Absolute Return Partners

The Absolute Return Letter

November 2020

A Constitutional Crisis in the Making?

Tyv tror hver mand stjæler. (The thief thinks everybody steals.)

Danish Proverb

Why I am about to break an earlier promise

Some years ago I said that I would never write about politics again as, every time I did so, I received the most incredible hate emails from readers – everything from "you don't know what you are talking about" to "I hope you and your company goes belly up as you don't deserve any better". I asked myself – what's the point of writing about things that will upset half my readers every time I do it? I have stuck to that principle ever since, even if it has been difficult at times, but a situation is now unfolding that I simply *cannot* ignore, and it is about the US presidential election on the 3rd November.

Before I go any further, allow me to make one thing very clear. What is about to come is not because I have an axe to grind, but because I care deeply for this country. I spent about 16 years working for US companies, I lived in New York for a while, and I have since been back more than 50 times. I know the country better than most Europeans and, until recently, I loved every bit of it.

Under normal circumstances, as a non-US citizen, I wouldn't care too much who is in power. By heart, I am closer to the Democrats, but I know some fine Republicans who have done a great job for the common good over there. Having said that, it pains me to see how polarised the country has become and, if not addressed soon, it could have fatal consequences. Here in Europe, Trump (deservedly) gets most of the blame for the polarisation, but the Democratic leadership must accept some responsibility too. It takes two to fight, and the rhetoric coming out of the blue corner is not always as constructive as it should be, to put it as mildly as I possibly can.

We need a level-headed leader now who can re-unite an increasingly polarised nation. Four more years with Trump, and I sincerely fear for the survival of the US Constitution, which would be horrific for everybody in the

free world. Why do you think Putin openly supports Trump? And why do you think Xi Jinping's reactions to Trump's various attacks on China have been rather muted? Because both Russia and China have a strong interest in a weaker USA, and they know four more years with Trump at the helm will deliver that.

Election Day

Tuesday the 3rd November, is Election Day in the US. All 435 seats in the House of Representatives, 35 of the 100 seats in the Senate, and the office of President will be contested. As far as the Oval Office is concerned, at this point, it looks like a convincing win for Biden, and the Democrats could also quite possibly earn a majority in both chambers of Congress, but life is not always as simple as it appears at first glance. You may recall that, at the same time in 2016, Hilary Clinton held a similarly convincing lead, and see what happened.

When Americans vote, three options are available to them. The first and most obvious one is to show up at the local polling station on Election Day. In 2016, 60% of all those casting a vote chose this option. The second option is what used to be called absentee voting. If you happened to be away on Election Day, you could vote by mail, but it required pre-approval. About 20% voted by mail in 2016. The third option is to cast your vote in person before Election Day. Another 20% chose this option in 2016 (Exhibit 1). In recent years, many, but not all, states have allowed voting by mail for all so, these days, absentee voting is a mix of people who are actually absent on the day and those who prefer to vote by mail (the green line in Exhibit 1). It is the latter group, the voluntary postal voters, that Trump argues are up to no good.

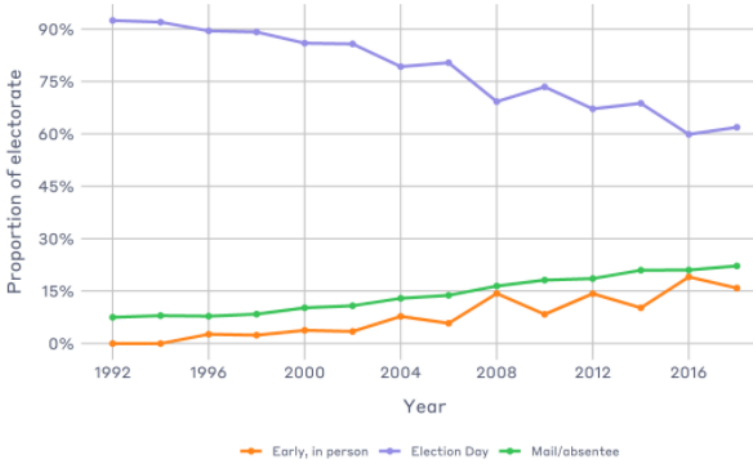

Exhibit 1: Ballots cast by modes of voting over time
Source: *electionlab.MIT.edu*

In 2020, 44 million voters (21%) in nine states will have received the ballot in the post and, at least in one of those states (Oregon), voting by mail is now the only option. In 34 states covering 118 million voters (57%), voting by mail is allowed for all. Only 46 million voters (22%) in seven states still require an excuse to vote by mail (source: New York Times).

The latest picture

As these lines are written ten days before the big day, tensions are rising. As you can see in Exhibit 2 below, Biden's overall lead is still solid (8.7 percentage points), but US presidents are not elected based on the popular vote. Rather, the candidate with the majority of Electoral College votes will take office. Electoral College votes are handed out state by state with one vote for each member of a state's Congressional delegation.

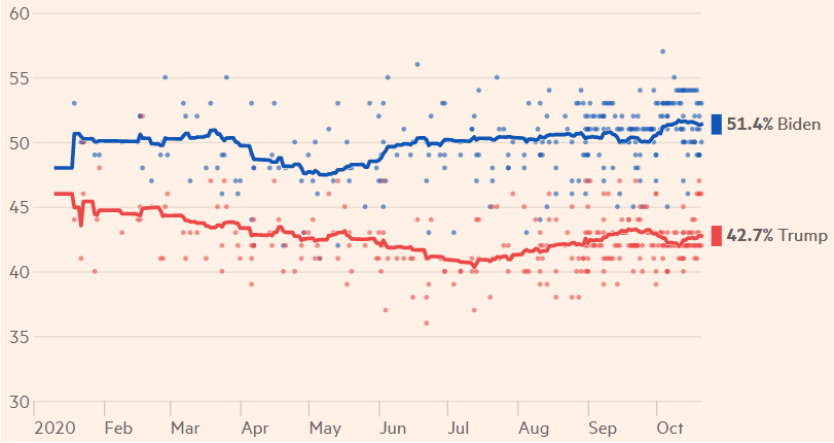

Exhibit 2: Biden vs. Trump in the polls
Source: *Financial Times*

Whoever wins in, say, California, takes all 55 Electoral College votes on offer in that state and, to become president, 270 of those are required. Should no candidate receive a majority of the 538 Electoral College votes on offer, US law states that the House of Representatives chooses the president and the Senate the vice president.

One should therefore not look at the popular vote, represented by the solid lines in Exhibit 2, but at all the local opinion polls, represented by the dots, and that is precisely what the researchers at Financial Times have done in Exhibit 3. Before going there, allow me to spend two minutes on why the candidate who is so clearly in the lead (Biden) may not win after all.

Biden leads by more, and in some cases by much more, than ten percentage points in *very* populous states (California, New York and Illinois being the most obvious), whereas Trump's big leads are all in states with much smaller populations. However, except for Maine and Nebraska, it is winner takes all, and the system favours the less populous states. Example: California with 39.5 million people have 55 Electoral College votes, i.e. 1.4 per one million people. Wyoming with 580,000 people have 3 Electoral College votes, i.e. 5.2 per one million people.

In Exhibit 3 below, state by state, Financial Times distinguish between "solid" leads (>10%), "leaning" leads (5-10%) and "toss-up" states (+/- 5%), as they have chosen to call those states that are hard to call. As you can see, Biden appears to be on relatively solid ground shortly before Election Day and may not need to win a single toss-up state to secure the 270 Electoral College votes he needs to become the next president. However, there is a problem.

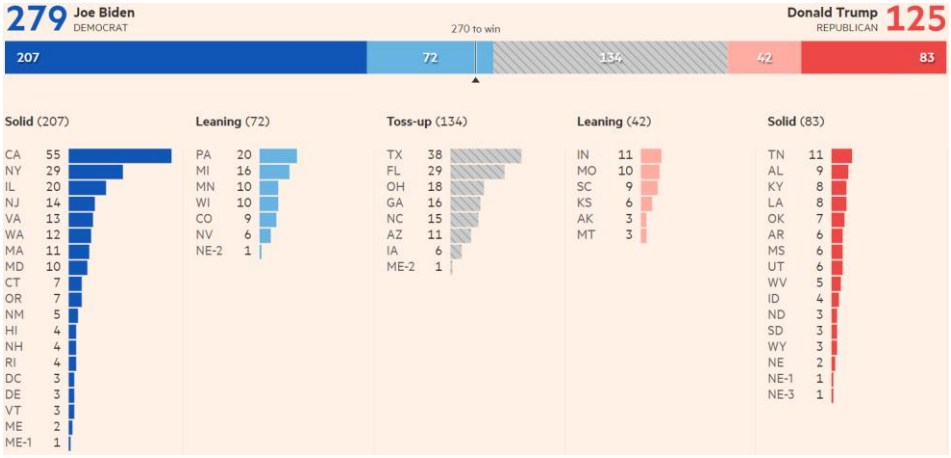

Exhibit 3: The Electoral College vote as of the latest count
Source: *Financial Times*

The problem

Given how many vote by mail this year, the following scenario is not farfetched: Trump wins on the night and declares himself the winner. A few days later, when all postal ballots have been counted, it turns out that Biden has actually secured the most Electoral College votes, but Trump claims (as he already does) that the postal votes have been rigged and refuses to accept the result. What will happen then? Before I (try to) answer that question, let me briefly explain why this could happen. Two reasons:

(i) Due to the outbreak of COVID-19, postal voting will almost certainly be higher than ever before, and Democrats are more likely to vote by mail than Republicans (see for example here).

(ii) Some states only begin counting postal votes once polling stations have closed. Counting postal votes is a much more labour intensive job and, given how many are expected to vote by mail this year, it could easily take several days, in a few states even weeks, before all mail-in votes have been validated and counted.

I can't comment on (ii), as that is simply a matter of fact, but let me make a couple of points on (i). Firstly, Trump has repeatedly argued that the Democrats are rigging the postal votes, but there is absolutely *no* evidence of that. Many studies have been conducted, and every single one of them has reached the same conclusion - that rigging is almost non-existent. One example: In a major study, covering more than 1 billion votes cast between 2000 and 2014, Justin Levitt at Loyola Law School found that only 31 votes could be challenged on reasonable grounds. In other words, potential rigging was less than 0.00000003%.

Secondly, whilst correct that various polls have showed that Democrats are more likely to vote by mail in 2020 than Republicans are, Trump's argument that postal voting will always favour the Democrats is a rather weak one. The results from 2016 show that postal voting favoured no particular party that year (Exhibit 4).

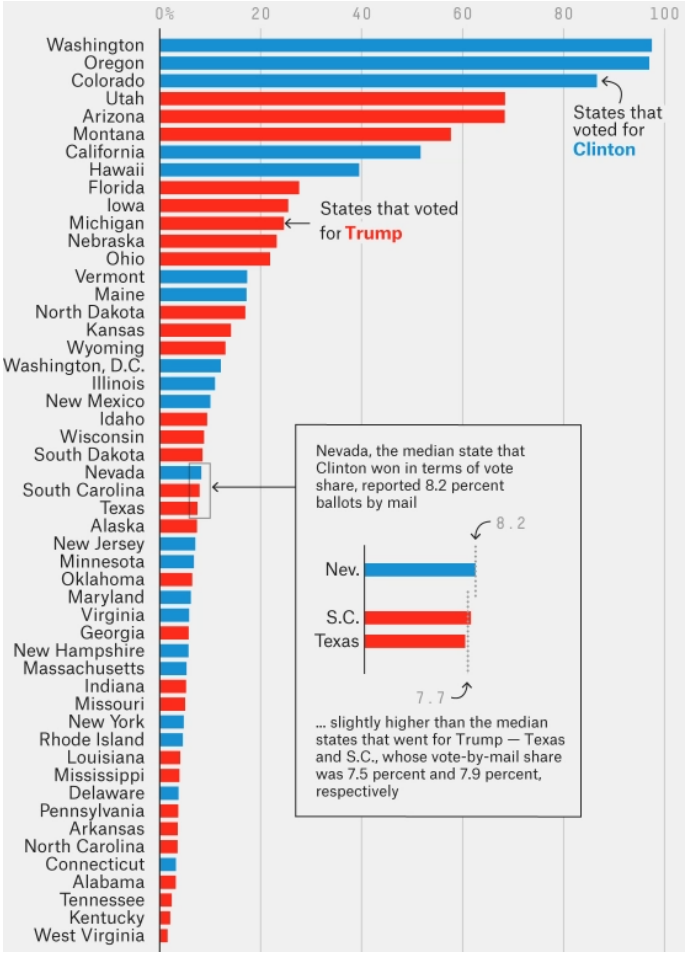

Exhibit 4: Share of ballots cast by mail in each state in 2016
Source: *five thirtyeight.com*

If Trump (ultimately) loses next Tuesday, he will almost certainly argue that the postal vote was rigged and refuse to accept that he lost. The obvious next step would then be to refer the dispute to the courts. I would hope that some of the more level-headed people in the Republican party can bring him back to his senses, but I am not sure.

Everybody talks about the potential involvement of the Supreme Court but, under common law, the case will have to start in the lower courts and then work its way up through the judicial system, which could take many weeks. However, assuming Trump loses and that the lower courts all back that result, the case *will* end in the Supreme Court, hence why Trump is so keen to get Amy Coney Barrett confirmed before Election Day. Another very conservative judge in one of the Supreme Court seats can only improve his chances (he thinks), although one shouldn't underestimate the integrity of even the most conservative judge.

Alternatively, what could also happen is that Trump is declared the winner, but the Democrats remain convinced that not all postal votes have been counted, so they take legal action. Under this scenario, Trump is now the defendant. There are obviously many variations of the scenarios outlined above, but the net result is the same - weeks or even months could easily pass before we know who the next president is.

The Congress could also play a role in all of this, which is why it is important who ends up controlling the two chambers, come January 2021. It is my

understanding (but I have struggled to find anything in plain English to confirm this) that the losing party in the Supreme Court (whether Biden or Trump) can refer the case to the Congress. The newly elected Congress shall then tally all Electoral College votes in a joint session on the 6th January.

If the outcome is still disputed, under US law, the final decision is referred to a so-called contingent election, in which the House of Representatives will decide who becomes president while the vice presidential race is decided by the Senate (source: Forbes). If no president has been appointed by the 20th January, Nancy Pelosi (assuming she is re-elected on the 3rd) will then be asked to step in as caretaker president.

Even worse, assume it is blatantly clear that Trump stole the election, i.e. Biden not only wins the popular vote but also would have won most Electoral College votes if all popular votes were counted; however, somehow, Trump manages to prevent a material number of postal ballots from being counted, and the victory is awarded to Trump. This is probably the scenario most likely to lead to civil unrest, which could pull the military in, possibly even to escort Trump out of the White House. The Pentagon has insisted that the military has no role to play in this predicament. That said, the Pentagon has also openly discouraged Trump from invoking the 1807 Insurrection Act, which would give him the authority to deploy troops to quell any civil unrest.

In other words, we have the recipe for a Constitutional crisis on our hands. An awful lot can go wrong over the next few days and weeks. Worst case? I am not even sure the quote below from The Atlantic *is* worst case, although it comes pretty close:

"The worst case, however, is not that Trump rejects the election outcome. The worst case is that he uses his power to prevent a decisive outcome against him. If Trump sheds all restraint, and if his Republican allies play the parts he assigns them, he could obstruct the emergence of a legally unambiguous victory for Biden in the Electoral College and then in Congress. He could prevent the formation of consensus about whether there is any outcome at all. He could seize on that uncertainty to hold on to power."

Along the same lines, I note that US gun and ammunition sales have exploded (no pun intended) in the months leading up to Election Day – see for example an account of that in the Financial Times. Maybe it is because people expect tighter gun laws under Biden, maybe all the ongoing political infighting and the mention of military involvement make people prepare for the worst. I don't know, but these are certainly tricky times.

Implications for financial markets

Many years in the financial industry have taught me that political crises, even if they often result in extraordinary volatility in the short-term, rarely lead to longer-lasting problems for equity markets. For equity markets to be affected longer term, the crisis in question must have some underlying economic ramifications, which most political crises don't. Having said that, the longer the US is plagued by a Constitutional crisis, the more likely it is that there will be economic ramifications.

What am I saying? I guess I am saying that if you can stomach a lot of volatility until the dust has settled – and that could easily take weeks and possibly even months – you'll probably do OK, even if you take no action. At the end of the day, what matters to most equity investors is the ability of companies to grow earnings and not much else.

Having said that, the days, weeks or even months after Election Day could be rather painful if things unfold as outlined above, but I urge you to think of it as a risk – not a fait accompli. Nobody knows what is *actually* going to happen, and we may wake up in the morning of Wednesday the 4th without a single cloud on the horizon.

Final comments

By now, we know enough about Trump to conclude that he will *never* concede, should he lose on the 3rd. Even if compelled to leave the Oval Office, he will forever maintain that the election was rigged, and his base will forever stay loyal to him, none of which will do any good in terms of re-uniting a deeply divided country.

A landslide victory to either side on Election Day is the outcome that is likely to lead to the fewest problems afterwards so, for everybody's sake, let's hope that is the outcome. Otherwise, we could end up with protracted warfare between the two parties and their supporters which will, at the very least, further divide an already very polarised country.

Latest

The second and final televised debate between Trump and Biden ended only a few hours ago. Although he didn't land a killer blow, the initial reaction from various media is that Trump did much better than he did in that first and very chaotic debate three weeks ago. Given that Trump's poor performance in the first debate cost him in the polls, last night's more measured performance could very well have the opposite effect, meaning that the risk I pointed to earlier – that Trump wins on the night but not overall – has risen.

Niels C. Jensen
23 October 2020

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Absolute Return Partners

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