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MACROCOSM

# 2020 Outlook: After a Near-Miss Recession, It's the Election

Thursday, January 2, 2020

**Donald Luskin**

**It's a real risk. Even the moderate Democrats want a tax hike that will crush earnings.**

*The US general election will be the greatest risk factor for 2020*. Trigger warning: we're going to be talking about politics. Please trust us to do so without letting our personal preferences get in the way and exclusively with economic and market forecasting in mind. And please bear with us as we jump back and forth between politics, economics and markets.

*It is our conviction* – and this seems to be a point of near-universal agreement among clients, regardless of their personal preferences – *that the re-election of Donald J. Trump as president, with the potential recapture of GOP House control that would likely go along with it, would be best for growth and for asset prices*. Election of a liberal extremist like Bernie Sanders (D-VT) or Elizabeth Warren (D-MA), and the associated loss of GOP Senate control, would imply extreme economic and market risks, even if only a fraction of their agendas were enacted. Moderates like the three B's – Joe Biden, Peter Buttigieg and Michael Bloomberg – are only moderate in relation to Warren and Sanders. *This is critical: the moderates would all repeal the Trump corporate tax cuts of 2018, which would have the first order effect of raising corporate tax payments by 60% and shaving more than 10% off S&P 500 after-tax earnings*.

- *2020's wall of worry about these matters will be built on a paradox. The extremist candidates risk catastrophic economic outcomes, which makes them less electable. The moderate candidates risk less-bad (but still bad) economic outcomes, but that makes them more electable. Pick your poison.*
- *There will also an element of "reflexivity" – George Soros's idea that markets influence reality, and in turn are influenced by reality in self-sustaining vicious (or virtuous) cycles. Fear that Trump might lose re-election would damage confidence and weaken the economy, thus making Trump's loss more likely, thus weakening the economy further, and so on. Conversely, rising confidence that Trump will win would have the opposite effect.*

According to our quantitative presidential election prediction model, the economy will be strong enough in 2020 to support Trump's re-election (see, every Monday, our "Investment Strategy Summary" and "Video: TrendMacro's 2020 election model" March 15, 2019). *We think the three great macro risks that haunted 2019 – a trade war forcing China into a*

**Update to strategic view**

**US MACRO, US ELECTION MODEL, US STOCKS, US BONDS, OIL, ASIA MACRO, EMERGING MARKETS MACRO, FX:** We expect rising stock prices, forward earnings, and Treasury yields in 2020, with stable oil prices keeping inflation in check. The presidential election will be the great risk event of the year. Love Trump or hate him, his policies have been pro-growth. Even moderate Democrats want to repeal the corporate tax cuts, which would cut after-tax S&P 500 lower by more than 10%. The radicals are less likely to win, but more dangerous. Moderates are less dangerous, but still dangerous, and more likely to win. Coming out of a near-miss recession, with a China deal, a Fed no longer too tight, and stable oil prices, accelerating growth should improve Trump's chances. Virtuous or vicious cycles of "reflexivity" may come into play if expectations for Trump winning or losing feed into economic strength or weakness. Our model shows a comfortable margin of victory for Trump, likely to improve over the year.

[Strategy dashboard]

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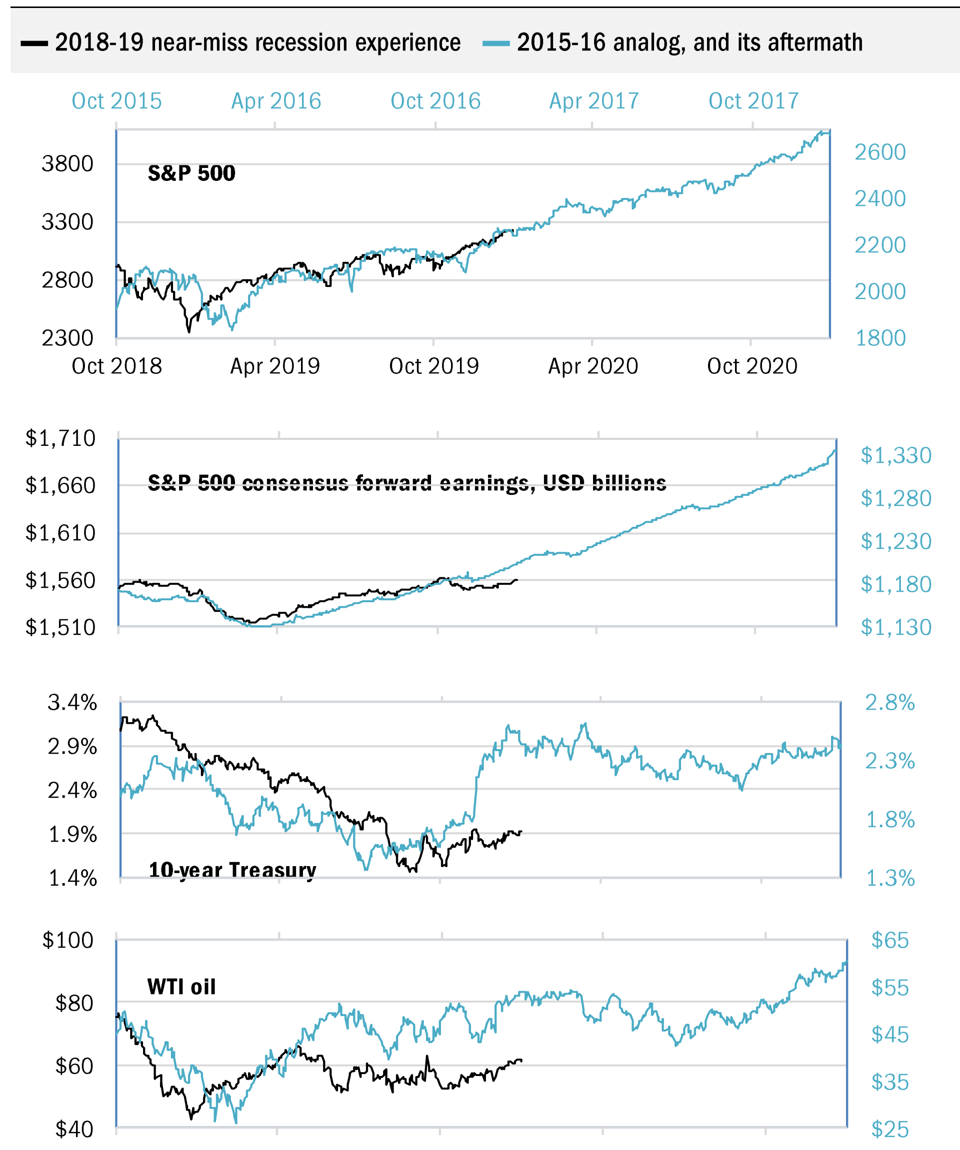
*disorderly first-ever recession, a too-tight Fed, and a deflationary collapse of oil prices – all favorably resolved themselves in mid-December* (see "On the November Jobs Report" December 6, 2019, "On the December FOMC" December 11, and "Video: What you're not hearing about the US/China 'Phase 1' trade deal" December 16). *These factors nearly caused a recession in late 2018 and early 2019. The same three factors did the same thing in late 2015 and early 2016, so this has been an instant replay, with stock prices, earnings, Treasury yields and oil prices following eerily similar patterns* (please see the charts below, and "Video: What you're not hearing about the recession of 2019" December 30, 2019). *A near-miss recession such as these serves as a "mid-cycle refresh" that reinvigorates and extends an economic expansion. If 2020 follows the near-miss of 2018-19 the same way 2017 followed the near-miss of 2015-16, we would expect higher stock prices, higher earnings, higher Treasury yields, and higher oil prices* (again, please see the charts below).

- We don't mean to overplay the analogy between 2017 and 2020 as





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**Recommended Reading**

**Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected U.S. Manufacturing Sector**
Aaron Flaaen and Justin Pierce
*Finance and Discussion Series, Federal Reserve Board*
December 23, 2019

**Elizabeth Warren Has a Plan, Oh My**
*Wall Street Journal*
December 27, 2019

**The Town That Lost Its Walmart**
Michael Corkery
*New York Times*
December 24, 2019

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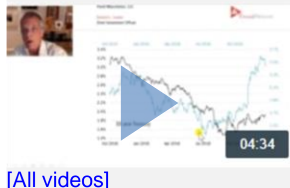
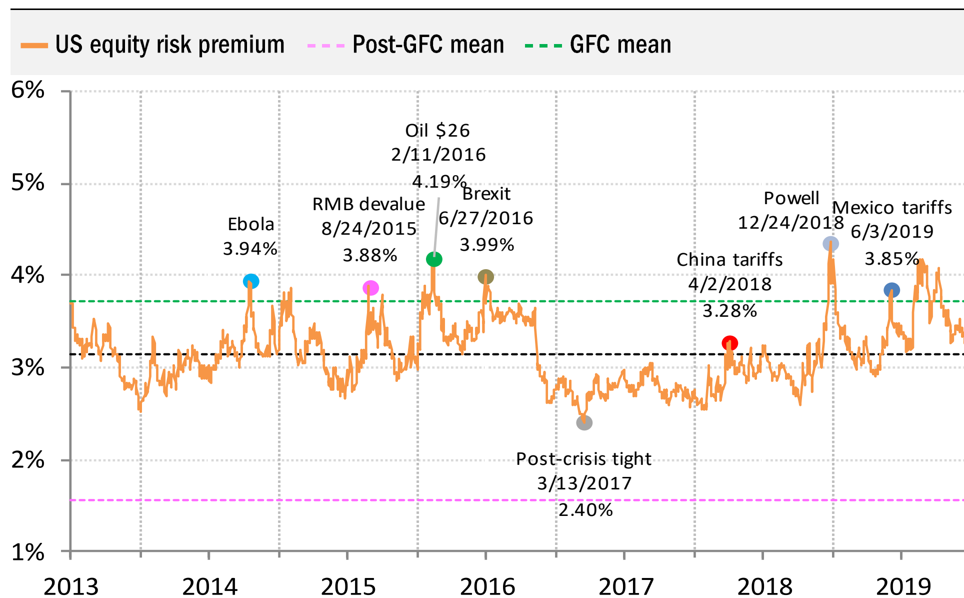
**Click to watch short video about the near-miss recession of 2019**




[All videos]

a point-forecast for the coming year. Especially with oil, there are unique supply-and-demand factors that make us doubt that crude can reproduce in 2020 its upside performance in 2017 – and that influences all the rest. *Without a lot of upside for oil, there is limited upside for inflation* – and that means less upside than would otherwise be the case for long-term Treasury yields. It also means that S&P 500 forward earnings won't recover as robustly as they did in 2017, because the energy sector won't participate as much in 2020. *But directionally, at least, we think 2020 will be like 2017 for equities, earnings, and Treasury yields, because whatever upside cap there may be on oil prices, we are expecting a strong recovery in the global economy after the near-miss recession of 2018 and 2019.*

- This flies in the face of client conversations we've had over the last week or so, in which we've noted a strong consensus that 2019 was just too strong a year for markets for there to be any room for follow-through in 2020. We guess this is a natural reaction to the S&P 500's 3.0% total return in December, and the 14 bp back-up in the 10-year yield, after a strong consensus a month earlier that 2019 was *already* too good a year to be true, and that trouble virtually had to lie directly ahead, with some clients fearing a year-end liquidity crisis (see "Can This Year Just Please Be Over?" December 4, 2019).
- Remember, 2019 was a great year, in large part, because it enjoyed a low starting point, with year-end 2018 coming just days after the end of a 20%-plus bear market in equities. Days from the bottom, everyone was too scared by their losses (*not us!*) to forecast a good 2019 – now it seems they're too scared by their *gains* to forecast a good 2020. *We're optimistic for equities – and higher bond yields – in 2020. We don't have the outright fear of one year ago to bet against – but there is still a great deal of skepticism.*

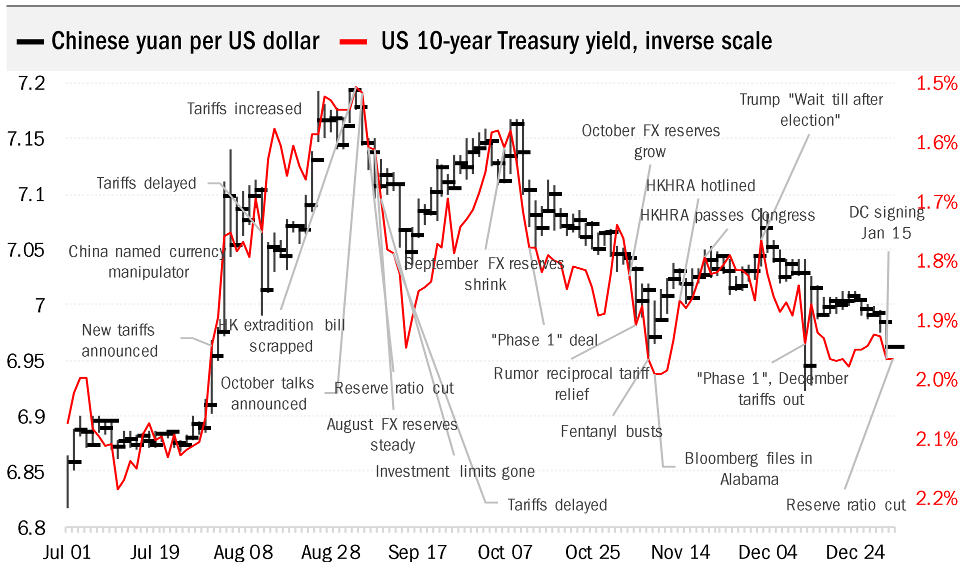



Source: Various, TrendMacro calculations

- Much of 2019's 31.5% calendar-year total return for the S&P 500 was, in fact, nothing but recovery. Measured from the September 2018 highs, equities have returned a precisely average 10.1% at an annual rate over 15 months, not an especially high hurdle. As for the 10-year yield, it's still 76 bp below where it ended 2018. Plenty of room for rebound, and in the meantime, it's an argument for seemingly high equity valuations with the S&P 500 sporting a forward P/E multiple of 18.3. Indeed, the S&P 500 equity risk premium – the forward earnings yield of the S&P 500 minus the 30-year Treasury yield – is just slightly below the post-global financial crisis mean. Valuations are quite ordinary for our post-Global Financial Crisis era (please see the chart on the previous page).
- *We urge clients not to underestimate the power of the sudden clearing of major risk factors facing the economy and the markets.*
- While we are skeptical about the upside for oil, *we are no longer worried about a big downside*. OPEC's winter meeting in Vienna last month confirmed that the cartel is willing to sacrifice market share, by cutting production, in order to support prices (again, see "On the November Jobs Report") – a Hobson's Choice given that the Saudi Aramco IPO was pricing the very same day. Yes, lower oil prices do act as a "tax cut at the pump," but we learned from the 2014-to-2016 price decline that such benefits are now more than offset by the tightening of financial conditions driven by consumer deflation (if not offset by the Fed), and by widening credit spreads (see "The Recession Caused by Low Oil Prices" January 8, 2016).
- *We continue to believe that the "phase 1" trade deal with China will be consummated*. On New Year's Eve, Trump tweeted that it will be signed in Washington on January 15. It is useful that, as we expected, Chinese President Xi Jinping will not be present to sign on behalf of China (again, see "Video: What you're not hearing about the US/China 'Phase 1' trade deal"). It means that Xi is taking the necessary steps to immunize himself domestically for conceding to Trump on any deal at all – and, indeed, against what we think will be an ongoing effort to help Trump with all the political optics necessary to assure Trump's re-election (see "On the Margin: CREEP, the Sequel – China to Re-Elect the President" December 23, 2019). *For Trump, that means campaigning on the triumph of a strong "Phase One" deal, while continuing to bash China in the process of pursuing "Phase Two" – which the same tweet said will take him to Beijing for negotiations in person.*

- *This is a market positive, we think, to the extent it succeeds in helping Trump get re-elected. But that aside, it is unambiguously positive in that it dials down the risk that an aggressive US-China trade war will push China into a disorderly first-ever recession, which would have global systemic consequences.*
- We continue to monitor the Chinese yuan as our canary in the coal mine on this – especially as it corresponds to the yield of the 10-year Treasury, which is a sensitive recession indicator. We note that the yuan and the 10-year yield have moved in parallel over the

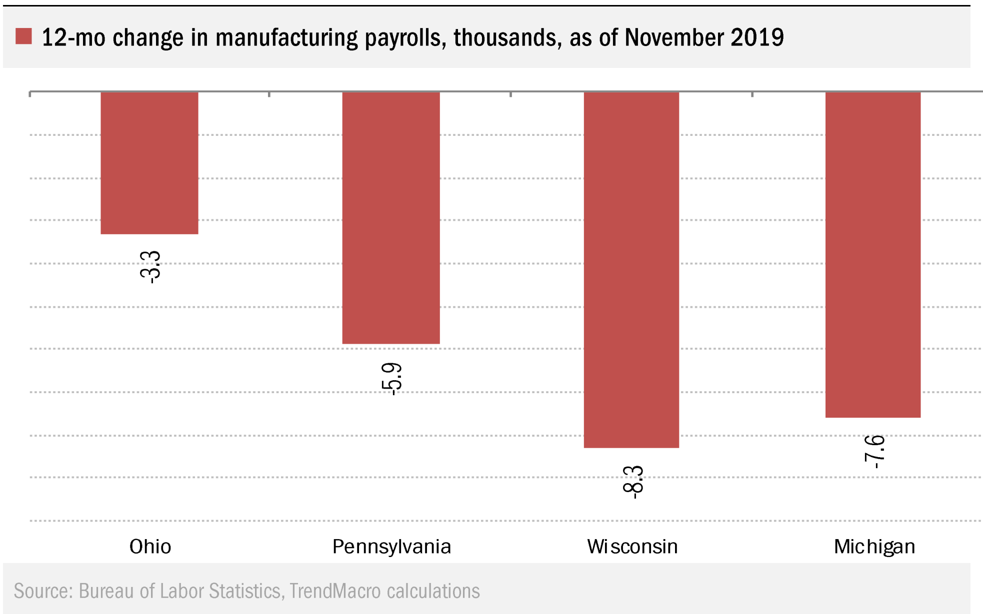
last half of 2019, with the 10-year yield reaching terrifying lows in August on the exact same day as the yuan reached its maximum weakness – in the face of Trump's having ramped up tariff threats that month (please see the chart below, and "Never Let a Good Currency Crisis Go to Waste" August 14, 2019).



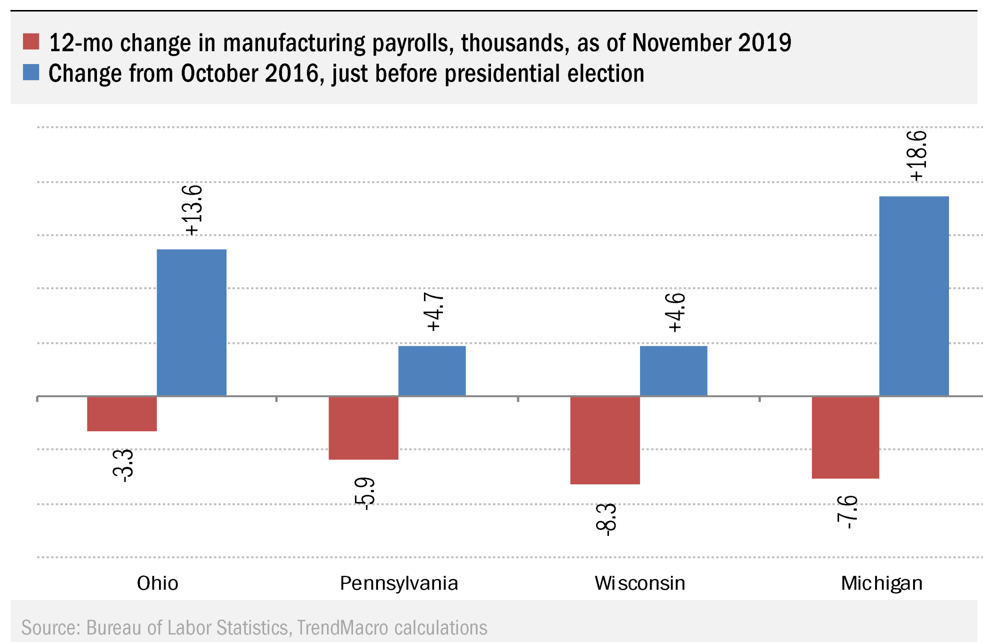
Source: Bloomberg, TrendMacro calculations

- Reducing the risk of global recession emanating from China is an end in itself for the supply-side, enabling a return to the robust global CAPEX growth we saw in 2018. But dialing back the trade war helps on the return axis as well as the risk axis. Reduced pressure from the US, all else equal, helps China grow. *And surely, part of China's domestic political imaging around the "Phase One" deal will be to do everything possible in policy to assure a growth surge – to prove the deal was good for China* – hence efforts like the People's Bank of China this week scrapping its benchmark lending rate, and reducing bank reserve ratios as part of a broad effort to support business. *This helps improve commodity and industrial demand worldwide – so we would expect this to contribute to outperformance in 2020 in emerging markets and in industrial nations and sectors*.
- But perhaps the most bullish news for 2020 is that the Federal Reserve, after three rate cuts, is no longer too tight – and its position now is that it will only hike rates upon visible evidence of sustained and unwelcome inflation pressures (again, see "On the December FOMC"). *This is a two-fer. It is good that the Fed is no longer too tight, and it is good that it has learned its lesson, apparently, and will not get too tight again at merely the first sign of better growth*.
- For all the publicity received by the US-China trade war, and for all the seeming self-serving convenience of Trump blaming the Fed for the industrial slowdown in 2019, we think there's some evidence that Trump is actually right. That brings us back to the 2020 election.

Many clients have pointed out to us a pessimistic finding by another investment strategy firm that economic weakness in 2019 has been concentrated in exactly the battleground states Trump must win in 2020 – specifically, that over the last 12 months there have been losses in manufacturing payrolls in Ohio, Pennsylvania, Wisconsin and Michigan (we reproduce it from scratch in the chart below).

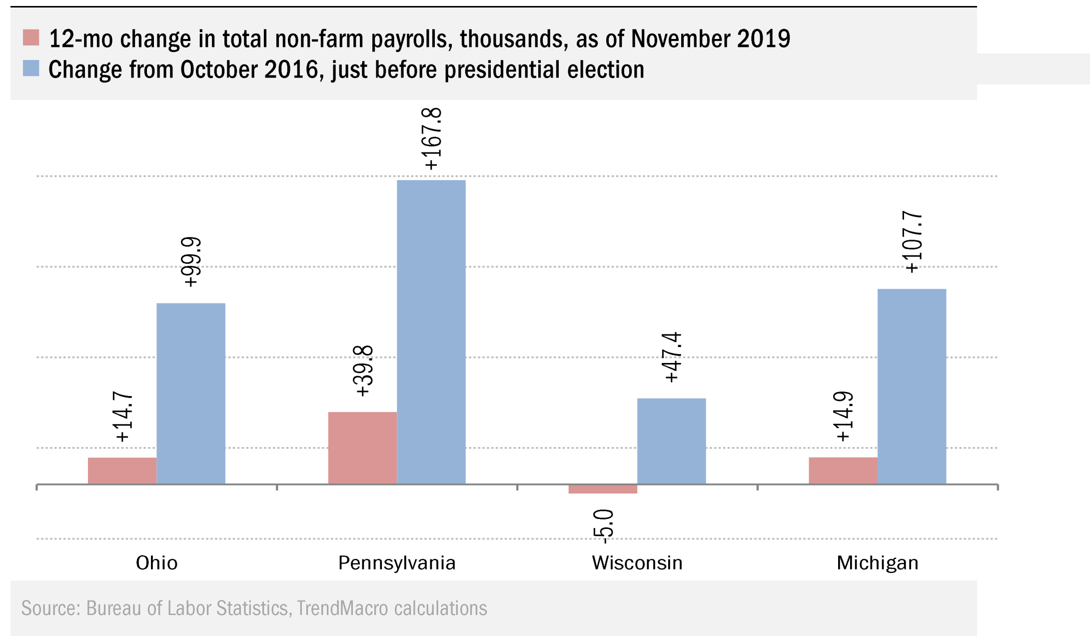



This finding seems like it has some political force, considering that Trump got elected in 2016 by carrying these battleground states, promising them a manufacturing renaissance. Now, they are steppingstones on his narrow path to the Electoral College in 2020. But let's look again. *Since the 2016 election, even with the losses of the last 12 months, there have been net gains in manufacturing payrolls in all four states* (please see the chart below).

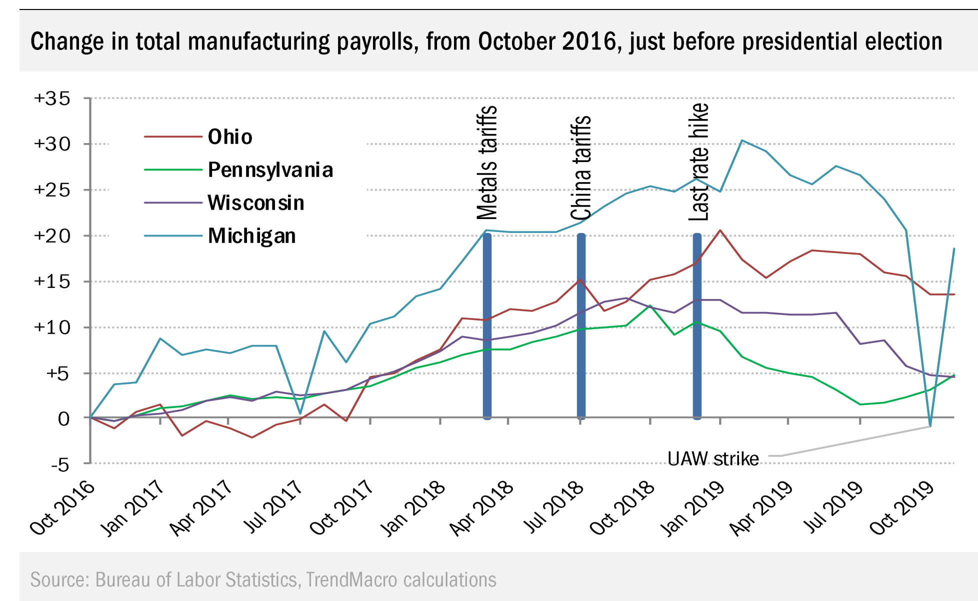


If voters are asking themselves the question Ronald Reagan famously posed in 1980, when he was debating incumbent Jimmy Carter – "Are you better off than you were four years ago?" – then they will be, on average at least satisfied. But if voters are just looking at the last 12 months, they won't be quite as happy, especially in Pennsylvania and Wisconsin.

All that said, manufacturing employment is hardly the entire labor market, even in these states. It's a politically charged sector, but a small minority of jobs. Looking instead at payrolls overall, the record has been quite different, with gains in the last twelve months in all the battleground states but Wisconsin, where the loss in total payrolls is smaller than the loss in manufacturing payrolls (please see the chart below). *So is Trump really in so much trouble in these states?*




Returning to manufacturing payrolls, how can we explain the decline in the last 12 months in the four battleground states? While there is credible

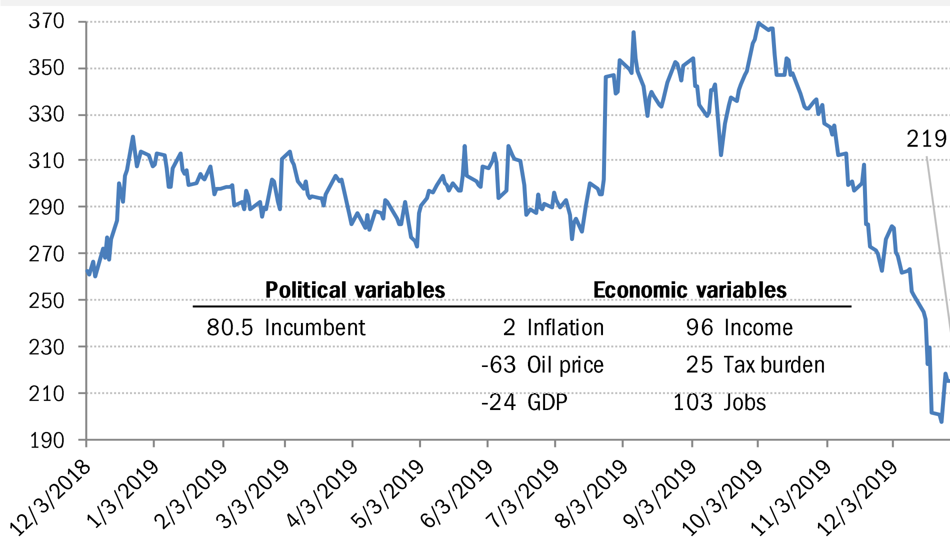


econometric evidence that Trump's tariffs were especially harmful to the industrial sector, a simple event-study approach suggests otherwise (please see the chart on the bottom of the previous page). Manufacturing payrolls in the four battleground states continued to rise after the announcement and imposition of, first, Section 232 tariffs on steel and aluminum, and second, Section 301 tariffs on imports from China. Manufacturing payrolls didn't start falling until the Fed's mistaken rate hike in December 2018 (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).

- *It hardly matters. With the "Phase One" deal, and after last month's December FOMC, both issues are significantly repaired. We would expect manufacturing payrolls to start rebounding in the four battleground states – with eleven months of repair to potentially take place before the election.*

In our quantitative presidential election prediction model, jobs growth is only one of six economic input variables – alongside GDP growth, inflation, personal income growth, change in tax burden, and change in oil prices (see "Inside Our 2020 Presidential Election Prediction Model" March 18, 2019). The model assigns a first-term incumbent (like Trump) 80.5 electoral college votes, because first-term incumbents always win except under extraordinary circumstances. Then each of the six economic variables contributes, or subtracts, electoral college votes – with the sum of all seven variables giving the model's estimate of the incumbent's margin. Running in real-time (not back-testing), the model correctly predicted Obama in 2012 and Trump in 2016.

TrendMacro presidential election prediction model: electoral college margin for incumbent




As of Dec 31

Source: Bureau of Labor Statistics, TrendMacro calculations

As of year-end, the model predicts Trump will win by a margin of 219 electoral college votes (please see the chart above). That's a far wider margin than his 77 in 2016, and wider than either of Obama's margins in 2008 or 2012. It's about the same as the margin earned by Clinton in both

1992 and 1996.

- The oil price is the model's only high-frequency variable, changing daily (jobs and inflation are monthly, the rest are quarterly). Most of the decline over the last three months in Trump's predicted winning margin is attributable to the worsening daily comparable for the oil price. At this point, it drives a penalty of 63 electoral college votes. That's because the model looks at year-over-year change, and Q4-2018 saw sharply declining oil prices, while Q4-2019 saw gently rising ones (today oil is 25.6% higher than it was a year ago). Oil prices stabilized and rose in Q1-2019, so all else equal we expect the model's forecast to improve over the coming quarter.
- We don't expect any change in the tax burden variable, and some improvement in all the others.

Clients often ask us about a possible blind-spot in the model – Trump's poor approval ratings, despite the overall very positive economic climate.

- At this point in Trump's first term, about ten months from the election, his approval ratings are about the same as Obama's – and Obama *did* get re-elected.
- The two most approved-of presidents at this point, Jimmy Carter and George H. W. Bush, did *not* get re-elected.
- Perhaps what counts is approval on election day. But we've experimented with using approval as an input variable in our model, and it doesn't improve the results.
- Anecdotally – but perhaps most powerfully – Trump's approval ratings were quite low when he was elected in 2016.
- But so were Hillary Clinton's. Elections aren't exactly popularity contests, but if they are, they are probably *relative* popularity contests.
- This brings us back to where we started. Trump's chances will surely be determined, in part, by whom he runs against – and the opponents most likely to have low approval ratings will be the ones with the most dangerous economic ideas.

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**Bottom line**

We expect rising stock prices, forward earnings, and Treasury yields in 2020, with stable oil prices keeping inflation in check. The presidential election will be the great risk event of the year. Love Trump or hate him, his policies have been pro-growth. Even moderate Democrats want to repeal the corporate tax cuts, which would lower after-tax S&P 500 earnings by more than 10%. The radicals are less likely to win, but more dangerous. Moderates are less dangerous, but still dangerous, and more likely to win. Coming out of a near-miss recession, with a China deal, a Fed no longer too tight, and stable oil prices, accelerating growth should improve Trump's chances. Virtuous or vicious cycles of "reflexivity" may come into play if expectations for Trump winning or losing feed into economic strength or weakness. Our model shows a comfortable margin of victory for Trump, likely to improve over the year.