

The US election - sound the trumpets?

Marko Papic | BCA Research | 18 April 2016

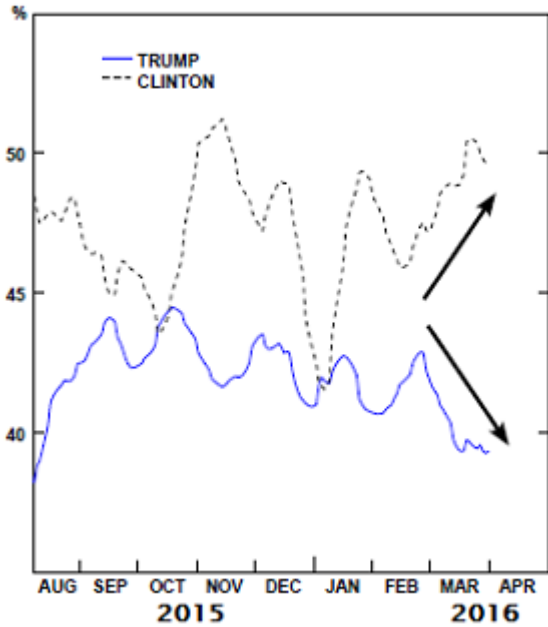
Donald Trump is facing his first real challenge during this GOP nomination race. His shellacking at the hands of Senator Ted Cruz in the Wisconsin primary in early April has thrown the race open. He may still be the frontrunner due to a sizeable lead in delegate count, but the probability that he becomes the nominee has fallen under 50%.

Trump may still be the favorite but the election calendar is not as friendly to him as conventional wisdom holds. Yes, Trump is the favorite to win the Northeast primaries but that is already "priced in" by the voters. His performance at this point can only disappoint to the downside, given expectations that he sweeps the upcoming states. After the Northeast, the race shifts to Indiana, Nebraska, Oregon, and Washington, where Ted Cruz could completely wrestle momentum from Trump ahead of the all-important 7 June primary in California. An inconclusive performance in California will probably end Trump's candidacy.

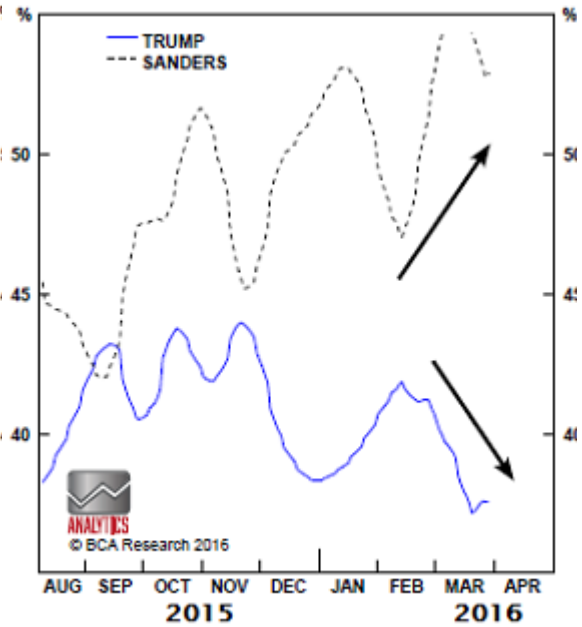
In addition, Trump's national polling has collapsed (Figure 1). Hillary Clinton has opened a 10% lead against him in the polls, while Senator Bernie Sanders commands an even greater advantage.

Figure 1: Trump: Deflation? General Election polling data*

Trump versus Clinton



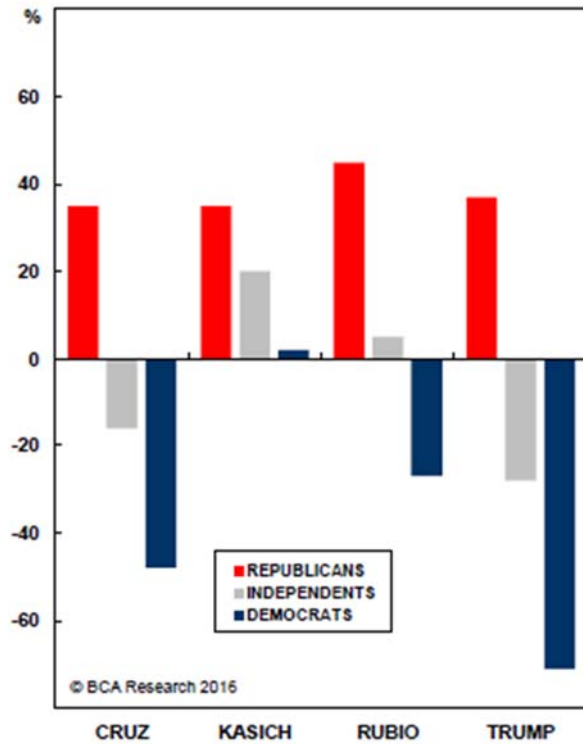
Trump versus Sanders



Source: Realclear Politics & BCA Calculations. * Source: Realclear Politics & BCA Calculations. *
Shown smoothed

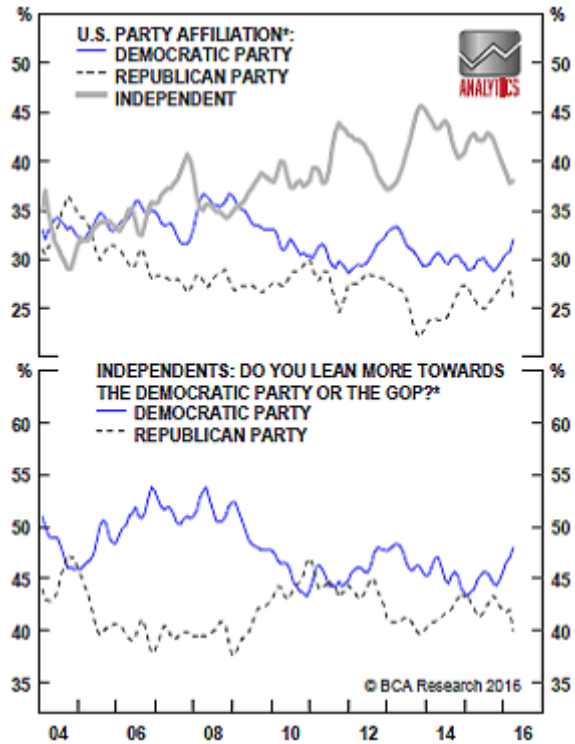
But the fact remains that Independents – America's "median voter" – will decide the presidential election, and they cannot stand Trump (Figures 2 and 3).

Figure 2: Trump is widely disliked
Net favourability by party



Source: CNN/ORC Poll conducted on 24–27 February, 2016.

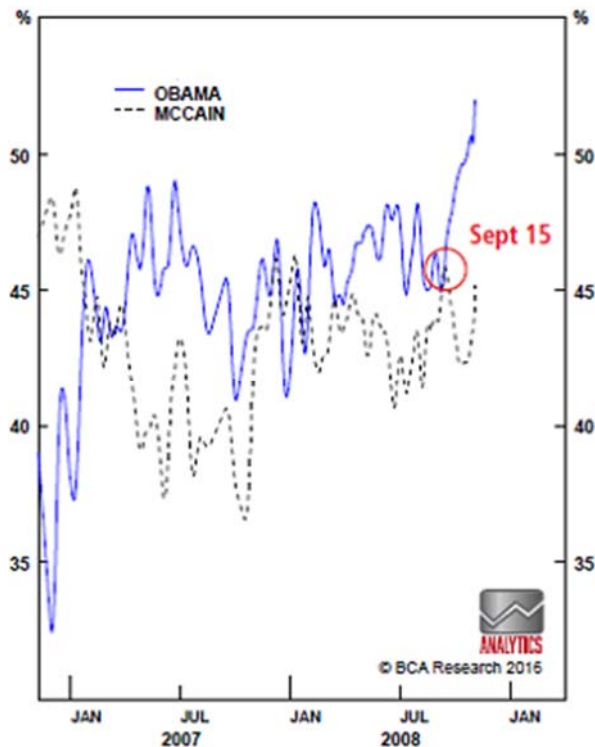
Figure 3: Independents pack biggest pu



Source: Gallup

Trump will face an up-hill climb if he wins the GOP nomination. However, exogenous events could intervene on his behalf. On 14 September 2008, Senator John McCain was leading in the polls against Senator Barack Obama. Then Lehman collapsed on 15 September and the rest is history (Figure 4).

Figure 4: Lehman gave Obama the White House
General Election polls



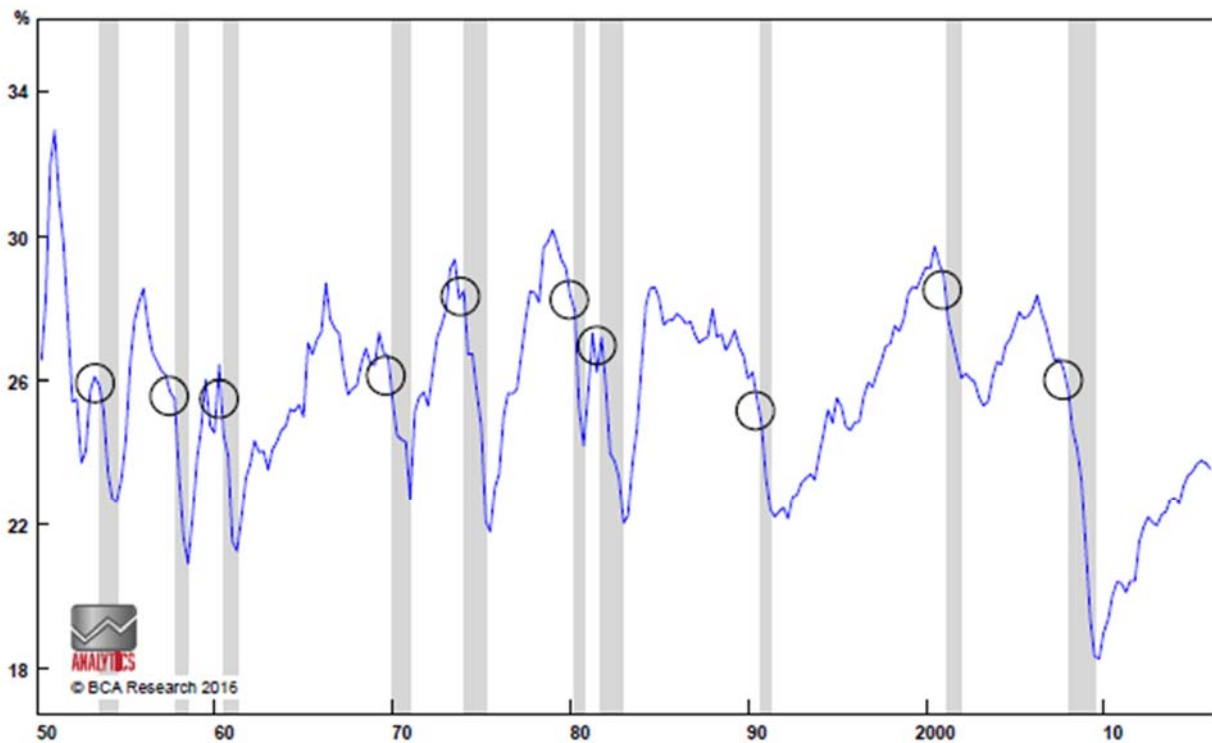
Source: Realclear Politics

There are four potential black swans that could derail the election and hand Donald Trump the presidency.

1. US Recession

Our house view is that the probability of a US recession is low. There are no major macro imbalances – corporate and housing investment has been constrained, cyclical spending (on goods like capital equipment) is relatively low, and the Fed can always back off from raising rates (Figure 5). A recession could potentially be induced by a major crisis in China or EM via a sharp appreciation in the USD. However, we do not expect such an event to happen in time to impact the US election.

Figure 5: Cyclical spending below levels that have signaled past recessions
US cyclical spending (as a percent of potential GDP)



Source: BCA Research Note: Cyclical spending includes: durable goods pce, residential investment, nonresidential fixed investment: equipment and property products, nonresidential structures, and business inventories. shaded areas represent nber-designated periods of recessions.

2. Terrorism

We have identified the structural and cyclical factors underpinning the bull market in terrorism – US geopolitical deleveraging from the Middle East, collapse of Middle Eastern and North African totalitarian regimes, sophisticated tactics, and ease with which homegrown cells can attack soft targets and use modern communications technology to coordinate their activities.¹

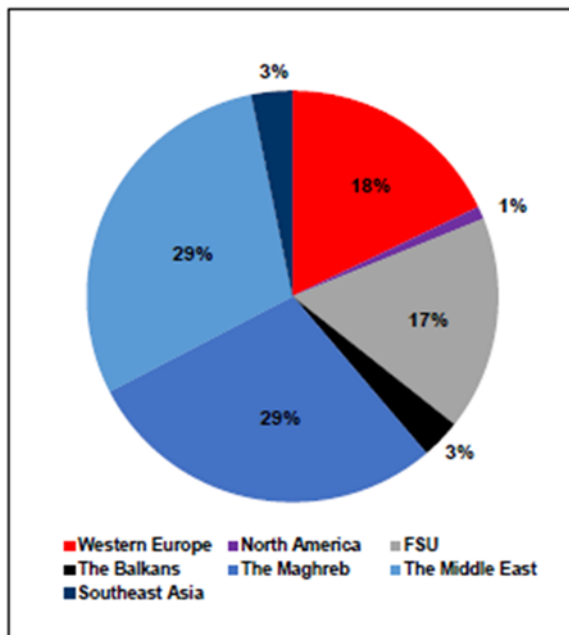
To this list we could also add the Islamic State's loss of territory in the Middle East and successive conventional military defeats over the past year. These setbacks could encourage foreign fighters to return to Western states.

About 19% of foreign militants currently in Syria and another 45% known to have returned home live in countries on the US visa-waiver list – i.e., persons who do not need a tourist visa to enter the US (Figure 6). These returnees could slip through the cracks and travel to

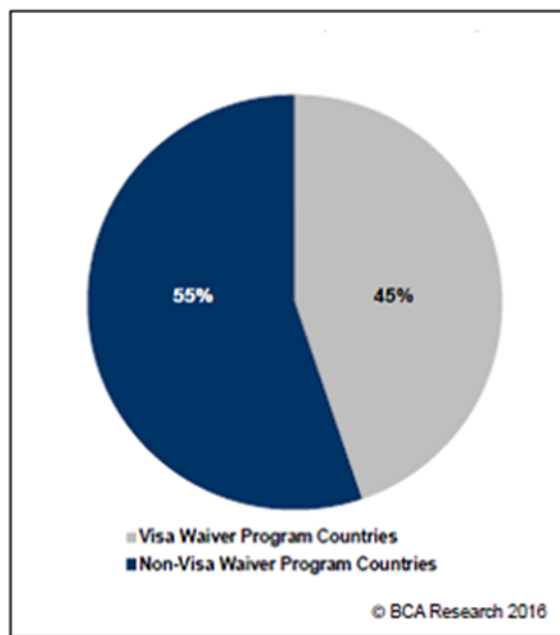
the U.S., although the more likely scenario would see them committing terrorist attacks in Europe.

Figure 6: Fighters come home

Isis fighters by origins



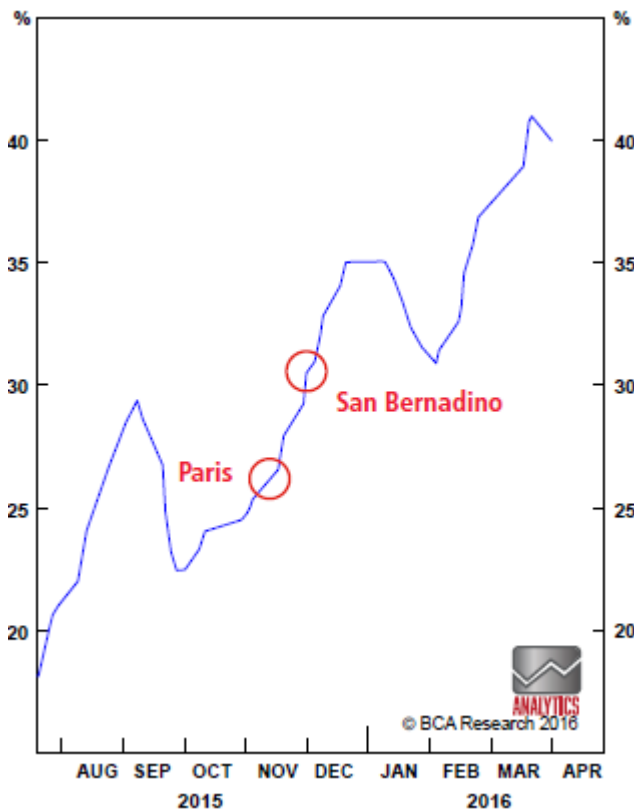
Returned Isis fighters by origins



Source: The Soufan Group.

A major terrorist attack that strikes a critical target or is especially effective in terms of casualties or symbolism could help Trump in the lead up to November. His polling numbers benefited from the Paris and San Bernardino attacks late last year (Figure 7).

Figure 7: Terrorist attacks give Trump a boost
National polling numbers: Trump



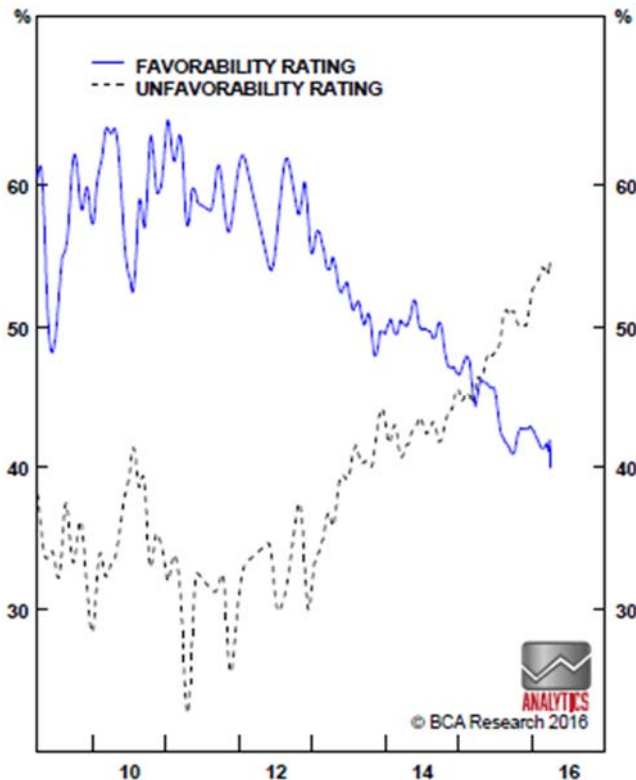
Sources: Real clear Politics and BCA Calculations.

3. Scandal

A bad enough scandal can destroy any candidate in any election overnight (see: Strauss-Kahn, Dominique). The ongoing investigation into Clinton's use of a private email during her tenure as Secretary of State has not yielded much attention recently, but the FBI investigation continues. If Clinton were to be charged with a crime, the public's perception of Clinton - which is already deeply skeptical (Figure 8) - could change overnight.

Clinton also remains vulnerable to charges of mishandling the Libya intervention, particularly the attacks against the US embassy in Benghazi in 2012. A terrorist attack somehow linked to Libya, or headline-grabbing instability in the country, could bring the issue back to the forefront of public attention.

Figure 8: Voters not crazy about Clinton



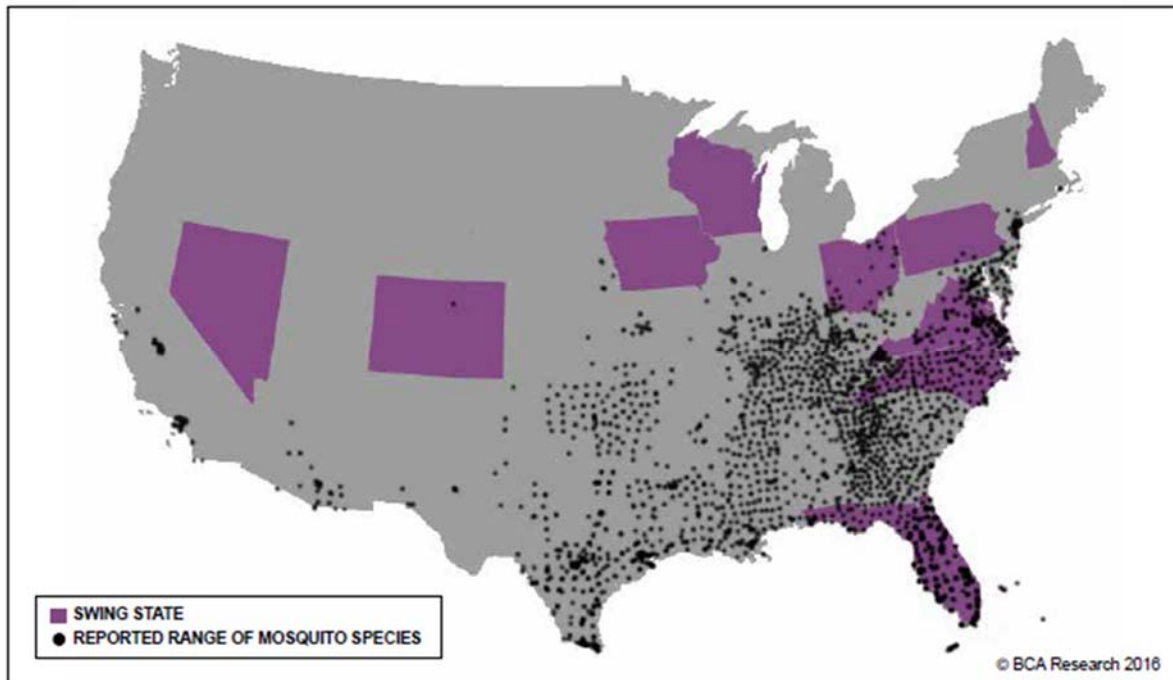
Source: Huffington Post.

5. Zika

The Zika virus is an ongoing pandemic that could influence the US election. It is a genuine public health threat, prompting the Center for Disease Control and Protection (CDC) to go to Level 1 activation (its highest response level). The virus spreads easily – both by mosquitos and human sexual transmission – and has no vaccine or medicine to treat it. In addition, the CDC has recently stated that the virus is more concerning than previously thought and can affect adults, not just newborns, in rare problems.² So far, the virus has appeared across the continental US primarily through travel-associated cases, but the numbers could spike when mosquito swarms arise in the summer.

The virus has considerable political salience because it affects children (causing incomplete brain development in newborns) and the measures needed to avoid it have serious consequences for families. Several US states are at risk of a Zika outbreak, judging by the presence of Zika-carrying mosquitos. As Figure 9 illustrates, this includes politically relevant swing states.

Figure 9: Zika-bearing mosquitos and swing states

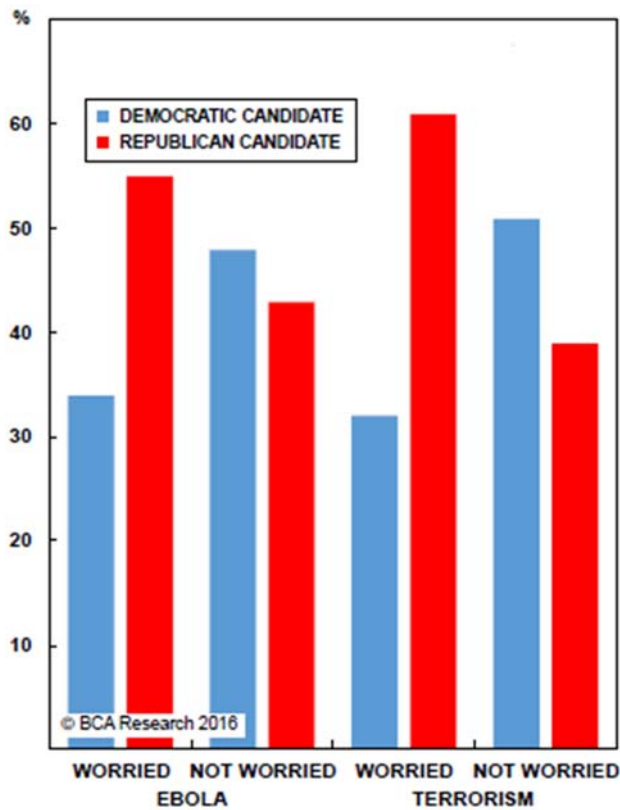


Sources: Moritz Kraemer et al, “The global compendium of *Aedes Aegypti* and *Aedes Albopictus* occurrence,” *Scientific Data* 2: 150035 (2015); *Washington Post*; *Cook Political Report*.

The Great Wall of Trump will not be able to keep mosquitos out, although he may claim to the contrary. Nonetheless, a full-blown pandemic that leads to brain-deformed newborns being born across America will not help the incumbent party, regardless of whether there is anything the White House can do to prevent it.

Of course, concerns over Ebola had little effect on the midterm election in 2014, but they could have if the situation had deteriorated. In the political arena, Ebola drew higher levels of concern from Republican voters (Figure 10).³ As such, Zika could at the very least prompt Republicans that are skeptical of Trump to come out and vote, ensuring that he gets the turnout he needs to remain competitive.

Figure 10: Ebola: republicans were more concerned
2014 Mid-term vote by concerns about Ebola and terrorism



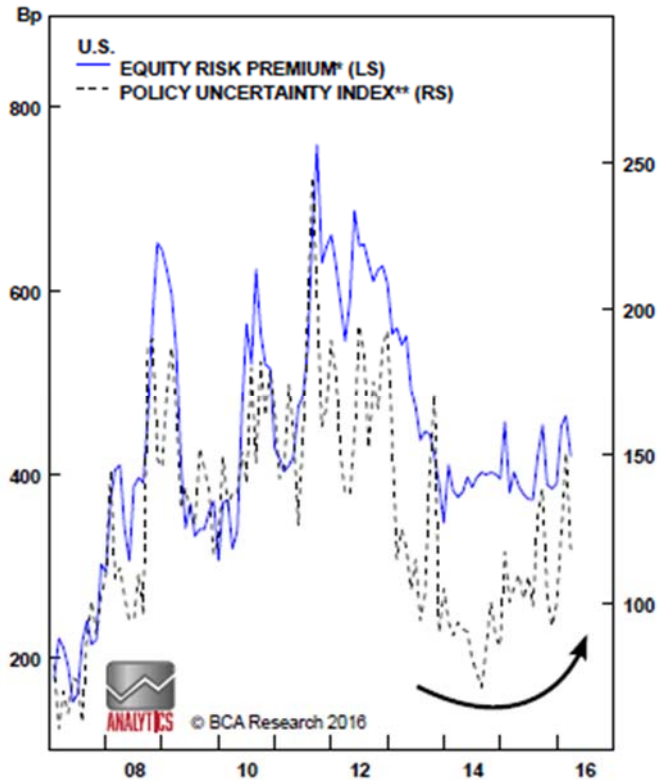
Source: Huffington Post.

The Bottom Line

The GOP nomination race has turned against Trump, who may not win the nomination. Were he to win it, most commentators (including us) believe that he would be an unusually flawed candidate. However, exogenous events can turn any election upside down. As such, investors should not assume that Hillary Clinton is a lock, not even against Mr Trump.

We expect the US election to start mattering for the markets at the end of August, once the conventions are over in July and the two candidates are chosen. Given the rhetoric on the campaign trail – which has decidedly moved to the left on economic ideology – and the possibility that an anti-establishment candidate wins the election, we expect policy uncertainty in the US to rise, and the equity risk premium to rise with it (Figure 11).

Figure 11: Will the election affect the ERP?



Source: Equity Risk Premium = US 12-month forward earning yield (Source: Thomson Reuters/Ibes) minus 10-year US Government Bond Yield. Policy Uncertainty Index source Baker, Bloom, and Davis, 2015

ENDNOTES

1. Please see BCA Geopolitical Strategy Special Report, “Tailwinds Of Terror,” dated November 16, 2015, available at gps.bcaresearch.com.
2. Please see BBC, “Zika virus ‘scarier than thought’ says US,” dated April 12, 2016, available at www.bbc.com.
3. Ebola may only have had a modest effect if at all on voter turnout since the group most alarmed by the disease – Republicans and especially Tea Party voters – was also already highly motivated to vote and had an unrelated structural advantage in midterm elections. Still, the potential exists for a health scare to affect voting. For example, 36% of respondents in a CNN poll in the final weeks before the election said Ebola would be “extremely important” to their vote, placing the issue close to the level of concern over the budget deficit and healthcare.

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