KANAWHA
CAPITAL MANAGEMENT

7201 Glen Forest Drive, Suite 200 / P.O. Box 18490 / Richmond, Virginia 23226 / (804) 359-3900

RAGE AGAINST THE MACHINE

October, 2016

In the wake of Hurricane Matthew and the battering of the southeast coast, our thoughts turn back to another storm that has been raging for a while. This one is political and will come to a head on November 8th. At times both entertaining and depressing, the U.S. presidential election campaign has been most notable for the rise of anti-establishment candidates in both major parties as large portions of the electorate clamor for "change." In fact, this election is not only about change. It also appears to be about anger.

Indeed, this election cycle has seen a striking rise of populism — the view that ordinary people have been ill-served, even betrayed by the elites. The "system" is rigged and needs to be fixed. This is not a new impulse, it has been simmering for decades. The current iteration is unique because the rhetoric has emanated from *both* ends of the political spectrum. And it was channeled into fervent support for both Bernie Sanders and Donald Trump.

Disaffected voters

The slow and uneven recovery from the Great Recession seems to have marked a tipping point for voter angst. Large swaths of the population feel that they have not fully participated in the rebound. Seven years after the official end of the recession, real median household incomes have not quite returned to prior levels. Moreover, the financial crisis exacerbated the impact of longstanding structural forces of global competition and technological innovation that have been dampening the prospects of less-credentialed and lower-skilled workers.

While Sanders and Trump constituencies are both disenchanted with the established order and the plight of the common man, they have very different political priorities. The two groups have identified some of the same symptoms but have come up with different diagnoses. In a June PRRI/Brookings Institution survey, Sanders' supporters listed *income inequality* and *education costs* as issues critically important to their vote. Those issues barely registered with Trump's supporters who mentioned *immigration* as a top concern.

As that poll indicated, the two blocs clearly do not agree on the impediments to economic prosperity. Sanders' signature proposal — free college tuition — as well as his plan to significantly tax the wealthy, reflect one approach: boost access to education and redistribute income. Trump's promise to build a wall and bring back jobs to America points to alternative solutions: keep out immigrants and improve existing trade agreements.

Battle of the unfavorables

But Bernie Sanders failed to capture the Democratic Party's nomination. So the final race has the outsider Trump pitted against an insider, Hillary Clinton. Many voters now confront a *Hobson's choice*. While both nominees have solid bases, a significant portion of each candidate's support is not an affirmative vote for them but a vote *against* their opponent. Roughly half of each candidate's "support" may be classified in this way. Harvard's satirical newspaper, *The Onion*, announced that 30% of Americans were still undecided whether to vote out of fear or spite.

Along with the presidency, all 435 seats in the House are in play as are 34 in the Senate. A recent tabulation of opinion polls by Real Clear Politics indicated that two-thirds of Americans believe that the country is on the wrong track. And according to Gallup, three-fourths of voters disapprove of the way Congress is handling its job. But will such dissatisfaction translate into real change?

Rock-bottom approval ratings for Congress are the rule not the exception, yet incumbents rarely lose. On average, over the last fifty years, congressmen have been re-elected at a 90%+ rate and senators at an 80%+ clip. How can this banana-republic like success be reconciled with opinion polls? Voters seem to be concluding that the problem is not with their own representatives but with the other bums.

Which way will Congress lean?

Naturally, Wall Street soothsayers and the financial press have been attempting to game the outcome and extrapolate the effect of the election on the stock market. Good luck. Our sense is that the ultimate impact will be more subdued than the hype might suggest. In other words, not a whole lot of change to political discourse or governance.

And substantive policy initiatives will depend on the relative makeup of the executive and legislative branches. Republicans currently control both houses of Congress. But in the Senate, there are 24 Republican and 10 Democratic seats up for re-election. The majority of these Republican incumbents came into office in 2011 during the tea-party movement. Democrats need to pick up only five seats to reclaim the majority.

The Republican Party's hold on the House of Representative seems more secure with 246 seats to the Democrats' 186 (3 seats are vacant). Also, gerrymandering by state legislatures over the years has left many House seats relatively safe. That is, a district is dominated by one party and will not typically turn over. In order to achieve control of the House, Democrats would need to gain 32 seats in 2016.

Checks and balances

Given his many unconventional positions, Trump would be the greater change agent. But less than thirty days out from the election, most national polls show him falling further behind Clinton. The Electoral College will actually select the next president and electors are determined by winners of the popular vote at the *state* level. Most electoral maps show Clinton with a commanding lead in the quest for the 270 required votes.

If the Trump-Pence ticket were to prevail, it would be hard to envision the Republicans losing control of the House and Senate. Therefore, this would be a scenario with the potential for significant policy shifts — and given that unpredictability, some anxiety by stock market participants. However, many of Trump's policy proposals would likely be watered down by a Congress presumably still controlled by the "establishment."

But absent some game-changer from *WikiLeaks* over the next few weeks, odds favor a Clinton-Kaine victory. In that case, from the stock market's perspective, the salient question involves the makeup of Congress. As with a Trump victory, a sweep in the other direction would also introduce the potential for big policy changes. But at this point, Democrats still face an uphill battle to wrest control of the House.

Capital markets may seem to prefer gridlock but a fractious and dysfunctional government obviously prevents vital issues from being addressed. Take the absurd battle to provide funding to combat the Zika virus, the poster child for Washington dysfunction in 2016. Who could oppose the merits of urgently channeling resources to meet this public-health threat? With input from the NIH and CDC, the administration requested emergency funding in February. It took Congress almost eight months to pass legislation, with members even leaving town for summer vacation after initial attempts stalled.

Get business going again

Whoever the players are, the 45th President and 115th Congress must wrestle with some critical challenges. Clearly, many voters have signaled their unease with the trajectory of the economy. It has not returned to form despite unprecedented monetary policy moves by the Federal Reserve over the past nine years. Most of the output gap has stemmed from a lack of business spending. Despite high profit margins, near-record cash flows, and very low borrowing costs, as a group, U.S. businesses have remained relatively cautious. They have not reinvested and hired as in prior expansions.

To move the needle, *fiscal* policy initiatives have to be considered. This will require a new mindset for those who reject incremental spending outright. And policymakers will obviously need to be smart about which policies to pursue and how to structure them.

Both candidates have proposed stepping up investment in infrastructure. The nation's highways, airports, rails, ports, and power plants have been neglected for years. The American Society of Civil Engineers gave the country's infrastructure a D+ grade in 2013. They project a $1.6 trillion funding gap through 2020 to get things in "good repair." Meanwhile, McKinsey estimates that U.S. infrastructure spending should run at over 3% of GDP, well above the 2.4% rate seen over the 2008-13 period.

Unlike many potential fiscal initiatives whose impact would be more marginal and fleeting, infrastructure investment can provide society with a high and ongoing return on investment, largely through enhanced productivity. Further, if $1.00 can be turned into say, $1.25, the impact of adding to government debt may not be so onerous — particularly today, with the cost of long-term borrowing being so low. And as McKinsey pointed out in its recent report, *Bridging Global Infrastructure Gaps*, funding does not necessarily have to come exclusively from public coffers. Institutional investors have $120 trillion of capital to invest worldwide. Some of that could be attracted to public-private partnerships.

Up the mobility

In a post-industrial and knowledge-based economy, the skill sets required for upward mobility have changed. Increasingly, there has been a mismatch between the needs of employers and the capabilities of the labor pool. This fundamental chasm will not resolve itself. A National Federation of Independent Business survey of small firms underscores this problem. In September, 17% of business owners cited the difficulty of finding qualified workers as their single most important problem. Of those businesses seeking to fill positions, half reported few or no qualified applicants. Twenty-four percent of business owners reported job openings that remained unfilled.

This predicament no doubt explains some voter discontent and support for "alternative" candidates. It may also be contributing to the underwhelming business expansion this cycle. In any event, here too is an area where the country could boost productivity and get some "bang for the buck" by channeling resources towards (re)training and education. But any initiatives need to be carefully crafted and sustained. They could also benefit from public-private partnerships.

It's all on us

Our political class has not managed the nation's affairs particularly well over the last few decades and there is plenty of blame to share. After all, we voters put these folks in office and remain polarized ourselves, while refusing to demand reform. Reasonable discourse has also been hampered by media that have become more partisan and sensational. So discontent has become a familiar feature of American political culture.

The United States has proven resilient, if nothing else, and the nation certainly has the capacity to overcome the challenges it faces — with some thoughtful political engagement. In the meantime, regardless of the election's outcome, the drivers of overall stock market performance will continue to be fundamental factors such as the economic cycle, corporate profits, interest rates, and valuations. On that score, the backdrop looks okay.

— Christopher J. Singleton, CFA, Managing Director

October 19, 2016