Confluence Investment Management

Weekly Geopolitical Report

By Bill O'Grady

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The Geopolitics of the 2020 Election: Part V

This is the final report in our five-part series on the geopolitics of the 2020 election, which was divided into nine sections. This week, we conclude the report by covering the eighth and ninth sections, the base cases for a Trump or Biden win and market ramifications.

The Base Cases

A Second Trump Term: History suggests that second terms tend to be more of the same from the first term as it relates to policy but less productive. There are a couple of reasons for this tendency. During the first term, especially if the party that gains power has been out of power before the election, there is a deep bench of candidates for cabinet and advisory positions. By the second term, the president usually has developed an understanding of his role and no longer feels he needs guidance as much as he needs execution. Consequently, the talent near the president tends to be less impressive in the second term. At the same time, "White House fatigue" sets in during the second term and it gets harder to recruit new people and keep the current ones in place. This can reduce the effectiveness of the president in the second term. Second, the political capital gained in winning the election dissipates much faster in the second term because Congress realizes the president will only be around for another four years. The political class begins to prepare for the next election cycle sooner and is less interested in the president's agenda.

Because of these dynamics, presidents tend to focus on foreign policy in the second term because it can be conducted with more independence from Congress compared to domestic policy. There can be a tendency to "reach across" to the opposition party in Congress to accomplish major policy initiatives.[1]

In a second Trump term, we would expect a continued focus on China. It is clear that China is considered a strategic threat and this attitude would likely harden in the second term. Deregulation would likely continue. It is unlikely that another tax cut of significance will occur.

A Biden Presidency: Uncertainty is always elevated with a new president. As we have noted before, a new president has his peak political capital on the day of inauguration. By the 18-month mark, it has mostly dissipated. Although new presidents have a laundry list of policies they want to implement, the reality is they usually only accomplish one or two goals and even those can be shelved if conditions are adverse.[2]

Still, with all these caveats, what can we expect from a Biden presidency? He has always been a member of the Left-Wing Establishment (LWE) and does not have a reputation for supporting radical policy

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[1] Examples of this include President Reagan's major tax reform in 1986 and President Clinton's "triangulation" in his second term. Reagan worked with both Democratic and Republican leaders to get tax reform accomplished. Clinton often frustrated his own party leadership by working with the GOP for policy goals.

[2] For example, 9/11 completely changed the path of the Bush presidency.

proposals. He opposed single-payer medical care during the Democratic Party debates, for example. Since becoming the presumptive nominee, he has been adding Left-Wing Populist (LWP) measures to his policy plans. He clearly fears that the LWP will abandon him in November, either by not voting or by selecting a third-party candidate, so he is actively courting Sanders voters. It is not clear whether this is a true conversion or if these policies will end up being so far down the priority list that they won't actually be promoted. We tend to think most politicians remain true to form; if so, Biden will remain a centrist LWE figure. Nevertheless, there is a possibility he will attempt to govern as a LWP. If so, more government programs and higher taxes are likely. And, a reversal of Trump era deregulation is highly likely as well.

There is one other area of note. When Biden was vice president, his economic advisor was Jared Bernstein. Although he is generally considered a center-left economist, he has publicly suggested the U.S. should abandon the dollar's reserve currency role. Although this action would undermine the incentive of foreigners to acquire dollars for reserve purposes and likely reduce the trade deficit, it would be a monumental policy change. It isn't clear if Biden still consults with Bernstein, but we suspect he does. This would be an issue to watch.

The other oddity of a Biden presidency would be his advanced age. He will turn 78 before the inauguration and thus would be the oldest president in our history.[3] Although the life expectancy of a 78-year-old American male is 9.4 years, the rigors of the office could put his health at risk. It is quite possible that he wouldn't run for a second term as he would be 82 when taking office for the second round. If this were the case, as we noted earlier, Biden could be viewed in Congress as a second-term president, giving him a more rapid decline in political capital.

Secondarily, his advanced age would make his choice for vice president extremely important. Under normal circumstances, the choice of VP is generally not all that critical. However, in this case, voters will likely consider the situation where Biden mightfail to complete his term and envision the vice president in the Oval Office. And, even if Biden completes his term, it is not uncommon for vice presidents to attempt to succeed the outgoing president. Thus, the choice for VP will be closely watched.

Concluding Thought

Before we discuss market ramifications, we have one additional comment. History shows that the current level of inequality is probably not sustainable. As we noted in our recent WGR series on Scheidel's Horsemen (Parts I, II and III), pandemics have historically been one of the factors that reverses an efficiency cycle toward an equality cycle. Thus, if the country is on the cusp of a switch in the cycle, the question then becomes which populist arrangement, right-wing or left-wing, will be politically dominant.

In general, the LWP trusts government more than business and supports policies designed to socialize capital. In other words, to reduce income inequality, the LWP look to nationalization and regulation as the primary tools. An example of this is when the U.K. socialized the "commanding heights" of the economy after WWII.

The Right-Wing Populist (RWP) alignment has less trust in government and generally opposes nationalization. Instead, the primary method of reducing income

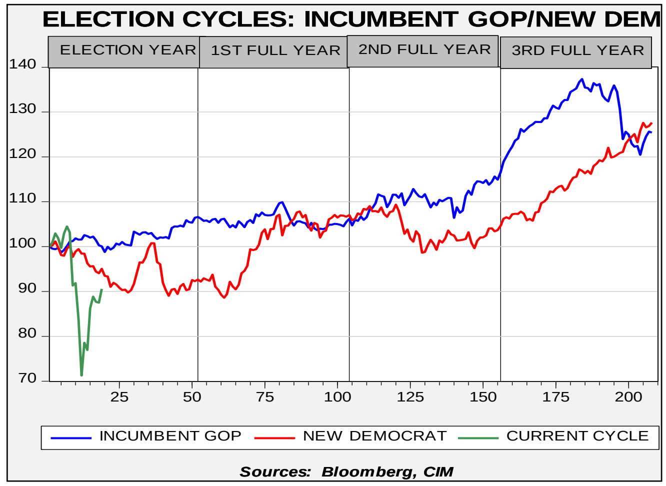
[3] Interestingly enough, eclipsing the previous oldest, Donald Trump.

inequality is by restricting the available supply of labor. This is accomplished by restricting trade and immigration which fosters the growth of unionization. Even RWP members who oppose unions tend to benefit from the restraint of labor supply. This doesn't mean that the RWP doesn't want some policies from government. They will tend to be indifferent to taxes on the wealthy as they need some degree of regulation to prevent capital from using automation to replace jobs. But, the thrust of RWP policy is less about the socialization of capital and more about restricting the labor supply.

For both wings of the establishment, the issue is which outcome is preferred. In U.S. history, the establishment tends to support the RWP policy mix rather than the LWP policy prescriptions. In this cycle, we expect a similar response.

Ramifications
We have developed a chart to show the general behavior of the S&P 500 given different scenarios of who wins the presidential election. To create the chart, we index the S&P 500 to the first Friday close in the election year. This creates a four-year indexed series for each election cycle. We can then create averages for various scenarios, e.g., incumbent party versus new party, second-term market behavior by party, etc.

The following chart shows the average S&P 500 performance for a second-term incumbent Republican compared to a new Democrat. We have created a new series for the 2020 election cycle. As the chart shows, the COVID-19 pandemic has triggered a massive drop and recovery in the equity index.



Although it is possible the equity markets are discounting a Biden presidency, it is more likely that the decline is mostly due to market reaction tied to the pandemic. According to the data, equity investors tend to look at a new Democrat with some degree of concern. However, by the end of Q1 in the first year after the election, equities tend to rally as investors likely conclude that the new Democrat isn't going to dramatically change the policies that affect investment. This realization triggers a strong recovery to the point where the market would have been if the GOP candidate had held office.

This chart suggests that a Trump win in November would likely bring an immediate lift to equities. A Biden win should lead to an eventual recovery but uncertainty surrounding the path of policy will likely delay the lift until late H1 of 2021. Of course, this estimation rests on the expectation that the COVID-19 recession will be deep in magnitude but short in duration. If the recession lasts more than two quarters, equities may struggle longer regardless of who wins in November.[4]

[4] Our base case, on the other hand, is that this cycle's low in the equity markets has probably already been made.

In terms of Congress, odds are that the body remains divided. Although there is a chance the Senate could turn in favor of the Democrats, it is inconceivable that they would win a veto-proof majority. And so, as long as filibuster rules remain in place, massive changes in legislation are unlikely.

As we stated in our 2020 Geopolitical Outlook, this year's election could be momentous. The current pandemic is an additional complication we didn't anticipate. As we head into November, we would, at a minimum, expect volatility to remain elevated as investors attempt to discount the outcome.

Politics is a topic fraught with risk. It is easier not to discuss the issue. However, insofar as it affects financial markets, we believe investors cannot avoid thinking about it. The goal of this report is to frame the upcoming elections in a dispassionate manner to help investors and our own financial management team prepare for what lies ahead.

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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.