Trump's "very close to complete victory"

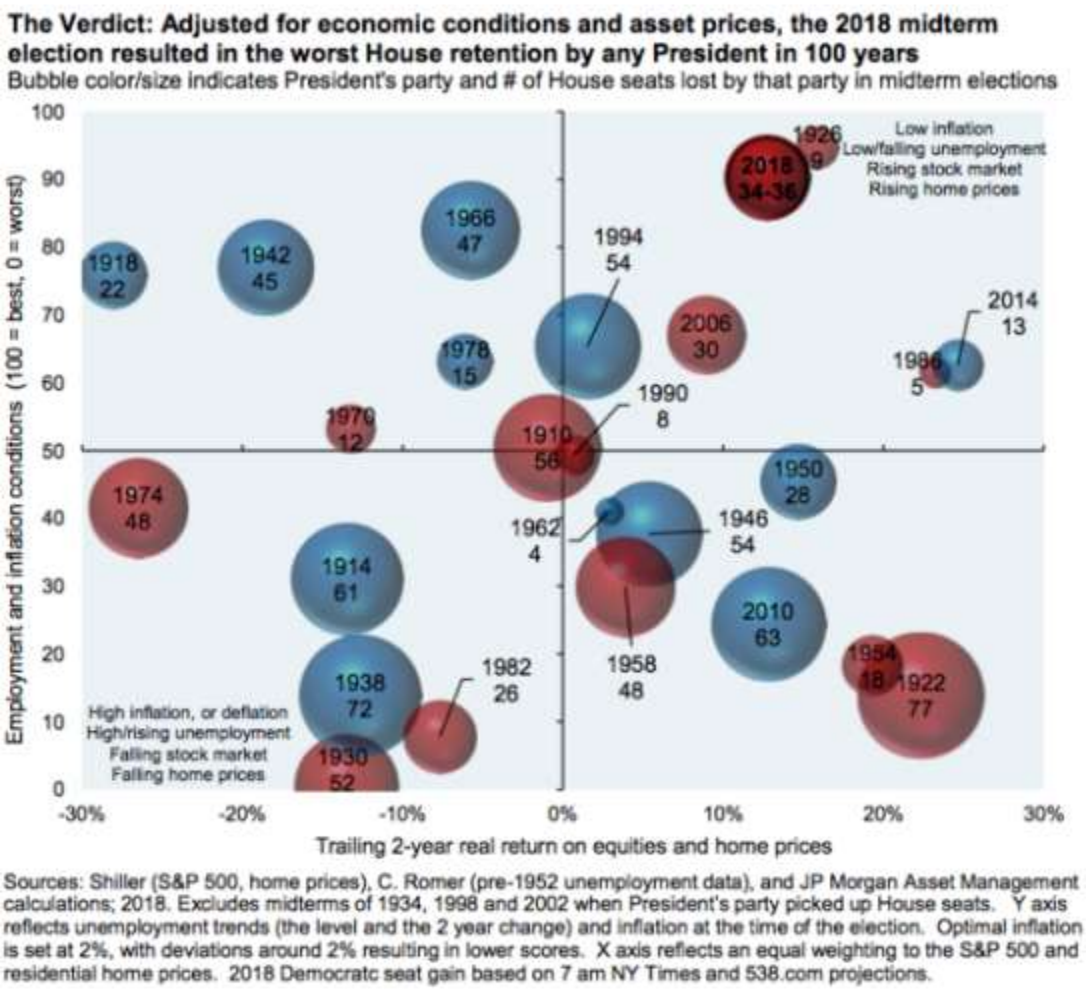
The above quote came from Trump's post-election press conference in which he blamed losing the House on Republican's that didn't sufficiently "embrace" him, whom he proceeded to mock as he named them, and the record number of House Republicans who had seen the handwriting on the wall and decided to retire. When asked if he could work with Democrats even if they begin investigating him, Trump fired back: “No if they do that, then it’s just – all it is, is a warlike posture.” Later that day he unleashed a firestorm by replacing Attorney General Sessions with a political "hack" ("A Trump Hack Hacks Justice" Bret Stephens NYT Nov. 9, 2018).

What follows is the best analysis from an investment perspective that we have seen. As usual, our parenthetical comments are in red. From Thursday's The Finance 202:

President Trump argued in his post-election news conference that the Republican Party’s performance in the midterms defied history. An analysis by a JPMorgan economist suggests Trump is right — just not in the way he intends.

Measured against the strength of the economy, the GOP’s losses in the House mark the worst midterm results for a president's own party in at least a century, per Michael Cembalest, JPMorgan Asset Management’s chairman of market and investment strategy.

Cembalest put together this chart to illustrate the point:



The size of the bubbles correspond to the number of seats each president's party lost in the midterms. The y-axis plots employment and inflation, and the x-axis plots the stock market and home prices. So the bubbles floating in the upper right-hand quadrant represent losses that came despite rosy economic conditions, when inflation and joblessness were low and stock and home values were rising.

Note that the bubble for 2018 is larger — and further up and to the right — than any in its immediate vicinity. That means the economy was in prime position for Trump's party to succeed in the polls. "You can't ask for more than that as an incumbent," Cembalest says. And yet no incumbent party enjoying similar sunniness has managed to rack up as many losses as Trump's GOP did Tuesday. (Economies for the nearest comparisons, the contests in 1994 and 2006, weren't nearly as strong).

The result points to the GOP's failure to turn the midterm into a referendum on the strength of the economy. Instead, Cembalest says, "this was very much a referendum on the unusual circumstances surrounding the way this administration functions."

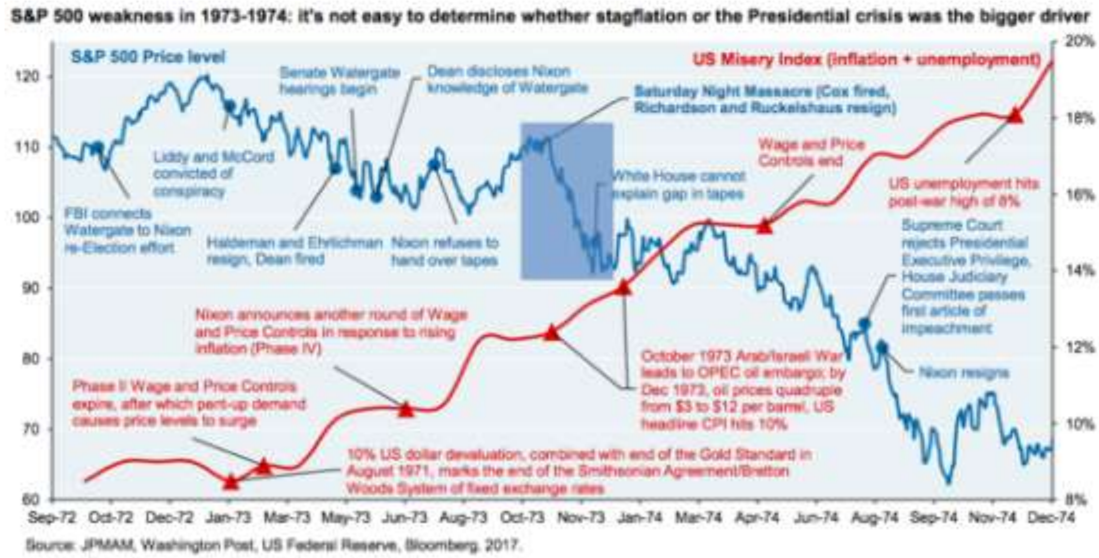
A closer look at the districts that Democrats flipped throws the phenomenon into sharp relief: **The party romped in urban and suburban districts where voters are largely comfortable, if not wealthy.**

Perhaps no surprise then that exit polls show the economy ranked third among issues voters cited as the country's top challenge, behind health care and immigration. Those pointing to health care as their top issue broke for Democrats by a three-to-one margin; voters most concerned about the economy went for Republicans by a two-to-one margin.

Broadly, the election saw the continuation of a trend that's accelerated under Trump's presidency, as white collar voters realign behind Democrats, while blue collar voters increasingly back Republicans. (The relative moderates in both parties fell, increasing the political divide and thereby further reducing the likelihood of any bipartisanship.) "All of these suburban seats were in places where voters are doing best in the buoyant economy, but widespread discomfort with Trump's style and values ignited a huge backlash among college-educated white voters—primarily women, but also an unusually large number of men," The Atlantic's Ron Brownstein writes. "The exit polls put Trump's approval rating among college-educated white voters at only about 40 percent. Burdened by that verdict, Republican House members were swept away in fast-growing, economically dynamic metro areas."

That House Republicans could perform so poorly during boom-times raises a scary proposition for the party: What will happen to their political fortunes if the economy starts heading south? **"Almost everything they've done, with a couple exceptions, has been geared toward to maximizing short-term growth and the stock market at the expense of deficits and how it gets financed," Cembalest says.** "It's almost like they were doubling down on trying to get a growth boom that would protect them in the midterms. **It doesn't appear to have worked."**

There's little evidence the midterm outcome will change the economy's trajectory or that of the stock market. **But Cembalest's report points to a historical example to argue that a showdown over special counsel Robert S. Mueller III's investigation could drag stocks sharply lower.** Deteriorating economic conditions sent the S&P 500 into a bear market during the Watergate era, making it tough to assign blame to the political turbulence alone. Yet the Saturday Night Massacre — an event to which Trump's Wednesday firing of Attorney General Jeff Sessions drew comparisons — was a different story. It coincided with the start of a 15 percent drop by the index that didn't appear to have another catalyst, as this chart demonstrates:



Cembalest estimates an event that investors recognize as the beginning of another constitutional crisis could precipitate a 10 percent market drop. And that in itself could further weaken the president's standing. "Unquestionably, the president is more vulnerable when the economy is not as good," he says.

From Friday's Signal:

WAITING OUT TRUMP

Like many US presidents before him, Donald Trump suffered a significant electoral setback in the midterm elections earlier this week. The Democrats won the popular vote by more than 7 percentage points, and their new majority in the House of Representatives will give them real political power for the first time in two years.

True, the result wasn't as bad as what Barack Obama suffered in 2010 (losing both houses of Congress in one night). But the perception that Trump has been wounded politically ahead of his own re-election bid in 2020 will now start to take hold in many foreign capitals.

As a result, allies and adversaries who've been on the receiving end of Trump's aggressive policies are now actively considering a strategy we might call — "Wait Trump Out." Consider a few examples:

China's President Xi Jinping: The current US-China conflict is about more than just trade and investment. It's the beginnings of a bigger contest for global power. The US is worried about China's growing commercial and technological clout. China, meanwhile, wants to roll back US influence in East and Southeast Asia. Both sides are vying for dominance over new technologies that will determine the economic balance of power in the 21st century.

When Xi and Trump meet on the sidelines of the G20 summit in Argentina later this month, Xi will try to persuade Trump to slow down the trade standoff that's already weighing on China's economy. He'll try to open the door to fresh progress at the negotiating table in the coming months. But will he really put all his cards on the table? Doubtful. He knows that in two years he could be dealing with a different US president and may hold off on making big concessions to a recently-weakened Mr. Trump.

European leaders: In July, European Commission President Jean-Claude Juncker cut a temporary deal with the Trump administration that postponed US tariffs on European automobiles in exchange for promises to work toward the broader elimination of transatlantic tariffs on industrial goods. But this was merely a ceasefire rather than a trade peace treaty. And it envisions concessions from Europe that many EU member states are loath to even consider.

After Tuesday night, EU leaders may calculate that the optimal strategy is simply to extend negotiations with the US for long enough that Trump can't extract any big concessions from them before he has to face the electorate again.

Iran's leaders: Earlier this week, the US re-imposed sanctions on Iran's oil exports. The damage to Iran's economy will be substantial, and Iran's leaders aren't happy about it. But don't look for them to immediately renounce the nuclear deal that the Trump administration decided to abandon in May. Tehran still cares about preserving good relations with Europe and now hopes to win a reprieve with a new US president in 2020.

Kim Jong-un: North Korea's leader has lovingly played the waiting game with Trump longer than anyone. Since the Singapore Summit the script has been simple: Smile. Make promises. Avoid provocation. Take no irreversible action. Improve relations with China and South Korea in hopes of extending "denuclearization" talks long enough to reap economic rewards and then take your chances with a new US president.

Japan's Prime Minister Shinzo Abe: Trump has successfully pressured Abe into opening negotiations on a US-Japan trade deal that Japan doesn't want and that Abe has promised at home never to sign. Abe will try to persuade Trump to delay big tariffs on Japanese cars with the hope that he can allow these negotiations to die a natural death if Trump leaves office in 2020. He may even be able to persuade a successor to Trump to rejoin the Transpacific Pacific Partnership, the massive trade deal that Trump pulled out of in his first week on the job.

We have previously expressed our concern that the Democrats will nominate a left wing populist like Senator Elizabeth Warren. From Friday's The Daily 202:

Some of the left's biggest stars belly-flopped.

Liberal groups spent months hyping progressive candidates in tough races across the country, saying that their victories would prove Democrats can safely nominate an unapologetic liberal for president in 2020. But they lost almost across the board.

The two liberal candidates who won primary upsets over more moderate Democrats favored by the DCCC both lost on Tuesday. Kara Eastman lost by three points to Rep. Don Bacon (R-Neb.) in Omaha and Dana Balter lost by seven points to Rep. John Katko (R-N.Y.) in a Syracuse district that Hillary Clinton had carried.

Katie Porter ran as an acolyte of her mentor and former law professor Elizabeth Warren. That allowed her to win a crowded primary in Orange County, but she lost to Rep. Mimi Walters (R-Calif.) by two points. Another progressive favorite, Randy "Ironstache" Bryce, lost by 12 points in the open race to replace retiring House Speaker Paul Ryan.

Former NAACP president Ben Jealous got crushed in the Maryland governor's race, losing to incumbent Republican Gov. Larry Hogan by 13 points – in a state Clinton won by 26 points two years ago.

Two groups from the Bernie Sanders wing of the party, Our Revolution and Justice Democrats, failed to flip a single House seat. The moderate New Democrat Coalition won in 23 of the 29 races where it picked a horse, per NBC's Alex Seitz-Wald.

Trying to spin a disappointing election for themselves, Dave Weigel notes that liberal groups have taken to claiming credit for candidates they didn't support. As he writes in his newsletter The Trailer, "New York's Antonio Delgado, for example, pushed past some challengers who warned that he was not a true 'progressive,' yet in a pre-Tuesday memo, the Working Families Party included Delgado in a list of eight 'races the DCCC would never have considered viral.' That wasn't true, as Democrats had always intended to contest Delgado's 19th District. What was true? The other seven candidates on the WFP's list lost, and the progressive-backed challenger there in the 2016 election had lost, too."

This narrative could shift if Andrew Gillum in Florida or Stacey Abrams in Georgia somehow prevails in a recount or a runoff, but both trail their opponents at this point.

From BCA Research's Geopolitical Strategy on Wednesday:

A Preliminary Look At The Midterms

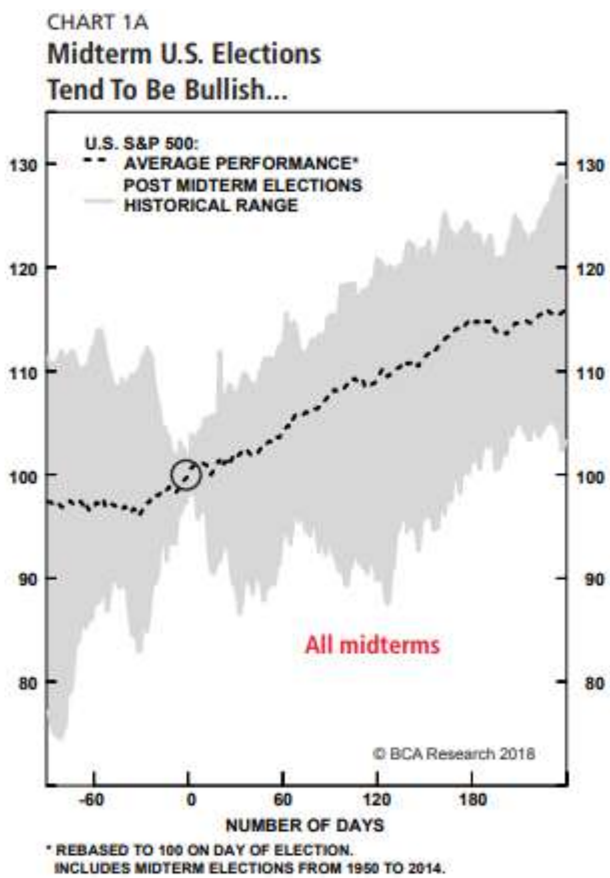
First, the preliminary takeaways from the midterms, as the results come in:

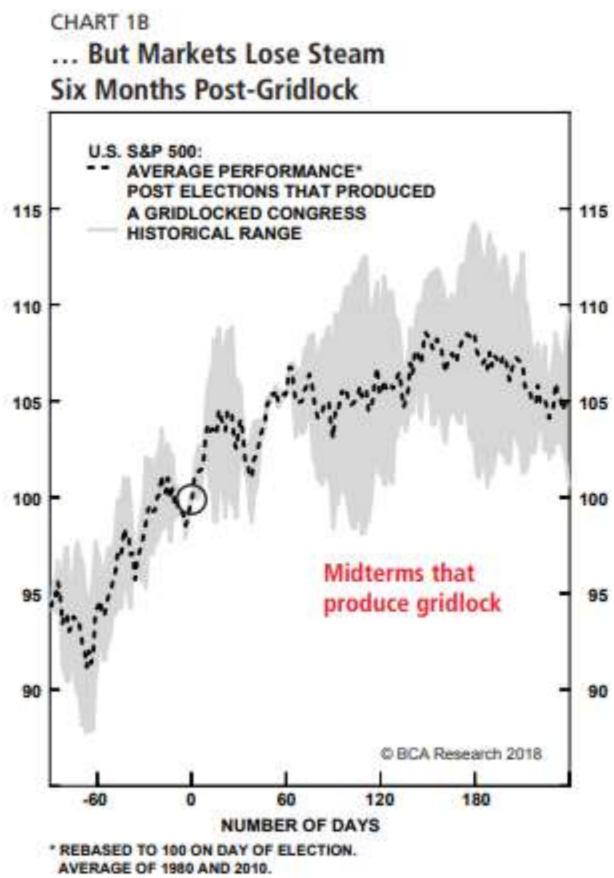
- The Democrats took the House of Representatives, with a preliminary net gain of 27 (now 32 and counting) seats, resulting in a 51%-plus majority, and this is projected to rise to 34 seats as we go to press Wednesday morning. This is above the average for midterm election gains by the opposition party, especially given that Republicans have held the advantage in electoral districting. Performance in the Midwest, other swing states, and suburban areas poses a threat to Trump and Republicans in 2020.
- Republicans held the Senate, with a net gain of at least two seats, for a 51%-plus majority. Democrats were defending 10 seats in states that Trump won in 2016. While Democrats did well in the Midwest, these candidates had the advantage of incumbency.
- On the state level, the Democrats gained a net seven governorships, two of them in key Midwestern states. The gubernatorial races were partly cyclical, as the Republicans had hit a historic high-water mark in governors' seats and were bound to fall back a bit. However, the Democratic victory in Michigan and Wisconsin, key Midwestern Trump states, is a very positive sign for the Democrats, since they were not incumbents in either state and had to unseat incumbent Governor Scott Walker in Wisconsin. (Their victory in Maine could also help them in the electoral college in 2020.) The governors' races also suggest that moderate Democrats are more appealing to voters than activist Democrats. Candidate Andrew Gillum's loss (which now appears to be headed to a recount) in Florida is a disappointment for the progressive wing of the Democratic Party.

With the House alone, Democrats will not be able to push major legislation through. In the current partisan environment it will be nigh-impossible to reach the 60 votes needed to end debate in the Senate ("cloture"), and even then House Democrats will face a presidential veto. They will not be able to repeal Trump's tax cuts, re-regulate the economy, abandon the trade wars, resurrect Obamacare, or revive the 2015 Iranian nuclear deal. Like the Republicans after 2010, they will be trapped in the position of controlling only one half of one of the three constitutional branches.

The most they can do is hold hearings and bring forth witnesses in an attempt to tarnish Trump's 2020 reelection chances. They may eventually bring impeachment articles against him, but without two-thirds of the Senate they cannot remove him from office (unless the GOP grassroots abandons him, giving senators permission to do so).

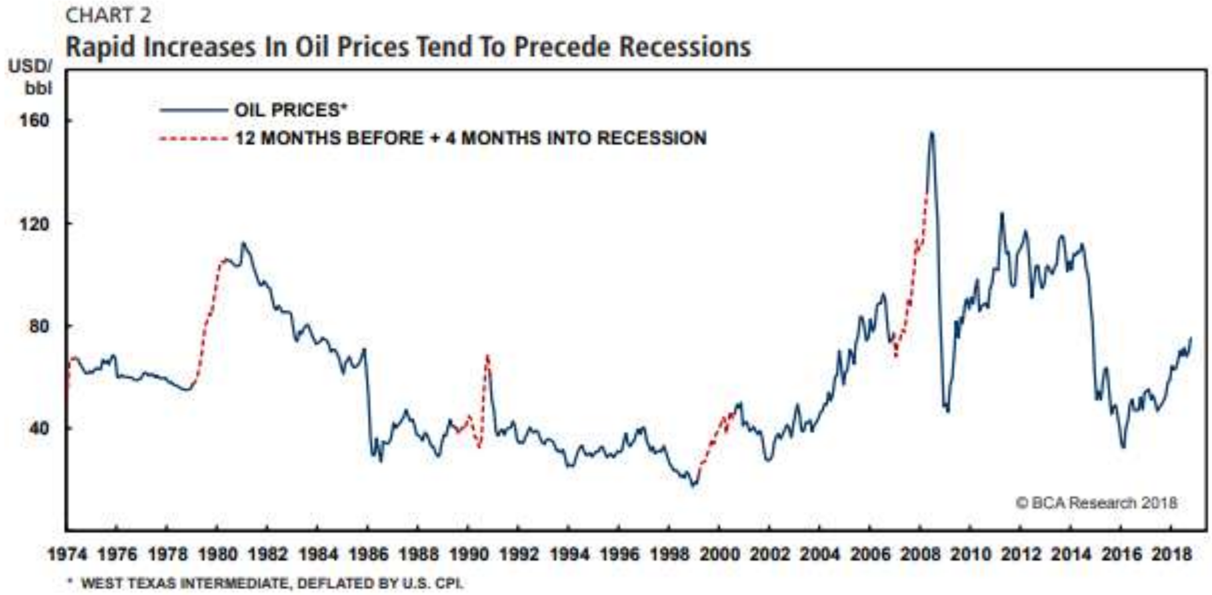
U.S. equities generally move upward after midterm elections – including midterms that produce gridlock (**Chart 1A & B**). ... More worryingly, as **Chart 1B** shows, the post-election rally tends to peter out only six months after a gridlock midterm, unlike midterms that reinforce the ruling party.





However, the 2018 midterms could be mildly positive for the markets, as they do not portend any major new policies or uncertainty. Trump's proposed additional tax cuts would have threatened higher inflation and more Fed rate hikes, whereas House Democrats will not be able to raise taxes or cut spending alone. Bipartisan entitlement reform seems unlikely in 2018-20 given the acrimony of the two parties and structural factors such as inequality and populism. An outstanding question is health care, which Republicans left unresolved after failing to repeal Obamacare, and which exit polls show was a driving factor behind Democratic victories.

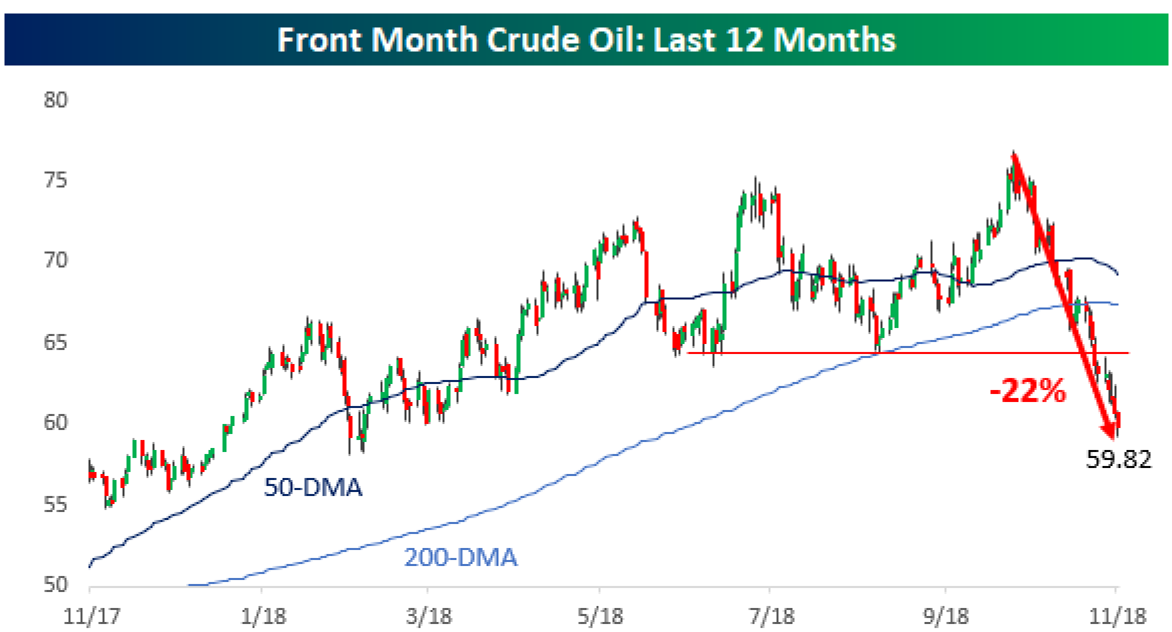
Separately, as an additional marginal positive for risk assets, the Trump administration has reportedly granted eight waivers to countries that import Iranian oil. We have signaled that Trump's "maximum pressure" doctrine poses a key risk for markets due to the danger of an Iran-induced oil price shock. A shift toward more lax enforcement reduces the tail-risk of a recession in 2019 (**Chart 2**). (As shown in Friday's Bespoke chart below, WTI is in a bear market, having been down 10 consecutive days, the longest streak going back to 1983.) Of course, the waivers will expire in 180 days and may be a mere ploy to ensure smooth markets ahead of the midterm election, so the jury is still out on this issue.



Bottom Line: The midterm elections have produced a gridlocked Congress. Trump can continue with his foreign policy, most of his trade policy, his deregulatory decrees, and his appointment of court judges with limited interference from House Democrats.

The only thing the Democrats can prevent him from doing is cutting taxes further. He tends to agree with Democrats on the need for more spending!

While the U.S. market could rally on the back of this result, we do not see U.S. politics being a critical catalyst for markets going forward. On balance, a gridlocked result brings less uncertainty than would otherwise be the case, which is positive for markets in the short term.



We occasionally share James Mackintosh's WSJ column, which is titled STREETWISE. From Friday's online version:

Right on the Election, Dead Wrong on the Market Reaction

I had a well-worked-out forecast for what would happen to stocks after the midterm elections. It was smart, logical, and 100% wrong. ...

My flawed prediction was that U.S. stocks would fall in the event of the widely expected Democrat win of the House and Republican retention of the Senate. (The consensus view is usually priced into the markets.)

... Alan Ruskin, macro strategist at Deutsche Bank, points out that much of the analysis being circulated by Wall Street and reported by the media showed that previous midterm elections were typically followed by a stock rally to the end of the year. This past record might have given investors—shaken by the October selloff—confidence to pile back into the market after the election.

Equally, investors might have just been nervous about the election outcome and holding on to cash to avoid the uncertainty. With the result out, they were ready to get back into stocks, pushing up prices. Either way, U.S. stocks had a fabulous day on Wednesday.

The fact that European stock futures did basically nothing after the election until the equity market opened, when stocks soared—and that this coincided exactly with U.S. stock futures taking off—supports the idea that nervous investors had held off buying until after the election. Only when the futures-market speculators saw real money going to work in stocks did they join in.

... the obvious lesson is not to have too much confidence in one’s predictions of how the market will respond.

Even if you’re sure what will happen in some event, stocks might do something quite different. Moves in other assets can have big knock-on effects to the stock market. And anticipating how other investors will react—investors who are trying to predict each other’s reactions too—is typically more important in the short run than the true fundamental effects of whatever actually happens.

The basic advice is longstanding: Regard any short-term trade as no more than a punt, and expect to lose your stake.

Finally, some thoughts from the often shared resident guru at Morningstar:

Sometimes, Investment Ignorance Is Bliss

John Rekenthaler 09 Nov 2018

The Presidential Premise
Recently, I overheard somebody crediting the economy's strength to the president. Under Donald Trump, the argument ran, businesses have recaptured their "animal spirits" and are acting with renewed confidence, which has stimulated job creation, thereby sparking the stock market. In addition, companies are benefiting from January's tax cut.

Such claims are difficult to corroborate. Nobody measures the animal spirits of corporate executives, nor can the effect of a single factor on the economy be readily judged. Even if U.S. job growth had accelerated since January, it would be speculative to credit that change to the tax bill. It is more speculative yet when such an event has not occurred.

One possible test of the Presidential Premise, as we shall call it, was this Wednesday's stock market performance. If the business community has been heartened by presidential actions, then it presumably would been discouraged by Tuesday's election results, which thoroughly spiked the idea of further tax cuts. That did not happen; stocks rallied sharply.

Competing Theories

Not that the opposition should declare victory. It would be no more believable to claim that the stock market saluted the Democratic victory in the House of Representatives than it would be to claim that equities rose because buyers were pleased that the Republicans retained the Senate. Neither claim makes much sense. If anything, the results suggest that investors desire federal gridlock.

(An alternative explanation is that stocks surged because the market *does* desire gridlock. With a divided government, goes the theory, the two sides will forge a compromise that is better than what either could achieve on its own. This narrative is unconvincing. Without question, the House will launch a series of investigations of the executive branch. When that happens, the president stated, he will adopt a "warlike posture." Few compromises would seem to be forthcoming.)

The final justification offered for Wednesday's rise, which most reporters offered, was that the election's results removed the election's "uncertainty." That account, too, strikes me as less than credible. There was no doubt that an election would occur; and there was no doubt that its results would land within a narrow range, with the two parties roughly splitting the Senate and House. What uncertainty existed to dispel?

Just Say No

Which leads to this column's point: Avoid analyzing stock-market movements. Equities cannot be interviewed. They cannot explain why they behaved as they did. Nor are scientific explanations possible. What remains are stories that can easily be deconstructed. They tell much about the speaker, but little about reality.

This sounds simple. Shrug off stock market fluctuations, because their signals are illusory. One might as well try to interpret the pattern of several dozen coin flips. If the first eight flips of a sequence are heads, heads, heads, tails, heads, heads, heads, and tails, that doesn't mean that a seventh heads will be coming. Or that another tails is overdue. The pattern does not exist.

(The analogy is imperfect because, unlike coins, people act with purpose. There are reasons why the stock market rises or falls. However, if those reasons either cannot be divined, or can be understood but contain no additional information--for example, stocks decline when the monthly inflation report is higher than expected--then the comparison holds, despite that difference. Whatever insight the market's movement seems to contain, it does not.)

Breaking the Habit

In my experience, however, the lesson does not come easily. I spent many years diligently following the Dow Jones Industrial Average's daily change, then attempting to determine what lay behind that day's behavior. Perhaps the markets had sent a signal? Maybe that long-awaited rally had finally begun. Or, conversely, the latest loss of a two-week downturn suggested the arrival of the next bear market.

Breaking that habit required acknowledging my errors. It meant realizing that for each time when the market acted as I expected, based on my reading of the recent tea leaves, there was another time when it did not. I possessed no insight. Nor did others. Our apparent forecasting successes were random events, the coin turning up heads, with those of us who had anticipated such a result savoring our sagacity.

More to Learn

I was reminded of this by another recent conversation, with an investor who told me that she checks her portfolio three times each trading day. She was surprised to hear that I had not done so for more than a week. (We were each on vacation.) As it turned out, it was an eventful period: The Dow had dropped 1,000 points. But what would I have gained from knowing that? And what can she learn from her thrice-daily inquiries?

Nothing, I should think. Perhaps worse than nothing. There's always the chance that closely monitoring stock market changes, and attempting to think through their implications, could lead to portfolio trades. Such actions would have an expected value of zero before taxes and trading costs, and a negative value afterward. Worse yet, the anxieties caused by such trades might eventually lead the investor to reduce her equity stake.

Of course, I am not immune to such impulses. Should equities plunge, as on Black Monday 1987, I would snap to attention. Whether I would act on that information is unclear--aside from some tax-loss sales, I made no trades during the 2008 financial crisis--but I would certainly investigate the problem. It would seem irresponsible to pretend as if the decline had not occurred, without attempting to understand its causes.

Such assiduity is likely a fault rather than a boon. The ideal stockholder, I suspect, doesn't even sweat the catastrophes. He understands that attempting to decipher clues from huge stock market movements is no sounder than doing so from small ones. Therefore, he resists all such analysis. He just plods ahead, holding the same portfolio, as if the disaster had not occurred.

Well, nobody's perfect.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.