SPOTLIGHT: UNITED STATES ELECTIONS

MANAGING UNCERTAINTY VIA ALTERNATIVES

Spotlight | November 2016

While a Trump presidency creates new uncertainty in the global economy and global markets, a strong economic backdrop in the US combined with near-term policy tools should be enough to keep US growth on track. Elevated valuations in both government bonds and equities suggests attractive risk-reward opportunities remain in alternative asset classes while tactical opportunities may present themselves once valuations reset more fully.

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Key points

- *Defying expectations, Donald Trump has been elected President of the United States, while the Republican Party maintained control of both houses of the US Congress.*
- *Control of the legislature provides the President-elect with the ability to enact his fiscal agenda more meaningfully.*
- *US economic growth should remain on track despite the uncertainty President-elect Trump might bring.*
- *The proposed Trump fiscal programme brings the risk of unpriced inflation expectations more fully to the fore. We believe inflation-linked notes provide good protection against such risks.*
- *With bond and equity markets richly priced, we believe alternative asset classes provide the most attractive risk-reward opportunities for investors.*

Economic implications

By holding on to the US Congress, Republicans should be able to enact their fiscal agenda

Donald Trump secured the US Presidency with an estimated 48% of the popular vote, with the state of Wisconsin apparently tipping the balance and pushing him over the 270 vote level required to clinch the highest political office in the United States.

Just as important, Republicans appear to have held control of both the US House of Representatives and the US Senate, providing President-elect Trump with the ability to push his legislative agenda forwards, something that has been absent from US national politics for the previous eight years.

Though a Trump administration brings uncertainty for the US and global economy, the economic backdrop that the president-elect inherits is a strong one.

Growth has been on a solid trend in the second half of 2016, which should continue into 2017. Underlying domestic growth is expected to stay in a range of 2%-2.5%, while net exports should progressively contribute more to economic activity. US growth is expected to reach 2.3% in 2017, after an estimated 1.7% in 2016.

Inflation already shows signs of rebounding and Trump's fiscal plans should add further pressure

Inflation, which is already showing signs of rebounding, is expected to recover further in 2017, as the drag from oil prices has faded and commodities should begin to contribute positively to headline inflation. Core inflation has already been driven by rises in rents and healthcare costs. Consequently, some core indices already exceed 2%, with the expectation of a rebound in headline inflation closing the gap with core indices. Rising wages and volatile oil prices represent upside risks to inflation, which could temporarily exceed the Fed's medium-term target of 2%.

Market turbulence and uncertainty looks set to emerge with the Trump victory which may postpone a Fed rate hike in December. However, monetary policy is expected to remain in a soft normalisation process, especially if the incoming administration pursues the aggressive fiscal programme it outlined during the campaign.

With recent job data highlighting growing wage pressures, there is the risk that the Fed might fall too far behind the curve. However, with the election result, the Fed will need to balance the risks carefully, as the subsequent tightening in financial conditions comes on the back of financial conditions that have already been tightening since 2015.

The success of President-elect Trump's legislative agenda will be key to assessing the domestic economic impact of a Trump presidency in the months and years ahead. Consumer spending, which has been the most important growth driver, may suffer in the near term as a result of increased uncertainty. However, with strong underlying job and wage data, consumers should remain resilient.

In the longer term, the US economy has two major challenges: weak productivity and an ageing population. Investment and structural reforms are the keys to addressing these issues that could propel growth onto a higher trend, or, if not addressed, leave US growth on its current sluggish trend.

With these near- and longer-term headwinds, the Republican-controlled executive and legislative branches have the ability to enact legislation that can begin to address these challenges.

Indeed, President-elect Trump's tax proposals have the potential to cushion domestic consumption, as well as the domestic investment agenda which would have positive short-term benefits for growth. However, a potential drag on external trade could mitigate these benefits.

The cost of this stimulus, however, is likely to be higher deficits and – more importantly – higher public debt. Estimates based on the Trump campaign's proposals suggest that US public debt could reach an estimated 115%-120% of GDP by 2026.

Investment implications

Valuations and policy responses are key to assessing opportunities ahead

As seen with market performance immediately following the election results, risk assets will reprice to accommodate uncertainty. However, as seen with the outcome of the UK referendum, while repricing uncertainty is important in the near-term, the policy responses to the shock are equally important in setting the tone for the markets in the months to come.

As outlined above, a tightening in financial conditions may result in the Federal Reserve delaying its anticipated December rate hike. More importantly, however, the Republican-controlled executive and legislative branches have the ability to move swiftly to roll out fiscal stimuli. While infrastructure spending may take time to implement, tax reforms focused on the repatriation of overseas earnings for corporates, combined with a consumer stimulus, may be a quick win for a Republican-controlled Congress.

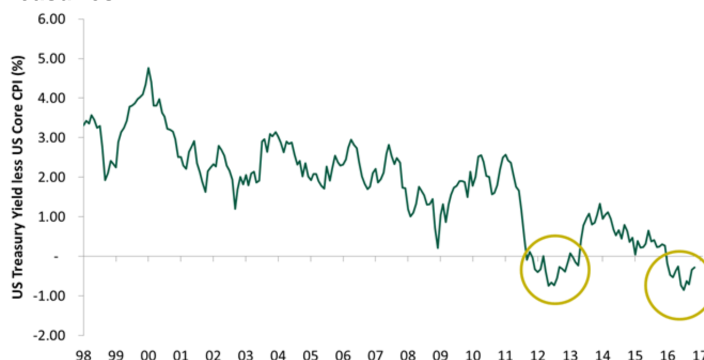
On the US bond markets, with Treasury yields declining sharply in overnight trading before rebounding, markets attempted to reassert the risk-off trade of the summer months. Investors will recall that, following the surprise outcome of the UK referendum, real (after inflation) US Treasury yields fell to -85 bp (from the -34 bp at yesterday's close). To replicate such a risk-off environment, nominal 10-year Treasury yields would need to decline to 1.3%-1.4% from the 1.85% on 8 November. We do not anticipate such a decline, even if the Fed were to delay the anticipated rate hike in December.

Such risk-off scenario might rekindle the hunt for yield, renewing the bid on investment-grade USD corporate bonds, which had been on a weakening trend since July. High-yielding USD corporate bonds could see meaningful volatility as they did in June at the time of the UK referendum, and we suspect any widening in spreads would draw yield-seekers into providing support for this more volatile asset class.

USD fixed-income investors should seek to manage interest-rate risks more proactively

Looking forward to 2017, however, investors in the USD fixed-income markets should be cautious, as the proposed legislative agenda would be inflationary and put a strain on long-term US debt sustainability should US debt levels rise, as projected, to 115%-120% of GDP by 2026. With nominal government bonds underpricing this prospect, we believe inflation-linked bonds provide an attractively priced alternative. In addition, should this scenario play out as expected, investors will increasingly need to manage interest-rate risk more proactively in the fixed-income space.

Firmer inflation, higher deficits and higher debt not priced in to nominal US Treasuries



Source: Federal Reserve Bank of St. Louis

On the US equity markets, where we are underweight and where equity prices were already richly priced at over 20x trailing earnings, risk premiums appear tight and longer-term, and look likely to widen on a trend basis. However, with the prospect of substantial fiscal stimulus in the months ahead, we believe declines that might follow President-elect Trump's victory could provide opportunities for investors once valuations reset. In terms of sectors, those related to healthcare and infrastructure could benefit from the election outcome.

Alternative asset classes should benefit from ongoing uncertainty

The broader alternatives asset class, where we are overweight, should benefit from the expected volatility. Gold, a beneficiary of the uncertainty surrounding a Trump presidency, will also benefit further, should the proposed fiscal programme drive inflation higher and the Fed fall behind the curve in its tightening process. Our overweight in hedge funds built over the course of 2016 should similarly provide a cushion for the volatility in equity markets, as they did around the UK referendum in June. Moreover, the increase in volatility should help restore the structured-product, volatility-carry opportunities in the markets which had been absent, with the low levels of the CBOE SPX Volatility Index (VIX) since June.

From a currency perspective, the combination of potential expansionary policy on the part of the US Congress and a Fed that might need to pause and fall behind the curve should financial conditions tighten, suggests a near-term break in US dollar's strength in the weeks ahead. However, with a fragile economic recovery in continental Europe and Japan, the prospect that the US dollar may continue to weaken without a complementary policy response in those countries looks low, suggesting limits to a sustained US dollar weakness in the months ahead.

Outside the US, European equities are likely to be affected by both the increased risk premium that results from the US election outcome, as well as the read across that the results of the UK referendum and now the US election might have to the full political slate on the Continent in the year ahead, beginning with the Italian referendum in early December. This means that the expansion in risk premiums that began with the UK referendum and which should continue with the US election results, may persist through the series of political contests still to come on the Continent.

The policy response from the ECB from the potential of a US shock to confidence in Europe may be the anticipated expansion of its quantitative easing programme in the coming months, serving to cap the amount of strength in the EUR/USD rate. While the Swiss National Bank will likely intervene aggressively to contain EUR/CHF and USD/CHF strength, the Swiss franc could see appreciation pressure in the months ahead.

On balance, while a Trump presidency creates new uncertainty in the global economy and global markets, a strong economic backdrop in the US, combined with short-term policy tools, should be enough to keep US economic growth on track. Elevated valuations in both government bonds and equities suggest attractive risk-reward opportunities remain in the alternatives universes (i.e. gold, hedge funds, risk premium strategies and structured products), while tactical opportunities may present themselves, should valuations reset more fully.

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