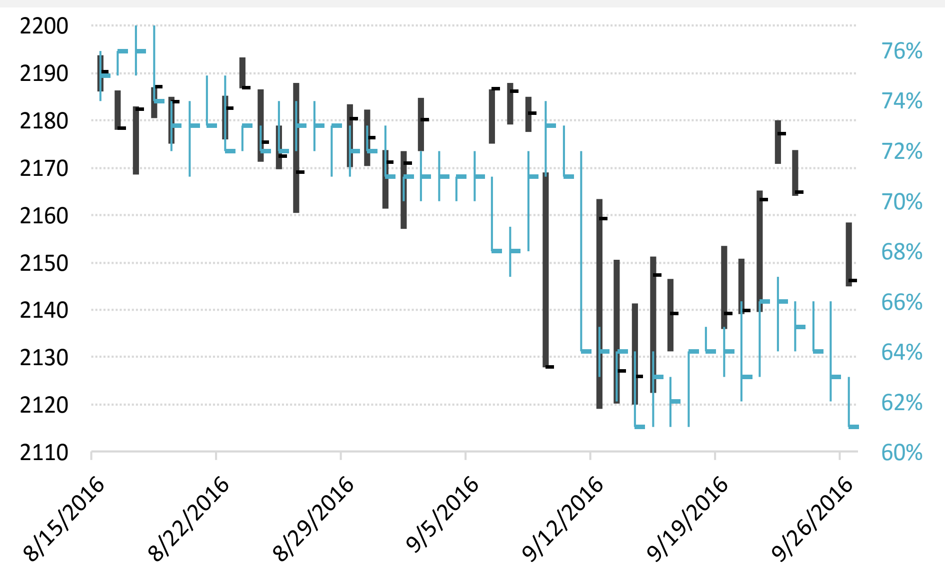
Donald Luskin

Front-runner Clinton wins this tie. It's not over: remember Romney's first debate win in 2012.

In our view, neither candidate changed the game much last night. But Hillary Clinton came into it the front-runner, so achieving a draw means she won. *Donald Trump needed to put it away, and he didn't.*

- During the course of the debate, S&P 500 futures rallied 16 handles, while the on-line futures contracts on a Clinton win rose from 64 to 70. This correlation between stocks and the market-implied probability of Clinton defeating Trump has been quite strong, ever since the S&P 500's all-time highs on August 15 when Trump began resurrecting his campaign (please see the chart below, and "Gundlach and Load" September 12, 2016).
- Trump's job in the debate was to present himself as presidential – calm, collected and in control. That could have over-written negative perceptions among undecided voters. But Trump just didn't do it. He wasn't at his worst, but he needed to be at his best.
- Clinton's job was to present herself as sincere and honest. We suppose she did, but being honest for 90 minutes cannot over-write prior perceptions of longstanding untrustworthiness.

— S&P 500 from Aug 15 all-time high
— Market-implied probability of Clinton election



Source: Bloomberg, PredictIt, TrendMacro calculations

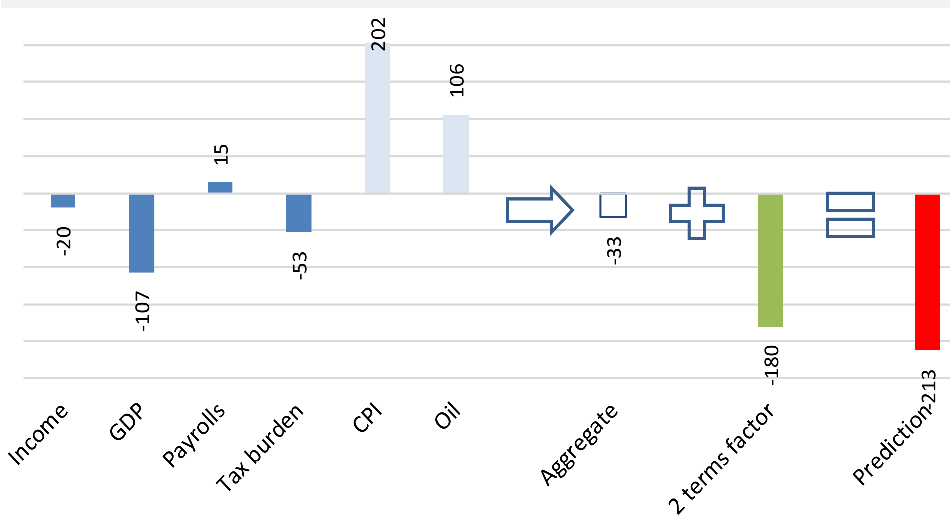
Update to strategic view

US STOCKS, ELECTION MODEL: Neither candidate made much of a difference in last night's debate. But Clinton came in as the front-runner, so even if Trump fought her to a draw she wins. S&P 500 futures declared Clinton the winner by rallying 16 handles during the debate; they've been closely correlated to her market-implied probability of victory since the top in mid-August. This election is far from over, and our election model still gives Trump a strong edge. If he wins, we think it will be a risk-off event for markets, which would have to build in a "Trump risk premium" based on extreme policy uncertainty. The severity will depend on whether it is a surprise, and whether Trump's victory is decisive. The worst outcomes are black swans in which a close election is thrown to the House of Representatives, either by a third-party win in at least one state, or "faithless electors" who abstain from the Electoral College vote – dragging the election's outcome into next year, and into constitutional crisis.

[Strategy dashboard]

- *Trump tried to be measured – more at first, when arguably the television audience was at its peak. But by the end of the evening this attempt had only constrained him from taking some easy shots at Clinton, allowing her to turn attention away from her own checkered past and onto Trump's, often leaving him sputtering to defend himself.*
- *So Clinton failed in a task in which she could never have succeeded anyway – to change perceptions of her trustworthiness. But she succeeded in making Trump fail in a task at which he could have succeeded. And again, Trump came into this as the underdog. With both candidates having failed, Clinton effectively won.*
- But this isn't over yet. Remember, in 2012 Mitt Romney decisively won the first debate, but then Barack Obama won the next two, and the election.
- There are easy lessons that Trump can learn from this rocky start, and we've seen in this campaign that he is capable of some degree of self-reinvention in the face of failure. And we really don't know what Clinton could do for an encore – she took her best shots already. Next time they will be stale and repetitive, and Trump can be more ready for them.
- But more broadly, the logic of our presidential election model argues compellingly that Trump – or for that matter, any candidate of the non-incumbent party – enjoys a strong advantage in this election, especially considering that the weak economy is unhelpful to the incumbent party candidate (please see the chart below, and "Trump's To Lose" August 12, 2016).

Our election model Electoral College votes + For incumbent party – Against



Source: TrendMacro calculations

So it's way too soon to rule out a Trump win, which would be a risk-off event for global markets as we've been warning all year (see "2016: Two Charts, Six Words, One Man" December 31, 2015). There are several ways such a risk-off event could play out. But all the scenarios have in common the obvious fact that Clinton's economic policies are more of the

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slow-growth *status quo*, while Trump's are an unpredictable mixture of pro-growth tax and regulatory reforms and anti-growth protectionism. We're tilted toward expecting that the actual policies that would emerge from a Trump administration would be, on net, strongly positive (see "Trump's Pro-Growth Path to Victory" June 21, 2016). But in the meantime, while markets are forced to wait and see, they would have to build in a "Trump risk premium."

- **BREXIT SHOCK** If Trump wins as a complete surprise – like the referendum for the United Kington to leave the European Union (see "On the Brexit Referendum" June 24, 2016) – there would be a severe correction in global risk assets after election day.
- This would be in large part due to the sheer surprise of it. Surprise always requires investors to go risk-off while they appraise how their expectations could have been so terribly wrong, and whether they might continue to be wrong in other critical ways.
- The surprise would be compounded by and intertwined with, as it was in the Brexit vote, the consensus belief that electing Trump would be a suicidal mistake, a mistake so obvious – or so the consensus believed – that voters couldn't possibly make it.
- **WISELY AND SLOW** If Trump wins after a steady and gradual rise in the polls, then his win would not come as a shocking surprise, and markets would be able to see it coming and adapt with a milder correction that would play out during the run-up to the election.
- Furthermore, a steady march to victory by Trump would likely only be achieved by his gradually earning the confidence of skeptics – which we think he failed to do in the debate last night – in which case, by election day, electing him would not be seen as a suicidal mistake.
- **EVENT RISK** A third way Trump could win is if Clinton has to withdraw from the race, either for health reasons or due to revelation of a new scandal.
- If this happened very soon, Vice President Joseph Biden could replace her on the ticket, and would likely be a more effective opponent against Trump. There would be several days of risk-off before it was known that Biden would serve, and the logistical questions were answered, but we think soon markets would respond well to a more likable and electable figure in the race, who also represents the *status quo*.
- If Clinton has to leave the race close to the election, the Democratic party could not likely mount an effective alternative in time. Trump would likely win, and it would certainly be a surprise for him to win that way. But it wouldn't be a surprise like Brexit, in which seemingly rational consensus analysis had been overturned, but rather only a stroke of fate. So the correction in global assets would be less severe than in the Brexit scenario – and if it occurs while Trump is making slow and sure progress anyway, the correction could be quite mild.

There are two more remote – but more frightening – scenarios that we have been discussing with clients over the last several months

- **THIRD PARTY DISRUPTION** If it's a close election, and if Libertarian party candidate Gary Johnson becomes the first third party candidate to carry a state since George Wallace carried five in 1968, then both Trump and Clinton could be deprived of the constitutionally required 270-vote majority in the Electoral College. Under the 12th and 20th amendments to the US Constitution, the president would be selected from the top three candidates by the House of Representatives, and the vice president from the top two by the Senate.
- This has already happened once in US history, in the election of 1824. Andrew Jackson was the front-runner in the Electoral College tally, but didn't achieve a majority. The House ultimately selected John Quincy Adams, after he struck what became known as the "corrupt bargain" with third-place finisher Henry Clay.
- This process would not take place until the new Congress is seated in January, so there would be two agonizing months of uncertainty following the election.
- The House will very likely be strongly Republican as it is now, so it would seem that Trump would be easily selected. But if the Senate is 50-50 – which is a very feasible outcome this election – then just one GOP abstention would make it impossible to select a vice president. At that point, in the House, if several GOP-dominated states wished to do so, they too could abstain, denying Trump the presidency, and leaving the country without either a president or a vice president.
- At that point, the Presidential Succession Act of 1947 would kick in, and the Speaker of the House would succeed to the presidency – presumably Paul Ryan, but at this point it is not known whether he will be re-elected by his district, or re-elected as speaker by his caucus.
- But under the 20th Amendment, the same authority of Congress to pass the Succession Act could also be used to amend it, in which case Congress could select as president virtually any constitutionally qualified person it wished. It is not clear whether such an amendment would have to be signed by President Obama, or if so, whether he would do so – which might trigger a constitutional crisis. But if it went into effect, that would put the United States on a parliamentary system for four years, in which the chief executive serves at the pleasure of the legislature.
- During the two months over which this played out, we would expect global markets to undergo a very severe correction. Markets would have to process many unknowns, including possible constitutional crises which would be experienced as existentially destabilizing.
- Johnson's gaffe about Aleppo two weeks ago may have slightly reduced the probability of this already unlikely black swan scenario. But all an event has to do to qualify as a black swan is for it to be possible when the consensus thinks it is impossible.
- **FAITHLESS ELECTORS** There is another path to similar uncertainties, and a similarly harrowing correction. If Trump wins a close election, some electors appointed by the states to the Electoral College – perhaps political insiders who may resent Trump's outsider victory, or who are loyal to candidates who hold a

grudge from the bruising GOP primaries – might abstain from voting for him, putting the choice of President in the House.

- Nothing in the Constitution pledges electors to the will of their states' voters. When they defy the voters' choice, they are called "faithless electors." There have many examples in US history. The most prominent is the election of 1836, in which the entire Virginia slate of electors abstained from voting for Samuel Mentor Johnson as Martin Van Buren's vice president (oddly, by today's standards, because he was seen as *not* a racist, openly carrying on a love affair with a part-African American woman). That threw the choice to the Senate, which elected Johnson anyway.
- If this scenario were to arise, it might do so in a particularly volatility-making way. After election day, if Trump is elected, markets will process it, with the severity of volatility depending on whether it is a surprise or not. But then, just when you thought it was safe to go back in the water, the electors from the fifty states and the District of Columbia will convene separately on December 19 to officially cast their votes. It would not be until then that we would learn that Trump has not in fact been elected. Then the real volatility would begin.
- Ted Cruz's endorsement of Trump probably reduces the probability of this scenario – his dead-enders were the most likely to be faithless. But again, it's a black swan – don't rule it out.

Bottom line

Neither candidate made much of a difference in last night's debate. But Clinton came in as the front-runner, so even if Trump fought her to a draw she wins. S&P 500 futures declared Clinton the winner by rallying 16 handles during the debate; they've been closely correlated to her market-implied probability of victory since the top in mid-August. This election is far from over, and our election model still gives Trump a strong edge. If he wins, we think it will be a risk-off event for markets, which would have to build in a "Trump risk premium" based on extreme policy uncertainty. The severity will depend on whether it is a surprise, and whether Trump's victory is decisive. The worst outcomes are black swans in which a close election is thrown to the House of Representatives, either by a third-party win in at least one state, or "faithless electors" who abstain from the Electoral College vote – dragging the election's outcome into next year, and into constitutional crisis.