

June 15, 2020

The Geopolitics of the 2020 Election: Part IV

In this five-part series on the geopolitics of the 2020 election, we have divided the reports into nine sections. Last week, in [Part III](#), we covered the incidence of establishment policy and the role of social media. This week, we reveal the sixth and seventh sections; we handicap the race as it stands and discuss how foreign nations are likely to intervene in the election.

Who is Going to Win?

Before we discuss our expectations of the outcome, we want to note that we analyze elections with an eye toward answering two questions. First, who is going to win? Second, what will they do once elected? In our primary role of managing money, we cannot afford to allow any political preference to distort our process as that bias could affect investment performance. And, being well ensconced in the flyover zone of the U.S., our political biases don't matter anyway. It's not as if our analysis affects the actual outcomes of elections. Our position is that, as a money manager, we want to know what the future looks like, not necessarily root for a certain outcome. So, here goes.

To forecast the outcome of elections, we have various factors we examine that have signaled the outcomes of previous elections. These factors are:

1. Incumbency
2. The Economy
3. Polling

4. Prediction Markets
5. Base of Support
6. Money
7. Social Media Presence

We are also sensitive to the fact that we don't directly elect presidents; we elect electors to the Electoral College who, in most states, vote for the president based on the majority of votes in that state.¹ So, our focus is on determining our best estimate of the Electoral College based on polls and available decision markets, along with economic activity at the state level.

Incumbency: Incumbents have a clear edge in winning reelection. They are a known quantity. Voters already see the incumbent as president. Even vice presidents who are elevated due to the death of a sitting president and fill out the term of the deceased seem to enjoy an edge. Thus, President Trump does have the incumbent edge in this election.

The Economy: However, there is one factor over the past 120 years that has prevented incumbent reelections—recession. Presidents Carter and H.W. Bush lost reelection bids when recessions occurred in the two years before the election. The only candidate to overcome this problem was Calvin Coolidge. The National Bureau of Economic Research has officially declared a recession. This factor is a negative for President Trump. It is possible that voters will overlook this event because it wasn't caused by policy error. The forced stay-at-home orders have led to the drop in economic activity and thus it is possible that

¹ [Maine and Nebraska can have split electoral votes.](#)

Trump won't be held responsible for the downturn. But this would be an exception to the historical pattern.

Polling: We focus our analysis of polling on states that are considered “toss-ups.” In other words, there is no point in watching polls in states safely ensconced in either party. There are various sources that estimate electoral counts using current polling data. Here is one from the Cook Political Report:

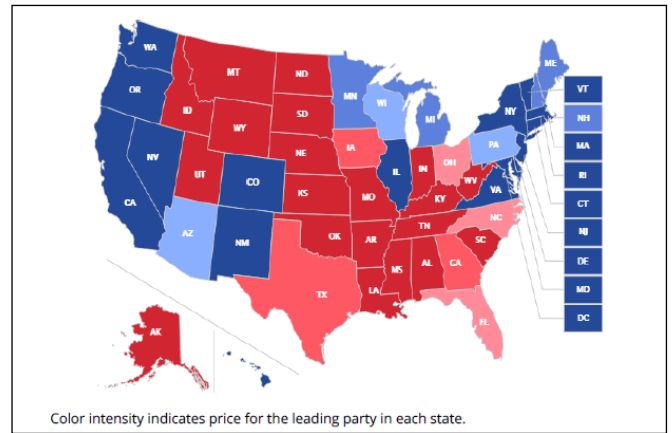
THE COOK POLITICAL REPORT
2020 Electoral College Ratings
 March 9, 2020

188		28	16	102	54	25	125
Democrats have 232 electoral votes in the Solid, Likely and Lean categories and would need 39 (38%) electoral votes from the Toss-Up column.				Republicans have 204 electoral votes in the Solid, Likely and Lean categories and would need 67 (66%) electoral votes from the Toss-Up column.			
SOLID DEMOCRAT	LIKELY DEMOCRAT	LEAN DEMOCRAT	TOSS UP	LEAN REPUBLICAN	LIKELY REPUBLICAN	SOLID REPUBLICAN	
14 States (+ ME, DC)	3 States	3 States	6 States (+ NE, DC)	2 States	2 States (+ ME, DC)	20 States (+ NE, DC & NE, DC)	
188 Electoral Votes	28 Electoral Votes	16 Electoral Votes	102 Electoral Votes	54 Electoral Votes	25 Electoral Votes	125 Electoral Votes	
California (55) Connecticut (7) Delaware (3) Washington DC (3) Hawaii (4) Illinois (20) Maine 1st CD (1) Maryland (10) Massachusetts (11) New Jersey (14) New Mexico (5) New York (29) Oregon (7) Rhode Island (4) Vermont (3) Washington (12)	Colorado (9) Virginia (13) Newevada (6)	Maine (2) Minnesota (10) New Hampshire (4)	Arizona (11) Florida (29) Nebraska 2nd CD (1) Michigan (16) North Carolina (15) Pennsylvania (20) Wisconsin (10)	Georgia (16) Texas (38)	Iowa (6) Maine 2nd CD (1) Ohio (18)	Alabama (9) Alaska (3) Arkansas (6) Idaho (4) Indiana (11) Kansas (6) Kentucky (8) Louisiana (8) Mississippi (6) Missouri (10) Montana (3) Nebraska (2) Nebraska 1st CD (1) Nebraska 3rd CD (1) North Dakota (3) Oklahoma (7) South Carolina (9) South Dakota (3) Tennessee (11) Utah (6) West Virginia (6) Wyoming (3)	

Note: All states and the District of Columbia each allocate their Electoral College votes on a winner-take-all basis. Maine and Nebraska each award two electoral votes to the statewide winner and one electoral vote to the winner in each congressional district.

Copyright © 2020 Cook Political Report. All rights reserved.

unbiased sample. Sampling errors can lead to erroneous results. In addition, there is a phenomenon known as the “Bradley effect,” where voters lie to poll takers because they don’t want to show support for a controversial candidate. Prediction markets avoid such issues as a participant can “put their money where their mouth is.” It’s one thing to favor a candidate, but it’s another to risk losing money for that position. There are parallels to sports betting—you may love your team but when it comes to winning or losing money, you might place your bets on your favorite team’s opponent.



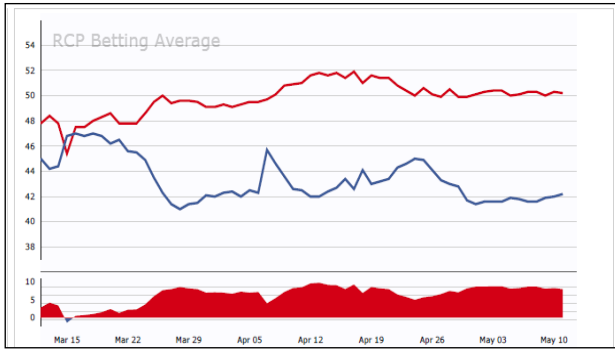
(Source: <https://www.predictit.org/>)

According to Cook, there are six states that are too close to call. The unaccounted-for state with the most electoral votes is Florida; using Cook’s count, it is nearly impossible for President Trump to win the Electoral College without winning Florida. Current polling shows Biden holding narrow leads in all the toss-up states except North Carolina. However, in 2016, President Trump carried all of the current toss-up states. The polling data suggest a very close race.

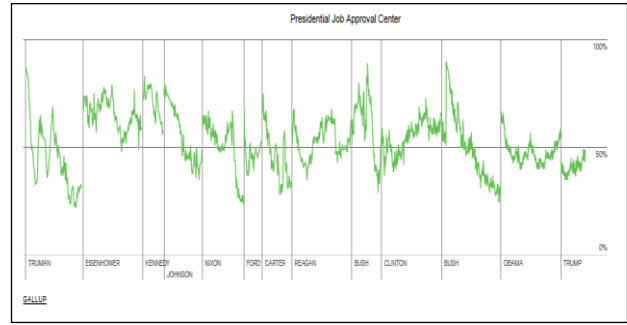
Prediction Markets: The prediction markets are another method of measuring sentiment. Polling is an inexact science; after all, if it were perfect, we wouldn’t bother to hold elections. Sampling would, in theory, be enough to select a candidate. In real life, polls struggle to acquire an

PredictIt, a U.S.-based prediction market, has state markets which allow for bettors to place wagers on each state. The current map is shown above. At present, Vice President Biden has 290 electoral votes, giving him the edge.

The other prediction markets are for the election itself. In these markets, which include numerous sites, President Trump is dominant.



(Source: https://www.realclearpolitics.com/elections/betting_odds/2020_president/)



(Source: <https://news.gallup.com/interactives/185273/presidential-job-approval-center.aspx>)

The prediction markets have a couple of weaknesses. First, any market is only as good as its depth. If there is a general lack of liquidity, the signal being sent may be inaccurate. Second, one of the failures of voting itself is its inability to account for intensity.² Voting is a binary choice; it doesn't give any reflection of a voter who is mostly indifferent compared to one who is a rabid supporter. Prediction markets can resolve this issue by allowing (a) multiple bets, and (b) allowing for larger bets. However, resolving this issue creates a bias in the outcome since (a) voters can't vote multiple times,³ and (b) votes are one size only. This issue was seen in the Brexit vote; the prediction markets were signaling the vote would go to Remain. In the aftermath, it was seen that the number of bets favored Exit, but the larger wagers were on Remain, affecting the results. So, prediction markets, like polls, are not perfect, but they can offer us some information.

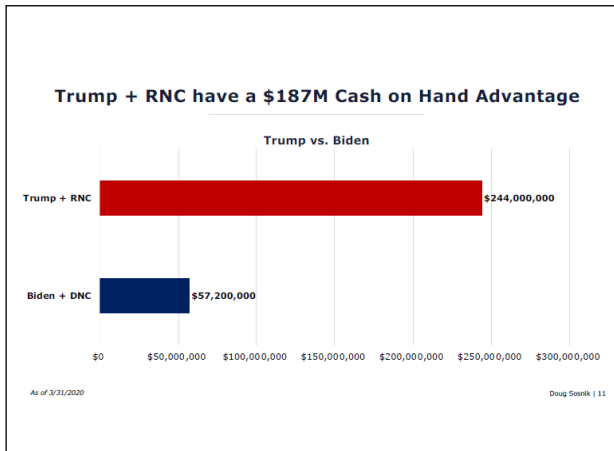
Base of Support: President Trump's approval ratings have been remarkably steady in his first term.

This chart shows the job approval ratings for the postwar presidents. There was a great deal more variability in this rating for previous presidents. President Trump's job approval ratings have barely budged, suggesting he has a stable base of support that doesn't change significantly. For this reason, he can't be counted out in the upcoming election. His supporters may not be a majority, but they are clearly committed in their backing. Related to this factor is that GOP voters tend to be better distributed geographically. Winning the popular vote in the U.S. electoral system is only a consolation prize. Democratic Party voters tend to be concentrated in the high population states, meaning a significant number of votes are "wasted" in that they exceed the number needed to win the state.

Money: Cash is a key element in building campaigns. Candidates spend money on staffing, advertising, travel, etc. and lacking funds can be a challenge. Currently, President Trump and the GOP have a large advantage in this area.

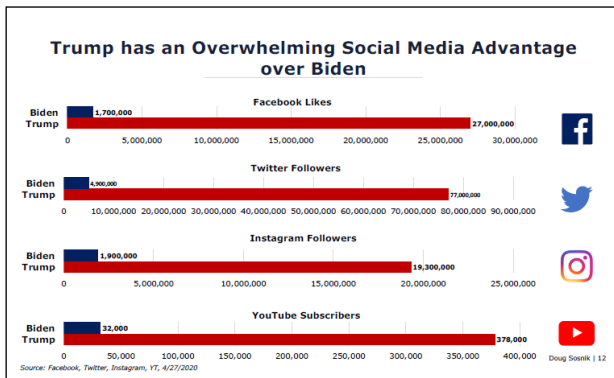
² [Kenneth Arrow's research](#) concludes that no voting structure can fully accommodate the intensity of voter preference.

³ Cue the [Chicago jokes](#) here.



(Source: https://assets.documentcloud.org/documents/6882201/Corona-Virus-Election-FINAL.pdf?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top)

Social Media Presence: As we noted in Part III, President Trump’s campaign used social media with great effect in 2016. By all indications, he has a dominant position going into November.



(Source: https://assets.documentcloud.org/documents/6882201/Corona-Virus-Election-FINAL.pdf?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top)

To recap, here are how the factors break down:

1. Incumbency—Trump
2. The Economy—Biden
3. Polling—Biden
4. Prediction Markets—?
5. Base of Support—Trump
6. Money—Trump
7. Social Media Presence—Trump

Of course, these factors are not equally weighted. The order in which these are listed is our ranking, but even then, some ranks are more important than others. In general, we tend to expect an incumbent to win unless the economy is in recession during the 18 months prior to the election. Prior to COVID-19, the economy would have favored President Trump and, given the unique characteristics of the current downturn, this factor may not be as potent as normal. The current electoral map and polling in the swing states favor Vice President Biden. If we had to put a bias on the prediction markets, it would lean toward Biden because of his lead in the swing states. But Trump’s strong showing in the overall markets leads us to conclude they are indecisive at present. We judge that Trump’s base of support is very strong; it is unclear how committed voters are to Biden. Money and social media clearly favor the incumbent. Overall, our current view is that this election is a toss-up, but we would have a modest lean toward Biden, primarily due to the recession. If we had published this report in February, we would have been leaning Trump, but the downturn in the economy is a headwind for reelection. What would change our minds? We would need swing state polling and prediction markets to move toward President Trump. That will be the focus of our attention heading into November.

Foreign Influence

Foreign nations have good reason to try to sway U.S. elections. America remains the world superpower and having a “friend” in the White House or among members of Congress could be quite helpful. It is also important to realize that foreign interference is nothing new to American elections. The U.S. has done its share of interference as well, although we tend to couch such activities as extending the liberal democratic order. What we view as democracy-

building is often seen by foreign leaders as meddling. The new development is that [social media has reduced the costs and increased the effectiveness of such interference](#). We expect foreign powers to [use social media](#) to affect the outcome of the election or perhaps offset the activities of other nations. Here are the nations that are most likely to interfere:

1. *Russia:* Russia was involved in 2016 and [will likely be in 2020 as well](#). Russia is a [master at disinformation](#) and [has been at it for years](#). Simply put, Russia's actions in 2016 were nothing new in terms of intent; what was new was the medium. Russia has two goals: to undermine the legitimacy of whomever is in the White House, and to elect a populist, not an establishment figure, as president. Russia wants the U.S. to pull back from the hegemonic role it has occupied since the end of WWII. It would make sense that Russia would tend to favor Trump over Biden; the former vice president is an establishment figure and would support the traditional role of U.S. hegemony. However, it would be incorrect, in our estimation, to draw this conclusion. Russia's primary goal is to undermine the U.S. and sow disorder. Who is in the White House likely matters less than this goal and [we would not be surprised to see Russia intimate that it interfered with the voting process](#) even if it was unable to do so. From Moscow's perspective, if we are talking about Russia, they are winning.
2. *China:* China has significant cyberwarfare capabilities, but they are mostly used for industrial espionage. The Chinese are relatively new at political manipulation, so we expect them to be involved but their methods probably won't be as effective as the Russians' techniques. At the same time,

there is [evidence they are working hard at this form of "soft power"](#). At first glance, it would make sense that [China wants the establishment back; the U.S. political establishment wants globalization and that works best for China's economy](#). However, Biden supported TPP, a trade association designed to exclude China and eventually force it into a U.S. trade orbit. Although China has clearly struggled to manage its relations with the Trump administration, [a Biden presidency could use trade relations with Asian governments to isolate China and would almost certainly bring up human rights issues](#). [Beijing might reluctantly conclude](#) that the president it knows is less risky than a new resident in the White House. There are reports [that China has already targeted the Biden campaign](#) with "phishing" attacks. In the end, China may simply decide that Russia's goals work for Beijing as well.

3. *Israel:* Israel has impressive cyberwarfare capabilities and a deep understanding of U.S. politics. It wants a GOP candidate to win as the Democratic Party is seen as hostile to its interests.
4. *North Korea:* The Hermit Kingdom also has sophisticated cyber capabilities but little evidence of democratic nuance. Its preferred outcome would be a Jeffersonian isolationist who would pull back from the hegemonic role. At the same time, [there is some evidence that Kim Jong un may feel somewhat used by President Trump](#) for public relations purposes and may decide to harm his chances out of spite. Nevertheless, divining the behavior of North Korea is very difficult.
5. *Iran:* Iran has also developed cyber capacity. Its goal, similar to North Korea's, would be to bring a populist to

the White House. Iran would prefer nothing more than a power vacuum in the Middle East. However, the Trump administration has been a nightmare for Tehran. It scuttled the nuclear deal and reapplied sanctions, crippling the Iranian economy. We would expect Iran to be in the camp of “anyone other than Trump” and there is [evidence Tehran has already targeted the Trump campaign](#).

6. *EU*: Although the Europeans generally don’t get directly involved in U.S. elections, it doesn’t mean they don’t have biases. The [EU supported Barack Obama for a Nobel Peace Prize in 2009](#) when he had barely been in office, a clear attempt to shape his future behavior. The Europeans were unhappy with President Bush; they didn’t support his incursion into Iraq and wanted a friendlier ally in the White House. Obama proved to be problematic; his “red line” fiasco in Syria upset [France and the U.K., which were poised to launch air strikes against Damascus](#). But the disruption caused by President Trump has been significant for Europe. He has questioned the reason for NATO’s existence. Essentially, Europe enjoyed a free ride on U.S.-supplied security during the Cold War and they want to return to that world. That world is never coming back. Overall, we would expect the EU to prefer Biden to Trump. How aggressive they would act to sway opinion is unclear. However, we would not expect aggressive activity in social media from the EU members. Instead, their interventions will likely be overt (e.g., op-eds, diplomatic overtures, intelligence sharing).

These are the six nations/regions we deem to have the most capacity and interest to interfere, but this roster is not exhaustive.

Smaller powers or non-governmental organizations may also become involved. For example, Islamic State has a history of using social media and hacking; the candidates these groups would prefer are probably mixed too. The key point is that social media and the internet have reduced the costs of interference. In addition, there is a threat of “false flag” operations, where an actor engages in an attack but makes it appear as though it came from somewhere else.

As deglobalization accelerates and the world steadily evolves into a G-Zero⁴ environment, the winners and losers in such a planet are trying to manage the changing environment. As noted above, some actors want to hasten the change of the post-WWII order, while others are trying to keep as much of it in place as possible. Since the U.S. was integral to the postwar order, shaping the path by affecting the outcome of American elections is a reasonable expectation. Unfortunately, in our current partisan political environment, foreign actions become aligned by “sides.” Our take is that foreign nations are less driven by the party in power as much as they are by their goals in the emerging world order. In the U.S., their actions will be part of the political narrative going forward.

Part V

Next week, we will conclude this report by discussing the base cases of a Trump second term or a Biden win and offer market ramifications.

Bill O’Grady
June 15, 2020

⁴ Bremmer, Ian. (2012). *Every Nation for Itself: Winners and Losers in a G-Zero World*. New York, NY: Penguin Books.

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 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, 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.