THE DRIVE YOU DEMAND

SPOTLIGHT: UNITED STATES

Navigating a Trump Presidency

Spotlight | February 2017

President Donald Trump has moved quickly to enact his policy agenda outlined during his 2016 Presidential campaign. Though medium-term risks exist, the UBP 'Start-Stop' framework highlights the priority President Trump's appears to place on pursuing tax reform and a repeal of the Affordable Care Act to solidify his perceived legitimacy via the 2018 Congressional Elections. These priorities enhance the existing strong global growth momentum which should be the near-term focus for investors. Equities remain best positioned to capitalize on these trends as fixed income markets no longer compensate investors well for interest rate or credit risk. Gold and risk premia strategies remain our preferred vehicles to hedge against medium-term policy uncertainty.

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Key points

- *Donald Trump has moved quickly to begin enacting the policy agenda outlined during his 2016 campaign.*
- *A 'Start-Stop' framework should be helpful in navigating the early days of a Trump presidency that seeks to fulfill campaign 'promises', strengthen his political mandate/legitimacy, while at the same time acknowledging the 'America First' focus of his medium-term policy agenda.*
- *The 'Start' phase of the Trump presidency is likely to see a drive to achieve several of the cornerstones of the Trump campaign including tax reform, the repeal of the Affordable Care Act ('Obamacare'), and regulatory reform while beginning the debate on trade and immigration reform.*
- *The 'Stop' phase of a Trump presidency may emerge as the new President seeks to pursue and potentially implement more contentious immigration and trade policies especially in the context of underpinning the drive to solidify his control of the US Congress in the 2018 Congressional elections.*
- *Though the 'Stop' phase poses risks for investors in the medium term, against a strengthening global growth backdrop and a supportive 'Start' phase, we view equities as a key beneficiary with the prospects of an upside earnings surprise still in place. The pause in the rise in interest rates presents an opportunity to reduce interest rate risk in portfolios as economic strength and rising inflationary pressures warrant higher rates in the year ahead.*

Identifying President Donald Trump's Policy Priorities

Following the election of Donald Trump as the 45th President of the United States, many were hopeful that what some viewed as extreme proposals outlined on the campaign trail would soon give way to more balanced solutions once he took office.

Laying the groundwork to solidify President Trump's legitimacy in 2018

However, these expectations of a more moderate actual outcome belie the political reality for President Donald Trump. In light of the deeply divided domestic view on his presidency and having lost the popular vote in the election, President Trump appears to seek to both 'reward' his supporters by delivering on campaign promises while also laying the groundwork for solidifying his legitimacy ahead of the US Congressional elections in 2018.

With these political objectives in mind, a turn away from his aggressive and sometimes divisive campaign rhetoric appears unlikely and instead provides a roadmap for the Trump policy agenda over the coming weeks and months.

As a reminder, the policy agenda outlined in the campaign focused on:

- Support for economic growth/regulatory reform
- Trade policy reform
- Immigration reform
- Repeal/reform of the Affordable Care Act

The first two weeks of the Trump Administration have demonstrated President Trump's focus on sticking to his campaign script including:

- Announcing a temporary freeze on new regulations and taking steps to begin the weakening of financial regulations enacted since 2008.
- Formally announcing the US withdrawal from the Trans Pacific Partnership.
- Ordering the start of the construction of a border wall between the US and Mexico.
- Blocking the admission of nationals from seven 'countries of concern' to the United States for 90 days and stopping the admission of refugees to the United States for four months (since blocked by US courts).
- Instructing US agencies to waive fees/grant exemptions from Obamacare regulations 'to the maximum extent permitted by the law'.

Unsurprisingly, the bulk of these actions were taken via ‘Executive Orders’ which do not require US Congressional approval. This approach serves a key political purpose. The volume of actions (more Executive Orders should be expected in the coming weeks) signals to voters that he is moving quickly to deliver on his ‘promises’, cementing his credibility with his core supporter base which swept him into office in November.

In doing this, it allows the administration to pivot and buy time to achieve the next stage of his political agenda, strengthening the legitimacy of his administration by securing a more decisive majority in the US House of Representatives and more importantly, the US Senate in the 2018 elections. With campaigning for these elections set to begin in September 2017, it will be important for President Trump to secure not only political victories among his supporters (which the Executive Orders help achieve) but also to expand his appeal more broadly.

Economic stimulus and the repeal of Obamacare are the Trump ‘100 day’ priorities

The Trump administration appears to believe that it can broaden its appeal by focusing on providing support to the economy and the repeal/reform of the Affordable Care Act. While many fear that restrictive trade policies may top the Trump agenda, looking to the Trump campaign’s own ‘100 day Action Plan to Make America Great Again’, the language used focused on announcements rather than concrete actions with regards to existing trade policy (emphasis mine):

- ‘**ANNOUNC(ING)** my intent to withdraw or **RENEGOTIATE** the North American Free Trade Agreement...’.
- ‘I will...**IDENTIFY** all trading abuses that unfairly impact American workers and direct them to use every tool under American and International law to end those abuses immediately’.

In contrast, the language used in connection to tax reform and the Affordable Care Act repeal is more decisive (emphasis mine):

- ‘I will work with Congress to introduce the following legislative measures **AND FIGHT FOR THEIR PASSAGE WITHIN THE FIRST 100 DAYS OF MY ADMINISTRATION**’.
    - ‘A middle-class family...WILL GET a 35% tax cut’.
    - ‘The business rate **WILL BE** lowered from 35% to 15%’.
    - ‘...American corporate money overseas can now be brought back at a 10% rate’.
    - ‘**FULLY REPEAL** Obamacare (Affordable Care Act) and **REPLACE it**...’.

Interestingly, the language used to talk about infrastructure is much softer:

- ‘**LEVERAGES** public-private partnerships...to **SPUR** $1 trillion in infrastructure investment’.

Thus, while undoubtedly there will be much political noise about trade in particular, and to a lesser extent immigration policy, we expect the political objectives of the Trump administration to be focused on seeking to lay the groundwork for the 2018 Republican campaigns for the US Congress by securing its tax reform agenda and the repeal/replacement of the Affordable Care Act.

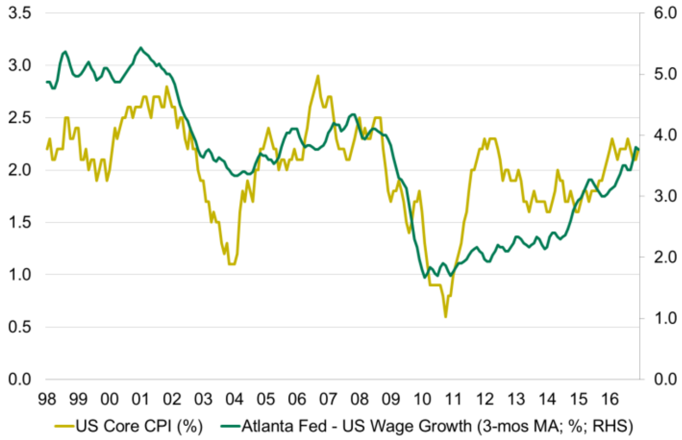
Implications and Outlook for the US Economy

Sustained activity and upside risks in growth, inflation and wages

The US economy has shown recent signs of acceleration, with strong rebounds in both business and consumer confidence. Though fourth quarter GDP came in lower than expected at 1.9% due to a negative net export contribution, momentum on domestic demand has improved, with this now growing at 2.5% driven by sustained consumption, a high level of activity in the housing sector and a rebound in capex.

With momentum positive across several sectors, it makes sense to revise the growth outlook upwards should key economic indicators continue to improve. This has the potential to generated upside risks to inflation and wages as the slack in the economy declines further. Headline inflation is now above 2% and it could increase further in the second quarter. With the economy operating at full employment, there is increasingly a shortage of available workers for specialized and non-specialized activities already putting upward pressure on wages.

Core Inflation and Wage Pressures accelerating in the US



Source: Federal Reserve Bank of St. Louis

'START-Stop': a 4% growth target through lower taxation and lower regulation

The economic policy promised by Donald Trump, the candidate and now being implemented by President Trump, tends to favour the supply side of the economy, as seen in former US President, Ronald Reagan's reforms.

The already strengthening US economy would receive a further boost if taxation is reduced as promised for households and the corporate sector, potentially generating a rebound in disposable income and profits (USD 350 bn scheduled the first year according to Republican proposals).

Adding to lower taxes, the deregulation process for banks, energy and healthcare (via the repeal of the Affordable Care Act) could provide further support for corporate profits and spending.

Indeed, there is hope that by lowering US corporate taxation below the OECD average while easing the regulatory burden on companies, that there will be a restoration in the competitiveness of the US manufacturing (11.5% of GDP), reinforcing corporate profitability, investment and employment in this sector of the economy.

'Start-STOP': Economic overheating, trade and immigration policy, potential headwinds to growth

Though there is an expectation of President Trump's fiscal and regulatory strategies providing more support to a strengthening US economy in the coming quarters, they also pose a medium term risk to the sustainability of the current US growth trend.

While the 4% target for US GDP growth mentioned by candidate Trump looks ambitious, pursuit of this target risks overheating in the US economy. With headline inflation already approaching the 2% level and core inflation seeing upward pressure towards the Federal Reserve's 2% target, President Trump's fiscal programme risks a further rise in both short and longer-term bond yields as inflation expectations continue to rise.

Indeed, markets currently price in only two rate hikes by the Federal Reserve versus the three rate hikes suggested by the Federal Reserve itself creating risks should that gap be closed in favour of higher rates, especially once clarity on the Trump fiscal plan emerges moving into the summer of 2017.

Such clarity on fiscal and interest rate policy would potentially also renew a strengthening in the US dollar against major trading partners as US interest rates rise relative to those seen in other countries. This strength could provide a meaningful headwind to US corporate profitability as seen in 2014-2015 as the Federal Reserve began 'tapering' its quantitative easing programme.

A strengthening USD may be a catalyst to accelerate trade policy reforms in 2H

Indeed, a dramatic strengthening in the US dollar, especially against politically sensitive trading partners such as China and Mexico might accelerate the timetable on a more aggressive pursuit of trade reform outlined by the US administration. Politically, this could be used as a catalyst to fulfill its Presidential campaign promises on trade, laying the groundwork for Republican Congressional campaigns beginning in the fall of 2017.

Though the discussion around tariffs and a new 'border tax' illustrates the complexity of this topic, what appears clear is that such policy would distort costs and pricing power for American and international firms operating in the US depending on sector and business model. A corporates make adjustments in response to these distortions, we would expect a drag on overall growth and upward pressure on already accelerating inflation with the longer-term benefits, at best, being somewhat uncertain.

The trade policy discussion could morph quickly into the immigration debate posing longer-term economic threats should the flow of immigration slow more permanently. According to the US census bureau, the 'foreign-born' population within the United States is expected to expand almost three times as much as the 'native born' population (14.5% vs. 4.2%) by 2040, helping to offset the demographic aging of the overall American population. As seen with the current situation in Japan, where the population is now shrinking, such population dynamics have implications for a nation's long-term growth prospects.

UBP 'START-STOP' Framework

STAGE 1 – 'START'

- Affordable Care Act repeal/replace
- Corporate Tax reform
- Individual Tax reform
- Regulatory reform

STAGE 2 – 'STOP'

- Headwinds from 'START' policies
  - Accelerating inflationary pressures
  - More aggressive Fed tightening
  - Rising fiscal deficits and public debt
- 2018 mid-term election politics will shift the legislative focus to
  - Immigration
  - Trade Policy

Source: UBP

Focus on global growth trends and managing risk around political trends in 2017

While policy shifts certainly have the potential to inject uncertainty into global markets during 2017, we believe the primary driver to markets in the coming months remains the strong economic growth that is evident across major economies around the world. This suggests that investors should primarily seek to participate in this global recovery and, around that objective, to manage risks that the prospect of policy changes by the new Trump administration might present in the months ahead.

Investors not well compensated for interest rate or credit risk

Although global equities are not cheap by historical measures, the premium investors are paid to take on credit risk (the credit spread) in US bond markets is approaching historically low levels. Indeed, at current spreads, high yield bonds have seen lower spreads during periods of economic boom such as 1994-1997 and 2004-2007. With yields after inflation also very low, total return prospects for the fixed income asset class suggest that investors are not being well compensated for the prospect of rising interest rate volatility nor being overly compensated for the credit risk they are taking on.

As a result, we continue to moderate our interest rate exposure via floating rate and inflation-linked exposure in the fixed income universe. While we remain overweight high yield and emerging market debt, we have moderated the size of both positions in light of today's shifting risk-reward prospects.

With these fluctuating risk-reward prospects, and following the Trump election, we have been tilting our exposure in favour of 'direct' equity exposure at the expense of 'indirect' equity exposure (high yield, emerging market debt, convertible bonds, etc.).

Japan: A primary beneficiary from corporate reform and global recovery

The strong US and global growth backdrop that lies ahead should provide a clear benefit for globally-oriented Japan. Indeed, earnings expectations in Japan have been revised up in recent months in anticipation of just such a situation. Despite this, returns on equity delivered by Japanese corporates have been near to cyclical lows at end-2016 suggesting that further upgrades could be in store, as global growth not only continues but also as Japanese corporates work to drive returns via reform and restructuring as they have done in 2016.

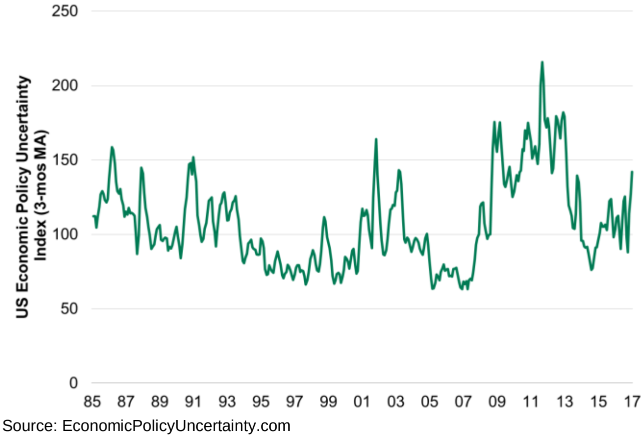
The global growth backdrop should also benefit globally sensitive European corporates as well. However, unlike Japan, where the market appears to continue to underprice the earning power of Japanese corporates, European markets have already begun to anticipate the recovery in European corporate earnings, requiring further upside surprises to growth in an already rebounding European economy.

In contrast, US equities at the headline level sit at a historically expensive level. However, the market has not yet fully priced the prospect of an earnings surprise going forward driven not only by strong US growth but also the potential for a boost to growth driven by Trump tax reforms. Looking beyond this, however, within the US market, the divergence between historically expensive and cheap stocks remains at levels last seen in 2001-2002 following the bursting of the tech bubble. This suggests to us that the prospects for active, stock pickers in the US should be high in 2017.

Gold and Risk Premia strategies key to managing 'Stop' risks in 2017

Should our Start-Stop framework underestimate the prospect of an accelerated Stop stage, managing these risks will be important for investors in 2017. We believe gold provides a valuable tool to manage such risk, while acknowledging that it comes with a higher level of volatility and capital risk for portfolios. Complementing our gold positions, we continue to believe in the alternatives space, especially via risk premia strategies which will be important in helping to cushion portfolios in times of stress, should they re-emerge in 2017.

US Economic Policy Uncertainty reaching elevated levels



Source: EconomicPolicyUncertainty.com

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