24 November 2023

Global Political Drivers

US ELECTION FEVER: UPFRONT IMPACTS

Christopher Granville / Grace Fan

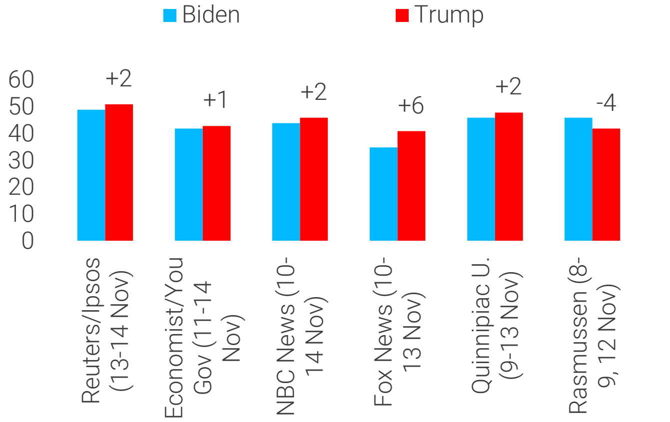
- Regardless of whether the US elections just under a year from now produce a revolutionary rupture, the fever pitch of associated hopes and fears will have investment-relevant impacts during the coming months of campaigning.
- This election-year political ferment stems mainly from a Trump second term - along with Republican majorities in both houses of Congress - appearing to be at least within the bounds of possibility; but the ferment is not wholly Trump-dependent.
- The main market impact of this ferment is positive: it will cement the Fed's dovish turn.
- Concerns about the political and judicial campaign to axe the administrative state may well be overblown, but in this atmosphere the Fed's institutional interest lies in making itself inconspicuous - by preventing, or at least minimizing, recession.
- Alongside this passive hunkering down by the Fed, the political fever may spew out more actively - into the geopolitical arena.
- One already visible effect is the disruption of the support on which the Ukrainian war effort depends. This could help spark a global risk spike on the back of a 'doubling down' conflict escalation that would further enflame domestic US political passions in a reinforcing feedback loop.
- Another is enhanced tensions over the wedge issue of migration, that, as jingoistic rhetoric fires up, will undermine some benefits of rare bipartisan consensus on hawkishness towards China.
- The effect in question is further impairment of Mexico's unique potential to supply the 'nearshoring' counterpart to decoupling supply chains from China - with a negative feedback loop likely in this area too given Mexico's own mid-2024 general election.

US election run-up: major impacts regardless of results

The US elections a year from now will be a major global political driver for markets in 2024. That is, regardless of the electoral outcome, the actual race is shaping up to be a driver in its own right. The increasingly feverish domestic political atmosphere in America as the campaign unfolds will affect the US economy as well as spilling over into the international arena that is already fraught with geopolitical risk.

Trump could win a Biden-Trump rematch in 2024

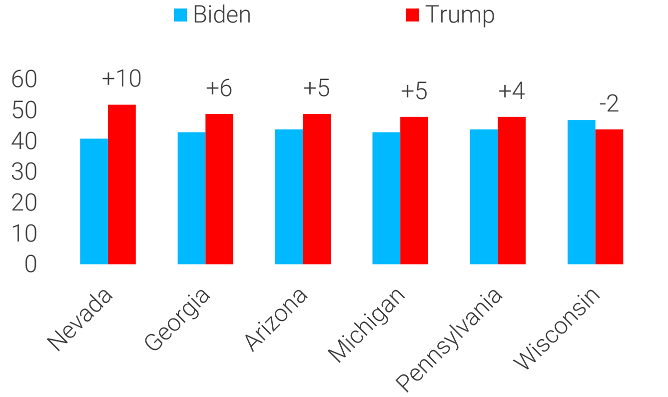
% of national voter intentions if the presidential election were held today*



*Poll margins of errors at +/- 2.4-5.3pp.Sources: Local polls.

Advantage Trump in key swing states too*

(% of state voter intentions if the presidential election were held today – NYT/Siena College poll)

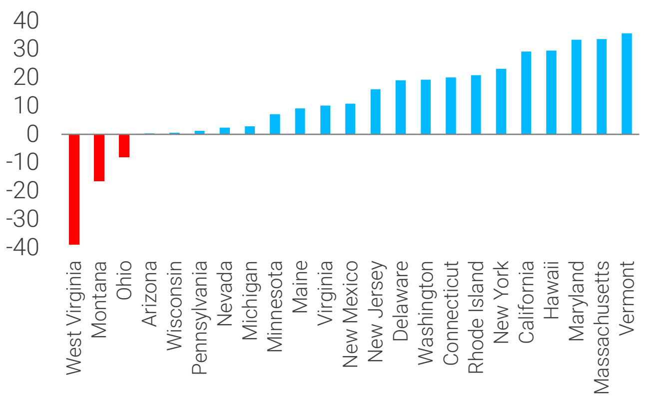


*Poll of 3,662 registered voters taken 22 Oct – 3 Nov; state poll margins of error at +/- 4.4-4.8pp.Source: NY Times.

These various impacts will persist for as long as one particular election outcome, which seems plausible at present (see charts above), remains a serious possibility. The outcome in question is a presidential election victory for Donald Trump, especially if accompanied by the Republican Party ('GOP') winning majorities in both houses of Congress (see charts below).

GOP favoured to take control of Senate in 2024 . . .

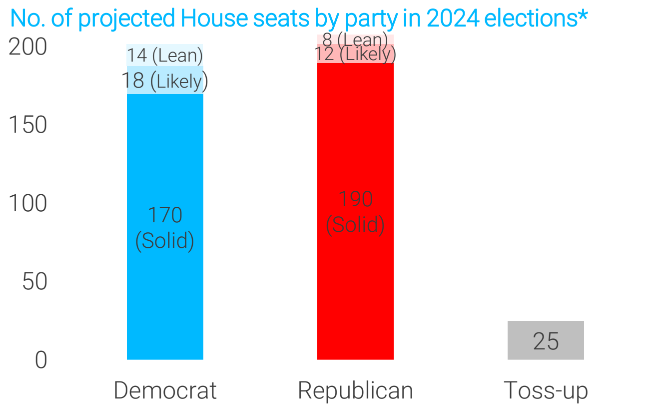
Democrat-held Senate seats up for election, by margin of Biden's 2020 presidential results in the state (pp)



Source: AP.

. . . with a fighting shot at keeping the House too

With 90% of House races in electorally "safe" districts, control hinges on a few dozen toss-up and "lean" races



*As of 16 Nov 2023. Ongoing legal battles around redistricting in at least 10 states will affect electoral outcomes too.Sources: Cook Political Report, GlobalData TS Lombard.

This political shock scenario might yet evaporate. The most visible potential path back to business as usual in American politics runs through Trump's four criminal indictments and 91 felony charges undermining his campaign. On the other hand, Trump may yet milk more political dividends from his legal difficulties. The outlook could in any case be transformed for many other reasons – such as, to pick only one possibility, the replacement of President Biden by a more popular Democrat nominee. **For as long as a Trump-GOP victory remains on the cards, however, the associated political ferment in the US will have various investment-relevant effects heading into 2024.** The hot domestic political temperature might preserve these effects even if the election race looks completely different a year from now – with, say, neither Trump nor Biden ending up on the ballot. The chief exhibit here is the dovish turn in the 'reaction function' of the Fed. We will also consider how this US ferment might affect the re-globalization theme via Mexico, and the outlook for the conflicts in Ukraine and the Middle East where commodity markets are in the frame.

Ferment fuel

This note will not be adding to the avalanche of commentary about the likelihood and implications of Trump returning to the White House. Our focus, instead, is on **the perception reflected in that avalanche – namely, that a second Trump term ("T2") could spell some kind of rupture**. The perceived high stakes are not limited to Trump's specific radical policy commitments on, for example, immigration or trade – with Trump pledging to enact "the largest domestic deportation operation in American history" and revive Depression-era Smoot-Hawley protectionism.

The deepest forebodings stem rather from Trump's proclaimed "Agenda 47" crusade against the "deep state" in the name of "democratic accountability". His stated plans, set out more fully in the table in the Appendix to this note, point to an authoritarian order. The main means to this end are a planned purge of the federal bureaucracy in which tens of thousands of career officials would be replaced by political appointees pre-vetted for loyalty and the tightening of political control by the White House over key independent federal agencies – starting with the Justice Department and potentially extending to the Fed. Enthusiasm for this agenda on the part of other Republican presidential candidates, notably Florida Governor Ron DeSantis (who talks of "slitting throats on Day One") speaks to the grassroots zeal it has engendered on the right.

This threat perception is also fuelled by the revolutionary fervour with which several leading Trump supporters are publicly discussing practical steps to ensure that, in contrast to Trump's first term, such rhetoric is translated into action. On both sides of the political barricades (i.e. pro- and anti-Trump), hot-blooded rhetoric is intensifying and the fervour reciprocated. Trump's vow to "root out . . . vermin within the confines of our country" was described by Biden during his trip to California last week as echoing "language you heard in Nazi Germany in the 1930s". Thomas Klingenstein, one of Trump's most generous and politically committed donors, has long subscribed to the concept of a cold civil war between "those who want to preserve the American way of life and those ["the illiberal "woke" left"] who want to destroy it" but since 2021 has increasingly urged Republicans to wage war "as if the choice were between liberty and death". This "civil war" diagnosis seems to be accepted – only with a reversal of the roles (e.g., slot in "fascists" for "Woke Communists") – by Trump's opponents who see him as a menace to the US Constitution and rule of law.

Risk perceptions are further compounded by one of the two consequential results of Trump's generally disorganised first term – the establishment of the conservative 6-3 super-majority in the Supreme Court (the other being the policy turn against China that Biden has maintained and extended). The fact that Trump was able to appoint the largest number of Supreme Court justices since Reagan (and nearly as many federal appeals judges as Obama in half the time) raises the perceived stakes of the GOP potentially controlling all branches of the government (i.e. winning the White House, the Senate and the House of Representatives). The fallback scope for legal challenge against the radical Trump-GOP agenda would likely be limited with the judiciary being less likely to rule against T2 actions.

To repeat, the driver we are focused on here is the effects of this rising threat perception rather than the chances of such threats materializing in the form of these modern-day revolutionaries getting the opportunity to try out their ideas and succeeding in the attempt. For the latter issue, the 2024 elections will be a key crossroads. But before Election Day arrives, other actors will have reacted to the rising political temperature in ways that matter for asset allocation. Such reactions might be more passive, in the sense of seeking shelter, or active anticipatory moves designed to favour or frustrate the radical agenda that will dominate the coming months of election campaigning.

Impact #1: Dovish Fed

Among all the effects ahead, the most investment-relevant is an example of passive shelter-seeking – by the Fed. In a change of view put out last week, our Chief US Economist Steve Blitz portrayed the Fed's monetary policy bias ('reaction function' in the jargon) as shifting in a dovish direction – with the domestic political ferment an important cause of this shift.

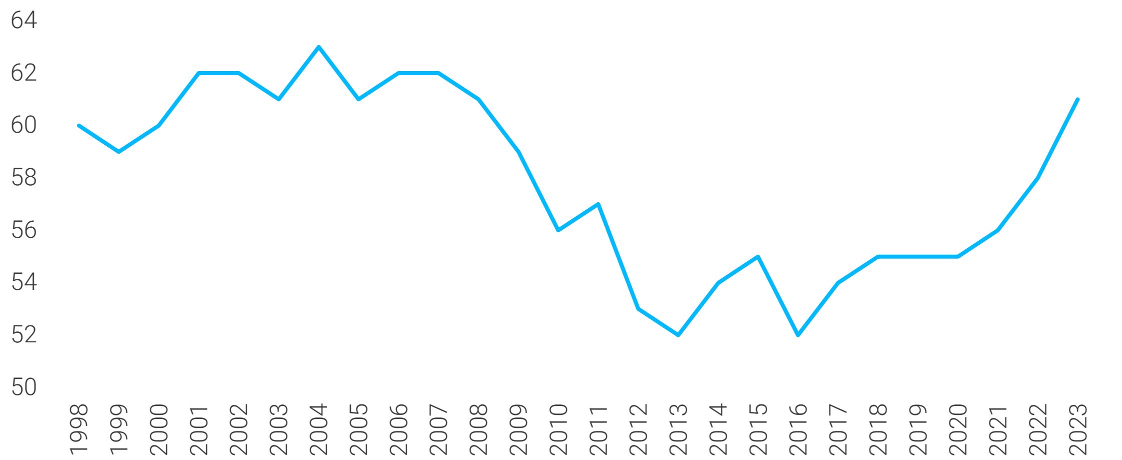
This shift has since been borne out by the publication of the minutes of the FOMC's last meeting (31 October-1 November). The priorities ring out loudly. Further reduction in inflation (down to the ritually reaffirmed 2% target) is deprioritized; and the main focus for next year is on the other (employment-related) leg of the Fed's dual mandate. Monetary policy will therefore be set to pre-empt economic weakness (by means of rate cuts) – or at worst, if weakness ('technical recession') materializes anyway, policy will nip it sharply in the bud (by means of more aggressive rate cuts).

This political driver is not exactly measurable, but its existence is palpable. The driver emerges from the counter-factual proposition that the Fed would have treated the coming slowdown with more benign neglect but for the fraught election season. But counter-factual does not mean theoretical. There are plentiful examples of the Fed bending to the political wind – and the present case may run deeper than past incidents of particular rate decisions being softened by presidential suasion (with Richard Nixon the worst, but by no means the sole 'offender'). With the stakes in 2024 perceived to be so high, the Fed is at greater risk of becoming a political football.

This institutional risk for the Fed is accentuated by a particular feature of the present intense political battle – the conservative campaign, with Trump and his followers in the vanguard, against the "administrative state". This campaign has already taken on a structural feature regardless of the prospects of the above-mentioned plans to purge the 'deep state'. Under its conservative supermajority, the Supreme Court has staked out an increasingly assertive position in striking down the actions of federal agencies that it deems have exceeded the authority granted to them by Congress on "major questions" of great significance. Some legal experts worry about the potential for this so-called "major questions" doctrine to be extended into a "nondelegation" doctrine that could incapacitate any federal agency including the Fed. Such fears being most likely overblown is beside the point: the very fact of their being voiced intensifies the election seasonal fever and strengthens the incentive for monetary policy settings designed to minimize the risk for the Fed of finding itself on the receiving end of a political backlash that could pose much more serious long-run challenges to price stability than merely de-prioritizing the inflation target in 2024.

Stock ownership back to eve-of-GFC level

Percentage of adults owning equities: direct, mutual funds, 401Ks etc



Source: Gallup, GlobalData TS Lombard

Always the core macro policy driver for markets in general, the Fed's rates decisions – with their politically-driven dovish bias during the coming months – could be even more than usually supportive of the equity market. This thought is prompted by a Gallup poll finding last spring that household ownership of equities has returned to levels last seen on the eve of the GFC (chart above). A key detail is that stock ownership is not the preserve of the wealthy but extends also to over half of households in the relatively modest annual aggregate income bracket of $30-75,000. This increases the equity market's potential contribution to the 'reflexivity' – that is, mutually reinforcing reductions in consumption (from negative wealth effects in this case) and employment – that can turn a mild downturn into a more severe recession. Since a mild recession is the most that the Fed is prepared to tolerate, it will react that much more promptly to weakness in the equity market. For 'chapter and verse' on this, see Steve Blitz's US Watch this week.

Impact #2: Splits over Ukraine and Israel-Gaza wars

The Fed hunkering down seems like a more passive response to election fever compared to the way that the fever may also spew out actively – notably into the geopolitical arena. The first of two examples of this effect highlighted in this note concerns the conflicts in Ukraine and Israel-Gaza – and is already very visible.

This war-related effect captures nicely the distinction between, on the one hand, the real live driver of the election ferment and, on the other hand, the causes and consequences of the actual election result come November 2024. A solid general rule about US elections is that foreign policy has a minimal impact on voting intentions – with the sole exception of foreign wars where American troops are directly involved in combat and taking casualties. This exception will not apply to the wars in Ukraine and Israel-Gaza for as long as the US military involvement in these conflicts remains indirect. They would become burning election issues only if the US armed forces got directly involved in combat (or in the event of terrorist attacks linked to wars). Leaving aside that imponderable, the question of US policy in relation to these two wars is already a focal point of pre-election political struggles, contributing to the general ferment.

The struggles in question are now playing out as much within the parties as between them. While the mainstream political class converges on a bipartisan consensus in support of Ukraine and Israel, there is dissent at either end of the political spectrum. Many left-wing Democrats would like their misgivings on humanitarian grounds about Israel's retaliatory invasion of Gaza to be more clearly reflected in US government policy. Their radical counterparts in the Republican camp – once again led by Trump and his supporters – are critical of the Biden administration's policy of unconditional and open-ended support for Ukraine's war aim of liberating all its territory now occupied by Russian forces, arguing that a more urgent national security focus is the surge of migrants across the US' southern border (more on this in the Mexico section below).

To the extent that the Israel-Gaza war is caught up in domestic US political struggles, this is unlikely in itself to affect for better or worse the investment-relevant risk of the war spreading into the Gulf region that is crucial for global oil supply. The reason for this is that if the Biden administration's so far successful efforts to prevent the war spreading cease to be successful, the reason for that failure will probably not have been domestic political pressures in the US but rather the conflict dynamic in the Middle East region itself getting out of control. It follows that the reverberations of the Israel-Hamas war in the US political arena matter only indirectly – that is, by intensifying in general the domestic political fever and therefore the strength of that fever's economic and market impacts.

That same indirect effect of political divisions over Ukraine war policy is supplemented by a direct risk driver – making this the more important conflict-related risk for the purposes of this analysis. The Ukrainian war effort depends on American support and may be undermined by Trump-leaning Congressional Republicans' opposition to the additional $60 billion-worth of funding for financial and military support to Ukraine that the Biden administration has requested. Although a minority view in Congress as a whole, especially in the Senate, this opposition draws strength from evidence of public 'fatigue' with funding and arming Ukraine that has been building since the summer (table below).

US support for Ukraine: isolationism prevailing, strong partisan polarization

Support for Ukraine (enough now provided vs more needed)

Funding for Ukraine (no more funding vs more funding)

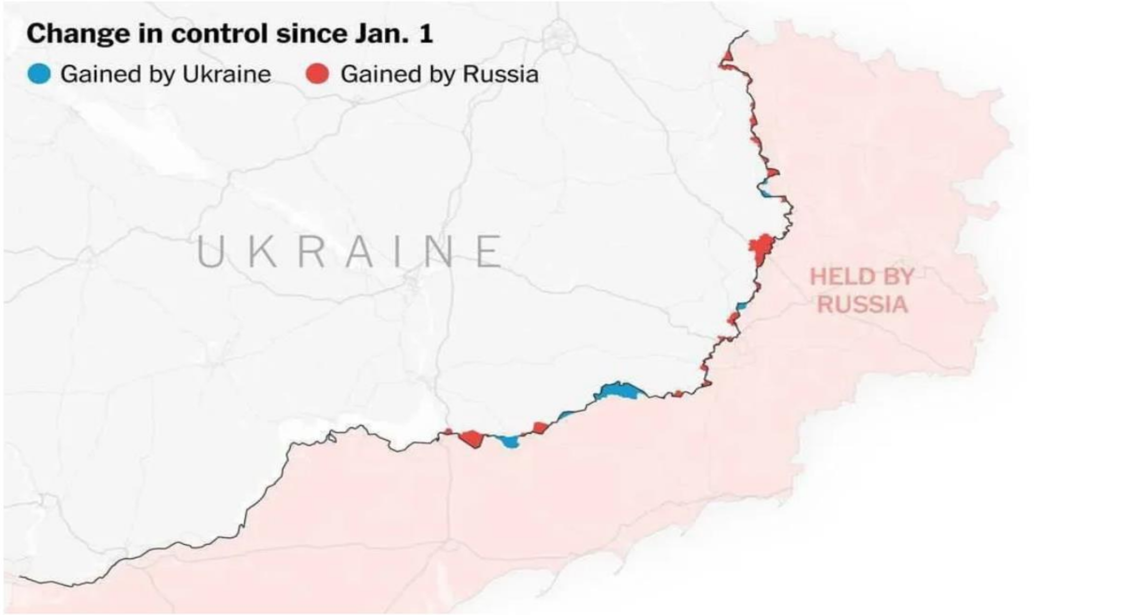
	Enough	More	End funding	More funding
Total	51	48	55	45
Republicans	60	39	71	29
Democrats	40	59	35	64

Source: SSRR poll for CNN, 1-31 July 2023. 32%/32% - Republicans/Democrats, 36% Independents

The present consensus among political observers in Washington appears to be that some additional funding for Ukraine will be approved during the first quarter of next year. But further timing slippage is possible given fraught negotiations on linking any Ukraine package to other spending (especially on the Mexican border – see next section). And any eventual compromise may also involve a reduction in the overall size of the package. This fraying of US support for Ukraine has already weakened the domestic political position of President Zelensky, who said last week that unless ammunition and other military supplies are intensified and enhanced, the

Ukrainian army would be forced to pull back. On the financial side, the Ukrainian war effort may also be impaired by the inflationary effect of the likely major shortfall in the $30 billion of official external financing that the IMF says Ukraine requires during the winter months.

Ukraine war outturn YTD: Post-counteroffensive stalemate unfavourable to Ukraine



Source: Institute for the Study of War

With little to show after five months of costly offensive operations (see map above), the Ukrainian armed forces are increasingly on the back foot. The Biden administration has responded to this situation by imposing further sanctions on Russia (notably a measure designed to undermine the development of Russia's LNG industry). But the administration appears reluctant to escalate the economic war more seriously by tightening the 'oil price cap' regime to reduce the oil rents that are crucial for Russia's war effort. While such hesitation stems in part from the practical difficulty of enforcement, another factor at work here may be fear of increased pressure on Russia's oil export trade causing a global oil price spike which the Republicans could exploit electorally – as they were able to do in the run-up to last year's midterm elections when they narrowly captured the House of Representatives.

As and when one or another belligerent gains a clear advantage, risks will escalate. Since the stakes for all involved are far too high to cut losses and settle for a compromise, the side which is suffering military reverses can be expected to double down. While the front could yet remain static during the winter months, the side in question is now more likely to be Ukraine with the external support on which it depends snagged by US domestic political turmoil. **Whatever form that new roll of the dice took, it would likely reflect the Ukrainian interest in drawing the US military more directly into the conflict** – and in any case, would cause a spike in risk perceptions compared to the more steady state associated with the stalemate fighting seen this year. The US election ferment (perhaps in conjunction with parallel European political blockages to support for Ukraine) would thus be one of the causes of any such risk spike which, in turn, would likely inflame the political atmosphere in the US in a self-reinforcing loop.

Impact #3: Mexico – nearshoring impairment

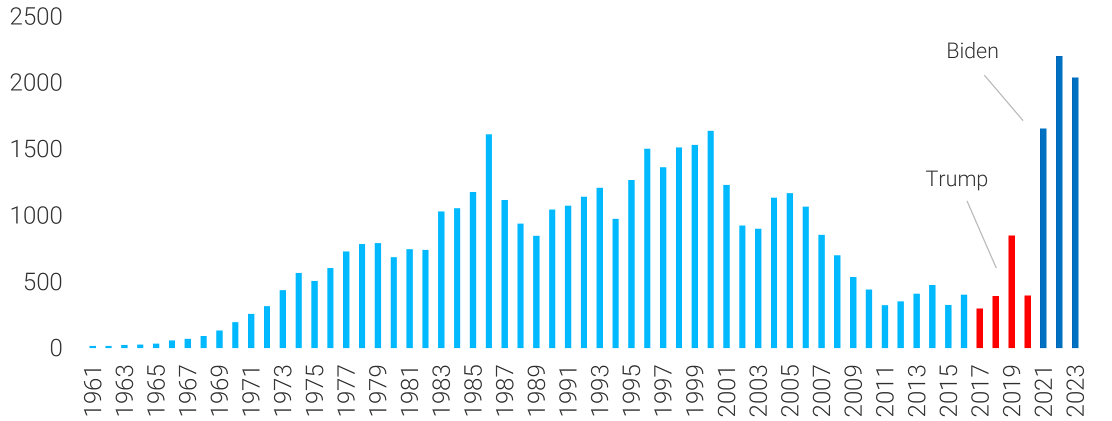
Mexico is uniquely well-positioned to benefit from nearshoring – the counterpart of the important global investment theme of US businesses decoupling supply chains from China. In the normal course of events, next June's general election in Mexico would be the main market driver, given that the country has hitherto failed to capitalize on its immense potential in this area following years of market-unfriendly policies from President Andrés Manuel López Obrador (AMLO). Moreover, with the country's fiscal deficits swelling, the next President may be forced to take a more constructive approach to facilitating FDI related to 'China decoupling' even if the winner is presidential frontrunner (and AMLO's handpicked successor) former Mexico City Mayor Claudia Sheinbaum.

However, the parallel election-related ferment in the US throws a spanner into these works for two reasons. Front of mind here (particularly in the auto sector as a longstanding focus of Trump's NAFTA ire) is that the mere possibility of a future baseline 10% tariff on Mexican imports under T2 will inject an additional dose of uncertainty into FDI decisions. This uncertainty will come on top of the looming USMCA joint review process and sunset clause in 2026 (inserted by Trump to maintain leverage in future negotiations) and alongside existing Mexican bottlenecks (e.g., water/energy deficits, skilled labour shortfalls, elevated crime levels).To be sure, Tesla's planned US$5bn Mexican gigafactory – which could see delays owing to an uncertain EV demand outlook – may well prove resistant to T2 threats given Elon Musk's GOP allies and the US military's outsized dependency on Musk's SpaceX. However, other automakers and Tesla's many Chinese suppliers planning to open up shop in Mexico may not be as lucky (apart from the separate but related issue of the US Treasury's imminent guidance on EV subsidy qualifications for "foreign entities of concern").

To this must be added an unrelenting migrant surge at the US' southern border (see chart below) that has stoked increasingly violent language from multiple GOP presidential hopefuls on border control. This includes Florida Governor DeSantis' vow to shoot suspected fentanyl-smuggling migrants "stone cold dead" (with former UN Ambassador Nikki Haley's endorsement of sending US special forces to Mexico to "eliminate" drug cartels likely a nod to GOP primary realities). In addition to moving the Overton window from fringe to mainstream on these potent populist issues, the potential effect of this rhetoric about a resort to force in relation to Mexico is to cast doubt on the country's ability to play the starring nearshoring role at all.

Double jeopardy: Migrant 'encounters' have hit a historical high under Biden

US-Mexico Border Patrol – no. of migrant encounters (thousands))



Sources: CBP, Wola.

Moreover, as the GOP drumbeat for solving this complex problem by 'simply' infringing on its neighbour's sovereignty grows (a striking example being this case set out by Trump's former Attorney-General Bill Barr, for fighting "narco-terrorist" Mexican cartels like ISIS), **a corollary risk is that this will trigger a negative feedback loop** by stoking an equivalent nationalist fervour south of the border leveraged by AMLO to aid his ruling Morena party in both the presidential and legislative elections over the business-friendly opposition.

A glaring disconnect here is that in America's hyper-polarized politics, border issues have long been a wedge issue despite (rare) bipartisan consensus around the necessity of decoupling supply chains from China. In the current context of an uncontrolled migrant spillover in both red and blue states, this is an issue that strong favours the Republicans in the coming election cycle. The striking finding of a Siena College poll out this week that no less than three-quarters of New York Democrats are now calling the recent influx of migrants "a somewhat serious" problem is the latest case in point.

If the hope as these pressures grow is for an elusive consensus on a Ukraine-for-border security deal (or, harder yet, immigration reform), the irony for a hawkish Washington united around the need to decouple from China is that so long as these same dynamics add to investor jitters about nearshoring to Mexico, the more costly and inflationary it will be to diversify supply chains. Given that Mexico is not easily substitutable, the knock-on effect of the T2 'degrading' of such prime nearshoring real estate will be to inhibit faster decoupling altogether – a boon to Beijing both as it tries to get its economy on track and as it accelerates the hardening of its own system with less inhibition (than might otherwise have been the case) related to the parallel economic costs to China of decoupling.

Appendix

Trump 2.0 plans are taking shape

Key Trump policy architects and allies are laying plans to broadly expand the use of executive power by:	Sector(s) impacted
1. Bringing independent federal agencies under White House authority with an executive order (EO).	Regulation
• This includes the **Justice Dept. (DoJ), SEC, FTC (trade), FCC (communications), FERC (energy) and even potentially the Fed**.	
• Trump's DoJ greenlit this idea in 2019 but it was not implemented in the end as a result of confusion over the fine print.	Multiple sectors
• Trump has also called for using the DoJ to investigate and punish his foes (starting with Biden, former staffers, "every Marxist prosecutor" and "radical-left thugs that live like vermin within…our country". • Trump says his own indictments "released the genie out of the bottle".	
2. Stripping employment protections from up to 50,000 civil servants to "dismantle the deep state" and replace them with political appointees.	Civil service
• This would be a repeat of the Oct 2020 Trump EO ("Schedule F") that was revoked by Biden.	Multiple sectors
• Political appointees in senior government positions currently number around 4,000.	
3. Refusing to spend money appropriated by Congress to fund some agencies, a practice known as "impounding funds" that Nixon deployed.	Budget
• Trump this year called for defunding both the DoJ and FBI "until they come to their senses".	Select sectors
4. Enacting sweeping changes to migration/immigration policies:	Immigration
• Suspending the US' current refugee/asylum programmes.	
• Reinstating Title 42 to bar migrants for applying for asylum claims on the grounds of a public health emergency from common illnesses (e.g., flu, R.S.V., tuberculosis) in a post-pandemic era.	
• Fast-tracking the mass deportation of millions of undocumented migrants (vs the average of hundreds of thousands in past administrations including Trump and Obama) via the expansive use of expedited removals, mass sweeps of workplaces/public spaces and sprawling detention camps near the border.	Economy-wide impact
• Invoking the Alien Enemies Act of 1798 to expel suspected criminals or drug cartel members without due process.	
• Invoking the Insurrection Act to allow federal troops to apprehend migrants.	
• Plan to end birthright citizenship for infants born in the US to undocumented migrants on the grounds that the 14th Amendment has been historically misinterpreted.	
5. Trade war redux	Trade
• Slapping a tariff of 10% on baseline imports from friends and foes alike • Revoking China's Most Favoured Nation Status • Phasing out all Chinese imports of essential goods in four years	Economy-wide impact

Sources: Local press reports, www.donaldjtrump.com, Project 2025

Authors

Christopher Granville
Managing Director,
EMEA and Global
Political Research

Grace Fan
Managing Director,
Global Policy and
Disruptive Themes
Research

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