



The bull market in US politics; implications for global macro investors

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For most of the past 25 years, the West generally, and the United States particularly, experienced a surprisingly apolitical interlude. The great perturbations of armed conflict, trade disputes, sweeping social reforms, petrodiplomacy, and their ilk were largely absent. For investors, this meant politics became a much less important variable in the economic calculus of interest rates, innovation, global integration, and so forth. But the apolitical climate of the recent past, at least in the US, is giving way to a much more politicized future, with profound implications for a wide range of asset classes.

One way to help understand the shift is to conceive of bull and bear markets in politics. In bear markets, like that which recently prevailed in the West, ordinary life is mostly unaffected by politics; the lives of the economy and citizens progress without substantial overt interference by government. By contrast, in a political bull market, government influence—over trade policy, social programs, decisions of war and peace—becomes much more important. The US now finds itself shifting from a bear market in politics to a bull market.

While it is always difficult to generalize about economic history, a few broad characterizations about bull and bear markets can be fairly drawn. Periods of heightened political ferment, while undoubtedly more interesting, tend to be less economically salubrious than more serene times. Bull markets in politics are associated with major wars, expansion of government, and the politicization of large

parts of the economy, with post-tsarist Russia serving as an important example (this does not imply that all bull markets are cut from that same dismal cloth: Medici Italy, Louis XIV's France, and Gladstone-Disraeli Britain are examples of political bull markets that produced benefits for the populace and investing classes.) In contrast, bear markets in politics produce more congenial results. Konrad Adenauer's Germany is an outstanding recent example, in which the de-emphasis of politics led to the *Wirtschaftswunder* that helped transform an almost totally dysfunctional post-war economy into one of the world's strongest. And, whatever one's views on civil liberties, China after the counter-Maoist reforms of Deng Xiaoping has been an extraordinary example of the benefits that can accrue in a political bear market.¹

American history, too, is characterized by political bull and bear markets. A review of just the past sixty years shows three major cycles: the Eisenhower bear market; the bull market of the '60s and '70s (the Great Society, Apollo program, the Vietnam War, etc.); and the twenty-five year bear market reaction that began with Reagan and continued until quite recently. While the effects of these political cycles has been more muted, and the record of each more mixed, than the European experience over the same period, the general economic implications have been the same.

The US is embarking upon another bull market in politics. The major impetus is not the conflict in Iraq or a response to terrorism (as commonly believed), but the more prosaic vehicle of global competition: China, India, Japan, and Europe challenge American industry and labor, and the US is finally awakening to the implications.² And so investors must now account not only for a resurgence in the importance of politics, but a political bull market whose genesis and consequences are explicitly economic.

Hammers & Anvils: The global challenge to US trade

The fundamental economic issue driving the political bull market is that the US finds itself wedged uncomfortably between sets of economic hammers and anvils.

The hammers, the emerging economies of China and

India, compete successfully for US markets and against US industries in mass manufactured goods and tradable services. The rough outlines of the challenge are well appreciated—both China and India have extraordinarily cheap labor. But the subtleties, which belie the true scope of the challenge, are frequently overlooked. For example, competitors understand that Chinese labor is cheap, but perhaps not quite how cheap: even a 100% revaluation of the renminbi will only raise Chinese hourly wages to no more than 20% of those in the US, showing that China's labor is so tremendously inexpensive that the US can never again compete with China in mass manufactured goods. And while many understand that globalization brought competition closer, fewer appreciate that barriers to Chinese competition continue to fall rapidly. For example, the imminent introduction of a new generation of ultra-high capacity cargo ships will greatly reduce the costs of shipping, a key variable cost of Chinese goods.

India, which competes against the US for lower-end services such as call centers and basic accounting functions, enjoys as China does a decisive wage advantage over the US. And not only is India cheap, but it also has educated, English-speaking citizens to staff its tradable services industries. But again, the scope of the challenge is frequently underappreciated. India has a vast Anglophone population, equal to that of the US and UK combined. Its universities churn out twice as many degree-holders as the US, functionally all of whom are willing to work for wages no US college graduate would accept. While India has many structural problems, it offers much of the advantages of US service industries, with the potential to do so at a vastly greater scale and at a fraction of the cost.

China and India have posed a challenge for some time, but their challenge has heretofore not produced a major political response because declining savings rates, rising leverage, and the subsidy of cheap imports have allowed US workers to offset job losses and wage stagnation resulting from developing-nation competition. But those coping mechanisms are reaching their limit even as the challenge from China and India gathers, meaning that US voters will soon demand action.

While the challenge posed by the hammers is understood in at least its broadest terms, the challenge posed by the anvils is as yet almost completely unrecognized in the US, where other developed economies are frequently derided as stagnant and dysfunctional. But while growing no faster than the US, the anvil competitors are defending successfully entrenched industry positions: Japan and Germany

¹ While the state still exercises control over many aspects of Chinese life, the violence of the Cultural Revolution and economic lunacy of Mao's five year plans were eliminated by Deng; China in that sense is firmly in the midst of a bear market in politics.

² Opinion polls in the party primaries that will lead to the 2008 presidential election consistently show that voters are more concerned about the economy than other issues.

in advanced manufacturing (to oversimplify somewhat) and non-Germanic Europe in luxury goods and advanced services. (In the age of peak oil, the anvils also have the added advantage of energy efficiency; investments already made by them in nuclear power, efficient transport, and urban density in an era of cheaper energy are costs the US will have to bear in an environment where energy is much dearer.) These highly capitalized anvil societies with slow-growing populations seem, upon present evidence, able to maintain their comfortable positions if they play their cards right.

Wedged between the hammers and the anvils, and as yet without meaningful response, the US now faces something we can call the Global Challenge. The macro transformations of the Global Challenge will unfold over decades. The US will remain the world's dominant economic polity for some time. But investors will have to confront the political (and thus investable) consequences of the Global Challenge over a much more immediate timescale. If ordinary Americans perceive that their well-being is under threat, they will insist that government respond. The political effects of the Global Challenge will begin as soon as there is a critical mass of public awareness that the challenge exists. It will intensify as the full dimensions of that challenge are realized, long before the dangers play themselves out or are averted. This acceleration is happening now.

To posit a Global Challenge is not to imply that the US economy is hopelessly uncompetitive: for every GM, there are still several Apples, Boeings, and Intels. And the US remains very entrepreneurial. The real question is whether such companies and entrepreneurialism create enough middle-class jobs to forestall far-ranging policy responses.

The political evidence suggests they do not, and that policy changes will come first in two areas that have profound implications for the economy.

The future face of trade & immigration

In recent years, free trade and relatively open immigration have been settled parts of the bipartisan policy consensus – and therefore of little concern to investors, even though the economy is highly sensitive to changes in each. For better or worse, that consensus will soon change: in the next few Congresses, the US will change either its trade or its immigration policy (or both) to an extent that will strike most readers as extreme and unpleasant. For the investor,

what matters is not the moral debate but when and how policy will actually change, which depends on how persuasive the arguments are for change – not to the investor, but to the electorate.

The old consensus on trade and immigration was simple because it broke along class lines. In one camp were the globalist elite, who favored free trade and open immigration. In the other camp stood the less-powerful nationalists, who opposed both. Until June 27, 2007, the old axis appeared to be holding. S. 1348, a bill that proposed to grant legal status to 12 million illegal aliens, appeared to be sailing toward easy victory. Behind S. 1348 stood almost the entire policy elite: Congressional leaders and the White House, the private sector, academia, the great and the good. Less than 24 hours before the vote, fewer than 30 Senators were in opposition. But the next day, because of an unprecedented Internet campaign that had been going for months, 53 Senators scuttled the bill. A bull market in US politics had begun, one which profoundly shifted the political axis.

The new axis of American politics is more complicated than the old: Rightists (anti-immigration, but pro-free trade) vs. Leftists (pro-open immigration, but anti-free trade). The Global Challenge, which grinds away at the working- and middle-class cores of each policy camp, demands a response from each camp. The emerging Leftist answer is to shrink the relative exposure of the American economy to the global economy through trade restrictions. The emerging Rightist answer is to reduce the number of slices into which America's economic pie is cut, by restricting immigration. Both policies would have cascading effects through vast areas of the American economy and society. For investors, the triumph of either or both policies would have profound implications. As the current recession deepens and the electorate grows more desperate for action, the only question is, which will it be?

It is easy to see the path to immigration restriction. The argument is well-developed and straightforward: over the short term (which is the only term that matters in elections), mass immigration drives down wages, strains public resources, and poses national security risks. And immigration restrictions are already popular, even enjoying some support across party lines. The deepening recession will only intensify the visceral appeal of the restrictionist argument. The major impediment to immigration restriction is that the Republicans are in retreat, compromising their ability to drive major legislation.

By contrast, trade restriction is neither simple nor well

developed. The strongest objection to free trade, New Trade Theory, is still immature. But support for New Trade Theory is gaining strength. The movement, which began with Nobel Prize winner Paul Samuelson, finds growing support among prominent academics like Princeton professors William Baumol and Ralph Gomory. And while most academics would shy away from endorsing protectionism based on the as-yet underdeveloped body of New Trade Theory, there is no reason to suppose that politicians desperate for new policies to confront the Global Challenge will exercise such restraint. Moreover, unlike immigration reform, trade restriction is favored by a party that is likely to control both the legislature and the executive in 2009. Having few credible answers to the Global Challenge and constituents hostile to free trade, the Democrats will probably promote restrictions on trade. That the Democrats would obtain control as the economy marked its first full year in recession would only heighten pressure.

So what are the general implications for global macro investors? If immigration is curtailed, US population growth will decelerate rapidly, as more than half of all US short-term population growth derives from immigration. Correspondingly, the rout in housing prices will be much deeper and more prolonged than virtually any analyst now predicts. Home builders will go bankrupt. An immigration-driven housing degrading will bring deflation, both in the form of outright disinflation in owner-occupied rent equivalency and in alternative measures of inflation that capture the true costs of housing. In this scenario, bonds should rally and the dollar may gain strength as demand for goods wanes.

If free trade falls, it seems unlikely that the yuan peg can survive long in its present form. In the immediate aftermath of the peg break, the yuan and yen would soar, with the euro tagging along for the ride. After that, the dollar is likely to strengthen considerably, as tariffs are an alternative to currency devaluation, while, paradoxically, inflation spreads as the dollar price of goods in the US rises.

The prospects for Mexico and Latin America are not good in either scenario. Each region depends heavily on free trade, as well as remittances sent home by immigrants. Hence the almost obsessive focus of Latin American policymakers on prodding the US to keep its borders open to people and goods.

One sector that should successfully weather the Global Challenge and the political bull market it engenders is defense. Bull markets tend to be good for defense spen-

ding, and defense (including aerospace) is the one major sector in which the US enjoys advantages in skilled labor, technology, and trade pathways that are world-beating. Since Reagan's reelection, it has become the investment community's custom to monitor major elections, make minor tweaks to portfolios to account for shifts in the political winds, and then ignore politics until the next campaign. It will be tempting, but unwise, to continue this practice.

After a long recession, politics is about to resume a central role in economic life.

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