

POLITICAL PULSE

Mid-terms: Animal Spirits on the Ballot

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A referendum on whether America is glad it got exactly what it wanted. Can we stand more?

We are constantly asked in client meetings for our fearless prediction for the mid-term elections. Our presidential election model correctly predicted Obama in 2012 and Trump in 2016, both with great accuracy – but unfortunately we don't have a congressional model for the mid-terms. The analytic challenge is vastly more complex, with 470 seats in play in 464 idiosyncratic jurisdictions. We cannot say what a model we don't have would predict. Without one, our view is probably pretty in-consensus, and probably what the market expects. We're not expecting a "blue wave." The GOP will lose control of the House, but keep control of the Senate. For reasons we will discuss in a moment, we think that there would be a little upside if we are wrong about the House, but serious downside if we are wrong about the Senate.

We do know some things from our presidential modeling that very likely apply to Congress in the mid-terms, too.

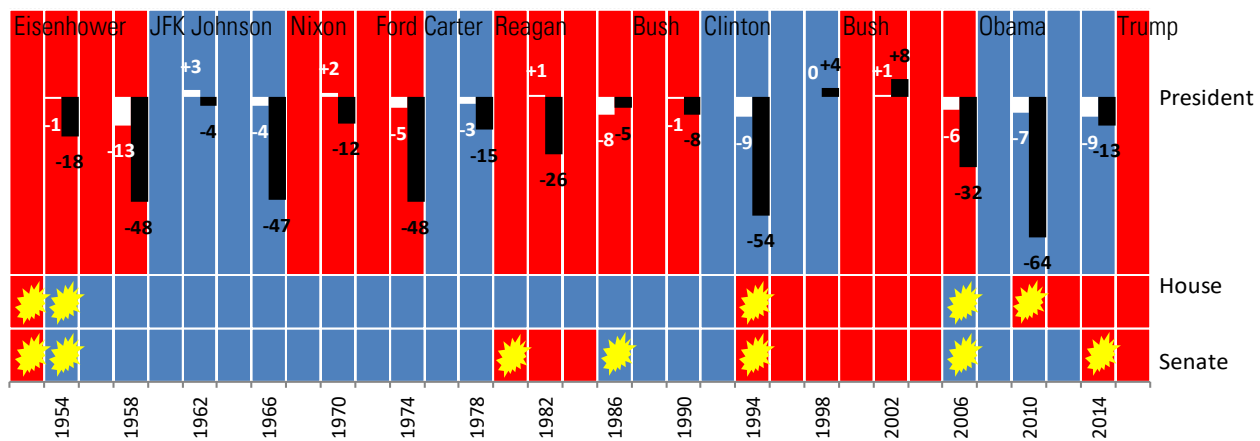
- **Party alternation is very powerful.** For the presidency, in the post-war record, there has been only one exception to the rule that no party may have more than two terms in the White House (in 1988 George H. W. Bush made it three for the GOP – please see the chart below). A similar rule for Congress is that the president's party always loses seats in the mid-terms (with two exceptions for

Update to strategic view

US MACRO: For the mid-terms, we think the GOP will lose House control, with Democrats having only a narrow majority. We think the GOP will keep Senate control, perhaps gaining 2 seats. We think that this is the present market consensus, and therefore that only deviations from this would be market-moving. For growth policy, House control is irrelevant, but Senate control is critical for approval of cabinet, agency, Fed and court nominees. The bullish surprise would be the...

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Mid-year election gains/losses in □ Senate ■ House for president's party ■ GOP ■ Dem ☀ Flip



Source: Senate and House Clerks, TrendMacro calculations

the House, 1998 and 2002) and five exceptions for the Senate (1962, 1970, 1982, 1998 and 2002 – please again see the chart below).

- We think the most likely explanation for this is that mid-terms are generally low turn-out elections, with voters of the party that controls the White House resting on their laurels while the opposing party, spoiling for a fight, turns out to vote in relatively greater numbers. There have been many over-heated media stories this year during Congressional primaries and special elections promoting a “blue wave” by attributing relatively strong Democratic turnout to revulsion toward President Trump, but this disproportionate turn-out dynamic is actually quite typical.
- Whatever the reason, party alternation shows up undeniably in the historical data, and would have to be a very influential dummy variable in any mid-term model. For the Senate, the historical average is a loss of 4 seats for the president’s party – in this election, 2 would be enough to flip control. For the House, the average loss is 24 seats, and 23 would be enough to flip control.
- **Incumbency of individual candidates is very important.** For the presidency, unless a candidate is running afoul of the party alternation rule, since 1888 every incumbent individual has won (with the single exception of Carter in 1980). Similarly, in Congressional elections, incumbents enjoy a large advantage, and in this mid-term election Democrats are in a relatively strong position.
- 42 House seats and 4 Senate seats will have to be defended by non-incumbent Republicans (for Democrats it’s only 23 in the House and none in the Senate). But geography blunts this disadvantage for the GOP to some extent, because their non-incumbents tend generally to be running in relatively reliable Republican districts and states (in the House, of the 42 GOP non-incumbents, only 11 are in districts with a [Cook Partisan Voter Index](#) less than R+5, while of the 23 Democrats, 9 are in districts with a PVI less than D+5; in the Senate, all 4 GOP non-incumbents are in states Trump carried in 2016).
- There is a very interesting and under-appreciated dynamic at the intersection of turn-out and incumbency, which argues for skepticism about some the strongest “blue wave” narratives.
- Those narratives have drawn power from the results of special House elections resulting, mostly, from GOP representatives giving up their seats to take positions in the Trump administration. In all cases but one (PA-17, in which the district had just been redrawn to encompass a Democratic majority), the GOP has successfully defended the seat, yet the new GOP representative won by a narrower margin than his predecessor, or Trump, in November 2016. This has been offered as evidence that disdain for Trump keeps GOP voters from turning out to the polls.
- Perhaps. But again, mid-term elections are always relatively low turn-out, and more so for the party that controls the White House, whose voters are relatively complacent at that point. At the same time, incumbents can use the power of the office to drive turn-out, and by definition, all these candidates were non-incumbents. So no

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...GOP keeping the House, the bearish surprise would be the GOP losing the Senate. The stakes are bigger than just policy. The mid-terms may reveal whether the electorate is willing to continue to live with the unleashing of animal spirits reflected in the Brexit referendum and the Trump election, for the sake of accelerating growth. For all the cacophony, Trump has delivered – now the question is whether the electorate is willing to continue.

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one should be surprised at the seemingly unenthusiastic results – which were nevertheless enough to get GOP candidates elected.

- A related narrative is that GOP voters are turning out less than Democratic voters in this year’s primaries. But consider that, and the special election results, alongside the results in the June California primaries.
- Under an almost unique law, California conducts “jungle” primaries in which all candidates from all parties are on a single ballot set before the entire electorate. Only the top two vote-getters, even if they are of the same party, advance to the November final. That creates a strong incentive for all voters to participate in primaries, which are generally very low turn-out elections – for fear that one’s party might get shut out in November.
- In the 7 most competitive districts for the GOP – districts currently held by a GOP representative, but which nevertheless voted for Clinton in 2016 – a Republican and a Democrat were the top two vote-getters, and will advance to November. In 6 of the 7 districts, the total vote for all Republicans on the ballot exceeded the total vote for all Democrats – a very promising dry-run for November, one that contradicts the narrative that GOP enthusiasm is fatally weak. The single district in which Democrats got more votes was one of 2 in which an incumbent GOP individual was not on the ballot – no surprise, considering the special election results.
- So while the historical record certainly counts against the GOP in turn-out (thanks to the party alternation rule) and incumbency (because there are twice as many GOP non-incumbents running), we think there is plenty of reason, and the evidence in California’s “jungle” primaries, to point toward a less devastating result than the dominant “blue wave” narrative.
- **The economy is only rarely decisive.** You can correctly predict every post-war presidential election except for 1980 and 1988 with only the party alternation rule and the incumbency rule. But you need to consider the economy to get them all right (the economy was weak enough in 1980 to defeat the incumbent Carter, and strong enough in 1988 to allow the GOP to have three terms in a row). Today’s very strong economy is the best thing the GOP has going for it. Considering that the historical average House loss is 24 seats, that it takes 23 for the GOP to lose control, the strong economy is conceivably enough to make the crucial difference of a seat or two.
- **Presidential approval is only rarely decisive.** One variant version of our presidential election model uses approval ratings, and they do slightly improve the accuracy of forecasted winning margins. But the model gets every election directionally right without using them. For mid-terms, anecdotally, George W. Bush’s very high popularity in 2002 might seem to explain the single instance in the historical record in which both the House and the Senate moved in the direction of the president’s party. But statistically we are unable to establish a useful connection between presidential approval and mid-term results.
- That would seem to be of paramount importance today, considering Trump’s low approval ratings. But even if the historical record were

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more encouraging as to some causal connection, in today's world we would have to worry that approval ratings don't count for much – or Trump wouldn't have gotten elected president in the first place.

There is one obvious feature of Congressional elections that is irrelevant to our presidential model – and that is political geography – the tendency of districts and entire states to reliably vote for one party or the other.

- For the House, the GOP has 23 seats in districts that voted for Clinton, and the Democrats have 12 seats in districts that voted for Trump. As a first approximation, these are the swing-districts that will make the most obvious difference (please see the chart below).

<p>House of Representatives: 23 to flip</p> <p>★ Open seat</p> <p>■ 12 Dems in Trump districts</p> <p>■ 23 GOP in Clinton districts</p>	<p>Senate: 2 to flip</p> <p>★ Open seat ✘ Vulnerable</p> <p>■ 10 Dems in Trump states</p> <p>■ 1 GOP in Clinton states</p>
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Democratic representatives	2016 votes	Republican representatives	2016 votes	Democratic senators	Republican senators
Tom O'Halleran AZ-01	50.7%	Martha McSally AZ-02	57.0%	Baldwin (WI)	Barrasso (WY)
Cheri Bustos IL-17	60.3%	Jeff Denham CA-10	51.7%★	Brown (OH)	Cochran (MS)
Dave Loebsack IA-02	53.7%	David Valadao CA-21	56.7%	Cantwell (WA)	Corker (TN)★
Tim Walz MN-01	50.3%	Steve Knight CA-25	53.1%	Cardin (MD)	Cruz (TX)✘★
Collin Peterson MN-07	52.5%★	Ed Royce CA-39	57.2%	Carper (DE)	Fischer (NE)
Rick Nolan MN-08	50.2%	Mimi Walters CA-45	58.6%★	Casey (PA)	Flake (AZ)
Jacky Rosen NV-03	47.2%★	Dana Rohrabacher CA-48	58.3%	Donnelly (IN)	Hatch (UT)✘★
Carol Shea-Porter NH-01	45.8%★	Darrell Issa CA-49	50.3%	Feinstein (CA)✘	Heller (NV)
Josh Gottheimer NJ-05	51.1%★	Mike Coffman CO-06	50.9%★	Gillibrand (NY)	Wicker (MS)✘
Sean Patrick Maloney NY-18	55.6%	Carlos Curbelo FL-26	53.0%	Heinrich (NM)	
Conor Lamb PA-17	53.8%	Ileana Ros-Lehtinen FL-27	54.9%	Heitkamp (ND)	
Ron Kind WI-03	98.9%	Peter Roskam IL-06	59.2%★	Hirono (HI)✘	
Average	55.8%	Kevin Yoder KS-03	51.3%	Kaine (VA)	
		Erik Paulsen MN-03	56.7%	King (ME)(I)	
		Leonard Lance NJ-07	54.1%	Klobuchar (MN)	
		John Katko NY-24	60.5%	Manchin (WV)	
		Ryan Costello PA-06	57.3%	McCaskill (MO)✘	
		Patrick Meehan PA-07	59.5%★	Menendez (NJ)	
		John Culberson TX-07	56.2%★	Murphy (CT)	
		Will Hurd TX-23	48.3%	Nelson (FL)	
		Pete Sessions TX-32	71.1%	Sanders (VT)(I)✘	
		Barbara Comstock VA-10	52.7%	Smith (MN)	
		Dave Reichert WA-08	60.2%	Stabenow (MI)	
		Average	56.0%	Tester (MT)	
				Warren (MA)	
				Whitehouse (RI)	

Source: Various, TrendMacro calculations

- If the Democrats capture all 23 Clinton districts (only 6 of which will be defended by GOP non-incumbents) – and hold on to all 12 Trump districts (4 of which are defended by Democratic non-incumbents) – they will have achieved a House majority of one seat. Not impossible by any means – even likely, given history, and all the more so because districts in Pennsylvania have been redrawn to be less favorable to the GOP – but once again, that is not the stuff of “blue waves.”

- In the Senate, 35 seats are up for election (the normal 33, plus special elections in Minnesota and Mississippi). Democrats are defending seats in 23 states, 10 of which were carried by Trump in 2016. The GOP is only defending in 9 states, and only 1 was carried by Clinton in 2016.
- The GOP seems likely to lose in Nevada, and is at some risk in Tennessee and Arizona. But we think the maximum GOP loss is three. On the other hand, Democrats seem likely to lose in North Dakota, and are at more than a little risk in Missouri, Florida and Indiana. We think the minimum Democratic loss is 2. *So even if the GOP loses its maximum and the Democrats only lose their minimum, the GOP would still hold the Senate at 50 seats plus Vice President Mike Pence's tie-breaker. We think it is more likely that the GOP will gain 1 or 2 seats on net.*

What do markets expect, and why should they care?

- As we said at the outset, we think the GOP will lose control of the House by a small margin, and keep control of the Senate. And we think markets think approximately the same thing. Obviously one never really knows what the financial market consensus is – about anything – but in this case *there are political futures markets that tell us about the mid-terms. For the House, they imply Democratic control has a 65% probability, with the over-under at about 23 to 33 seats gained. For the Senate, they imply Republican control has a 72% probability, with the over-under at 2 to 3 seats gained. We think those both seem like pretty plausible estimates.*
- **Consensus mid-term results like that are not market-moving.** Obviously they are not – because only surprises move markets, and we are positing that this is exactly what markets are expecting (but that said, markets may simply be relieved when this is over).
- **Losing GOP House control, while keeping Senate control, is not a major setback to growth.** Yes, it means there would be no more tax cuts enacted in 2019 or 2020 – but we think it's unlikely that any are expected now anyway. But with a split Congress, neither would there be any large-scale anti-growth initiatives enacted.
- A Democratic House, despite a narrow majority, may seek to bring a bill of impeachment against Trump, or drum up various investigative initiatives. It's not clear whether that would ultimately help or hurt Democratic ambitions in 2020. Either way, it would be a distraction. But unless there's a reason to think that "animal spirits" have been damaged (and we'll discuss that in a moment), that's no more than what markets have already to ignore, with the constant media-driven drumbeat of anti-Trump narratives, none of which seem to have kept Trump from catalyzing a great deal of economic optimism that is visibly paying off in employment, growth and equity market performance.
- *The GOP's continued control of the Senate is the key to maintaining pro-growth momentum.* As always when we present this kind of analysis, we want to be careful to disclaim that we are not passing judgment on policies across the broad spectrum of

issues that are not directly economic – we are focusing exclusively on market-moving policies centered on regulation, taxes, banking, trade and property rights. For *those* domains, it is important for growth that GOP Senate control remain in place to approve Trump’s nominees to cabinet, court and regulatory agency posts. It is likely that a Democratic Senate would block all such nominees for two years, during which departments and agencies would increasingly run without top-down pro-growth policy direction, and instead from the deep lifetime bureaucracies within.

- **More deeply – but admittedly subjectively – the most market-moving potential from the election is what a surprise in either direction would say about the “animal spirits” that have been unleashed since the “Brexit” referendum and the Trump election.**
- To be sure, the dominant narrative will interpret the election as a referendum on Trump himself, as an individual.
- But the 2016 election was about more than Trump the individual. It would seem that voters were willing to overlook many very obvious flaws in order to roll the dice to achieve a more growth-seeking and risk-tolerant environment, and pull out of “secular stagnation” – that is, to unleash “animal spirits.”
- *The first two years of Trump’s presidency have very much delivered on those expectations – all his individual flaws have been on prominent display, while at the same time he has manifestly moved the environment toward growth and risk-tolerance.*
- *So the question is – America, are you glad you got exactly what you asked for? You want more?*
- If America is glad, if it is willing to accept continued cacophony and more risk as part of a trade-off to achieve growth, then the source of the growth acceleration of the last two years – the unleashing of animal spirits – will be seen as intact. We would read a result in line with the present consensus – GOP lose the House by a little, GOP keep the Senate or improve a little – as just that.
- If America is not glad – if a mere two years of cacophony and risk was just too much, and if the growth acceleration we’ve seen is enough – then GOP losses in the House will be worse, and the GOP will lose the Senate. Loss of the Senate will create the practical problems we just mentioned – but the deeper issue will be that the pilot light of animal spirits will be seen as diminishing, or flickering out.
- And just to put it out there – the other possibility is that the GOP keeps House and Senate control. Considering the media environment, that would probably be the biggest surprise. Don’t rule it out – election results are perfectly capable of surprising.
- Again, this way of looking at things is terribly subjective. But anyone who thinks that economics or markets are anything but subjective is, in our opinion, not being realistic about the true nature of the most important analytic challenges we face.
- We’ve laid down our marker on what we think will happen in the mid-terms, based on what we know today. When the results are in, the challenge will be to accept the subjectivity of the enterprise, but

nevertheless try to figure out what the electorate is telling us about its growth preferences.

Bottom line

For the mid-terms, we think the GOP will lose House control, with Democrats having only a narrow majority. We think the GOP will keep Senate control, perhaps gaining 2 seats. We think that this is the present market consensus, and therefore that only deviations from this would be market-moving. For growth policy, House control is irrelevant, but Senate control is critical for approval of cabinet, agency, Fed and court nominees. The bullish surprise would be the GOP keeping the House, the bearish surprise would be the GOP losing the Senate. The stakes are bigger than just policy. The mid-terms may reveal whether the electorate is willing to continue to live with the unleashing of animal spirits reflected in the Brexit referendum and the Trump election, for the sake of accelerating growth. For all the cacophony, Trump has delivered – now the question is whether the electorate is willing to continue. ▶