

The Absolute Return Letter



February 2022

A Democracy on Crutches

"We mustn't dismiss these possibilities just because they seem ludicrous or too horrible to imagine."

Thomas Homer-Dixon, Professor, Cascade Institute, British Columbia

Introduction

This month's Absolute Return Letter deals with a hyper-sensitive topic. Consequently, I decided to seek advice from two long-standing American friends, Austin Erwin and Seth Novatt, both of whom have made invaluable contributions to the final output. Thank you so much to both of you for correcting the errors you spotted in my first draft and for softening my (at times) rather inflammatory language. Having said that, should any of the following contain any factual errors, it is solely my responsibility.

Have I smoked something I shouldn't have touched?

235 years after the United States of America was first established, the Union is facing one of its biggest challenges ever. In short, parts of the Republican party are toying with things that are *very* toxic, which is what this month's Absolute Return Letter is about. I am pretty sure my inbox will fill up with strongly worded messages but so be it. Before you put me in a straitjacket, I suggest you read what I have to say, though. You may not agree with it all, but at least you should listen to the words of a foreign soul who is not so emotionally involved as you might be.

Quite a few observers have already named it a right-wing coup d'état in the making but more on that later. Let's start somewhere else. As you are probably aware already, the investment strategy at Absolute Return Partners is based upon the six megatrends that we have identified over the years. Our work has identified another problem, namely that US wealth is absurdly inflated when measured as a percentage of US GDP. Simply put, one *cannot* outgrow the other for longer periods of time. There are some very technical, mathematical reasons for that.

Data on US wealth from the past 200 years or so suggests that the theory works well in practice too. Every time the two have been out of sync, sooner or later, mean reversion has kicked in to re-establish a well-defined balance between wealth and GDP of about 2.8 times, i.e. when the system is in good shape, total US household wealth is about 2.8 times bigger than nominal GDP. The wealth-to-GDP ratio is broadly similar in other countries but not exactly the same, the reason being that capital efficiency (i.e. how much capital it takes to grow GDP by \$1) is different from country to country.

Based on the latest statistics provided by the Federal Reserve Bank at the end of the third quarter of last year, total household wealth is now 6.2 times GDP in the US. In other words, a massive correction in wealth is on the cards. Unfortunately, the theory behind holds no hints as to the timing of it.

For those of you who don't follow my writing regularly, I should mention how household wealth is calculated, and what the key drivers are. Household wealth is, as the name suggests, a measure of all private wealth. Charity and foundation wealth is then added to arrive at the total. The key components are property, pension savings, investments in listed companies and the value of privately held (mostly family-owned) businesses, i.e. the three key asset classes are property, stocks and bonds (in that order).

The concept of wealth-to-GDP is closely associated with the debt supercycle concept, which I have written a fair bit about over the years. Debt supercycles have, on average, lasted 50-60 years, and the last big rebalancing of both wealth-to-GDP and debt-to-GDP took place in the 1930s. The one before that happened in the early 1870s, when large parts of the US financial system collapsed in the so-called railroad crisis. In other words, another rebalancing is long overdue, but central bankers are fighting desperately for it not to happen on their watch.

I am often confronted with the view that the introduction of advanced robotics and other digital devices has caused a seismic change in income distribution, i.e. the long-term mean value of 2.8 times wealth-to-GDP may never be seen again. Effectively, digitisation has resulted in a rising gap between rich and poor, where the rich will only get wealthier and the poor poorer, or so the argument goes.

To those people, I only have one answer, and that is that the economic theory behind has proven that wealth-to-GDP is long-term stable *regardless* of changing economic conditions and living standards, provided the economy in question remains a free market economy. For that reason, US wealth-to-GDP averaged 2.8 in the 18th century, in the 19th century and in the 20th century, and it will revert to that level again *provided* the US remains a free market economy.

If you look at the part of our website that deals with this issue (you can find it [here](#)), you will see that we have categorised *Mean Reversion of Wealth-to-GDP* as the aggregate result of the six megatrends we have identified. However, when looking for possible catalysts, likely to start the process, we have struggled. Only the gross underfunding of US pension funds has so far made it to our list of potential catalysts. Today, I am going to add *A US Constitutional Crisis* to the list of catalysts which could kickstart the next rebalancing of wealth-to-GDP.

One more point on the supercycle phenomenon before I move on. Supercycles are not necessarily global in nature, meaning that just because wealth-to-GDP begins to mean-revert in the US, the same may not be the case in for example Japan. The last supercycle in Japan peaked in the late 1980s, before Japanese property and equity markets collapsed. Therefore, the Japanese are at a very different point in the supercycle than the Americans are. More worryingly, today, some 30 years after the collapse of the Japanese supercycle, the Japanese are still dealing with the consequences.

The background

The Constitution of the United States of America was signed by delegates to the Constitutional Convention in Philadelphia on the 17th of September 1787, almost 235 years ago. It established the Union's first government as well as a set of fundamental laws. A key objective back then was to establish a system of checks and balances to ensure no single branch of government would have too much power (source: [History.com](#)), and that principle has never since been abolished – until now that is.

Allow me to digress for a moment. At the Constitutional Convention in 1787, there was a *lot* of debate about the powers given to the executive office. Many feared that the Constitution would create a de facto king; however, people trusted General George

Washington (who was widely expected to become the first president) enough that the Constitution was ratified despite these concerns. And now, 235 years later, the ambiguities in the document and the powers granted to the executive office are what is at least part of what is causing the problem.

Now, fast forward to the US presidential election in November 2016. Donald Trump came out of the political wilderness and took control of the world's biggest and most powerful economy. Only a year or two earlier, few had considered it even a remote possibility that Trump would become the next president. Such a suggestion was widely considered absurd. Now, he was about to move into the White House.

Almost four years of tragedy followed (yes, that is my unedited opinion), before another show began to line up in 2020. As I am sure you remember, Trump lost but refused to accept the result, calling it the Big Lie. *"The fraudulent Presidential Election of 2020 will be, from this day forth, known as the BIG LIE!"*, Trump suggested in a widely quoted news statement after the result was announced (source: [voa.news.com](https://www.voa.com)).

However, he did something else which has had a much bigger impact on the political scene. He persuaded about 70% of all Republican voters plus a critical number of political activists within his own party that it was indeed a Big Lie; that the victory was literally stolen from him, and this is where the problems began in earnest, and why this could still end in tears.

Important developments since the 'Big Lie'

Most presidential elections are decided by the outcome in 5-10 so-called swing states. In the 2020 election, Georgia, Arizona, Michigan, Wisconsin, Nevada and Pennsylvania were all considered important swing states.

In Georgia, Bradford Raffensperger was the secretary of state at the time of the 2020 elections. As Trump deployed ever more desperate tactics in his attempt to hold on to power, on the 2nd of January 2021, Raffensperger received a phone call from Trump, who asked him to "find an extra 11,780 votes" needed to swing the state from Biden to Trump. When Raffensperger declined to engage in such activities, he committed political suicide and has since been removed from key positions. At the midterm elections later this year, he will be up against Jody Hice, who has stated publicly that *"if the 2020 presidential election had been fair, Georgia would still be a red state"* (source: [CNN](https://www.cnn.com)).

In Arizona, the Republican governor, Doug Ducey, received a phone call on the 30th of November from a desperate Donald Trump. Ducey was about to sign the official election documents which would hand the victory to Biden, but he knew what Trump was up to, so he took the phone out of his inner pocket and placed it on the table in front of him without taking the call. Ducey is also history in the Republican party now. His term is up at the end of this year, so re-election was never an option but, within the Republican party, he is widely seen as a traitor, so his future is bleak.

In Michigan, each district has a supervisory committee, consisting of two Republicans and two Democrats. It is the committee's job to monitor the election process and confirm the results. Since November 2020, eight of the largest districts in Michigan have replaced their supervisory committee members with Republicans who have publicly supported the *Stop the Steal* movement.

In Pennsylvania, the *Stop the Steal* movement took many forms, including (according to the Philadelphia Inquirer) eight Republican Congressional Representatives voting against accepting the result of Pennsylvania's vote for President. One of them, Representative Mike Kelly, initiated a lawsuit before the Supreme Court – which was denied – arguing that a 2019 state law authorising universal mail-in voting was unconstitutional, asking that all mail-in ballots be thrown out.

In all the swing states mentioned above, the Republicans have nominated candidates for the forthcoming midterm elections who publicly subscribe to the Big Lie story, even

though there is not a shred of evidence supporting it. Regarding lack of evidence, the best example is probably the recently published election fraud report from Georgia. Donald Trump has repeatedly argued that at least 5,000 people in the state took advantage of a dead relative and voted on their behalf, implying they would all have voted for Biden. After months of reviewing absolutely *everything*, the report concluded that only 5 people had voted on behalf of a dead relative, and that the only one they could trace was a woman who had voted Republican (although she was a Democrat herself), as she was convinced that is what her husband had wanted.

In about a dozen states, the Republicans have proposed new legislation which will remove important powers from (mostly) neutral civil servants to (mostly) heavily biased politicians. These states are also legislating to restrict voter registration, voting accessibility (opening hours and polling places) and absentee voting rules, and all this is done to make it much harder for the Democrats to win the state in question.

Complicating the Democrats' position further, congressional districts are being redrawn in many states – particularly in Republican-controlled legislatures (about 30 of the 50 states at present). Rather sadly, gerrymandering could determine the outcome of many future elections, beginning as early as later this year.

In some states, the new legislation has already passed whereas, in other states, it is still work in progress. The intent is pretty clear. The Republicans are seeking to turn the American election system into a highly politicized one where the objective is to take control of, i.e. make it impossible for the Democrats to win, the important swing states.

The word is spreading

In a [recent interview](#) with the Guardian, Thomas Homer-Dixon, a respected Canadian professor and political scientist, painted a grim picture:

“By 2025, American democracy could collapse, causing extreme domestic political instability, including widespread civil violence. By 2030, if not sooner, the country could be governed by a right-wing dictatorship.”

I am struggling to put a probability on such an outcome. Who knows how it will all pan out? Having said that, civil unrest is much more likely to come from Trump's camp of supporters than from Biden's supporters so, at the very least, a Democratic win is probably required to cause significant civil unrest, possibly even a civil war. What could also cause significant problems were if a blue victory in a swing state was not accepted by the red camp – essentially the Big Lie argument all over again.

As Homer-Dixon said in the interview with the Guardian: *“Trump will have only two objectives, [vengeance and vindication] of the lie that his 2020 defeat by Joe Biden was the result of electoral fraud”*. Homer-Dixon went one step further: *“Trump and a host of acolytes and wannabes such as Fox News' Tucker Carlson and Georgia representative Marjorie Taylor Greene had transformed the Republican party into a near-fascist personality cult that is a perfect instrument for wrecking democracy”*. “Even worse”, he added, *“Trump may just be a warm-up act. Then the stage will be set for a more managerially competent ruler, after Mr. Trump, to bring order to the chaos he's created.”*

You may think that Homer-Dixon is just a Canadian loony who had forgotten to take his medicine before speaking to the Guardian, but I am afraid I have to disappoint you there. He is a highly esteemed political scientist, and he is not the only one thinking along those lines. See for example these articles in [The New York Times](#), [The Times](#), [The Washington Post](#) and [The New Yorker](#), all of which have been published in recent weeks.

Alternatively, take a look at [this book review posted in The New York Times](#) a short while ago or google Steven Levitsky, professor at Harvard, Timoth Snyder, professor at Yale, or David Becker, a senior lawyer at Cleary Gottlieb and a former General Counsel of the SEC. They have all expressed their concerns about the direction democracy in the US is currently taking and have all warned that this could end in civil war. As Timothe Snyder

said (on Twitter) recently: “We know historically that a failed coup is a trial run for a successful coup. Instead of just a person who makes a disorganized attempt, we now have that person, plus institutional machinery, time to plan, and the big lie.”

In all fairness, I should point out that not all members of the Republican party subscribe to the Big Lie, and that a handful of Republicans did their very best to save the democracy. At first, they refused to sign on to Trump’s preposterous claims that the elections were rigged and later, when Congress was stormed in early January 2021, they helped to protect the mob’s targets. The sad reality, though, is that only a handful of Republican members of Congress did so, at least overtly.

What next?

If the Trumpists succeed with their audacious plans to control the swing states, I would assign a high probability – at least 70% – to Trump returning to the White House after the 2024 elections but, in the interim, there are plenty of moving parts that can affect the outcome. A key one is the seats that are up for grabs in Congress in the midterm elections this November. The first, in Texas, is only four weeks away (see Exhibit 1).

Date	State	Elections	Date	State	Elections
March 1	Texas	  Primaries ¹	June 28	Colorado	  Primaries
May 3	Indiana	  Primaries		Illinois	  Primaries
	Ohio	  Primaries		Maryland	  Primaries
May 10	Nebraska	  Primaries		Mississippi	  Runoffs ¹
	West Virginia	  Primaries		New York	  Primaries
May 17	Kentucky	  Primaries		Oklahoma	  Primaries ¹
	North Carolina	  Primaries ²		South Carolina	  Runoffs ¹
	Oregon	  Primaries		Utah	  Primaries
	Pennsylvania	  Primaries	July 26	Alabama	  Runoffs ¹
May 19	Idaho	  Primaries	August 2	Arizona	  Primaries
May 24	Alabama	  Primaries ¹		Kansas	  Primaries
	Arkansas	  Primaries ¹		Michigan	  Primaries
	Georgia	  Primaries ¹		Missouri	  Primaries
	Texas	  Runoffs ¹		Washington	 Top 2 Primaries
June 7	California	 Top 2 Primaries	August 4	Tennessee	  Primaries
	Iowa	  Primaries	August 9	Connecticut	  Primaries
	Mississippi	  Primaries ¹		Minnesota	  Primaries
	Montana	  Primaries		Vermont	  Primaries
	New Jersey	  Primaries		Wisconsin	  Primaries
	New Mexico	  Primaries	August 13	Hawaii	  Primaries
	South Dakota	  Primaries ³	August 16	Alaska	 Top 4 Primaries
June 14	Maine	  Primaries ⁵		South Dakota	  Runoffs ³
	Nevada	  Primaries		Wyoming	  Primaries
	North Dakota	  Primaries	August 23	Florida	  Primaries
	South Carolina	  Primaries ¹		Oklahoma	  Runoffs ¹
June 21	Arkansas	  Runoffs ¹	September 13	Delaware	  Primaries
	Georgia	  Runoffs ¹		New Hampshire	  Primaries
	Virginia	  Primaries		Rhode Island	  Primaries
			September 20	Massachusetts	  Primaries
			November 8	Louisiana	 Hybrid Primaries ⁴
				National	 General Election
			December 10	Louisiana	 Runoffs ⁴

Exhibit 1: 2022 midterm election calendar

Source: 270towin.com

Once a few of those primary elections are behind us, we'll get a better sense as to how strong the Trumpists' hold on the Republican party really is. Should his loyal followers fail to land a reasonable proportion of the seats on offer on the 8th of November, Trump will probably not seek re-election in 2024. On the other hand, should they prevail, the road is open for him to go for a second term. And, given all the trouble Biden is currently in, Trump stands a reasonable chance.

I made the point earlier that the attack on Capitol Hill could have been a dry run, i.e. the real thing – i.e. a proper coup d'état – might still be looming. Professor Richard Hasen at University of California, Irvine, has made a very valid point on that issue. As he said to a Danish newspaper recently: *"It is much easier to stop a physical attack, orchestrated by Trump supporters, than it is to stop a slow motion coup attempt."* (Source: [b.dk](#)). As a matter of fact, this is a coup attempt *extraordinaire*. It is happening right in front of our eyes with very limited tools available to the sitting administration to stop it, because none of it is explicitly illegal.

Implications for financial markets

By adding the looming constitutional crisis to the list of catalysts which could potentially rebalance wealth-to-GDP in the US, I must expect it to have a meaningful impact on risk assets, should it materialise. It is not quite so simple, though. Let me explain.

Politically driven crises tend to have a less pronounced impact on risk assets than economic crises do. Obviously, if a full-blown coup d'état materialises with plenty of blood in the streets, it is hard to imagine it not having a meaningful impact on risk assets; however, that is not what I would expect in this case. As I said earlier, this would most likely be a coup d'état *extraordinaire* – a change of the institutional framework, which would effectively grant full control of the country to the Republican party without it being possible for the Democratic party to intervene.

Trump and his followers have, since November 2020, repeatedly claimed that the Democrats stole the White House in 2020. I find it almost hilarious (if it weren't so tragic) that the plan is now to blatantly steal the White House in 2024. How will Democrats react to that? The ultimate consequence is civil unrest, hence why several commentators refer to the possibility of another civil war, and that would obviously have a *very* negative impact on risk assets; however, I believe a more likely outcome is anger and despair but little blood in the streets. Society will be more polarised than ever, but it will continue to function, and businesses will continue to make money. In that scenario, the impact on risk assets will be meaningful but fairly short-lived, I believe.

The one caveat to that outcome is that democracies in Europe and Asia may decide to punish the Americans economically, for example by prohibiting imports of US goods, but there are two reasons why that is not very likely to happen. Firstly, at least here in Europe, we depend far too much on US commercial technology and far too much on US military technology for anybody to make such a move.

Secondly, given the fact that no common policy has yet been reached on the biggest dictatorship in the world, China, why on earth should they be able to reach one on the US? So many European and Asian countries benefit from a significant trade surplus with the Americans and have no interest in punishing them. Therefore, unless it results in a 'proper' war, I would expect financial markets in the US, after some initial suffering, to muddle through.

One final point before I close. This is *not* my base case scenario. I am not walking up and down the streets over here, telling people to plan for civil war in the US, but I am increasingly uncomfortable with the way the wind is blowing. Certain members of the Republican party are up to no good and, if they get away with it, we can all end up paying a hefty price. Until recently, I considered that risk to be negligible and therefore ignored it, but that is no longer the case – hence why I am raising the yellow flag now.

Some important news not to do with Trump

I wrote the very first *Absolute Return Letter* in October 2003 and have written one virtually every month since, i.e. for more than 18 years. That is an awful lot of writing over the years. Having said that, we are about to change the format. As our business grows, writing is taking too much of my time. Therefore, with effect from next month, the monthly letter will be noticeably shorter. In the past, my self-imposed guideline has been 2,500-3,500 words per letter, which typically adds up to 8-10 pages including a fair number of charts. From next month, I will limit myself to about 1,000 words per letter.

Going forward, most of my writing will take the form of research papers, which ARP+ subscribers will benefit from. The underlying logic is that we plan to launch at least a couple of megatrend products in 2022 with much of my work being allocated to researching investment opportunities in the megatrend space. As a subscriber to the *Absolute Return Letter*, you might find it annoying that it will be slimmed down but, on the other hand, you may also find it quite pleasing that the letters will be much quicker to read going forward.

As a one-off, we will make ARP+ available to existing subscribers of the *Absolute Return Letter* for as little as £225 for the first year. The normal rate is £300, i.e. we are offering a 25% discount on the first year's subscription – an offer that is only available during the month of February.

All you need to do is to subscribe [here](#). When you get to the payment stage, you click on the little icon saying "I have a coupon code", and you enter **arl25** when prompted. Once your subscription has been acknowledged, you will have access to all the papers we have published on ARP+ in recent years.

Niels C. Jensen

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