

August 17, 2015

Donald and Bernie

In the spring of 2014, we wrote a series of Weekly Geopolitical Reports that looked at the 2016 elections.¹ In these reports, we described the economic and political environment that had the potential to make the 2016 election historically important. The emergence and remarkable staying power of Donald Trump and Bernie Sanders suggests that our earlier analysis and conclusions may be coming to pass.

In this report, we will recap the economic and political factors that led us to conclude last year that the next presidential cycle could be unusually significant. From there, we will look at the unlikely rise of Donald Trump and Bernie Sanders and what their success thus far signals about the electorate and the next presidential election. Finally, we will analyze their potential impact on the election, including the possibility that each might mount an extra-party candidacy. As always, we will conclude with market ramifications.

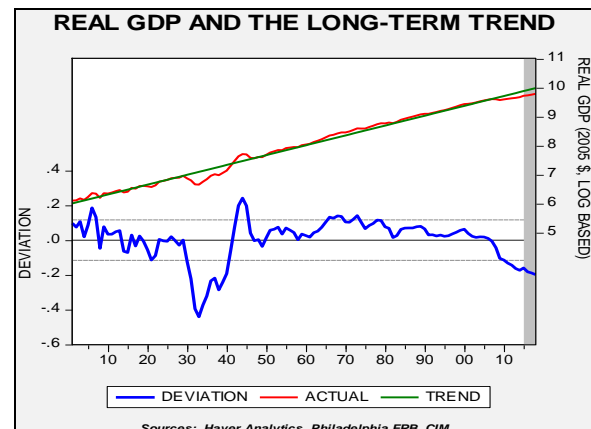
The Economic Problem

The U.S. economy is growing at a very slow pace, slow enough that some prominent economists² are calling the current situation

¹ See WGRs: 3/31/2014, [2016 \(Part 1, The Economic Issue\)](#); 4/14/2014, [2016 \(Part 2, The Political Situation\)](#); and 4/21/2014, [2016 \(Part 3, The Election Situation\)](#).

² Such as Larry Summers, former Treasury Secretary during the Clinton administration and Chairman of Economic Advisors for President Obama, who borrowed the concept from Alvin Hansen, a

“secular stagnation,” a period of substandard growth. We think there is ample evidence that secular stagnation has developed in the U.S. and it is affecting global economic growth as well.

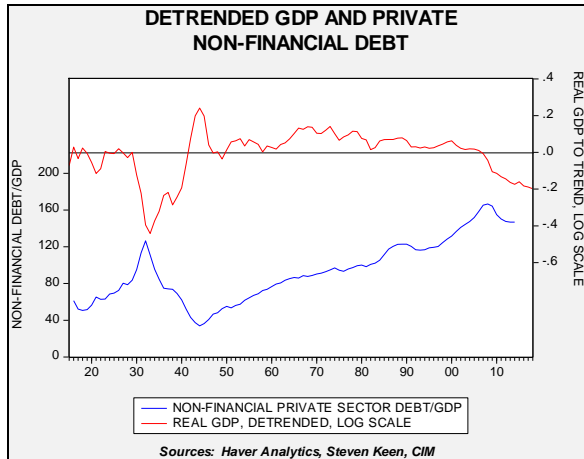


This chart shows real GDP from 1901 through 2018 on a logarithmic scale; the 2015-18 period, shown in gray on the above chart, is the consensus forecast from the Philadelphia FRB’s survey of professional forecasters. The key point of this graph is the deviation from trend. Note that GDP has been well below trend in two periods, the Great Depression and now. It is worth noting that the theory of secular stagnation originated during the 1930s.

Although the reasons for persistently below-trend growth are complicated, the most common factor from both eras is excessive private sector debt growth.

renowned economist who helped create the Council of Economic Advisors for President Roosevelt in the 1930s.

The chart below shows detrended GDP (the lower line on the above graph) along with private sector non-financial debt as a percentage of GDP.



In both periods of below-trend growth, debt levels had reached high levels. In the 1930s debt crisis, both household and business debt increased but the latter was probably the more important factor. In the current situation, household debt is more critical. It appears to us that until debt levels fall to what borrowers feel is a manageable level, economic growth will remain depressed.

The first debt increase mainly occurred due to the export boom that developed after WWI. After the 1921 recession, business activity rose as the U.S. economy began to take a pre-eminent position in the world. However, much like Japan in the 1980s or China today, the investment/export growth model only works if the rest of the world can absorb the goods that the exporting nation wants to sell. When that avenue began to falter,³ the U.S. found itself with too much productive capacity and too much debt.

³ A problem exacerbated by the Smoot-Hawley Tariff in 1930.

In the 1930-45 period, debt levels were reduced by two methods—vicious foreclosures and bankruptcies before WWII and essentially a “debt swap” between the private sector and the government sector, facilitated by war spending. As the government increased defense spending, jobs were created that increased household income. Ration programs limited household spending which freed up cash for debt service, and increased business activity allowed the business sector to repair balance sheets. This allowed private sector debt to fall; however, it was replaced with expanding government debt that was used to fund the war effort. After the war ended, debt levels were at such low levels that both businesses and households were able to borrow to lift the economy. Financial repression where interest rates were held below the rate of inflation allowed the government to reduce the debt burden to manageable levels by the 1970s.

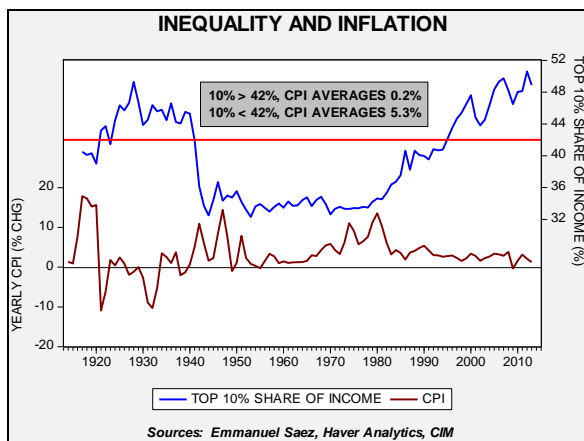
The steady increase in debt levels after the war peaked in 2008. This rising debt occurred mostly due to the burdens brought by the U.S. superpower role. As part of that role, America provides the reserve currency, meaning it must run persistent trade deficits in order to provide the reserve currency to support global liquidity and trade. The U.S. has used two methods to provide this liquidity since 1945. The first policy structure was designed to build a regulated economy that created a large number of high-paying, relatively low-skilled jobs. The program restricted disruptive technologies by concentrating industries and fostering the growth of labor unions.⁴ It also featured high marginal tax rates to discourage entrepreneurship as new businesses can upset the established order

⁴ For a thorough description of this period, see: Galbraith, J. (1967). *The New Industrial State*. Boston, MA: Houghton Mifflin.

and lead to job losses. This led to hiring and rising incomes for average households.

Although the economy successfully created a broad path to the middle class, it was inefficient. Persistent inflation became a serious issue. To address inflation, President Carter implemented a series of supply side measures designed to improve the efficiency of the economy. These included the deregulation of financial services and transportation. He also appointed Paul Volcker as Federal Reserve Chairman; he implemented a “hard money” monetary policy. President Reagan took Carter’s reforms and expanded them further, leading to additional deregulation and globalization.⁵

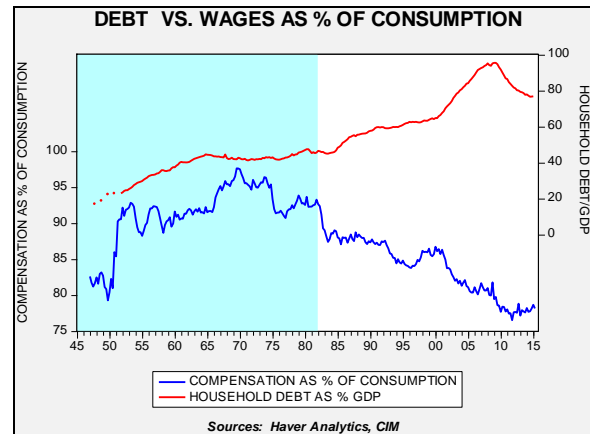
The good news was that the policies brought inflation under control. The problem was the broad path to the middle class in the developed world was dramatically narrowed. To now survive in the labor force, workers needed to rapidly adapt to new technologies and methods and compete on a global scale. Those who could were greatly rewarded; those who could not were left behind.



⁵ For a history of the global transition from regulation to deregulation, see: Yergin, D. (1998). *The Commanding Heights*. New York, NY: Simon & Schuster.

This chart shows the share of total income captured by the top 10% of income earners and inflation as measured by CPI. As the data shows, when this share is above 42%, inflation tends to be non-existent. When the top 10% share is below 42%, the CPI average is 5.3%. Inequality isn’t necessarily the cause of low inflation, but deregulation and globalization, which are effective against inflation, tend to cause increasing income inequality.

This led to a conflict between domestic and foreign policy. Containing inflation was a key domestic goal, but widening income differentials weakened the average household’s ability to consume, which undermined the reserve currency role of the superpower. The way the U.S. resolved this conundrum was through debt.



This chart shows how much of U.S. consumption is being funded through employee compensation. From 1950 to the early 1980s, wages generally funded between 90% and 95% of consumption. After deregulation, wages funded a steadily shrinking degree of consumption. Much of consumption was funded by household debt, as shown on the chart; note how it rose steadily as deregulation and globalization expanded. Of course, transfer payments played a role as well.

The Political Situation

Using debt to address the requirements of providing the reserve currency was never going to be a permanent solution to the problem of running a domestic economy and meeting the requirements of global hegemony. However, as long as credit was widely available, the political situation was manageable. The financial crisis of 2008 has made it clear that the debt option is no longer viable. And, to a great extent, the election of 2016 *should* be about answering these two questions:

1. Should the U.S. continue to act as global hegemon, which includes providing the reserve currency?
2. If the answer to #1 is yes, then how should the economy be restructured in order to fulfill the hegemon role in a sustainable fashion?

In the aforementioned 2016 reports we published in the spring of 2014, in Part 2 we described the four archetypes of American politics. There are two establishment classes and two populist classes. The establishment classes are the rentier/professional and the entrepreneurial. Within the first, there are two sub-categories, the center-left and center-right. Most of the Democratic Party establishment occupy the center-left whereas the GOP establishment is center-right. The rentier/professional groups have strong disagreements among themselves about social policy, but on economic policy they are firmly united behind deregulation, globalization and maintenance of America's global hegemony. The entrepreneurial group strongly supports deregulation and globalization but tends to oppose the military part of the hegemonic role.⁶

⁶ It should be noted that in the political arrangement that ran from 1932-80, the entrepreneurial class was severely oppressed as these "disruptive types" were

There are also two populist groups, left- and right-wing populists. In common parlance, these are the "bases" of the major political parties. For the most part, these groups represent those who have not fared well in the current environment of globalization, deregulation and global hegemony.⁷

The political coalition that created the economic system in place from 1932 to 1980 was comprised of right-wing populists and the rentier/professional classes. The coalition mostly excluded the entrepreneurial class and the left-wing populists. However, the civil and gender rights movements of the 1960s and 1970s led the working coalition to broaden to include the left-wing populists as well. This action threatened the status and position of the right-wing populists and they opposed the decision. The turmoil experienced by the Democratic Party in the 1968 and 1972 presidential elections was due, in part, to this tension. In addition, the inability of this coalition to resolve the inflation problem led to this arrangement's demise.

The Reagan Revolution meant that the establishment classes were in charge as the entrepreneurial class gained power. The establishment controlled political financing but did not have enough votes to win without the support of the populist classes. Thus, both the center-left and center-right used social issues to woo the "base"; the most successful political figures were able to inspire the base to vote for them. However, neither the left- or right-wing populists' economic goals were ever met. In effect, the establishment classes ran the economy, an

shunted into the defense industry, academia or the large industrial laboratories.

⁷ For a more complete description of these classes, please see: WGR, 4/14/2014, [2016 \(Part 2, the Political Situation\)](#), pages 1-3.

economy based on globalization and deregulation.

As time has passed, populists on both sides have discovered that they are not getting their economic needs met. However, to gain political power, either a durable relationship must reemerge with one of the establishment classes or the populist classes must create their own coalition.⁸ In our estimation, the populist classes will struggle to find common ground. Thus, we do not expect the right and left wing to agree on a common cause. Still, that doesn't mean that politicians that take up the populist cause won't have an impact on the next election.

Donald and Bernie

Into this power vacuum enter two unlikely presidential candidates, Donald Trump and Bernie Sanders. The former is a billionaire real estate mogul who has an aura of celebrity. The latter is a socialist senator from Vermont, a small liberal-leaning state, who caucuses with Democrats but accuses most of them of being in league with the establishment class. They could not be more different. However, what they have in common is that their campaigns have captured the anger of the populists on both wings.

Donald Trump is gaining favor among the right-wing populists. How is this wealthy establishment figure wooing this populist group? One of the concerns among right-wing populists is that the expense of campaigns means that candidates must raise money from the establishment classes which prevents them from representing populist interests. Since Trump is independently wealthy, he is viewed as “being his own

man.” In fact, his comments stating that former Secretary of State Hillary Clinton had to go to his wedding because of his campaign contributions suggest that Trump may “own” a few politicians. The brash statements he makes, comments that appear so offensive that they would have likely ended a traditional candidate's chances, only seem to improve Trump's poll numbers.

Trump's economic message is that illegal immigration and unfair foreign competition are the reasons the economy is in trouble. If a “hard man” were in office, forcing other governments to trade fairly or halt illegal immigration, then the economy would do better.

Right-wing populists no longer trust government; that trust was lost when the rentier/managerial and the right-wing populist coalition was disrupted by the gender and civil rights movements of the 1960s and 1970s. The right wing doesn't want the government to give handouts per se. However, it does want laws and regulations designed to recreate the economic structure that existed after WWII into the late 1960s. Trump's “outsider” status resonates strongly with this class because they don't trust government to support their interests. For example, right-wing populists are very skeptical of the Affordable Care Act (ACA).

Sanders's message is that large corporations and the financial system are unfair to common people, and government policies are designed to protect those with power and money. Unlike Trump, who faces a plethora of competitors, Sanders really only has one other candidate he is running against, Hillary Clinton. Sanders has been able to portray her as a member of the establishment who cannot represent the interests of “regular folks.” Thus, far, he is

⁸ The possibility of populist unity was discussed in a recent book, see: Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

making the charges stick. Although he does not have the great wealth of Trump, Sanders is well known as a man who does not need much money to exist; he can run a “cheap” campaign and thus isn’t beholden to establishment wealth.

Left-wing populists tend to be sympathetic to “identity politics” and are more trustful of government. They tend to support many government programs and generally approve of the ACA. Although they are currently angry at the government, they still seem to believe that if it worked properly (e.g., if regulators did their jobs), then bigger government would be acceptable.

The other issue that makes both candidates powerful is that neither is strongly affiliated with the parties they are trying to be nominated from. Trump has endorsed policies over his history that have been more affiliated with Democrats. Sanders represents the Socialist Party; he isn’t even a Democrat. At the GOP debate, Trump refused to rule out an extra-party candidacy. We suspect Sanders may consider such a position as well. And so, even if they fail to gain enough delegates to defeat an establishment candidate, they may still affect the outcome of the election in November 2016.

Among the pundit groups, both candidates are regularly written off as having no staying power. This stance is understandable. Trump’s stump speeches fail the test of simple logic. For Sanders, the U.S. has almost no history of supporting socialist causes on a national level. The expectation is that as the nominating process wears on, both candidates will falter and join other failed fringe candidates seen throughout history.

We have our doubts. Populists of both stripes are angry. They feel that no one represents their interests. They don’t necessarily want politicians with well developed “wonkish” platforms that detail the nuance of tax policy or health care. What they want is someone who is independent and promises to “get things done.” The message that “your life would be better if you didn’t have politicians in Washington who oppose your interests” is one that resonates.

The Consequences

The key is to return to the two questions on page four; can populism exist alongside American hegemony? We don’t think so. For left-wing populists, that is probably acceptable. They are mostly Jeffersonian in foreign policy⁹ and would be comfortable with adopting a more isolationist stance. Right-wing populists are mostly Jacksonian; they want a military-focused hegemonic United States but fail to connect the financial role. The U.S. cannot run a trade surplus without threatening the global economy as such action would withdraw dollar liquidity from the world. Thus, the tough talk from Trump about trade deals is really just that; as long as one is the superpower, domestic industries will always face strong foreign competition, in part because the rest of the world has strong incentives to skew policy to run trade surpluses with the U.S. It is hard to see how even the most crafty negotiator can overcome that issue. In addition, the global hegemon has an interest in encouraging other nations to use its currency as a way of projecting power.¹⁰

⁹ See WGR, 1/9/2012, [The Archetypes of American Foreign Policy](#).

¹⁰ This is one of the major reasons China is pushing so hard to join the IMF’s Special Drawing Rights basket.

To date, no one has developed a plan that would meet the needs of the domestic economy and maintain America's superpower status. That fact partially explains why there is so much anger against the political establishment. It appears the current model has failed but the elites have not developed a replacement. The lack of replacement has led to the charge that the elites do not intend to change the system because it works for them. If the superpower status is jettisoned, it would be much easier to develop a new policy; after all, only domestic policy would matter at that point. However, history shows that periods when the world lacks a dominant superpower tend to have more frequent wars and revolutions.

Ramifications

Elections with four significant candidates are not common in U.S. history, but they are not unprecedented either. The 1948 presidential campaign featured Harry Truman, Thomas Dewey, Strom Thurmond (Dixiecrat) and Henry Wallace (Progressive), with Thurmond capturing 39 electoral votes. During that period, those votes would have gone to Truman, so Thurmond's candidacy did not affect the outcome of the election. Perhaps the most famous four-candidate race was the 1860 election, featuring Abraham Lincoln (Republican), John Breckinridge (Southern Democrat), John Bell (Constitutional Union) and Stephen Douglas (Northern Democrat). All four candidates gained electoral votes, with Lincoln winning a majority within the college with 39.8% of the popular vote.

It is worth noting that both of these elections occurred during conditions of great uncertainty. In 1948, the country was trying to ascertain the best direction for both foreign and domestic policy. In 1860, the issues of slavery and the lack of clarity surrounding Federal and State power, an issue that emerged at the founding of the republic, were in dispute. In periods of great tumult, elections with multiple candidates often emerge.

If the establishment candidates win the major party nominations, but Sanders and Trump decide to run as extra-party candidates, the uncertainty will likely weigh on financial markets. Handicapping elections with two major candidates is difficult enough. Determining a winner with three or four candidates is quite hard and the lack of certainty will not play well with risk assets.

The rise of populism is not just a U.S. issue.¹¹ Globalization and deregulation, especially with regard to the open adoption of new technology and work structures, is increasingly being called into question. As we noted in our earlier reports on the 2016 election, there is increasing potential that major political and economic changes will emerge from this vote. The emergence of Donald Trump and Bernie Sanders is a reflection that the populists want a change in the direction of American policy. We will be watching closely to see whether any serious changes result.

Bill O'Grady
August 17, 2015

¹¹ See WGR, 1/12/2015, [European Populism](#).

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.