The Uncivil Civil War: Economic and Market Implications of Political Transformation

Come senators, congressmen Please heed the call Don't stand in the doorway Don't block up the hall For he that gets hurt Will be he who has stalled There's a battle outside And it is ragin'. It'll soon shake your windows And rattle your walls For the times they are a-changin' The Times They Are A-Changin' ? Bob Dylan America?s populace is politically divided in a way that has not been seen in decades. The growing rift is rapidly changing the landscape in Washington D.C. and has major implications for the nation. Amazingly, as voters from different parties espouse views that are worlds apart, they share a strikingly similar message. This article considers the juxtaposition of colliding worldviews and the unified message that voters across the political spectrum are sending. While many investors are aware of the political change afoot, it seems that very few have considered how said changes might affect the economy and financial markets. In this article, we share some of our thoughts and encourage you to give the topic more consideration going forward.

Given the importance of the subject, this article will likely be the first of several discussing the intersection of politics and markets.

The Changing Faces in Congress

Speaker of the House Paul Ryan and Congressmen Bob Corker and Jeff Flake are a few of the well-established Republicans not seeking reelection. While each has their reasons, it appears the prospect of losing re-election played a significant role in their decision making. Is this a case of ?playing not to lose? as opposed to ?playing to win?? Political capital can be delicately converted to monetary capital only if a politician, in or out of office, plays his or her cards wisely. This is not just a story about Republican discontent. In New York?s Democratic 14th Congressional District primary, Alexandria Ocasio-Cortez, a totally unknown candidate months ago, recently upset incumbent Joseph Crowley, the fourth-ranking Democrat in Congress and possible successor to Nancy Pelosi as the Democratic House leader. Crowley has represented New York since 1999, most recently as a representative of the Bronx and Queens. Ocasio-Cortez is a 28-year old Latino woman who was tending bar only a year ago. She ran on campaign promises that were decidedly left of the mainstream Democratic agenda represented by Crowley. Her political stance was not surprising given her support for Bernie Sanders during the last Presidential primary and her membership in the Democratic Socialists of America. While there are many messages 14th District voters are sending us; we believe there are two that are representative of voters of both parties throughout the country.

1. Voters appear to prefer political views that are less centrist and offer a change from the status quo of the existing parties.
2. Voters are looking to buck established party leaders in favor of someone different.

The Washington Post, in an article about Ocasio-Cortez?s victory, summed up these messages well - ?*Many of the key Democratic House primaries this year have been competitions over biography,with a premium given to those who break new ground or remove old barriers*.?

Economic and Market Implications

Assuming this trend continues, the implications for the economy and the financial markets will become increasingly important to follow. While the topic for another article, simply consider the massive social changes that occurred in the late 1960?s and early 1970?s. Those changes had profound and lasting effects on culture and society as well as the economy, monetary policy, fiscal policy and the financial markets. The following provides a summary of factors worth considering as this new era of politics takes hold: **Deficit** ? Despite a Republican-controlled Congress and President, the size of the fiscal deficit is surging. Current forecasts by the Congressional Budget Office (CBO) estimate that Treasury debt will increase by over $1 trillion a year for the next four years. While it seems that the Democrats and Republicans cannot agree on much, they currently seem to agree on increased government spending. Given a President that is not averse to debt financing and deficit spending and a slew of politicians concerned about future elections, collectively they may opt for more spending to please their constituents. Given the importance of retaining (or not losing) power, the tendency towards higher fiscal deficits will continue regardless of which party controls the House and Senate. Discipline of any form appears outdated in the halls of Congress and certainly not a popular political platform. **Recession and stock market crash response** ? During the great financial crisis of 2008/09, extreme fiscal and monetary stimulus were employed to right the economy and stabilize the markets. In just three years from 2009-2011, a timeframe spanning the recession and immediate recovery, the aggregate fiscal deficit was $4.006 trillion. In those three years, the government accumulated a deficit that equaled that of the 22 years immediately prior. The Fed?s monetary policy response was even more brazen. They lowered the

Fed Funds rate to zero which helped push longer-term bond yields to historically low levels. Further, they introduced QE and purchased over $4 trillion of U.S. Treasury, Agency and Mortgage-Backed Securities. Our concerns for the next recession and stock market drawdown are twofold. First, will the Fed acquiesce with unprecedented monetary policy as they did repeatedly during and well after the financial crisis and recession? Second, will the vastly different political views of Congress and the likely infighting make negotiations on fiscal bailouts harder than those that occurred in 2008 and 2009? Under Jerome Powell?s leadership, the Fed appears less concerned with financial asset prices than did the leadership of his immediate predecessors. Further, inflationary aspects of fiscal deficits may make them more apprehensive about easy policies that can have inflationary impulses. One of the key signals for a change in monetary policy came when outgoing New York Fed President William Dudley gave a speech on January 11 characterizing three to four rate hikes in 2018 as ?*gradual*.? Although there was no immediate market response, within two weeks the stock market convulsed. The market has yet to regain those losses and the Fed thus far has not walked back Dudley?s comments. The fiscal situation could also become problematic if the political parties continue down the path of discordance. Either party might be willing to push or block emergency fiscal stimulus to affect the President?s reelection chances heading into the 2020 presidential campaign. **Geopolitical** ? The changes occurring in our political system are closely monitored by other nations. While some nations are experiencing similar changes, especially in Europe and the United Kingdom, we have little doubt that our allies, our enemies, and everyone in between will try to capitalize on the situation. Trade and the dollar's status as the world?s reserve currency are the foremost concern. We believe many nations want to unseat the U.S. dollar as the world?s reserve currency. Trade tariffs and fair trade negotiations are likely fueling the desire even more so. Will political change and the possibility of a stalemate in Congress provide these nations an opportunity to reduce their reliance on the dollar? The implications, as discussed in *Triffin Warned Us*, are massive. **Public/Corporate confidence and spending habits** ? Consumers tend to spend when they are most confident about their own financial situation and that of their nation. As the political issues collide and political rhetoric from both sides increase, will consumers? confidence waver? Alternatively, what if current consumer spending has less to do with confidence and is largely based not on what they want to spend but what they need to spend? Food, gas, healthcare, housing, and education are all making unreasonable demands on consumer spending habits. These expenditures are being funded by dis-savings and credit as opposed to rising salaries and wages. The evidence for this lies in the concurrent rise in consumer credit data and decline in household savings. The demand for political change is not coming from the elite that profited from corporatism and speculation, but in large part from the majority being left behind. These are the marginal consumers and play a large role in determining the pace and quality of economic activity. Similarly, what of the confidence of corporate executives? We suspect that as political differences become acuter and the future less predictable, executives will hold back on investments in new projects, plants, equipment or employees.

Summary

Currently, the market seems indifferent to the recent wave of political upheaval. The relative stability in the economy and strong performance of stocks over the last few years is likely mesmerizing many investors. We believe investors should consider that the changes in the political landscape may only be in its infancy. Whether the recent move towards political divergence is a fad or the start of something much larger is anyone?s guess. **However, we believe the increasing influence of millennials at the expense of baby boomers will have impacts which we are just starting to see.** Given that equity markets are perched at extreme valuations, implying that the risks are significant and future returns well below normal, we believe the political unknowns and the associated risks they carry are among the reasons to maintain a conservative investment stance. The following video https://www.youtube.com/watch?v=tEczkhfLwqM provides a historical perspective of how Congress has become increasingly divided over the last 80 years. While it stops in the year 2013, the differences have only widened since then.