

## US election - the investment implications

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### EXECUTIVE SUMMARY

- Trump won by stealing votes from Democrats in the Midwest.
- His victory implies a national shift to the left on economic policy.
- Checks and balances on Trump are not substantial in the short-term.
- US political polarisation will continue.
- Trump is good for the USD, bad for bonds, neutral for equities. Favor SMEs over MNCs.  
Close long alternative energy / short coal.

### INTRODUCTION

"Most Americans do not find themselves actually alienated from their fellow Americans or truly fearful if the other party wins power. Unlike in Bosnia, Northern Ireland or Rwanda, competition for power in the US remains largely a debate between people who can work together once the election is over."

– Newt Gingrich, 2 January 2001

Former Speaker of the House Newt Gingrich (and a potential Secretary of State pick), was asked on NBC's Meet the Press two days before the US election whether he still thought that "competition for power in the U.S. remains largely a debate between people who can work together once the election is over." He made the original statement in January 2001, merely weeks after one of the most contentious presidential elections in U.S. history was resolved by the Supreme Court.

Gingrich's answer in 2016? "I think, tragically, we have drifted into an environment where... it will be a continuing fight for who controls the country."

Despite an extraordinary victory – a revolution really – by Donald J. Trump, the fact of the matter remains that the US is an polarised country between Republican and Democratic voters. As of publication time of this report, Trump lost the popular vote to Secretary Hillary Clinton. His is a narrower victory than either the epic Richard Nixon win in 1968 or George W. Bush squeaker in 2000.

Over the next two years, the only thing that matters for the markets is that the US has a unified government behind a Republican president-elect and a GOP-controlled Congress. We discuss the investment implications of this scenario below and caution clients to not over-despair. On the other hand, we also see this election as another evidence that American remains a deeply polarised country where identity politics continue to play a key role.

What concerns us is that these identity politics appear to transcend the country's many cultural, ethical, political, and economic commonalities. Republicans and Democrats in the US are fusing into almost ethnic-like groupings.

To bring it back to Gingrich's quote, that would suggest that the US is no longer that much different from Bosnia or Northern Ireland.<sup>1</sup>

#### ELECTION POST-MORTEM

Donald Trump has won an upset over Hillary Clinton, but his campaign was not as much of a long-shot as the consensus believed. US presidential polls have frequently missed the final tally by +/- 3% of the vote, which was precisely the end result of the 2016 election.

Therefore, as we pointed out in our last missive on the election, Trump's victory was not a "wild mathematical oddity."<sup>2</sup>

#### Why Did Trump Win The White House?

Where Trump really did beat expectations was in the Midwest, and Wisconsin in particular. He ended up outperforming the poll-of-polls by a near-incredible 10%.<sup>3</sup> His victories in Florida, Ohio, and Pennsylvania were well within the range of expectations. For example, the last poll-of-polls had Trump leading in both Florida (by a narrow 0.2%) and Ohio (by a solid 3.5%), whereas Clinton was up in Pennsylvania by the slightest of margins (just 1.9% lead). He ended up exceeding poll expectations in all three (by 2% in Florida, 6% in Ohio, and 3% in Pennsylvania), but not by the same wild margin as in Wisconsin.

When all is said and done, Trump won the 2016 election by stealing votes away from the Democrats in the traditionally "blue" Midwest states of Michigan, Pennsylvania, and Wisconsin. This was a far more significant result than his resounding victories in Ohio (which Romney won in 2012) or Florida (where Obama won only narrowly in 2012). Our colleague Peter Berezin, Chief Strategist of the *Global Investment Strategy*, correctly forecast that Trump would be competitive in all three Midwest states back in September 2015! We highly encourage our clients to read his "Trumponomics: What Investors Need To Know," as it is one of the best geopolitical calls made by BCA in recent history.<sup>4</sup>

As Peter had originally thought, Trump cleaned up the white, less-educated, male vote in all of the three crucial Midwest states. He won 68% of this vote in Michigan, 71% in Pennsylvania, and 69% in Wisconsin. To do so, Trump campaigned as an unorthodox

Republican, appealing to the blue-collar white voter by blaming globalisation for their job losses and low wages, and by refusing to accept Republican orthodoxy on fiscal austerity or entitlement spending. Instead, Trump promised to outspend Clinton and protect entitlements at their current levels.

This mix of an outsider, anti-establishment, image combined with a left-of-center economic message allowed Trump to win an extraordinary number of former Obama voters. Exit polls showed that Obama had a positive image in all three Midwest states, including with Trump voters! For example, 30% of Trump voters in Michigan approved of the job Obama was doing as president, 25% in Pennsylvania, and 27% in Wisconsin. That's between a quarter and a third of eventual people who cast their vote for Trump.

These are the voters that Republicans lost in 2012 because they nominated a former private equity "corporate raider" Mitt Romney as their candidate. Romney had famously argued in a 2008 *New York Times* op-ed that he would have "Let Detroit go bankrupt." Obama repeatedly attacked Romney during the 2011-2012 campaign on this point. Back in late 2011, we suspected that this message, and this message alone, would win President Obama his re-election.<sup>5</sup>

Why is the issue of the Midwest Obama voters so important? Because investors have to know precisely why Donald Trump won the election. It wasn't his messages on immigration, law and order, race relations, and especially not the tax cuts he added to his message late in the game. It was his left-of-center policy position on trade and fiscal spending. Trump is beholden to his voters on these policies, particularly in the Midwest states that won him the election.

A final word on race. Donald Trump actually improved on Mitt Romney's performance with African-American and Hispanic voters. This was a surprise, given his often racially-charged rhetoric. Meanwhile, Trump failed to improve on the white voter turnout (as percent of overall electorate) or on Romney's performance with white voters in terms of the share of the vote. To be clear, Republicans are still in the proverbial hole with minority voters and are yet to match George Bush's performance in 2004. But with 70% of the U.S. electorate still white in 2016, this did not matter.

### **Congress: No Gridlock Ahead**

Republicans exceeded their expectations in the Senate, losing only one seat (Illinois) to Democrats. This means that the GOP control of the Senate will remain quite comfortable and is likely to grow in the 2018 mid-term elections when the Democrats have to defend 25 of 33 seats. Of the 25 Senate seats they will defend, five are in hostile territory – North Dakota, West Virginia, Ohio, Montana, and Missouri. In addition, Florida is always a tough contest. Republicans, on the other hand, have only one Senate seat that will require defense in a

Democrat-leaning state – Nevada (and in that case, it will be a Republican incumbent contesting the race). Their other seven seats are all in Republican voting states.

As such, expect Republicans to hold on to the Senate well into the 2020 general election.

In the House of Representatives, the GOP will retain its comfortable majority. The Tea Party affiliated caucuses (Tea Party Caucus and the House Freedom Caucus) performed well in the election. The Tea Party Caucus members won 35 seats out of 38 they contested and the House Freedom Caucus won 34 seats out of 37 it contested.

The race to watch now is for the Speaker of the House position. Paul Ryan, the Speaker of the incumbent House, is likely to contest the election again and win. Even though his support for Donald Trump was lukewarm, we expect Republicans to unify the party behind Trump and Ryan. A challenge from the right could emerge, but we doubt it will materialise given Trump's victory. The campaign for the election will begin immediately, with Republicans selecting their candidate by December (the official election will be in the first week of January, but it is a formality as Republicans hold the majority).

**Bottom Line:** Trump's victory was largely the product of former Obama voters in the Midwest switching to the GOP candidate. This happened because of Trump's unorthodox, left-of-center, message. Trump will have a friendly Congress to work with for the next four years. How friendly? That question will determine the investment significance of the Trump presidency.

## INVESTMENT RELEVANCE OF A UNITED GOVERNMENT

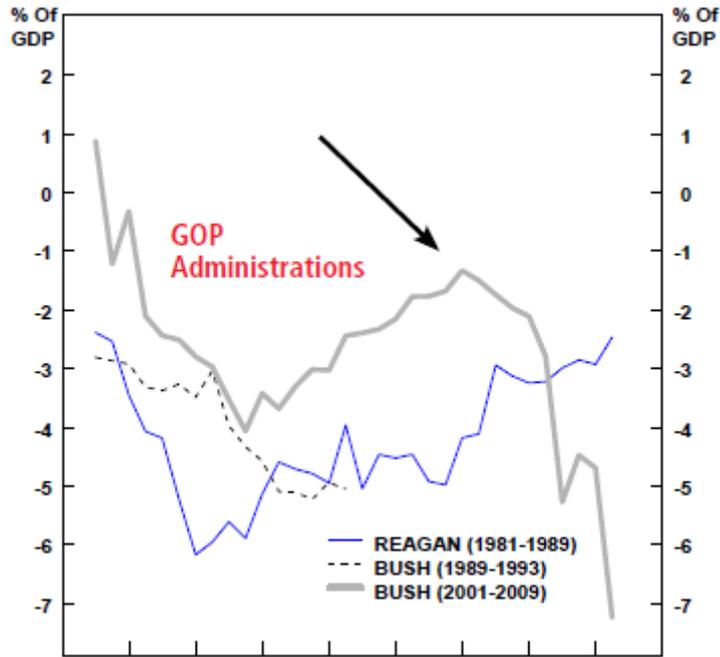
Most clients we have spoken to over the past several months believe that Donald Trump will be constrained on economic policies by a right-leaning Congress. His more ambitious fiscal spending plans – such as the \$550 billion infrastructure plan and \$150 billion net defense spending plan – will therefore be either "dead on arrival" in Congress, or will be significantly watered down by the legislature. Focus will instead shift to tax cuts and traditional Republican policies. We could not disagree more.

### **GOP is not fiscally conservative**

There is no empirical evidence that the GOP is actually fiscally conservative. First, the track record of the Bush and Reagan administrations do not support the adage that Republicans keep fiscal spending in check when they are in power (Figure 1). Second, Republican voters themselves only want "small government" when the Democrats are in charge of the White House (Figure 2). When a Republican President is in charge, Republicans forget their "small government" leanings.

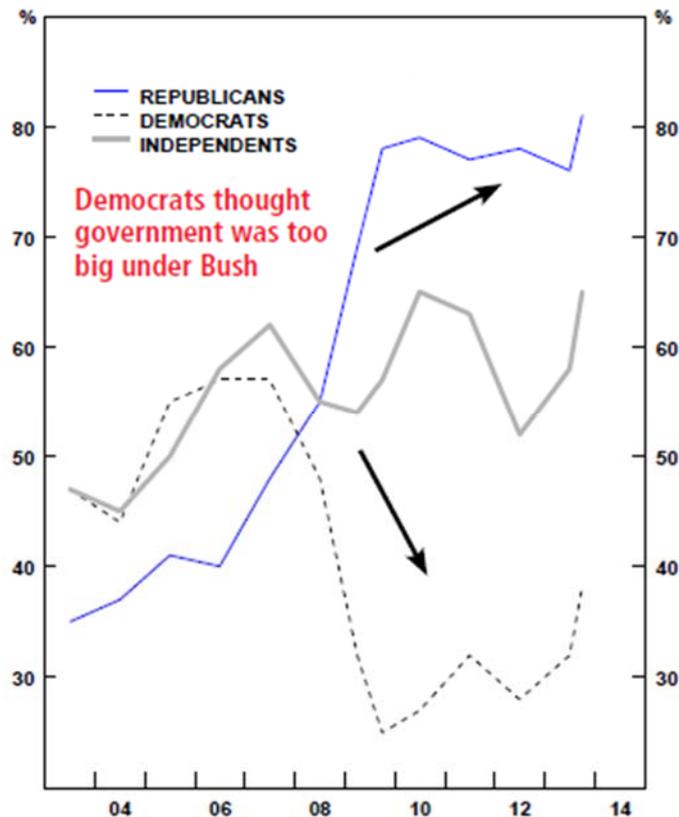
Figure 1: Republicans are not fiscally responsible

U.S. budget deficit



Source: BCA Research.

Figure 2: Big government is only a problem for the opposition  
Percentage of respondents that think the government is too big



Source: Gallup.

### Presidents get their way

Over the past 28 years, each new president has generally succeeded in passing their signature items. Congress can block some but probably not all of president's plans. Clinton, Bush, and Obama each began with their own party controlling the legislature, which gave an early advantage that was later reversed in their second term. Clinton lost on healthcare, but achieved bipartisan welfare reform. For Obama, legislative obstructionism halted various initiatives, but his core objectives were either already met (healthcare), not reliant on Congress (foreign policy), or achieved through compromise after his reelection (expiration of Bush tax cuts for upper income levels).

### Median voter has moved to the left

Donald Trump won both the GOP primary and the general election by preaching an unorthodox, left-of-center sermon. He understood correctly that the American voter preferences on economic policies have moved away from Republican laissez-faire

orthodoxies.<sup>6</sup> Yes, he is also calling for significant lowering of both income and corporate tax rates. However, tax cuts were never a focal point of his campaign, and he only introduced the policy later in the race when he was trying to get traditional Republicans on board with his campaign. Newsflash – traditional Republicans did not get Trump over the hump, Obama voters in the Midwest did!

Investors should make no mistake. The key pillars of Trump's campaign are de-globalization, higher fiscal spending, and protecting entitlements at current levels. And he will pursue all three with GOP allies in Congress. What are the investment implications of this policy mix?

## **USD**

More government spending, marginally less global trade, and pressure on multi-national corporations (MNCs) to scale back their global operations should be positive for inflation. If growth surprises to the upside due to fiscal spending, it will allow the Fed to hike more than the current 57 bps expected by the market by the end of 2018. Given easy monetary stance of central banks around the world, and lack of significant fiscal stimulus elsewhere, economic growth surprise in the US should be positive for the dollar in the long term. At the moment, the market is reacting to the Trump victory with ambivalence on the USD. In fact, the dollar suffered as Trump's probability of victory rose in late October. We believe that this is a temporary reaction. We see both Trump's fiscal and trade policies as bullish. BCA's currency strategist Mathieu Savary believes that the dollar could therefore move in a bifurcated fashion in the near term. On the one hand, the dollar could rise against EM currencies and commodity producers, but suffer – or remain flat – against DM currencies such as the EUR, CHF, and JPY.<sup>7</sup>

## **Bonds**

More inflation and growth should also mean that the bond selloff continues. In addition, if our view on globalisation is correct, then the deflationary effects of the last three decades should begin to reverse over the next several years. BCA thesis that we are at the "End Of The 35-Year Bond Bull Market" should therefore remain cogent.<sup>8</sup> As one "Trump hedge", our colleague Rob Robis, Chief Strategist of the BCA *Global Fixed Income Strategy*, suggested a 2-year / 30-year Treasury curve steepener. This hedge is now up 18.7 bps and we suggest clients continue to hold it.

## **Fed policy**

Trump's statements about monetary policy have been inconsistent. Early on in his campaign he described himself as "a low interest rate guy" but he has more recently become critical of current Federal Reserve policy – and Fed Chair Janet Yellen in particular – claiming that while

higher interest rates are justified, the Fed is keeping them low for "political reasons." What seems certain is that Janet Yellen will be replaced as Fed Chair when her term expires in February 2018. Yellen is unlikely to resign of her own volition before then and it would be legally difficult for the President to remove a sitting Fed Chair prior to the end of her term. But Trump will get the opportunity to re-shape the composition of the Fed's Board of Governors as soon as he is sworn in. There are currently two empty seats on the Board need to be filled and given that many of Trump's economic advisers have "hard money" leanings, it is very likely that both appointments will go to inflation hawks.

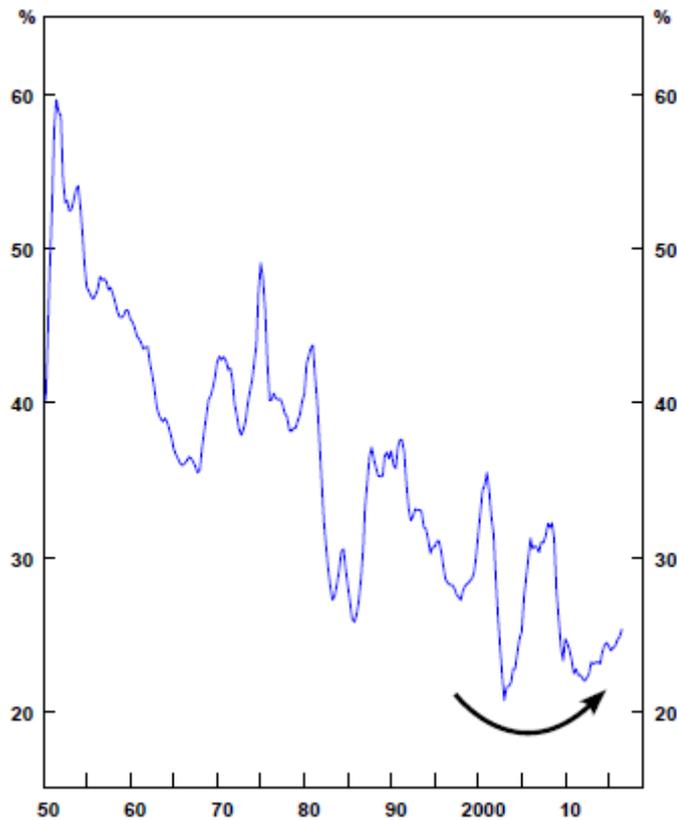
### **Equities**

Trump will be a source of uncertainty for US stocks, as the market deals with the unknown of his presidency. In addition, markets tend to not like united government in the US as it raises the specter of big policy moves. However, Trump should be positive for sectors that sold off in anticipation of a Clinton victory, such as healthcare and financials. We also suspect that he will continue the outperformance of defense stocks, although that would have been the case with Clinton as well.

In the long term, Trump's proposal for major corporate tax cuts should be good for US equities. However, we are not entirely sure that this is the case. First, the effective corporate tax rate in the US is already at its multi-decade lows (Figure 3). As such, any corporate tax reform that lowers the marginal rate will not really affect the effective rate. Why does this matter? Because major corporations already have low effective tax rates. Any lowering of the marginal rate will therefore benefit the small and medium enterprises (SMEs) and the domestic oriented S&P 500 corporations. If corporate tax reform also includes closing loopholes that benefit the major multi-national corporations (MNCs), then Trump's policy will not necessarily benefit all firms in the US equally.

Investors have to keep in mind that Trump has not run a pro-corporate campaign. He has accused American manufacturing firms of taking jobs outside the US and tech companies of skirting taxes. It is not clear to us that his corporate tax reform will therefore necessarily be a boon for the stock market.

**Figure 3: How low can it go?**  
Non-financial corporate sector effective tax rate



Source: BCA Research.

In the long term, we like to play Trump's populist message by favoring America's SMEs over MNCs. If we are ultimately correct on the USD and growth, then export-oriented S&P 500 companies should suffer in the face of a USD bull market and marginally less globalisation. Meanwhile, lowering of the marginal corporate tax rate will benefit the SMEs that do not get the benefit of K-street lobbyist negotiated tax loopholes.

### Global assets

The global asset to watch over the next several weeks is the USD/RMB cross. China is forced by domestic economic conditions to continue to slowly depreciate its currency. We have expected this since 2015, which is why we have shorted the RMB via 12-month non-deliverable forwards (NDF). Risk to global assets, particularly EM currencies and equities, would be that Beijing decides to depreciate the RMB before Trump is inaugurated on January 20. This could re-visit the late 2015 panic over China, particularly the narrative that it is exporting deflation.

Our view is that even if China does not undertake such actions over the next two months, Sino-American tensions are set to escalate. It is much easier for Trump to fulfill his de-globalisation policies with China – a geopolitical rival with which the US has no free trade agreement – than with NAFTA trade partners Canada and Mexico. This will only deepen geopolitical tensions between the two major global powers, which has been our secular view since 2011.

Finally, a quick note on the Mexican peso. It has already collapsed half of its value in the past 18 months and we believe the trade is overdone. Investors have used the currency cross as a way to articulate Trump's victory probability. It is no longer cogent. We believe that the US will focus on trade relations with China under a Trump presidency, rather than NAFTA trade partners. Our *Emerging Markets Strategy* believes that it is time to consider going long MXN versus other EM currencies, such as ZAR and BRL.

Investors should also watch carefully the Cabinet appointments that Trump makes over the next two months. Since Carter's administration, cabinet announcements have occurred in early to mid-December. Almost all of these appointments were confirmed on Inauguration Day (usually 20 January of the year after election, including in 2017) or shortly thereafter. Only one major nomination since Carter was disapproved. These appointments will tell us how willing Trump is to reach to traditional Republicans who have served on previous administrations. We suspect that he will go with picks that will execute his fiscal, trade, and tax policies.

**Bottom Line:** After the dust settles over the next several weeks, we suspect that Trump will signal that he intends to pursue his fiscal, trade, immigration, and tax policies. These will be, in the long term, positive for the USD, negative for bonds (including Munis, which will lose their tax-break appeal if income taxes are reduced), and likely neutral for equities. Within the equity space, Trump will be positive for US SMEs and negative for MNCs. This means being long S&P 600 over S&P 100. Lastly, close our long alternative energy / short coal trade for a loss of -26.8%.

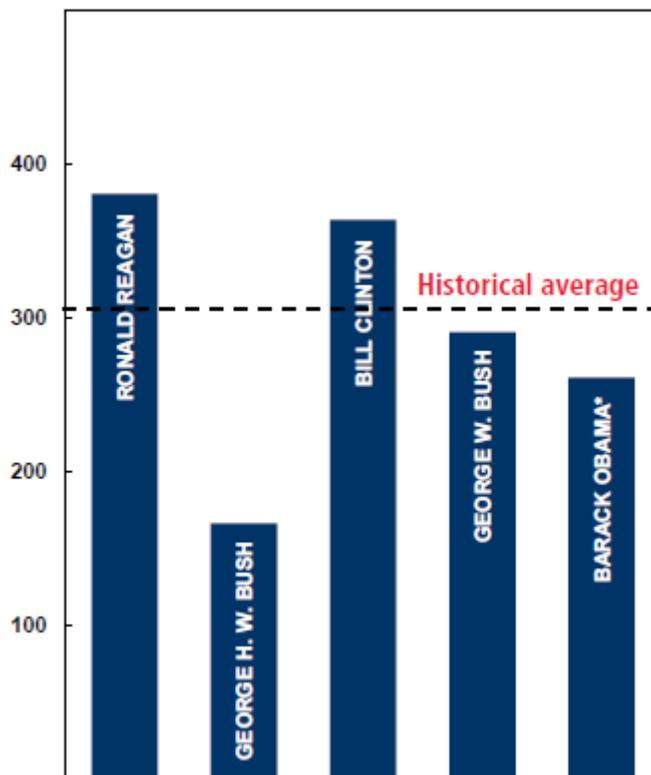
#### CONSTRAINTS? DON'T BET ON THEM

Domestically, the American president can take significant action without congressional support through executive directives. Lincoln raised an army and navy by proclamation and freed the slaves; Franklin Roosevelt interned the Japanese; Truman tried to seize steel factories to keep production up during the Korean War. Truman's case is almost the only one of a major executive order being rebuffed by the Supreme Court.

The Reagan and Clinton administrations have shown that a president thwarted by a divided or adverse congress will often use executive directives to achieve policy aims and satisfy particular interest groups and sectors. Though the number of executive orders has gone down in recent administrations (Figure 4), the economic significance has increased along

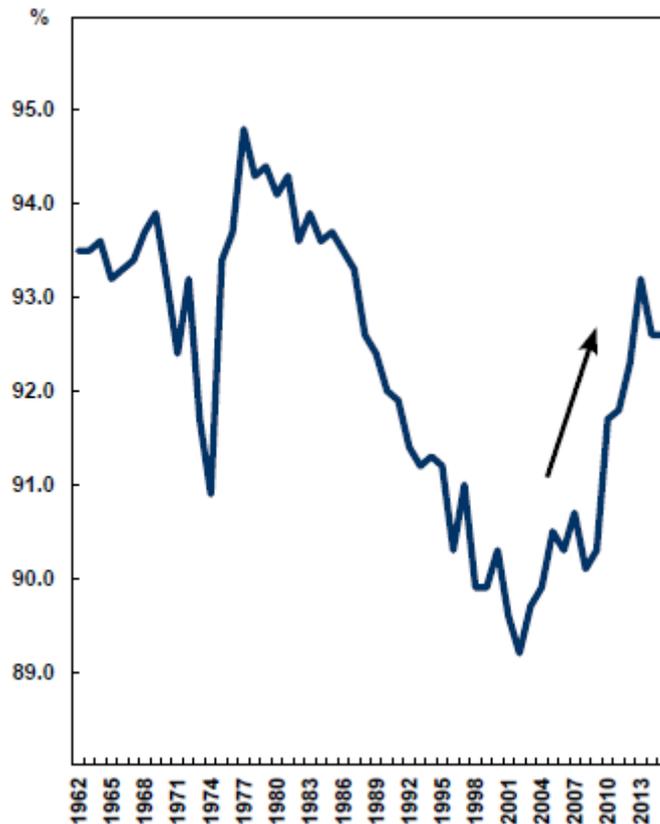
with the size and penetration of the bureaucracy (Figure 5). The economic impact of executive orders is always debatable, but the key point is that the president's word tends to carry the day.<sup>9</sup>

**Figure 4: Rule by decree**  
Number of executive orders



Source: The American Presidency Project, University of California, Santa Barbara.  
Notes: Prorated for 94 months out of 96 months in Obama's two term presidency.

Figure 5: Executive branch is growing  
Executive branch share of outlays



Source: White House historical tables.

Trade is a major area where Trump would have considerable sway. He has repeatedly signaled his intention to restrict American openness to international trade. The US president can revoke international treaties solely on his own authority. Congressionally approved agreements like the North American Free Trade Agreement (NAFTA) cannot be revoked by the president, but Trump could obstruct its ongoing implementation.<sup>10</sup> He would also have considerable powers to levy tariffs, as Nixon showed with his 10% "surcharge" on most imports in 1971.<sup>11</sup>

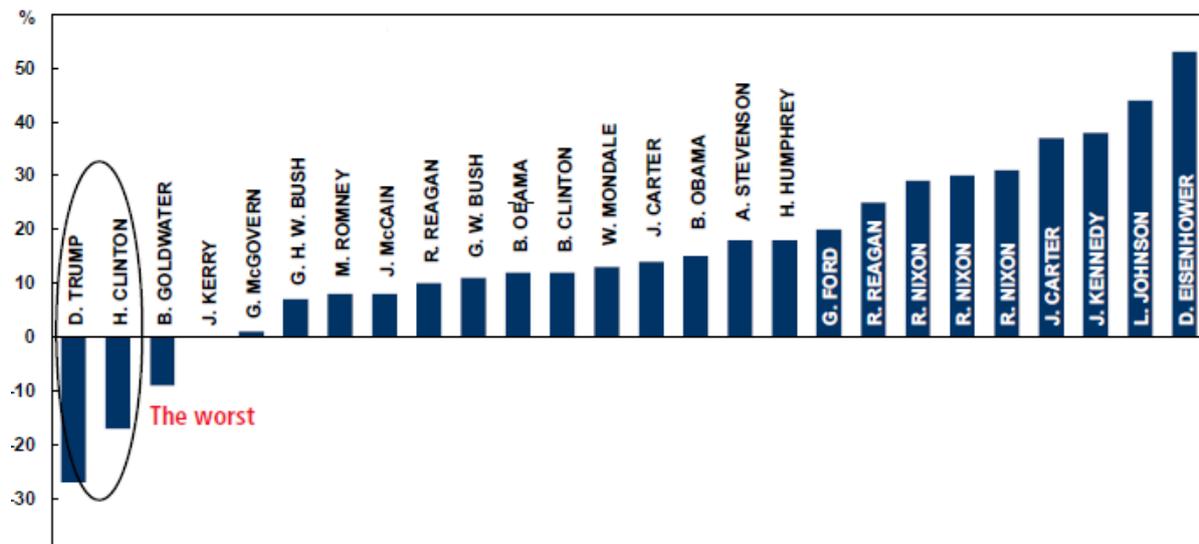
**Bottom Line:** Presidential authority is formidable in the areas Trump has made the focus of his campaign – immigration and trade. Without a two-thirds majority in Congress to override him, or an activist federal court, Trump would be able to enact significant policies simply by issuing orders to his subordinates in the executive branch.

## LONG-TERM IMPLICATIONS – POLARIZATION IN THE US

Does the Republican control of Congress and the White House signal that polarisation in America will subside? We began this analysis by focusing on the investment implications when Republicans control the three houses of the American government. But long-term implications of polarisation will not dissipate. Investors may overstate the importance of a Republican-controlled government and thus understate the relevance of continued polarisation.

We doubt that Donald Trump is a uniting figure who can transcend America's polarised politics, especially given his weak popular mandate (he lost the popular vote as Bush did in 2000) and the sub-50% vote share. And, our favorite chart of the year remains the same – both Donald Trump and Hillary Clinton have entered the history books as the most disliked presidential candidates EVER on the day of the election (Figure 6).

Figure 6: Clinton And Trump are making (the wrong kind of) history  
Net favorability by presidential candidates

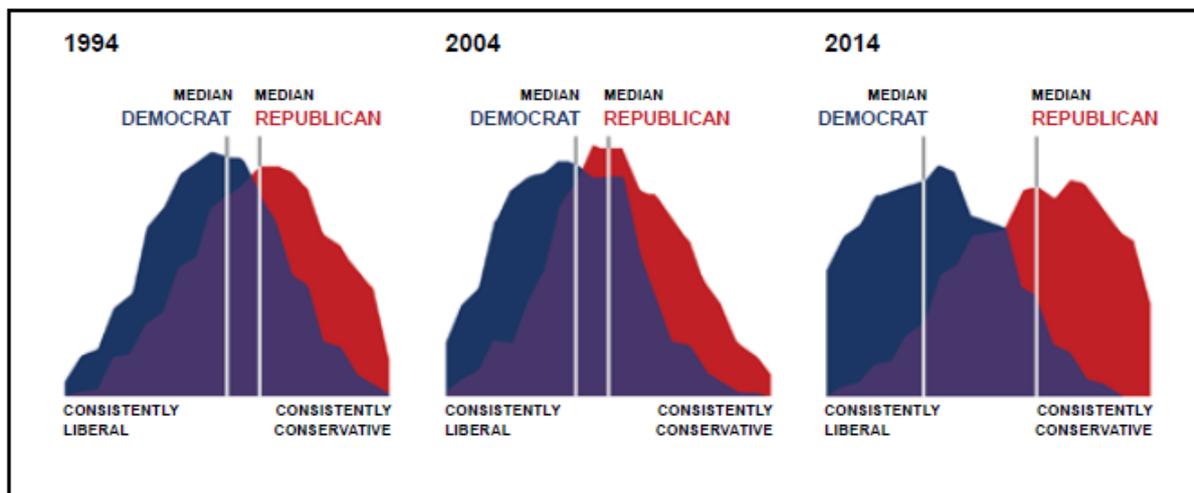


Source: Gallup. Notes: Net favorability is calculated by subtracting the unfavorability from the favorability rating of each candidate. For Donald Trump and Hillary Clinton, net favorability ratings are from November 7, 2016. For the others, the net favorability ratings are from October, one month prior to the presidential election in November.

According to empirical work by political scientists Keith Poole and Howard Rosenthal, polarisation in Congress is at its highest level since World War II. Their research shows that the liberal-conservative dimension explains approximately 93% of all roll-call voting choices and that the two parties are drifting further apart on this crucial dimension.<sup>12</sup>

Meanwhile, a 2014 Pew Research study has shown that Republicans and Democrats are moving further to the right and left, respectively. Figure 7 shows the distribution of Republicans and Democrats on a 10-item scale of political values across the last three decades. In addition, "very unfavorable" views of the opposing party have skyrocketed since 2004, with 45% of Republicans and 41% of Democrats now seeing the other party as a "threat to the nation's well-being"!

Figure 7: US political polarisation – growing apart



Source: Pew Research Centre, June 2014, "Political polarization in the American public".

Much ink has been spilled trying to explain the mounting polarisation in America.<sup>13</sup> Our view remains that politics in a democracy operates on its own supply–demand dynamic. If there was no demand for polarised politics, especially at the congressional level, American politicians would not be so eager to supply it.

We believe that five main factors – in our subjective order of importance – explain polarisation in the US today.

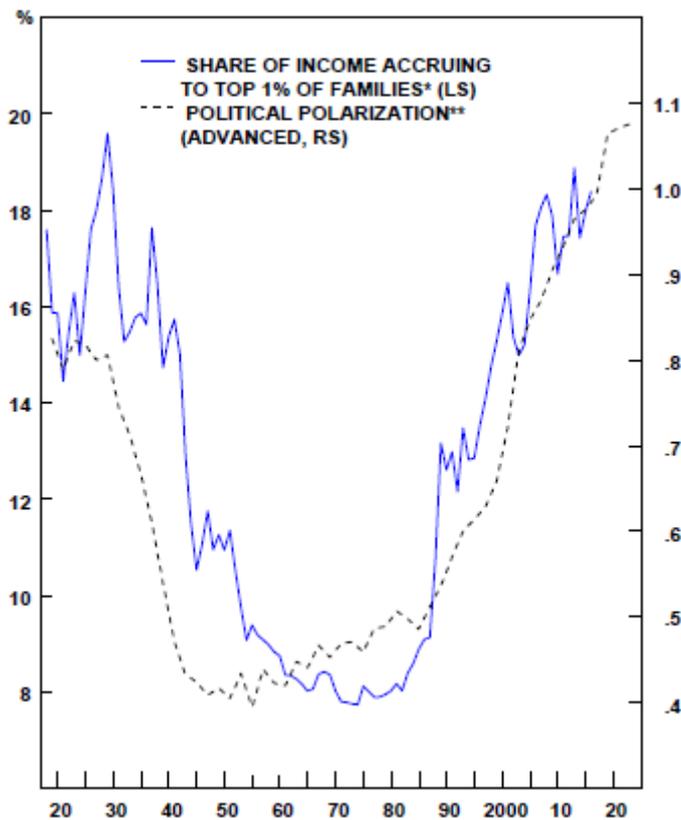
### 1. Income Inequality And Immobility

The increase in political polarisation parallels rising income inequality in the US (Figure 8). The US is a clear and distant outlier on both factors compared to its OECD peers (Figure 9).

However, Americans are not being divided neatly along income levels, because Republicans and Democrats disagree on how to fix income inequality. For Donald Trump voters, the solutions are to put up barriers to free trade and immigration while reducing income taxes for all income levels. For Hillary Clinton voters, it means more taxes on the wealthy and large corporations, while putting up some trade barriers and expanding entitlements. This means

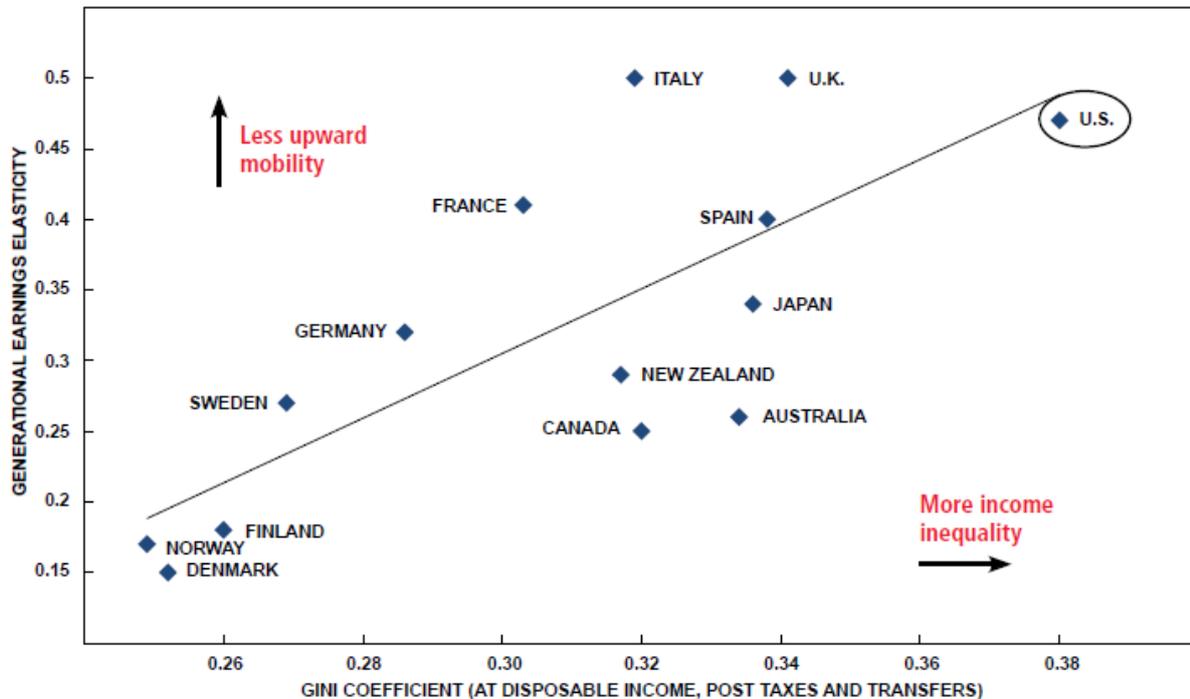
that the correlation between polarisation and income inequality is misleading as there is no causality. Rather, rising income inequality, especially when combined with a low-growth environment, shifts the political narrative from the "politics of plenty" towards "politics of scarcity." It hardens interest and identity groups and makes them less generous towards the "other."

Figure 8: Inequality breeds polarisation – US



Source: Piketty and Saez (2013) & Nolan McCarty, Keith Poole and Howard Rosenthal. Notes: \*Excluding capital gains. \*\* A measure of partisanship that gauges the extent to which members of congress vote with the majority of their own party.

Figure 9: Opportunity and income – Americans are outliers



Source: Corak (2011) and OECD. Note: Generational earnings elasticity refers to the elasticity of the child's earnings with respect to the parents. Higher elasticity means that the child's earnings are highly dependent on the parents', implying low social mobility.

## 2. Generational warfare

The political age gap is increasing. This remains the case following the 2016 election, with 55% Millennials (18–29 year olds) having voted for Hillary Clinton. The problem for older voters, who tend to identify far more with the Republican Party, is that the Millennials are already the largest voting bloc in America. And as Millennial voters start increasing their turnout, and as Baby Boomers naturally decline, the urgency to vote for Republican policymakers' increases.

## 3. Geographical segregation

Noted political scientist Robert Putnam first cautioned that increasing geographic segregation into clusters of like-minded communities was leading to rising polarization.<sup>14</sup> This explains, in large part, how liberal elites have completely missed the rise of Donald Trump. Left-leaning Americans tend to live in a left-leaning community. They share their morning cup-of-Joe with Liberals and rarely mix with the plebs supporting Trump. And, of

course, vice-versa. University of Toronto professors Richard Florida and Charlotta Mellander have more recently shown in their "Segregated City" research that "America's cities and metropolitan areas have cleaved into clusters of wealth, college education, and highly-paid knowledge-based occupations."<sup>15</sup> Their research shows that American neighborhoods are increasingly made up of people of the same income level, across all metropolitan areas.

Florida and Mellander also show that educational and occupational segregation follows economic segregation. Meanwhile, the same research shows that Canada's most segregated metropolitan area, Montreal, would be the 227th most segregated city if it were in the US! This form of geographic social distance fosters increasing polarisation by allowing voters to remain aloof of their fellow Americans, their plight, needs, and concerns. The extreme urban-rural divide of the 2016 election confirms this thesis.

#### **4. Immigration**

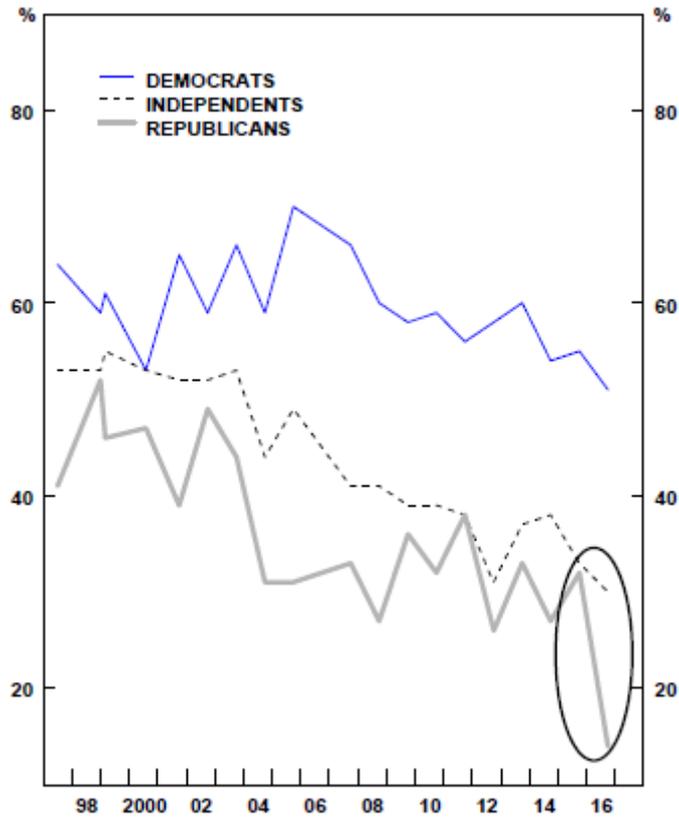
Much as with income inequality, there is a close correlation between political polarisation and immigration. The US is on its way to becoming a minority-majority country, with the percent of the white population expected to dip below 50% in 2045. Hispanic and Asian populations are expected to continue rising for the rest of the century. For many Americans facing the pernicious effects of low-growth, high debt, and elevated income inequality, the rising impact of immigration is anathema. Not only is the country changing its ethnic and cultural make-up, but the incoming immigrants tend to be less educated and thus lower-income than the median American. They therefore favor – or will favor, when they can vote – redistributive policies. Many Americans feel, fairly or unfairly, that the costs of these policies will have to be shouldered by white middle-class taxpayers, who are not wealthy enough to be indifferent to tax increases and may be unskillful enough to face competition from immigrants.

There is also a security component to the rising concern about immigration. Although Muslims are only 1% of the US population, many voters perceive radical Islam to be a vital security threat to the nation. As such, immigration and radical Islamic terrorism are seen as close bedfellows.

#### **5. Media polarisation**

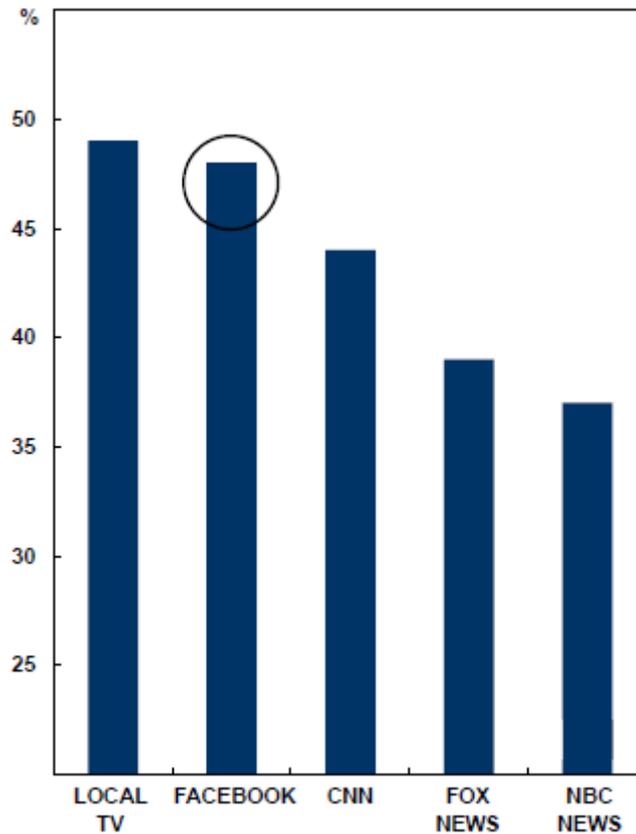
The 2016 election has been particularly devastating for mainstream media. According to the latest Gallup poll, only 32% of Americans trust the mass media "to report the news fully, accurately and fairly." This is the lowest level in Gallup polling history. The decline is particularly concentrated among Independent and Republican respondents (Figure 10). With mainstream media falling out of favor for many Americans, voters are turning towards social media and the Internet. Facebook is now as important for political news coverage as local TV for Americans who get their news from the Internet (Figure 11).

Figure 10: A war of words  
Trust in mass media by party.



Source: Gallup.

Figure 11: New sources of news not always credible  
Sources of news.



Source: Pew Research Center, October 2014, "Political polarization and media habits". Note: Percentage of web users saying they got news about government and politics from each in the past week.

The problem with getting your news coverage from Facebook is that it often means getting news coverage from "fake" sources. A recent experiment by BuzzFeed showed that three big right-wing Facebook pages published false or misleading information 38% of the time while three large leftwing pages did so in nearly 20% of posts.<sup>16</sup> The Internet allows voters to self-select what ideological lens colors their daily intake of information and it transcends geography. Two American families, living next to each other in the same neighborhood, can literally perceive reality from completely different perspectives by customising their sources of information.

In addition to these five factors, one should also reaffirm the role of redistricting, or "gerrymandering." Over the last two decades, both the Democrats and Republicans (but mainly the latter) have redrawn geographical boundaries to create "ideologically pure" electoral districts. Of the 435 seats in the House of Representatives, only about 56 are truly

competitive. This improves job security for incumbent politicians and legislative-seat security for the party; but it also discourages legislators from reaching across the ideological aisle in order to ensure re-election. Instead, the main electoral challenge now comes from the member's own party during the primary election.

For Republicans, this means that the challenge is most often coming from a candidate that is further to the right. Incumbent GOP politicians in Congress therefore have an incentive to maintain highly conservative records lest a challenge from the far-right emerges in a primary election. Given that the frequency of elections is high in the House of Representatives (every two years), legislators cannot take even a short break from partisanship. Redistricting deepens polarisation, therefore, by changing the political calculus for legislators facing ideologically pure electorates in their home districts.

**Bottom Line:** Polarisation in the US is a product of structural factors that are here to stay. Trump's narrow victory will in no way change that.

#### **BUT HOW MUCH WORSE?**

Political polarisation is not new. Older readers will remember 1968, when social unrest over the Vietnam War was at its height. Richard Nixon barely got over the finish line that year, beating Vice-President Hubert Humphrey by around 500,000 votes,<sup>17</sup> another contested election in a contested era.

Our concern is that the Republican and Democrat "labels" – or perhaps conservative and liberal labels – appear to be ossifying. For example, Pew Research showed in 2012 that the difference between Americans on 48 values is the greatest between Republicans and Democrats. This has not always been the case.

We suspect that the data would be even starker today, especially after the divisive 2016 campaign that has bordered on hysterical. This means that "Republican" and "Democrat" labels have become real and almost "sectarian" in nature. In fact, one's values are now determined more by one's party identification than race, education, income, religiosity, or gender. This is incredible, given America's history of racial and religious divisions.

Why is this happening? We suspect that the shift in urgency and tone is motivated at least in part by the changing demographics of America. Two demographic groups that identify the most with the Republican Party – Baby Boomers and rural or suburban white voters – are in a structural decline (the first in absolute terms and the second in relative terms). Both see the writing on the political wall. Given America's democratic system of government, their declining numbers (or, in the case of suburban whites, declining majorities) will mean significant future policy decisions that go against their preferences. America is set to become more left-leaning, favor more redistribution, and become less culturally

homogenous. Not only are Millennials more socially liberal and economically left-leaning, but they are also "brownier" than the rest of the US.

As we pointed out early this year, 2016 was an election that the GOP could reasonably attempt to win by appealing exclusively to white and older voters. The "White Hype" strategy was mathematically cogent.. at least in 2016.<sup>18</sup> It will get a lot more difficult to pursue this strategy in 2020 and beyond. Not impossible, but difficult.

We suspect that conservative voters know this. As such, there was an urgency this year to lock-in structural changes to key policies before it is too late. Donald Trump may have been a flawed messenger for many voters, but it did not matter. The clock is ticking for a large segment of America and therefore Trump was an acceptable vehicle of their fears and anger.

**Bottom Line:** Polarisation in the US is likely to increase. Two key Republican/conservative constituencies – Baby Boomers and rural or suburban white voters – are backed into the corner by demographic trends. But it also means that a left counter-revolution is just around the corner. And we doubt that the Democratic Party will chose as centrist of a candidate the next time around.

## FINAL THOUGHTS – WHAT HAVE WE LEARNED

### 1. Economics trump PC

Civil rights remain a major category of the American public's policy concerns. However, the Democratic Party's prioritisation of social issues on the margins of the civil rights debate has not galvanised voters in the face of persistent negative attitudes about the economy. More specifically, the surge in cheap credit since 2000 that covered up the steady decline of wages as a share of GDP has ended, leaving households exposed to deleveraging and reduced purchasing power. American households have lost patience with the slow, grinding pace of economic recovery, they reject the debt consequences of low inflation with deflationary tail risks, and they resent disappointed expectations in terms of job security and quality. Concerns about certain social preferences – as opposed to basic rights – pale in comparison to these economic grievances.

### 2. Polls are OK, but beware the quant models that use them

On two grave political decisions this year, in two advanced markets with the "best" quality of polling, political modeling turned out to be grossly erroneous. To be fair, the polls themselves prior to both Brexit and the US election were within a margin of error. However, quantitative models relying on these polls were overconfident, leading investors to ignore the risks of a non-consensus outcome. As we warned in mid-October – with Clinton ahead

with a robust lead – the problem with quantitative political models is that they rely on polling data for their input.<sup>19</sup>

To iron-out the noise of an occasional bad poll, political analysts aggregate the polls to create a "poll-of-polls." But combining polls is mathematically the same as combining bad mortgages into securities. The philosophy behind the methodology is that each individual object (mortgage or poll) may be flawed, but if you get enough of them together, the problems will all average out and you have a very low risk of something bad happening. Well, something bad did happen. The quantitative models were massively wrong!

We tried to avoid this problem by heavily modifying our polls-based-model with structural factors. Many of these structural variables – economic context, political momentum, Obama's approval rating – actually did not favor Clinton. Our model therefore consistently gave Donald Trump between 35% to 45% probability of winning the election, on average three and four times higher than other popular quant models. This caused us to warn clients that our view on the election was extremely cautious and recommend hedges. In fact, Donald Trump had 41% chance of winning the race on election night, according to the last iteration of our model, a very high probability.<sup>20</sup>

### **3. Professor Lichtman was right**

Political science professor Allan Lichtman has once again accurately called the election – for the ninth time. The result on 8 November strongly supports his life's work that presidential elections in the United States are popular referendums on the incumbent party of the last four years. Structural factors undid the Democrats, and none of the campaign rhetoric, cross-country barnstorming, or "horse race" polling mattered a whit.

The Republicans had momentum from previous mid-term elections, Clinton had suffered a strong challenge in her primary, the Obama administration's achievements over the past four years were negligible (the Affordable Care Act passed in his first term). These factors, along with the political cycle itself, favored the Republicans. Trump's lack of charisma did not negate the structural support for a change of ruling party.

Investors should take note – no amount of mathematical horsepower, big data, or Silicon Valley acumen was able to beat the qualitative, informed, contemplative work of a single historian.

### **4. Non-linearity of politics**

Lichtman's method calls attention to the danger of linear assumptions and quantitative modeling in attempting the art of political prediction. Big data and quantitative econometric and polling models have notched up key failures this year. They cannot make subjective judgments regarding whether a president has had a major foreign policy success or failure

or a major policy innovation – on all three of those counts, the Democrats failed from 2012 to 2016.

There really IS no way to quantify political risk because human and social organisations often experience paradigm shifts that are characterised by non-linearity. Newtonian Laws will always work on planet earth and as such we are not concerned about what will happen to us if we board an airplane. Laws of physics will not simply stop working while we are mid-air. However, social interactions and political narratives do experience paradigm shifts. We have identified several since 2011 – geopolitical multipolarity, de-globalisation, end of *laissez-faire* consensus, end of Chimerica, and global loss of confidence in elites and institutions.<sup>21</sup>

### **5. No country is immune to decaying institutions**

The US has, with few exceptions, the oldest written constitution among major states and it ensures checks and balances. But recent decades have shown that the executive branch has expanded its power at the expense of the legislative and judicial branches. Moreover, executives have responded to major crisis – like the September 11 attacks and the 2008 financial crisis – with policy responses that were formulated haphazardly, ideologically divisive, and difficult to implement (the Iraq War and the Affordable Care Act). The result is that the jarring events that have blindsided America over the past 16 years have resulted in wasted political capital and deeper polarisation. The failure of institutions has opened the way for political parties to pursue short-term gains at the expense of their "partners" across the aisle, and to bend and manipulate procedural rules to achieve ends that cannot be achieved through consensus and compromise.

### **6. The US is shifting leftward when it comes to markets**

Inequality and social immobility have, with Trump's election, entered the conservative agenda, after having long sat on the liberals' list of concerns. The shift in white blue-collar Midwestern voters toward Trump reflects the fact that voters are non-partisan in demanding what they want – they want to retain their existing rights, privileges, and entitlements, and to expand their wages and social protections.

### **ENDNOTES**

1. Except that it is better armed.

2. See BCA Geopolitical Strategy Client Note, "[US Election: Trump's Arrested Development.](#)" dated 8 November 2016, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).

3. However, Wisconsin polling was rather poor as most pollsters assumed that it was a shoe-in for Democrats. One problem with polling in Midwest states is that they were, other than Pennsylvania and Ohio, assumed to be safe Democratic states. Note, for example, the extremely tight result in Minnesota and the absolute dearth of polling out of that state throughout the last several months.

4. See *BCA Global Investment Strategy Special Report*, "[Trumponomics: What Investors Need To Know](#)," dated 4 September 2015, available at [gis.bcaresearch.com](http://gis.bcaresearch.com).
5. See *BCA Geopolitical Strategy Special Report*, "[US General Elections And Scenarios: Implications](#)," dated 11 July 2012, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
6. See *BCA Geopolitical Strategy Special Report*, "[Introducing: The Median Voter Theory](#)," dated 8 June 2016, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
7. See *BCA Foreign Exchange Strategy Weekly Report*, "[When You Come To A Fork In The Road, Take It](#)," dated 4 November 2016, available at [fes.bcaresearch.com](http://fes.bcaresearch.com).
8. See *BCA Global Investment Strategy Special Report*, "[End Of The 35-Year Bond Bull Market](#)," dated 5 July 2016, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
9. Only a two-thirds majority of Congress, or a ruling by a federal court, can undo an executive action, and that is exceedingly rare. The real check on executive orders is the rotation of office: a president can undo with the stroke of a pen whatever his predecessor enacted. Congress has the power of the purse, but it is sporadic in its oversight and has challenged less than 5% of executive orders, even though those orders often re-direct the way the executive branch uses funds Congress has allocated. More often, Congress votes to codify executive orders rather than nullify them.
10. Trump is not alone in calling for renegotiating or even abandoning NAFTA. Clinton called for renegotiation in 2008, and Senator Bernie Sanders has done so in 2016.
11. In Proclamation 4074, dated 15 August 1971, Nixon suspended all previous presidential proclamations implementing trade agreements insofar as was required to impose a new 10% surcharge on all dutiable goods entering the United States. He justified it in domestic law by invoking the president's authority and previous congressional acts authorizing the president to act on behalf of Congress with regard to trade agreement negotiation and implementation (including tariff levels). He justified the proclamation in international law by referring to international allowances during balance-of-payments emergencies.
12. The "primary dimension" is the liberal-conservative spectrum on the basic role of the government in the economy. The "second dimension" depends on the era and is picking up regional differences on a number of social issues such as the civil rights movement (which famously split Democrats between northern Liberals and southern Dixiecrats).
13. We have penned two such efforts ourselves. See *BCA Geopolitical Strategy Special Report*, "[Polarisation In America: Transient Or Structural Risk?](#)" dated 9 October 2013, and "[A House Divided Cannot Stand: America's Polarisation](#)," dated 11 July 2012, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).
14. Robert Putnam, *Bowling Alone* (New York: Simon and Schuster, 2000).
15. See *Martin Prosperity Institute*, "[Segregated City](#)," dated 23 February 2015, available at [martinprosperity.org](http://martinprosperity.org).
16. Please see *BuzzFeedNews*, "[Hyperpartisan Facebook Pages Are Publishing False And Misleading Information At An Alarming Rate](#)," dated 20 October 2016, available at [buzzfeed.com](http://buzzfeed.com).
17. Nonetheless, due to the third-party candidate George Wallace carrying the then traditionally-Democratic South, Nixon managed to win the Electoral College in a landslide.

18. See BCA *Global Investment Strategy and Geopolitical Strategy Special Report*, "[US Election: The Great White Hype.](#)" dated 9 March 2016, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).

19. See BCA Geopolitical Strategy Special Report, "[You've Been Trumped!](#)," dated 21 October 2016, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).

20. For comparison, Steph Curry, the greatest three-point shooter in basketball history, and a two-time NBA MVP, has a career threepoint shooting average of 44%. With that average, he is encouraged to take every three-pointer he can by his team. In other words, despite being less than 50%, this is a very high percentage.

21. See BCA *Geopolitical Strategy*, "[Strategy Outlook 2015 – Paradigm Shifts.](#)" dated 21 January 2015, and "[Strategy Outlook 2016 – Multipolarity & Markets.](#)" dated 9 December 2015, available at [gps.bcaresearch.com](http://gps.bcaresearch.com).



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*For more information about BCA's macro research, including the Geopolitical Strategy service, [contact Mark Trevena, BCA Research](#).*

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