

October 14, 2013

The Turmoil in Washington

(Due to upcoming business travel, the next edition of the WGR will be published October 28.)

At the time of this publication the budget situation has not been resolved, although it appears that both parties are backing away from the default abyss. However, given that these crises seem to come once or twice a year, it seemed appropriate to weigh in on the geopolitical impact of the intractable problems of American government.

In this report, we will discuss the evolution of the American political system over the past century, examining how these changes have affected governance. From there, we will move to how the uncertainty surrounding American governance affects global geopolitics, including a discussion of what we believe is the root cause of this turmoil. As always, we will conclude with market ramifications.

Moving from Party Bosses to Ideologues

American politics used to be dominated by the leadership of political parties. Candidates for office from both parties were selected by party elders, or bosses, who ran the two-party system. Candidates were usually picked at conventions with various interests selecting office seekers in “smoke-filled rooms.” Political party leaders had the power of patronage; they could select supporters for government jobs. Party bosses distributed promises of jobs for votes; if the party’s candidate won, jobs went to his supporters. Although money affected politics, it was funneled through

party leaders which lessened its impact. Party bosses tended to be practical types. Their goal was maintaining power; what they actually believed was much less important. The candidates themselves had viewpoints that shaped national policy. Some of the presidents from this era proved to be quite effective, despite the undemocratic selection methods deployed in their nominations. The Roosevelts, Calvin Coolidge, Dwight Eisenhower, Harry Truman and John Kennedy, all considered generally strong presidents, were mostly products of this system. There were some less than stellar selections as well, such as Warren Harding.

Reformers believed that voters should have a stronger voice in selecting candidates and pushed for primaries instead of caucuses and conventions. The 1968 Democratic Party convention in Chicago became the watershed moment for the reform movement. Senator Eugene McCarthy ran on a strong anti-war platform against Vice-President Hubert Humphrey for the Democratic Party nomination. Although McCarthy had won several state primaries, these were non-binding for delegates. Humphrey was able to secure the nomination even though 80% of primary voters had selected an anti-war candidate (either McCarthy or Robert Kennedy, who had been assassinated earlier in the year). The Chicago Democratic National Convention was infamous—Mayor Daley, the epitome of machine politics, enforced a heavy handed treatment of demonstrators that were there for various reasons, including opposition to the Vietnam War.

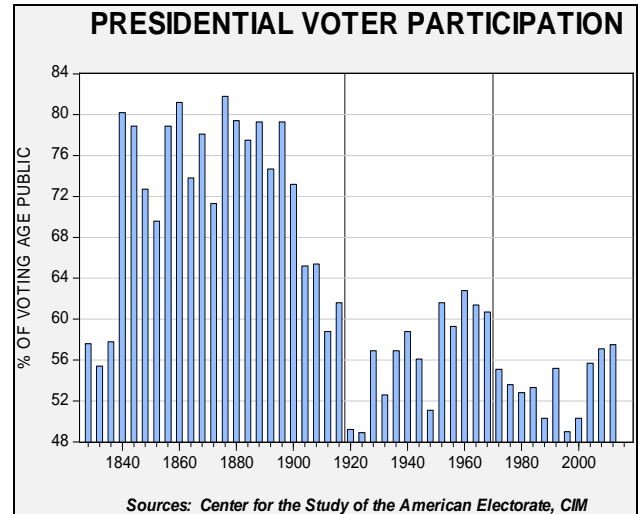
After the Chicago Convention, the Democratic National Committee commissioned a panel led by Senator George McGovern to expand participation in the nominating process. Most states adopted primaries to meet the new Democratic Party rules. The GOP eventually followed the Democratic Party’s lead.

The move to primaries severely reduced party influence on candidate selection, which was a goal of the reformers. However, it introduced three other problems. First, over time, elections have become very expensive. Multimedia is required for name recognition. This forces a candidate to raise significant amounts of money even in state races. Thus, the influence of money has increased. This isn’t to say money didn’t affect elections under the pre-reform system, but the money was mostly given to the parties instead of directly to candidates. Now, campaign financing can have a more direct effect.

Second, the current system reduces the number and quality of potential candidates. Candidates often face bruising primary races that expose all their failings even before they run against the other party’s candidates. The womanizing portrayed in the movie *Hyde Park on the Hudson* by Bill Murray’s Franklin Roosevelt would have likely precluded his candidacy today, or it would have severely damaged his campaign. Potential candidates, who might be solid elected officials, are often reluctant to run because of the public exposure they and their families will face.

Third, an unexpected development from reform was that, increasingly, candidates often face an ideological “litmus test” to win primaries. Reformers believed that the average citizen wanted, and should desire,

more input into the candidate selection process. In reality, most Americans lead busy lives. Voting in presidential elections, which tends to have the highest turnouts, rarely exceeds 56% of the voting age public.



This chart shows presidential voter participation, which is voters divided by the number in the voting age population, from 1824 to the present. We have added two vertical lines on the chart. The first, in 1920, notes when women’s suffrage was granted by the 19th amendment. The second was the 26th amendment, which lowered the voting age to 18 from 21. In both cases, the increase in the voting population led to a drop in participation.

Given that these turnout numbers are low for the most popular election, primaries often garner numbers in the 20% range. This means that candidates are selected by a small number of voters. These voters tend to be the most committed—most often, they are ideologues, who hold passionate beliefs about certain positions. This self-selecting group tends to support candidates that adhere to the positions held by the ideologues; simply put, winning the primary means that candidates must attract voters that often occupy the political fringes.

Otherwise, they will fail to win the nomination.

In contrasting the two systems, the pre-reform period, ran by party bosses, to the post-reform system, which uses primaries, we tend to see a significant change. In the first, one voted for the party's candidate to keep a patronage job. In the second, one voted in primaries because of a strong commitment to a position.

It is important to note the difference between principles and ideology. The former are core values that guide one's actions. Ideology, on the other hand, is a person's understanding of how the world works; to adopt an ideology, a person has to see this belief system as all-encompassing. Principles guide behavior but are just that—guides. Ideologies, on the other hand, become inviolate because to admit flexibility undermines the belief. If one believes that the environment must be protected at all costs, accepting a plan for a carbon tax is insufficient. All carbon emissions must be stopped. If one believes that all abortions kill, then accepting exclusions for rape is impossible. Compromise for an ideologue is an anathema because it undermines the belief system that underpins the ideology.

In a heterogeneous society, made up of a broad spectrum of ethnic, economic and religious backgrounds, competing ideologies are very difficult to avoid. For the most part, Americans have learned to live with these differences in a variety of ways. A certain degree of “live and let live” is followed. Some very committed ideological groups decide to segregate themselves, although the ability to do so does sometimes run afoul of the law of the land.

However, in the political sphere, the primary system, especially for Congress members, has increasingly become a haven for ideologues. Gerrymandering has created “safe” districts for both parties. Low primary turnouts mean that fringe voters essentially dominate the nomination process. In many districts, the most important election is the primary—the general election is often a foregone conclusion. This means that incumbents rarely worry about the other party's candidate. Instead, they are much more concerned about a primary challenge coming from a candidate that is more committed to the cause.

Increasingly, we are seeing members of Congress who have no interest in compromise; in fact, compromise appears to be an act of weakness that will surely bring a primary challenge. The incumbent, almost by default, becomes more concerned about meeting the demands of what may be a committed minority in his district rather than meeting the needs of the broader electorate.

The Geopolitical Fallout

Two weeks ago, President Obama decided not to make a trip to Asia where leaders were meeting to discuss regional economics. The administration is championing an effort to create a free-trade zone in the Pacific that includes nations in both Asia and the Americas. It noticeably excludes China. The U.S. is trying to create a trade bloc that will force China to join and abide by U.S. rules.

Needless to say, China does not support this program. China wants to become a regional hegemon. Since becoming the sole global superpower in 1990, the U.S. has tried to thwart the development of regional powers. This is because a regional power could someday become a superpower competitor to the U.S.

By forgoing the Asian trip, the U.S. has been perceived as a less reliable partner. China took the opportunity to offer a trade alternative to the U.S. zone. If American presidents cannot show they can manage domestic politics, it will be almost impossible to project soft power globally.

Both Russia and China will try to portray the disorder in America as further signs that it is a failing power. In fact, we would expect them to frame the U.S. not only as a failing power, but an irresponsible one, a superpower willing to undermine the credit standing of its own debt, which is the widest held instrument in the world. The longer the current budget problems persist, the more believable their arguments will appear.

Thus, the current budgetary difficulties have a broader impact. For the rest of the world, it appears that the U.S. lacks the will to perform the requirements of the global superpower, which include providing the reserve currency and a risk-free debt instrument that can be used by global entities as a store of value. If this is the case, the world is careening toward a G-0 world described by Ian Bremmer.¹

The Real Issue

Although GOP populists (Jeffersonians and Jacksonians in Meade's archetypes) are portrayed in the mainstream media as unsophisticated rabble, they are forcing an important debate. America has held superpower status since 1945 but became the sole superpower with the fall of the Soviet Union in 1990. Since then, the U.S. has struggled with managing this role. During the Clinton years, the obligations were mostly ignored. The Bush administration was solely focused on Jihadist terrorism, which is a problem but

should not have been the single-minded policy concern. It led to two inconclusive wars that were probably not the best way to protect the country from further attacks. The Obama administration has moved to withdraw from the Bush wars and has tried to shift the policy focus to Asia. However, it has found only marginal success.

Essentially, the U.S. lacks a policy narrative to construct a plan for operating as the single superpower. Unlike the creators of the Cold War "containment policy," such as George Kennan, the current international relations academic and policy infrastructure has not created a new plan that has been accepted by policymakers.

The populists in the GOP are essentially arguing that the U.S. should abandon the superpower role. The U.S. was founded as a small government republic and this wing of the GOP wants to return to that vision. As we have noted in the past, one cannot run a small government superpower. The government, by default, must be large enough to fund a military that projects power globally and must generate sufficient consumption to absorb the world's imports to supply the reserve currency, which usually requires transfer payments to ensure enough buying power exists. However, if the superpower role is abandoned, the military can shrink and the social safety net becomes optional.

Thus far, this element of the debate has not occurred. The discussions remain almost exclusively in domestic policy terms. This makes sense...foreigners don't vote in U.S. elections. However, the global implications of an American abandonment of its superpower role are enormous. It would be reasonable to expect a spate of local wars would commence as local powers try to dominate their regions. Global trade would

¹ Bremmer, Ian. *Every Nation for Itself: Winners and Losers in a G-0 World*, 2012, Penguin Group, NY, NY.

contract due to the lack of secure sea lanes and a reserve currency. America, blessed by its geography, would be safe for a time. The large oceans would make invasions difficult and the U.S. does not face a regional military threat. But, as WWII showed, eventually, this security could be violated.

Ramifications

If the government were to default on Treasuries, the ramifications could be dire, depending upon how holders of this debt react. If investors believed that the situation would not be resolved quickly and that the delayed payments signaled insolvency, a rate spike would ensue much like what we saw in the Eurozone periphery over the past two years. For example, Italian bill rates rose from under 2% to nearly 10% in a few weeks. Rates this high would virtually cripple the economy.

It could get worse. If money market funds were to face runs as investors pulled their cash out, worried that the government paper held in these funds was falling in value, the financial system could seize.

We doubt this will actually occur. Presidents, in times of crises, have tended to take unconstitutional measures to ensure conditions don't deteriorate. Be it suspending habeas corpus or interning Americans in concentration camps, extreme measures are sometimes taken that are not constitutional. For example, the president could instruct the Treasury to issue new debt to prevent default. Although this is probably unconstitutional (and sets a dangerous precedent), we would expect such action to be taken rather than default. If a default occurs, it's because the president allows it to happen.

On the other hand, this lack of a sustainable superpower policy remains with us. Until this is resolved, periodic crises will continue because there is no generally accepted narrative of how the nation should proceed. And so, markets will remain volatile and insofar as this lack of narrative depresses investment and spending, growth will remain sluggish as well.

Bill O'Grady
October 14, 2013

This report was prepared by Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.