February 22, 2016

The 2016 Election: An Update

Almost two years ago we published a series on the 2016 elections.[1] In these three reports we suggested that rising discontent among the electorate could increase the odds of electing a president that may turn America away from the superpower role. Although there have been a number of surprises in the current nominating process, some of the trends we discussed in these reports have come to pass. In addition, the underlying causes of discord we identified appear to be the driving force in the current political turmoil.

In this report, we will review the three issues related to the superpower role that the establishment has failed to properly address which have led to the rise of unconventional candidates. Next, we will examine the current primary season, focusing on the two major populist candidates, and discuss the reaction of the establishment thus far. As always, we will conclude with market ramifications and a short discussion about the long-term changes that the rise of populism may entail.

The First Problem

The first problem is coping with the financial requirements of being a superpower. Hegemonic Stability Theory[2] postulates that the world functions best when a hegemon acts in a way to bring about global stability. The global superpower provides a set of economic and security global public goods. The hegemon provides the reserve currency, which is the currency in which most nations conduct trade. This requires the hegemon to be the global consumer of last resort. By fostering global trade, a benevolent hegemon sponsors the development of the global economy. The superpower also acts as a global financial market stabilizer, leading rescue efforts during financial crises.

To perform this function, the hegemon must consume all the imports the world needs to acquire the reserve currency. That means that the superpower will normally run a persistent trade deficit and will need to create policies that constantly spur consumption.

The U.S. used two models to meet the requirements of financial hegemony. The first created an economy that purposely constrained creative destruction, the process where technology and entrepreneurship change markets. A series of measures, including high marginal tax rates, heavy regulation, a defense industry that absorbed a large number of highly talented workers, and the support for unionization all led to an economy that generated a significant number of high paying, semi-skilled jobs. For two decades, this structure worked well, leading to strong economic growth with

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

[2] Kindleberger, C. (1973). *The World in Depression, 1929-1939*. Berkley, CA: University of California Press.

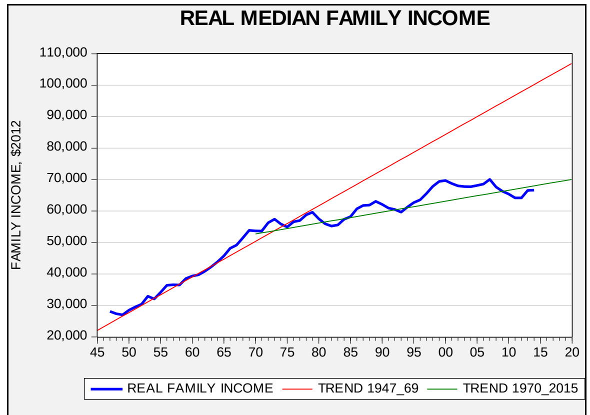
manageable inflation. However, two conditions developed that undermined the model.

First, the recovery of overseas economies led to rising import competition which undermined U.S. competitiveness. The fixed exchange rates of the Bretton Woods agreement exacerbated this problem, leading Nixon to close the gold window in 1971. Second, social policies that worked to address racial and gender discrimination increased the workforce and strained the economy's ability to generate an adequate number of high paying, semi-skilled jobs.

These two problems led to rising inflation. By 1965, inflation pressures began to mount but the Johnson administration, determined to maintain its expanding government programs, maintained fiscal stimulus. This spending, coupled with the cost of the Vietnam War, led to additional inflation pressures. President Nixon responded to mounting inflation with an ill-advised price freeze. By the end of the 1970s, inflation had become a serious problem.

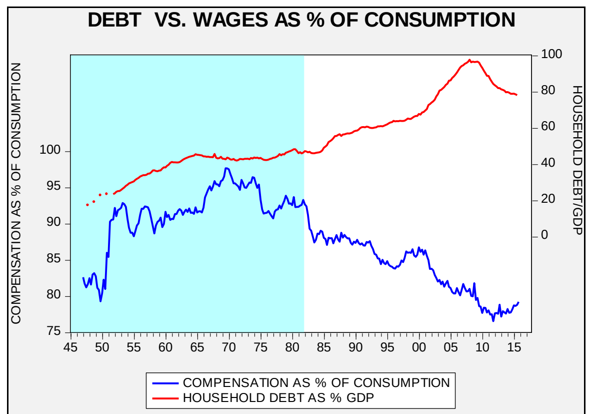
In response, President Carter implemented a process of supply side reforms designed to improve the efficiency of the economy. President Reagan expanded these efforts. Regulations were cut and marginal tax rates were dramatically reduced. These policies, coupled with hard money policies from the Volcker Federal Reserve, led to a sharp reduction in inflation. Consequently, family income growth declined rapidly. To maintain the consumption necessary to fulfill the financial superpower role, financial services were deregulated and household borrowing expanded rapidly.

Here are a couple of charts that highlight these two models.



Sources: Haver Analytics, CIM

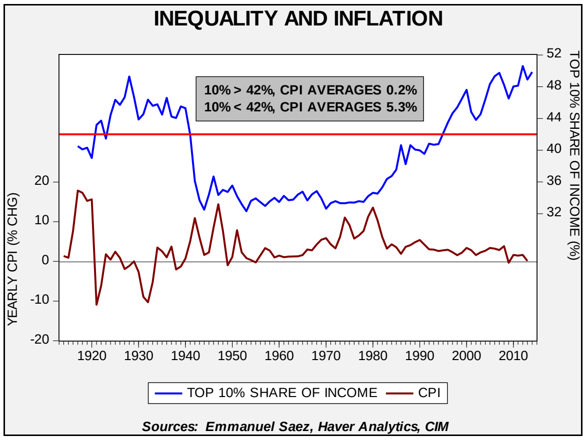
First, real median family income shows an impressive uptrend from the late 1940s into the late 1970s. As creative destruction was reintroduced into the economy, the trend in incomes slowed dramatically. Had we maintained that earlier path, family incomes would be near $100k per year.



Sources: Haver Analytics, CIM

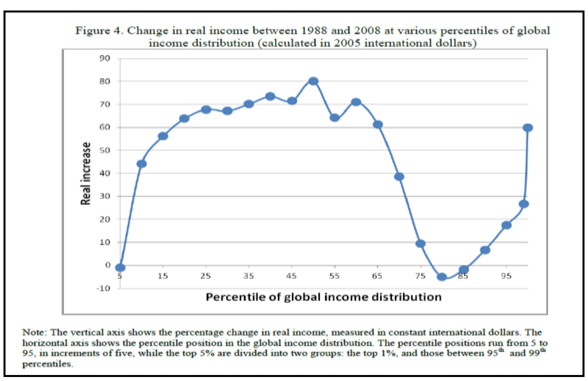
From the early 1950s into the early 1980s, 90% to 95% of household consumption was funded through wages; as inequality rose, this ratio fell below 80%. To compensate for this lost buying power from income, households increased borrowing.

The essential problem is that the U.S. has not been able to create an economy that will meet the consumption and import requirements of the hegemon role without high inflation or high income inequality and consequential high levels of household debt.



This chart highlights the problem well. When the top 10% of the income earners' share is less than 42%, inflation averages 5.3%. When it is greater than 42%, inflation is a mere 0.2%. The policies that foster creative destruction, namely, globalization and deregulation, lead to low inflation at the cost of higher income inequality. This leads to rising debt levels which, as we saw in 2008, became unsustainable.

The other phenomenon we note is that globalization tends to support income growth in the emerging markets to the detriment of the middle classes in the developed markets.



This chart shows real income growth levels by income deciles on a global basis from 1983 through 2008. Note that income levels rose strongly up to about the 65th percentile then dropped precipitously into the 85th percentile. It only rose at comparable levels to the 65th percentile at the highest income distribution levels. Essentially, the development seen in the emerging markets has come at the expense of the middle and working classes in the developed markets.

The Second Problem

The second problem, paradoxically, came from the success in winning the Cold War. When the Berlin Wall fell and the Soviet Union collapsed, the focus of American foreign policy was lost. Every president since President H.W. Bush has struggled to create an operating principle for foreign policy. As a result, ill-advised wars have been fought and ended prematurely because policymakers seem incapable of establishing what exactly America's core interest is. This failure has made U.S. foreign policy appear irresponsible. Essentially, without an opposing superpower, policymakers have been unable to create a working foreign policy. This lack of policy direction makes isolationism appear attractive.

The Third Problem

The other major role of the global superpower is the projection of military power. The hegemon acts as a stabilizing force, preventing major wars and freezing potential conflicts. The U.S. acted as a containing power against the Soviet Union and disarmed Germany and Japan, preventing those two powers from destabilizing Europe and the Far East. It brought stability to the Middle East as well. If America abandons this role, there is no other power prepared to accept this position, meaning the previously frozen conflicts thaw and the world becomes a dangerous place. For the most part, the populists fight the wars the establishment selects and the lack of a proper foreign policy, as noted above, has led to a rejection of military force among left-wing populists.

The Establishment and the Populists

President Roosevelt built a coalition of both the rentier/professional establishment and right-wing populists.[3] Left-wing populists and the entrepreneurial establishment were isolated from the ruling coalition. However, the civil rights and women's movements eventually cracked this coalition in the 1960s, alienating the right-wing populists. The move to deregulate and globalize the economy under Presidents Carter and Reagan created an economy that was inhospitable to both populist wings. To mask the fact that economic policy was working to the detriment of the populists, establishment political figures have focused on social policies. Establishment-left politicians have warned left-wing populists that electing a center-right candidate would lead to restrictions on abortion rights and end racial or gender preferences in the workplace, etc. Establishment-right politicians would tell right-wing populists that gun rights would be restricted and additional religious restrictions would be introduced if a center-left candidate were elected. In reality, these social battles are real, but there is a great deal of agreement between the establishment left and right on economic policy. Yes, they may disagree on environmental policy but in terms of supporting globalization and deregulation there is a high degree of conformity.

The 2016 Concern

Our initial concern behind the earlier three-part series was that the populists were angry at their economic predicament and would not be easily distracted by social issues. The financial crisis of 2008 had changed the situation and the lack of economic growth in the subsequent recovery has increased populist anger. However, throughout history, populist candidates have tended to be unattractive and have failed to unite the populist left and right wings.

In our initial report, we speculated that either a "strongman" or an "isolationist" might arise as a viable populist candidate. It does appear, at least in some form, that is what is developing.

Overall, though, we expected the establishment to prevail because it has more access to money and is sympathetically covered by the media. However, in a recent *New Yorker* article, Jill LePore[4] made the case that political upheaval tends to be assisted by new developments in media. After all, the Reformation probably would not have occurred without the Gutenberg Press. William Jennings Bryan used campaign speeches on wax cylinders to spread his populist message. Franklin Roosevelt used radio broadcasts to create his revolution. Both Sanders and Trump have deftly used the internet and social media; to some extent, Trump is running his campaign on Twitter. Deploying these new tools has allowed both to blunt the establishment's influence over the traditional media and unlimited campaign contributions.

Trump and Bernie

Although it is difficult to tell exactly what Donald Trump would do as president, he is clearly outlining a policy mix that is inconsistent with policies of the establishment. He is calling for secure borders and expulsion of undocumented people in the U.S. He is also arguing for protectionist measures. His tax plan would likely lead to large deficits. Although he promises expanded defense spending, his rhetoric appears to be isolationist.

[3] For details on the four political classes, see WGR, 2016 (Part 2: The Political Situation), 4/14/2014.

[4] http://www.newyorker.com/magazine/2016/02/22/did-social-media-produce-the-new-populism

Sen. Sanders's four major policy proposals are a single-payer health care system, free tuition in public colleges, higher taxes on the wealthy and a plan to break up large financial institutions. His spending plans will almost certainly lead to large deficits. Sanders's foreign policy is not well developed but given his opposition to the wars of the past 15 years, it is a safe assumption he would be mostly isolationist as well.

It is important to note that a Sanders or Trump presidency would signal a reversal of establishment policy that has been in place since 1978. Perhaps even more critical is that it probably means the U.S. is abandoning its superpower role as well.

The Establishment Response

Thus far, the establishment response has been flat-footed. The GOP continues to work under the assumption that Trump will implode at some point. So far, the establishment vote continues to be split among several candidates. It isn't clear if Trump can prevail if he is up against a single establishment candidate; however, the longer the primary campaign lasts without the establishment coalescing around a candidate, the greater the odds are that Trump will win the nomination.

The Democratic Party's primary situation is quite different. It is now a two-person race and Sen. Clinton is struggling to beat an avowed socialist. It seems unlikely that the party's establishment would allow a Sanders nomination, but it may be too late for another candidate to emerge if Sen. Clinton continues to struggle.

It appears that the establishment of both parties assumed that media influence and massive funding would prevail against an electorate that is growing increasingly angry and disenchanted. Although this assumption may turn out to be correct, at this point, investors need to be prepared for the possibility of a populist president.

Ramifications

The combination of isolationism and protectionism would likely play havoc on the global economy. History shows that periods without a viable superpower are fraught with risk—the aforementioned Kindleberger book argues that the Great Depression occurred because Great Britain was no longer able to fulfill the role of global hegemon and the United States was unwilling to accept the position.

From a market perspective, the U.S. will likely fare better than other nations. The loss of a reserve currency will damage global trade; in fact, it is hard to imagine that globalization as we currently know it would continue. The U.S. is relatively self-sufficient, and the American economy should manage assuming trade with Canada and Mexico continues. However, the rest of the world, especially nations dependent on trade (e.g., Germany, Japan, China), could be hurt badly.

The loss of American military influence will make the world increasingly unstable. Russia will try to boost its influence in Europe; Germany might rearm. China will try to dominate the Far East and face resistance from the surrounding nations. Military spending would likely rise and defense firms could benefit.

Inflation in the U.S. would likely rise, although it may not be as significant as one would expect. As long as firms are free to introduce new technology into the economy, price levels will probably remain under control. In other words, we may see some inflation but it probably won't be a repeat of the 1970s. Income differences would narrow to some extent but capital would probably not flee. After all, the world will be more dangerous and the U.S. could be an oasis of stability. Finally, commodity prices would likely benefit. Securing important resources and stockpiling them will become critical.

Overall, it is important to remember that all presidents are restrained by the courts and the legislature. Sen. Sanders defends the likelihood of his policy proposals based on the creation of a revolution. In the absence of such an event, it is hard to see how he could pass his platform in entirety. Therefore, the market changes described above could be mitigated to some extent.

However, it is also important to note that this populist fervor isn't likely to go away. The establishment needs to make some sort of peace with the populists. In fact, coming up with a program that would satisfy the populists and maintain America's superpower role would be ideal. At this juncture, that political figure and program doesn't appear to exist. If the establishment cannot make a deal with the populists, the era of American hegemony may be coming to a close.

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