Trump, Presidential powers and investment implications

Marko Papic | BCA Research | May 2016

Donald Trump may ultimately have insurmountable disadvantages among independents, women, and Hispanics, and will probably need an external shock to win.[1] But to be clear, Trump has a mathematical path to victory, the so-called "White Hype" strategy by which he manages to increase the GOP share of the white vote significantly in several key swing states.[2] However, he still has to dig his own party out of a significant Electoral College vote hole. In other words, he has little room for error.

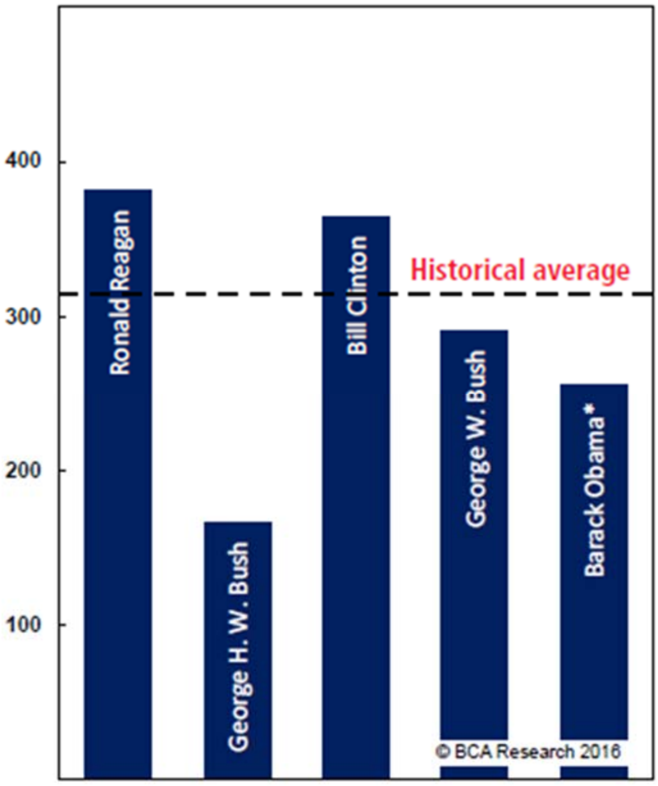
Investors are unsurprisingly asking – How much damage could a Trump presidency do?

Despite the checks and balances of a legislature and the Supreme Court, American presidents have extensive powers. The clear trend in recent decades – legal scholars widely attest – is for the executive branch to gain powers at the expense of the other branches. The constraints on presidential action are not as robust as the anti-royalist framers of the constitution would have liked.

TRUMP AT HOME

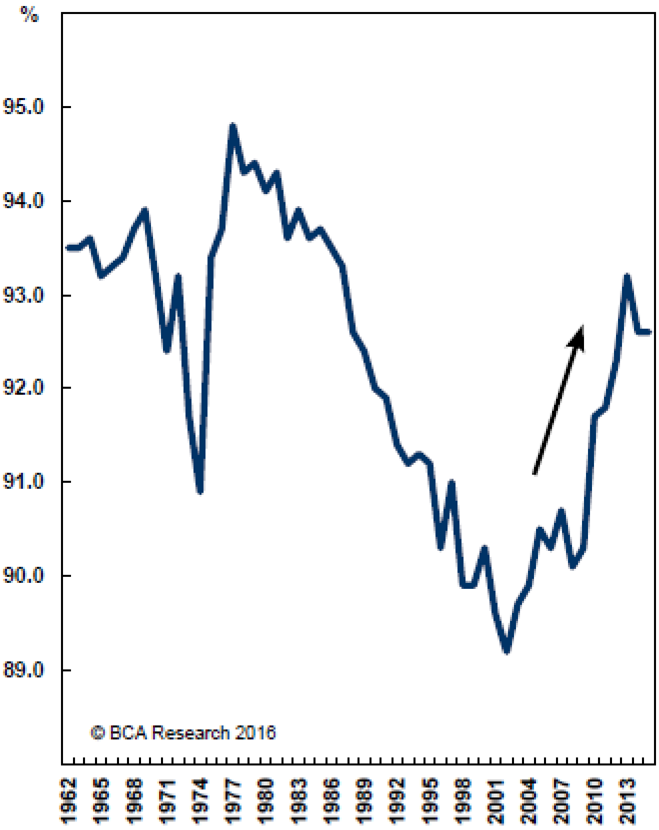
Domestically, a US president can take significant action without congressional support through executive directives. Lincoln raised an army and navy by proclamation and freed the slaves; Franklin Roosevelt interned the Japanese; Truman tried to seize steel factories to keep production up during the Korean 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 1), the economic significance has increased along with the size and penetration of the bureaucracy (Figure 2). The economic impact of executive orders is always debatable, but the key point is that the president's word tends to carry the day.[3]

Figure 1: A potent tool
Number Of Executive Orders



Source: Gerhard Peters and John T. Woolley, "Executive Orders". The American Presidency Project. Ed. John T. Woolley and Gerhard Peters. Santa Barbara, CA. 1999-2016. Available at http://www.presidency.ucsb.edu/data/orders.php.
Note: Horizontal line represents the historical average. For 89 months out of 96 months in total in his presidency.

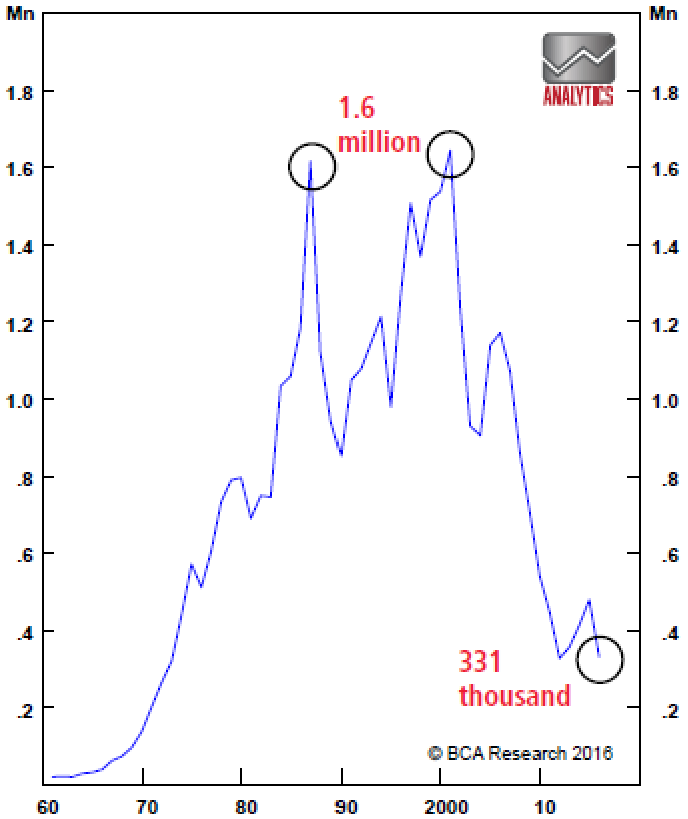
Figure 2: Executive branch is growing
Executive branch share of outlays



Source: White House historical tables

What does this mean for Trump? The "big idea" of Trump's campaign is his proposal to block illegal immigration - and here his office's authority is formidable. However, the actual implications for the economy and markets would be dubious. For one, illegal migration from Mexico has hit multi-decade lows (Figure 3), most likely a victim of the death of the Debt Supercycle and the associated insatiable American appetite for housing construction.

Figure 3: Fewer Mexican immigrants
US border apprehension: Southwest border sector



Source: U.S. Border patrol fiscal year southwest border sector apprehensions (FY 1960 – FY 2015).

Trade is another 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 their 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.[4] He would also have considerable powers to levy tariffs, as Nixon showed with his 10% "surcharge" on most imports in 1971.[5]

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.

TRUMP ABROAD

The area where presidential authority is incontestably the greatest is foreign policy – war, peace, and diplomacy. Needless to say, Trump's rhetoric suggests making dramatic changes to US foreign policy. Looking at his chief foreign policy statements so far, a few preferences become apparent:

- **Economic Strategy** – Though Trump's "American First" policy has an isolationist tone, the key to all his views is the economy and trade.
- **Anti-Idealism** – Trump is an outspoken critic of US interventionism, particularly in Iraq and Libya. Yet he does not oppose intervention, per se.
- **The Mideast Fixation** – Trump has argued for a more interventionist stance in Syria against the Islamic State, a renewed war against Islamist terrorism, and for a heightened threat of intervention (or containment policy) against Iran. The last policy could significantly increase tensions in the Middle East and lead to further large-scale US deployments in the region.
- **Re-engagement With Russia** – Trump's comments in praise of Russian President Vladimir Putin may appear like eccentricity to the media, but he has seriously called for an "easing of tensions and improved relations with Russia." One of his top foreign policy advisers is a businessman who made his career dealing with Putin's Russia. Trump sees anti-terrorism as a key plank of such a *détente*.
- **China Ultimatum** – Trump has attacked China relentlessly for dumping goods, manipulating its currency, stealing US intellectual property, and hacking US networks. He has threatened penalties on Chinese trade and warned that if China does not want to be a "better friend" then "we can both go our separate ways."
- **Burden-Sharing** – Trump has criticised US allies for not bearing their share of the fiscal burden for maintaining the existing global security architecture. He wants to hold two summits – one with NATO, the other with Asian allies – to revise strategic objectives and fiscal burdens, i.e. make the allies pay more. We infer that this would also mean more burden-sharing by Middle East allies, like Saudi Arabia, as well.

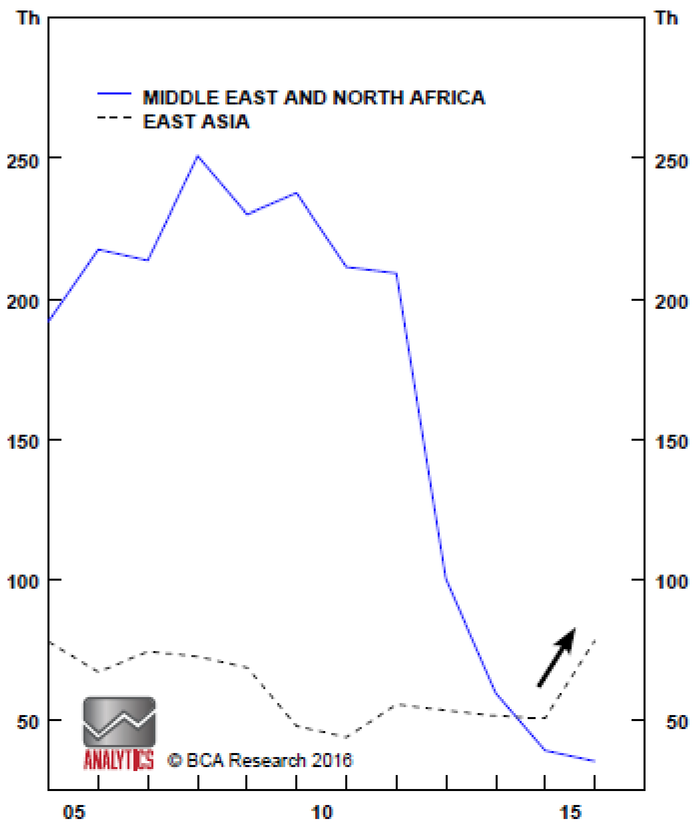
What are the *constraints* on these proposals?

Trump faces few constraints when it comes to his view that US interventions in the Middle East are a product of failed American adventurism – the public, in fact, agrees.

Moreover, his overall foreign policy proposal is essentially a "walk softly and carry a big stick" policy of reversing cuts to the armed forces, adding spending in defense R&D and veterans affairs, while refraining from conflicts unless necessary. This is in fact a form of fiscal stimulus, not an ostrich sticking its head in the sand. From an investment perspective, Trump's brand of isolationism would not be negative for the defense industry.

The more obvious constraints to Trump's form of isolationism come from East Asia. The current US "pivot to Asia" aims to rally American allies and in doing so raises some short-run risks by antagonising China (Figure 4). However, in the long run, the pivot might discourage conflict if, by demonstrating US resolve and alliance strength, it convinces China not to rebel against the global system.

Figure 4: A nascent pivot to Asia
Foreign deployment of US Troops



Source: The Heritage Foundation and Defense Manpower Data Center.

By contrast, Trump's proposed policy, while bringing plenty of risks in the short term, could trigger a dramatic spike in long-term uncertainty:

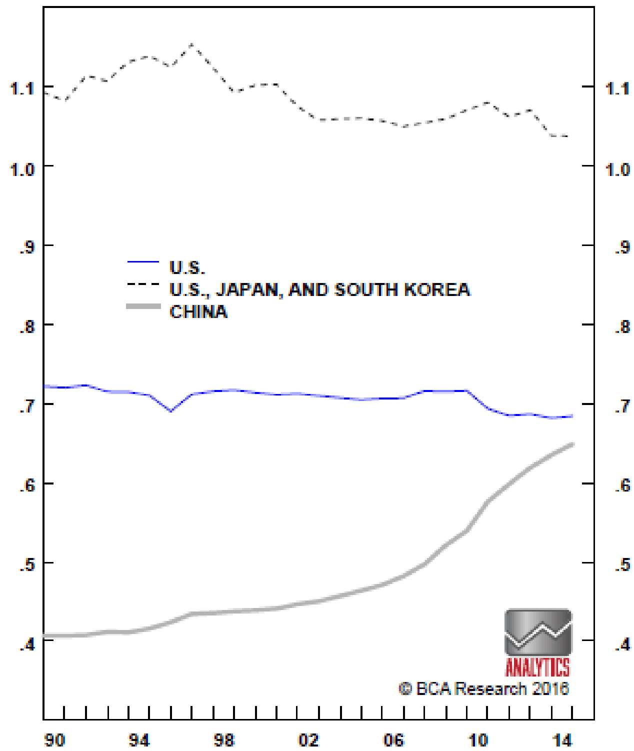
- **Trade** – Trump runs the risk of treating allies like Japan, South Korea and ASEAN states indiscriminately from China as threats to the US economy. He has routinely criticised Japan along with China on trade and might raise general trade barriers. In short, he risks alienating US partners and encouraging them to seek economic accommodation with China.

- **Security** – Trump has suggested that American allies need to do more to defend themselves and has singled out Japan and South Korea, ominously suggesting that they develop their own nuclear deterrent. Even assuming he avoids lighting that particular powder keg, he has implied US allies in East Asia will receive fewer assurances regarding North Korea and China's military emergence.

Bottom Line

Subsequent US presidents would likely regret any moves ceding China significant economic and military space, which it would use to gain regional influence. An American attempt in four or nine years to rebuild alliances and contain China – when China stands in a better strategic position – would create far greater risks to stability than the current pivot is creating by pressuring China while it still has many disadvantages relative to the US (Figure 5).

Figure 5: The benefit of friends
Geopolitical power index



Source: BCA Calculations. Note: The Geopolitical power index measures a country's power based on a weighted aggregation of its economic, military, political, technological, and geographical endowments.

INVESTMENT IMPLICATIONS OF A TRUMP PRESIDENCY

Trump is clearly a highly heterodox presidential candidate. His strategy to defeat Hillary Clinton is to outflank her from the left when it comes to economic policy. Trump has voiced support for a higher minimum wage, for higher income taxes on the wealthy, and even for renegotiating US government debt. In the past, he has also staunchly rejected cuts to spending on entitlement programs and supported protectionist measures against both China and allies like Japan.

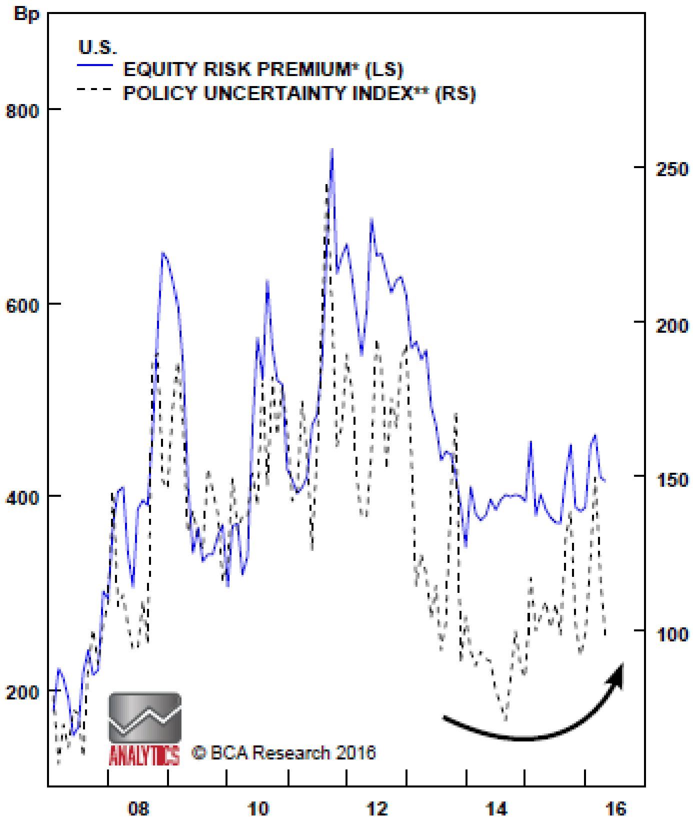
What are the investment implications of a potential Trump presidency?

In the short term, we actually think that Trump could be positive for equities and negative for bonds. For one, Trump has not talked about balancing the budget once on his campaign trail, a sharp deviation from the "Tea Party" Republicans who have come to dominate the GOP agenda narrative since 2010. In fact, he has proudly spoken of taking on debt as a business owner with the explicit intention and expectation of defaulting on it later. We suspect that his left-wing stance on economic issues is genuine and that he would therefore have no qualms with increasing fiscal expenditure after being elected. We also do not think that Congress would stand in his way in this effort – he may actually find that Democrats are his closest allies in the legislature, with just enough Republicans crossing the aisle to make the coalition viable.

More fiscal spending in 2017 will mean higher economic growth, higher equity prices, and higher bond yields. In the short term, Trump will be "risk on" and not in the way most of our clients are thinking.

Aside from a temporary fiscal spending sugar high, Trump will likely be negative for US equities in the medium term. This is not necessarily his fault. As we wrote in last month's missive, the "median voter" in both the US and the U.K. has moved to the left. Trump (and Bernie Sanders) are merely supplying what America's democratic market is demanding. It is difficult to see how profit margins stay as high as they are and corporate taxes as low as they are amidst the pendulum shift to the left. At the moment, US Policy Uncertainty Index remains muted, but it may rise as investors realise that both presidential candidates are campaigning from the left of the economic spectrum, perhaps for the first time in US history (Figure 6).

Figure 6: Will the election affect the ERP?

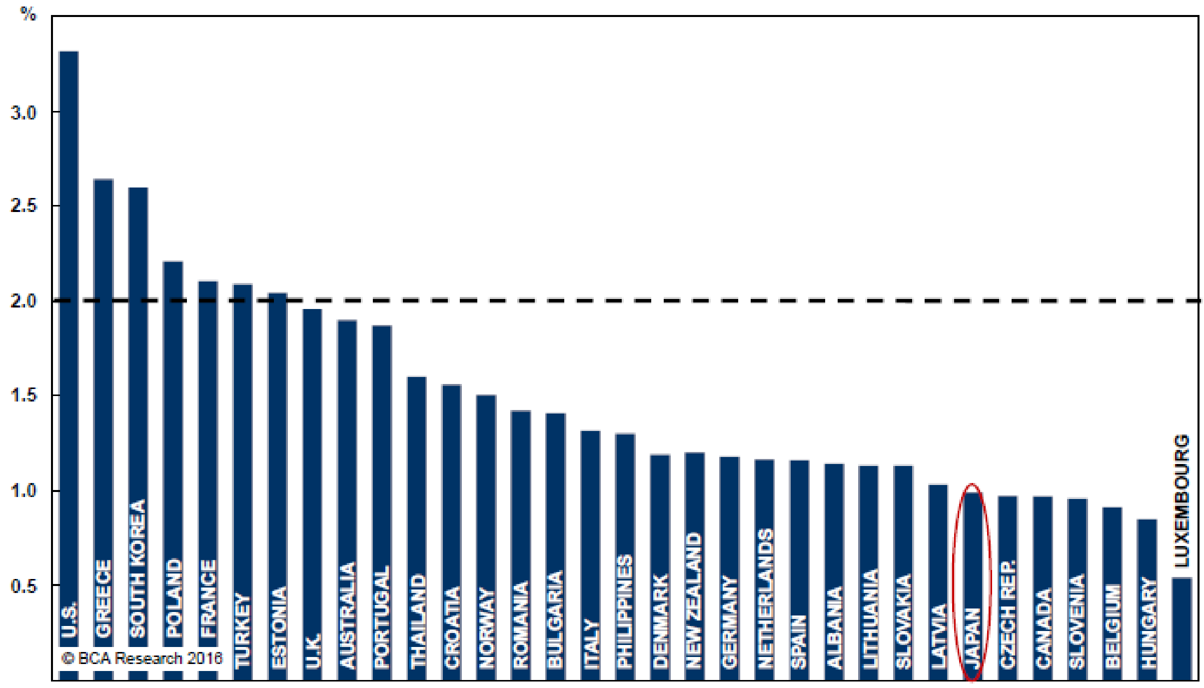


Source: Baker, Bloom and Davis (2015). Note: U.S. 12-month forward earning yield (Source: Thomson Reuters / IBES) minus 10-year U.S. Government bond yield.

In the long term, a dramatic shift in US foreign policy may be the most investment-relevant component of the Trump presidency.

Trump's foreign policy is ultimately an extension of his "America First" economic policy. And there is some truth in his criticism of US allies. For example, it is true that US allies can shirk military spending because of American security guarantees. Japan, surrounded by geopolitical rivals and threats, only spends 1% of its GDP on defense. And it is well known that only four NATO countries spend their supposed minimum of 2% of GDP on defense (Figure 7).[6]

Figure 7: Defense spending of U.S. allies in NATO and Asia
Military expenditure as a percent of GDP (2015)

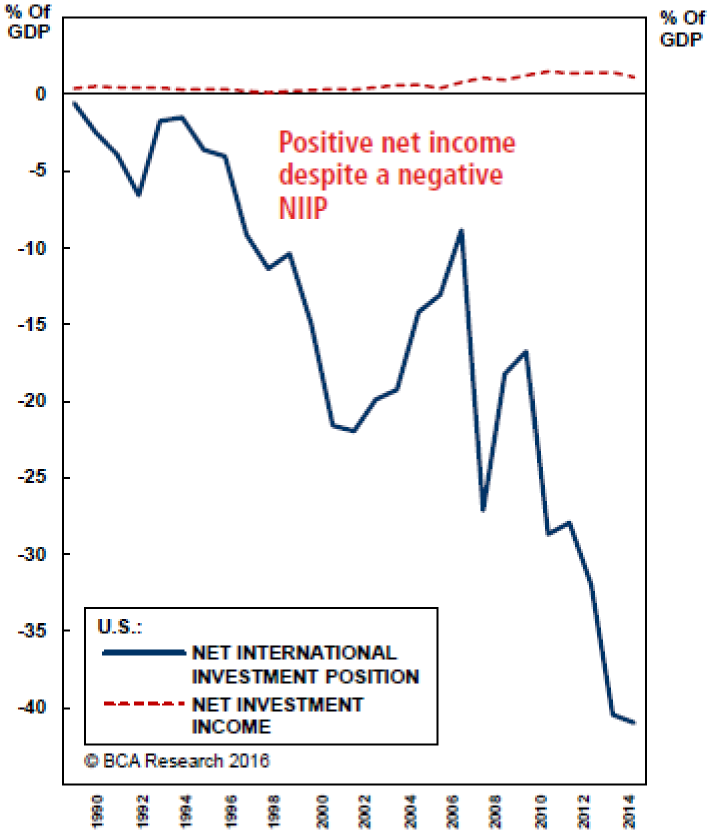


Source: SIPRL. Note: Horizontal line represents the NATO recommendation for member states' military spending as percent of GDP.

Yet, in at least one major sense, the allies are already paying for American hegemony: through their investments in US dollar assets.

Figure 8 illustrates this so-called "exorbitant privilege."[7] Foreigners hold US assets because of the size of the economy, the sustainability of the market, and its deep liquidity, but also because the US military provides them with assurances of peace through security. If Washington raises barriers to its markets and becomes a doubtful provider of security, states may gradually see less of a payoff in holding US assets and thus diversify more rapidly. They could also be forced to diversify by new security guarantors, regional hegemons, and geopolitical bullies. For example, if China were to become the security guarantor in the Middle East, what would prevent it from demanding that Saudi Arabia price its oil exports in renminbi while plowing its petro dollars into Chinese provincial debt markets?

Figure 8: The "Exorbitant privilege"



Source: Bureau of Economic Analysis.

The US may have the luxury of isolationism due to its geography and military power, but it is not an isolated economy. Global economic and financial conditions affect the US economy via currency markets and effects on large multinationals. In addition, the dollar's role as the reserve currency has provided the US economy with an interest rate that it "does not deserve." The concept of exorbitant privilege, however, cannot easily be explained to voters.

Investors may think that the ongoing campaign rhetoric is irrelevant as Trump is unlikely to come to power. However, foreign leaders would be remiss to ignore Trump's rhetoric as it reveals an appeal in the American populace for some form of isolationism. Therefore, they are likely to begin planning contingencies for "Fortress America" contingencies that could create a self-fulfilling prophecy in the future.

There is a difference between global institutions atrophying on their own – as NATO and Bretton Woods already have – and a situation where the reasoning that brought them into existence becomes clouded by time and events. The US benefits considerably from its hegemonic position, even if its power has declined in relative terms. However, despite the risks of a more isolationist foreign policy, voters can entertain such an idea for long enough to elect a president who wants to try it.

ENDNOTES

1. Please see BCA Geopolitical Strategy Monthly Report, "Partem Mirabilis", dated April 13, 2016, available at gps.bcaresearch.com.

2. Please see BCA Geopolitical Strategy Special Report, "U.S. Election: The Great White Hype", dated March 9, 2016, available at gps.bcaresearch.com.

3. 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.

4. 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.

5. In Proclamation 4074, dated August 15, 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.

6. Poland, France, Turkey and Estonia are the four countries in the latest data, with the U.K., Australia, and Portugal not falling short by much.

7. While the U.S. runs a massively negative net international investment position, its net international income remains positive. In other words, foreigners receive almost nothing for holding U.S. assets, while the U.S. benefits from risk premia in foreign markets.

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