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POLITICAL PULSE

The First Skirmish in the Chaos Election

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A Supreme Court deadlock on Pennsylvania balloting, but stocks continue to vote Trump.

Trigger warning: we are going to have to talk about politics. Please join us in setting personal preferences aside and using best efforts to objectively assess the dynamics and the possible outcome of the 2020 elections, and their impact on markets and the economy.

US equities continue to fluctuate near all-time highs, whipped about from day to day by endless false signals about fiscal stimulus. We continue to think that's a red herring at this point, and that the outcome of the election just three weeks away is what really matters. We continue to think that Mr. Market would prefer to see the re-election of president Donald J. Trump and have four more years of pro-growth Trumponomics, *and* that Mr. Market also expects that outcome (by the way, some clients have asked us to adjust the preferred pronoun here; we're still figuring out what to do with that).

We continue to expect our quantitative election prediction model will, by election day when all the Q3-2020 data is in, be forecasting a tie, as it did in the razor-close 2000 election (see "On Our 2020 Election Model and the September Jobs Report" October 2, 2020). That sets the stage for this election to be drawn out over weeks or months in recrimination, litigation and potentially a Constitutional crisis (see, most recently and among many, "Forget the Debates, Hack the Election" October 9, 2020"). *We think such a chaotic environment favors Trump's re-election, which may go some way to explaining why Mr. Market seems to be ignoring the polls.*

We had a preliminary skirmish yesterday. *A deadlocked US Supreme Court let stand – by virtue of being deadlocked, without any written opinion – a controversial Pennsylvania Supreme Court decision extending mail-in ballot deadlines, effectively ruling against – by default – the appellant Pennsylvania Republican Party*.

- *On the face of it this is a setback for Trump. But it increases the potential for this critical swing state to become the focus of strategic litigation designed to throw the election to the House of Representatives under the 12th amendment to the US Constitution, where we think Trump has an advantage – because the GOP will likely control a majority of House state delegations* (see "Video: What you're not hearing about how a blue wave could re-elect Trump" September 25, 2020 and "Video: Zoom meeting with Constitutional scholar John Yoo" September 25, 2020).

Update to strategic view

US ELECTION MODEL, US STOCKS: Mr. Market still expects Trump to win. Historically, equity performance ahead of the election has been an excellent predictor, and now rising stock prices from August 3 point to Trump. In all of the very few cases when stocks have been wrong, the Republican candidate was elected. The risk is that markets are setting themselves up for disappointment if Trump loses. Yesterday's Supreme Court deadlock on Pennsylvania's mail-in ballot rules is an opening skirmish in a contested and litigated election that may lead to a Constitutional crisis. A full court won't deadlock, and Roberts siding with the liberal justices will confer legitimacy when the high court acts a "friendly ref" for Trump through the crisis to come.

[Strategy dashboard]

- It is good for Trump that Chief Justice John Roberts joined the three Democrat-appointed justices in voting to uphold the state court (all four Republican-appointed justices voted to overturn it).
- When Amy Coney Barrett is seated on the court in time for any election-related rulings (or, if she is not for some reason, some recess-appointment by Trump in her place will be), four-to-four ties will no longer be possible, so dispositive decisions will be able to be made (see "RBG RIP, the Election, and the Markets" September 21, 2020).
- A 6-to-3 court is the perfect "friendly ref on the field" for Trump. Roberts can be relied upon to side with the Democrat-appointed justices, as he always has in politically charged decisions. So election decisions will come down 5-to-4 for Trump, yet it won't have the full taint of illegitimacy of a straight party-line vote.

We have no idea, really, whether Mr. Market is thinking about such scenarios – or whether he has internalized the macroeconomic risk of three months of extreme political uncertainty. *But history is on our side when we say we think Mr. Market expects Trump to win, by hook or by crook.*

As we've mentioned only in passing before (see "On the Dems' 'Virtual Convention'" August 21, 2020), *US equity performance is indeed a very good presidential election prediction model – when the market rises before the election, incumbents win*.

- **Presidents:** Incumbent *presidents* have run for re-election in 21 of the 30 elections from 1900 and won 16 times. *The stock market correctly predicted 87% of the wins and 80% of the losses* (please see the table on the following page).
    - In only one case, 1980 (Carter vs. Reagan), did the incumbent *president* lose when the stock market return 3 months prior to election day was above average.
    - In only two cases, 1924 (Coolidge vs. Davis and LaFollette) and 1956 (Eisenhower vs. Stevenson) did the incumbent *president* win when the return was below average.
- **Parties:** The incumbent *party* has won 18 of the 30 elections. *The stock market correctly predicted 89% of the wins and 83% of the losses*.
    - In only two cases, 1968 (Humphrey vs. Nixon and Wallace) and 1980 (Carter vs. Reagan), did the incumbent *party* lose when the stock market return 3 months prior to election day was above average.
    - In only two cases, 1924 (Coolidge vs. Davis and LaFollette) and 1956 (Eisenhower vs. Stevenson) did the incumbent *party* win when the return was below average.
- **Fun fact:** In every case in which the stock market failed to predict correctly, the winner was a Republican.

As of this writing, the S&P 500 is up 4.5% over the 72 days from August 3, the day three months before the November 3 election (the excess return

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US stock market track record for predicting US presidential elections

Failure to predict incumbent win   Failure to predict incumbent loss

Election year	Stock market excess returns	Incumbent	Incumbent party	Winner	Winner party	Did incumbent run?	Did incumbent win?	Did incumbent party win?
1900	4.5%	McKinley	R	McKinley	R	Y	Y	Y
1904	24.3%	Roosevelt	R	Roosevelt	R	Y	Y	Y
1908	1.0%	Roosevelt	R	Taft	R	N		Y
1912	-1.0%	Taft	R	Wilson	D	Y	N	N
1916	19.4%	Wilson	D	Wilson	D	Y	Y	Y
1920	-0.6%	Wilson	D	Harding	R	N		N
1924	-0.7%	Coolidge	R	Coolidge	R	Y	Y	Y
1928	13.7%	Coolidge	R	Hoover	R	Y	Y	Y
1932	-3.8%	Hoover	R	Roosevelt	D	Y	N	N
1936	6.7%	Roosevelt	D	Roosevelt	D	Y	Y	Y
1940	7.3%	Roosevelt	D	Roosevelt	D	Y	Y	Y
1944	1.0%	Roosevelt	D	Roosevelt	D	Y	Y	Y
1948	4.1%	Truman	D	Truman	D	Y	Y	Y
1952	-4.5%	Truman	D	Eisenhower	R	N		N
1956	-3.8%	Eisenhower	R	Eisenhower	R	Y	Y	Y
1960	-2.0%	Eisenhower	R	Kennedy	D	N		N
1964	1.4%	Johnson	D	Johnson	D	Y	Y	Y
1968	5.2%	Johnson	D	Nixon	R	N		N
1972	1.8%	Nixon	R	Nixon	R	Y	Y	Y
1976	-1.3%	Ford	R	Carter	D	Y	N	N
1980	5.4%	Carter	D	Reagan	R	Y	N	N
1984	3.6%	Reagan	R	Reagan	R	Y	Y	Y
1988	0.7%	Reagan	R	Bush	R	N		Y
1992	-2.5%	Bush	R	Clinton	D	Y	N	N
1996	6.9%	Clinton	D	Clinton	D	Y	Y	Y
2000	-4.5%	Clinton	D	Bush	R	N		N
2004	0.9%	Bush	R	Bush	R	Y	Y	Y
2008	-20.7%	Bush	R	Obama	D	N		N
2012	1.2%	Obama	D	Obama	D	Y	Y	Y
2016	-3.1%	Obama	D	Trump	R	N		N

Source: Bloomberg, various, TrendMacro calculations   Methodological note: From 1900, the average compound quarterly price-only return for US equities (the Dow Jones Industrial Average from 1900 to 1927, and the S&P 500 and its predecessors from 1928 to 2016) has been 1.25%.

above average for 72 days is 3.4%), *pointing to a Trump win*. That will fluctuate between now and election day, but so will any poll or any model. Three weeks to go, but it is at least indicative.

- So far this is strictly a "technical analysis" exercise, relying only on the pattern of past data without any narrative substructure.

- One narrative explanation is a simplified version of "reflexivity," the theory propounded by George Soros that financial markets both reflect and determine real-world events.
- Rising (or falling) stocks give a thumbs-up (or thumbs-down) to existing economic conditions and expectations, including an expectation of which candidate will win – the one likely to improve conditions, or the one likely to damage them.
- *And* they send a positive (or negative) signal and positive (or negative) wealth-effects to voters about to choose between an incumbent and a challenger promising change.
- *We don't see how the change that Joseph R. Biden is promising would cause markets to expect better results than four more years of Trumponomics.*
- Biden vows to repeal Trump's 2017 tax cuts for business. For the public companies whose stocks make up the major indices, that means raising the tax rate on profits from 21% to 28%, reducing deductions on overseas income, and assessing a tax on "book profits" even when a company doesn't have actual profits. According to the non-partisan Tax Policy Center, that would reduce corporate profits by about $200 billion per year, or about 14%. That would knock S&P 500 after-tax earnings back down to where they were right after the worst of the pandemic lockdown.
- Long-term, those lower after-tax profits will cause firms to hire fewer workers and pay lower wages than otherwise, and to be less price-competitive for their customers. They will undertake fewer job-creating and innovation-nurturing capital projects, because many such projects won't look profitable at higher tax rates. That's a deadweight loss to economic growth, and therefore to price/earnings multiples.
- At the same time, Biden's plan would tax dividend income and long-term capital gains like ordinary income. For top earners, that about doubles the tax rate on those two forms of investment income. Because that effectively lowers the after-tax return on investing, the prices of all investments have to be lower – permanently – to compensate in valuation terms. In money-flow terms, immediately post-election, companies and investors alike would hedge against higher tax rates on dividends and capital gains. Companies would weaken their balance sheets by dividending out cash, and investors would sell stocks to lock in capital gains at today's low rate.
- *We've focused here just on tax policy – but Bidenomics includes many other elements we regard to be inimical to growth, including increasing regulation and expanding the role of government in technology development and resource allocation.*
- *We reject the notion that Bidenomics offers a superior policy mix for growth, or that markets could possibly think that it does*. For one thing, Trumponomics is hard to beat – before the pandemic arrived as a bolt-from-the-blue, Trump's policy mix had extended an already-mature business cycle into the longest ever, lowered unemployment to generational lows, helped America achieve energy independence, and all with no inflation. Seriously – is

running Trump's agenda in reverse for the next four years going to provide something better?

- *We dismiss the analysis by Moody's that Biden's policy mix would result in more growth and more employment, which both Biden and vice-presidential candidate Kamala Harris have pointed to triumphally*. Moody's simplistic research treats regulatory burdens as non-existent, and tax increases as neutral so long as they are more than offset by increased government spending – as though it makes no difference who does the spending or on what, so long as there is spending. We don't wish to be rude, but we're not going to pull our punches when the stakes are this high: remember that *Moody's was one of the ratings agencies that gave their highest endorsement to the toxic mortgage securities that triggered the Global Financial Crisis*.
- We are more open to the narrative that markets don't really believe that Biden, if elected, would implement his tax and regulatory agenda when the economy is still struggling out of recession. But at last week's town hall, ABC's George Stephanopoulos asked Biden point-blank whether he would, and the candidate's one-word answer was: "absolutely." In the prior week's vice presidential debate, Harris said Biden would repeal the Trump tax cuts "on day one."
- Another alternative narrative is that Mr. Market is prepared for Biden to win, but expects the Senate to remain under Republican control, limiting the damage that Biden could do. Critically, Trump's corporate tax cuts have no "sunset" – they can only be changed by legislation that gets past the Senate, the House and the president.
- We don't have a formal model for the Senate. But we note that there is a reliable "coat-tails effect" that typically causes the Senate to shift composition in the direction of the party that wins the White House. It's a small effect – on average, just 1.4 seats. So if Biden wins, and the effect has the average magnitude, the current GOP majority of 53 seats is enough to withstand the blow.

As we head into the election, don't forget that Mr. Market's predictions may turn out to be wrong. But if they are nevertheless Mr. Market's true expectations, then Mr. Market will not be happy if Trump loses. He'll be downright miserable if the GOP loses the Senate too.

Bottom line

Mr. Market still expects Trump to win. Historically, equity performance ahead of the election has been an excellent predictor, and now rising stock prices from August 3 point to Trump. In all of the very few cases when stocks have been wrong, the Republican candidate was elected. The risk is that markets are setting themselves up for disappointment if Trump loses. Yesterday's Supreme Court deadlock on Pennsylvania's mail-in ballot rules is an opening skirmish in a contested and litigated election that may lead to a Constitutional crisis. A full court won't deadlock, and Roberts siding with the liberal justices will confer legitimacy when the high court acts a "friendly ref" for Trump through the crisis to come.