

POLITICAL PULSE

Elections Have Consequences

Thursday, October 20, 2016

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Maybe not “rigged,” but brutal and corrupt. It will erode confidence and create instability.

The third presidential debate has come and gone, and Donald J. Trump failed to pull a rabbit out of his last hat. Unless Jullian Assange has one ready to go, *it seems pretty clear that Hillary Clinton will be elected president in November. Our election model will have been wrong, for the first time.* We guess it's time so say, *“It's dead, Jim.”* But we have to point out that in a unique election like this one, in a world as hungry for populist change as this one, the outcome is not preordained no matter what the polls say. Remember, at the comparable moment before June's Brexit referendum, polls and betting markets had *seemingly* written it off for dead (see *“On the Brexit Referendum”* June 24, 2016). For what it's worth, even when the polls had closed on June 23, betting markets gave a “leave” vote a mere 18% probability – which is just what *they are giving Trump today.*

As we have been saying all year (see *“2016: Two Charts, Six Words, One Man”* December 31, 2015), if Trump wins somehow – especially because it would be a big surprise – it will be a risk-off shock for markets. *But that doesn't mean if Clinton wins, markets will just be business-as-usual. We*

**Update to strategic view****ELECTION MODEL, US STOCKS, US BONDS, US MACRO:**

The last debate is over. While Trump could still pull a Brexit-like upset, it looks like Clinton will win. Clinton's policies are all growth-negative, and her attempts to carry them out will be in a poisoned atmosphere of thwarted hunger for change, resentment after a brutal election and downright corruption – all of which will erode economic confidence. The GOP will very likely hold the House, and possibly the Senate too, which will brake the worst of the policy mistakes. But the House will likely be radicalized, leading to debt ceiling crises and government shutdowns. We're not pulling any triggers until we see the election outcome, but we are very cautious here.

[\[Strategy dashboard\]](#)

see substantive long-term risks there, and we are concerned that markets are only just beginning to think about them.

- We're just going to call 'em as we see 'em here. We hope that after all these years our clients will trust us not to let our personal political preferences get in the way of our analysis, nor to forget how subjective and fluid these matters really are.

We see five risk-factors in a Clinton presidency.

- First, we can't name a single economic policy position Clinton has taken that would be a positive for growth. The more she is able to achieve as president, the worse it will be for the economy and for markets.
- **Second**, if Clinton wins, it will only have been because of idiosyncratic deficiencies in her opponent. The victory of such an "establishment" figure will not change the facts that America prefers to alternate party-control of the presidency every two terms, and that a general hunger for "change" – especially populist change – is particularly intense everywhere in the world this year. The hunger for populist change will only increase after the election, for having been thwarted – especially having been thwarted by what amounts to a lynch-mob against Trump. This is the true underlying meaning of his claim that the election is "rigged," and the economic residual of it will be a tamping down of "animal spirits" (see "If – When? – Hillary Wins" October 10, 2016).
- **Third**, this election has been especially brutal, and no doubt quite painful for Clinton. We think her character is such that she will nurse resentments, and will exercise power with similar brutality, thinking that it is utterly fair for her to do so.
- **Fourth**, whatever one may say about Trump's lack of fitness for the office, the campaign has surely revealed that Clinton is willing to go right up to, and beyond, the boundaries of propriety in the conduct of public duties. Okay, we'll just say it – she's corrupt. We think even her supporters know that. The brutal exercise of power by a person known to be corrupt will both further corrode confidence in institutions among economic actors, and set the stage for debilitating institutional instability as scandals emerge, further eroding confidence.
- **Fifth**, the brutal exercise of power amidst corruption and instability will inflame the unsated appetite for change among the electorate. Knowing that a populist backlash is coming, the brutal exercise of power will have to be done in haste, which will lead to large legislative mistakes, making anti-growth policy worse.

The 469 elections in the Senate and the House will have a lot to do with exactly how these five risks play out.

- Obviously, if Democrats take control of both the Senate and the House, riding on Clinton's coat-tails, the brutal, hasty and corrupt exercise of power will lead to actual legislation – and lots of it. The

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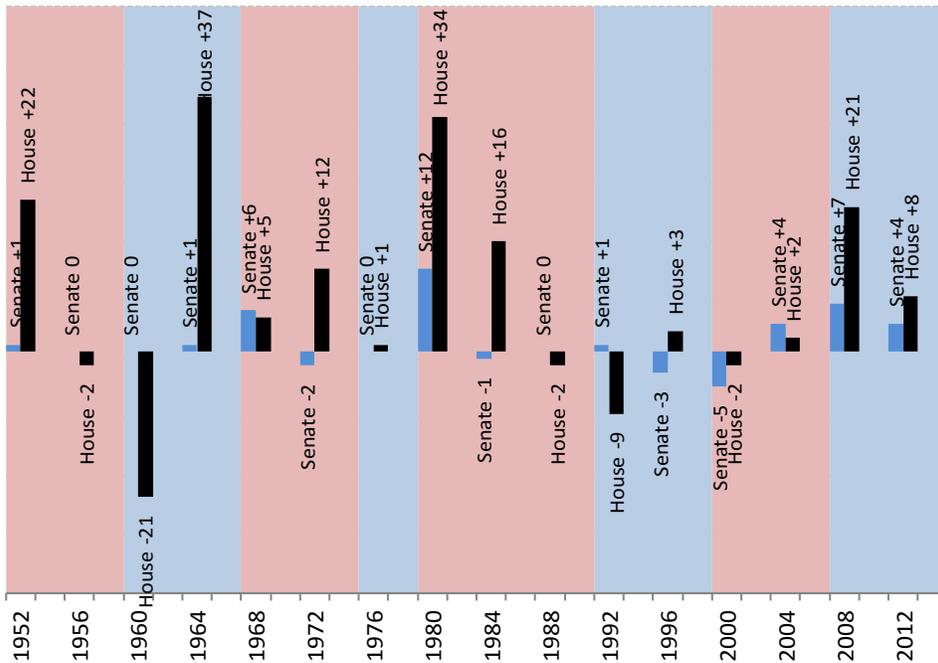
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Seats gained by winning president's party by presidential election year
 ■ GOP president ■ Dem president



Source: TrendMacro calculations

dying Affordable Care Act would be augmented with a “public option,” or replaced entirely with a “single payer.” Higher taxes. A public college entitlement. Union card-check. Carbon taxes. Fracking ban.

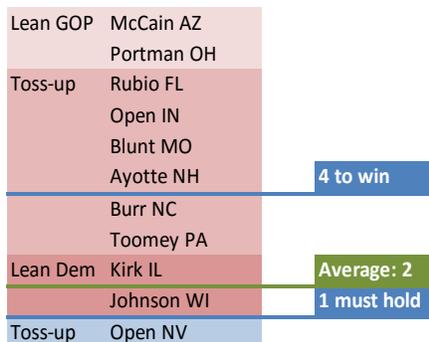
- The coat-tails effect on congressional voting in presidential election years – that is, congressional composition shifting in the direction of the winning president’s party – is definitely visible in the data, but it is not an extremely strong effect, nor is it highly reliable (please see the chart above).
- To take control of the Senate, the Democrats would have to net a flip of four seats. They would have to flip four GOP seats deemed “toss-ups,” *and* hold on to one of their own seats deemed a toss-up. Sounds easy, considering that there are six GOP toss-ups in play, plus two “leaners” (please see the chart on the following page). *But historically, on average, the winning president’s party flips only two Senate seats.*
- To take control of the House, the Democrats would have to net a flip of 30 seats. After that, they would have to flip the two GOP seats that are already “likely,” *and* three leaners; *and then* they would have to flip all 15 GOP toss-ups, *and* flip 10 out of 13 leaners, *and* hold on to three of their own toss-ups, *and* hold one seat that is likely to flip to the GOP (again, please see the chart on the following page). *But historically, on average, the winning president’s party flips only eight House seats.*
- For the Senate, there is no correlation between the magnitude of the president’s victory and the number of seats that flip. There is

Competitive seats ■ GOP incumbent ■ Dem incumbent
 Democratic path to control ■ Goal ■ '52-'08 average, president's party

House of Representatives



Senate



Source: Cook Political Report, US Congress, TrendMacro calculations

strong correlation for the House, but there have been only two landslide elections in the post-war period – 1964 and 1980 – in which enough House seats flipped to meet the Democrats' goal this year of 30. Two even larger landslide elections – 1972 and 1984 – yielded less than 30.

- So it's not obvious that even a landslide win by Clinton would have any particular effect on congressional control.
- Furthermore, in 1988, the only post-war election in which either party was able to win a third-in-a-row presidential term, the coat-

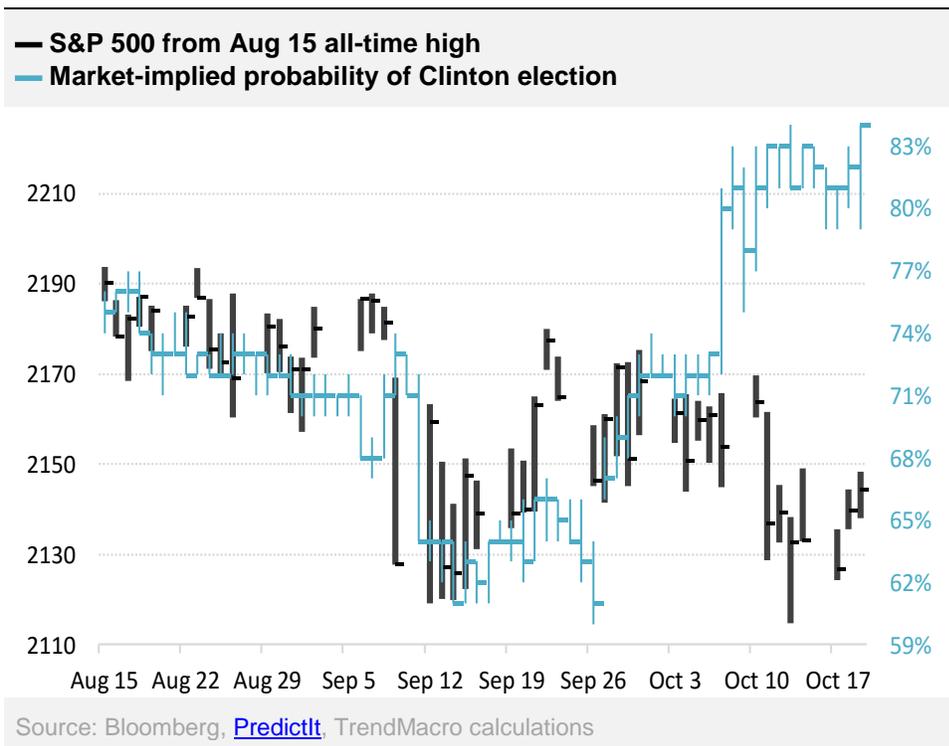
tails effect was especially weak. No seats flipped in the Senate, and only two flipped in the House.

- So by historical patterns, it's not at all an unlikely outcome that Clinton would win the presidency, but the GOP would retain congressional control. This would be the best outcome for the economy and the markets, as it would put a very strong brake on brutal and hasty legislation.
- Contemplating this outcome, many clients have recalled the fruitful six years from 1995 to 2001 in which Bill Clinton was president and the GOP controlled Congress, and speculated that these happy days could come again. Perhaps, at last, the elusive “grand bargain” of tax reform and entitlement reform could at last be struck. Never say never, but – to be frank – we think this is pretty much just wishful thinking. Until proven otherwise, we stand by our subjective judgment that after this toxic election, and given our take on Clinton’s personal disposition, the atmosphere in Washington will be more, not less, poisonous than it is today.
- We think the single best guess for congressional control is that the GOP will lose a few seats in both chambers – but narrowly retain Senate control, perhaps by a single seat, and see its House control contract slightly. This is a change from what we have previously said was our modal outcome, in which the GOP would lose the Senate but hold the House (again, see [“If – When? – Hillary Wins”](#)).
- A key indicator of the degree of toxicity to expect over the next four years will be the battle to fill Antonin Scalia’s vacant Supreme Court seat, which would likely reverse the institution’s long-standing 5-to-4 conservative/liberal composition. Consider this toxic scenario. Fearing a more liberal justice than President Obama’s current nominee Merrick Garland and wanting to put the matter to bed with the least toxicity, the lame-duck session of the Senate could move to approve him. But if the Democrats want to get toxic about it, Obama could withdraw the nomination, or the Democratic Senate minority could [thwart the approval by filibuster](#). Then when Clinton assumes office and nominates a more liberal justice, a narrow GOP majority could thwart him or her, repaying toxicity with more toxicity. If the Democrats control the Senate, a GOP majority could block approval by filibuster. But then the Democratic majority could invoke, or threaten to invoke, the [“nuclear option”](#) of changing the rules to forbid such a filibuster. How this plays out will speak volumes about the tenor of the next four years.
- But whichever party ends up controlling the Senate, the true key to the next two years will be the narrow GOP majority in the House.
- Only two of the GOP toss-ups and leaners in the House are members of the overlapping [Freedom Caucus](#) and [Tea Party Caucus](#), the most radical fringe of the GOP membership. Such radicals tend to come from the safest districts.
- These caucuses make up a bloc that is willing, apparently, to bear the consequences for taking highly principled positions on spending and appropriations, raising the debt ceiling or bailing-out systemic banks. Their influence was especially strong from 2011 to 2015. It was behind the debt ceiling showdown that led to the Standard and

Poor's downgrade of US Treasury debt in the summer of 2011.

- They are numerous enough to be the swing-bloc in the House, in that they are necessary to the GOP being able to pass legislation with Democratic votes.
- As an official body the Tea Party Caucus is now inactive, but its members remain radicals. The Freedom Caucus remains active and influential – indeed, the relatively moderate Paul Ryan insisted on its explicit support as a precondition of accepting the role of House Speaker.
- If Clinton's coat-tails reduce the GOP majority in the House by, say, 15 members – but reduce these two caucuses by only, say, two members, then the caucuses' influence as a swing-bloc will be increased. *In what is likely to already be a poisonous and confrontational political atmosphere – and one in which thwarted populist appetites are inflamed – this bloc will probably once again blockade must-pass legislation, leading to government shut-downs, debt crises, and if the occasional arises, the unmitigated failure of systemic institutions.*
- *This dynamic would be in play whether or not the GOP controls the Senate.*

For now we're going to take a wait-and-see posture, leaning toward the cautious. While these risks are out there in the future, they do live on a spectrum of severity, and for now, they would occur from a starting point of very positive forward-looking indicators (chief among them: rapidly rising forward earnings, narrowing credit spreads, and rising oil prices). To be sure, some macro data is coming in on the weak side, and we would judge intuitively that a Clinton win would put the Yellen Fed in a mindset that would bull through with an ill-advised December rate hike (see ["On the](#)



[September Jobs Report](#)” October 7, 2016).

We are very conscious that US stocks are not performing very well, even as the supposed threat of Trump recedes – and the supposed promise of Clinton ascends (please see the chart on the previous page). And global long-term government bond yields, which according to guru Jeff Gundlach were supposed to have had a “big, big moment,” are instead acting quite cautious, hanging around at about the same levels seen just before the Brexit referendum (see [“Gundlach and Load”](#) September 12, 2016).

So we’re staying especially alert. But before we pull any triggers, we’re going to wait and see how the election turns out – the Senate, the House, and, yes, even the presidency.

Bottom line

The last debate is over. While Trump could still pull a Brexit-like upset, it looks like Clinton will win. Clinton’s policies are all growth-negative, and her attempts to carry them out will be in a poisoned atmosphere of thwarted hunger for change, resentment after a brutal election and downright corruption – all of which will erode economic confidence. The GOP will very likely hold the House, and possibly the Senate too, which will brake the worst of the policy mistakes. But the House will likely be radicalized, leading to debt ceiling crises and government shutdowns. We’re not pulling any triggers until we see the election outcome, but we are very cautious here. ▶