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GLOBAL ASSET MANAGEMENT

After the 2016 U.S. election: What comes next?

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Executive summary

- Voters delivered a genuinely surprising outcome on November 8, electing Donald Trump the 45th president of the United States and allowing Republicans to keep full control of Congress.
- Trump's winning message of economic populism and nationalism could reverberate through his agenda next year, but congressional Republicans will have their say as well.
- The 2017 legislative calendar will likely include increased infrastructure and defense spending as well as potentially sweeping individual and corporate tax reform.
- After a brief shock in overnight trading as the votes were being tallied, equity markets have reacted positively and bond markets negatively amid rising growth and inflation expectations.
- While a Trump presidency undoubtedly injects some uncertainty into the direction of policy, a wider array of fundamental factors should drive markets over the next 6-12 months.

A shock to the system

Surpassing even Brexit as perhaps the biggest shock in modern political history, Donald Trump has defeated Hillary Clinton to become president of the United States. The list of prognosticators, pundits, politicians, and pollsters that failed to predict this outcome is too long to include here. Suffice it to say that while we hear a lot about potential "black swans" (rare and unexpected events that disrupt the markets), it turns out the biggest black swan in recent memory was living in a golden penthouse in Manhattan's Trump Tower.

Crucially, Trump will come to Washington with Republican majorities in both the U.S. Senate and House of Representatives. Only a few weeks ago, these majorities seemed to be under threat, but they're now primed to help president-elect Trump pass an aggressively pro-growth, pro-business agenda during the first half of next year.

Before the networks had even called the race for Trump, financial markets started expressing alarm. S&P 500 Index futures fell 5% overnight, triggering a stop loss, while U.S. Treasuries yields plunged. But investors who wisely chose to get some sleep woke on the morning of November 9 to far better market news. We will spend the balance of this paper analyzing the markets' behavior since the election, outlining the likely policy agenda for the new administration and Congress, and factoring politics into our investment outlook for the rest of 2016 and beyond.

"What do we do now?"

Robert Redford's character in the 1972 film, *The Candidate*, famously asks this question upon realizing he has won an unlikely election to the U.S. Senate. It's not hard to imagine Trump positing the very same query. Given the short honeymoons typically granted to new presidents, most attempt to pass sweeping policy changes during the first few months in office. The unorthodox nature of many of Trump's campaign themes—he appears to lack the ideological consistency of

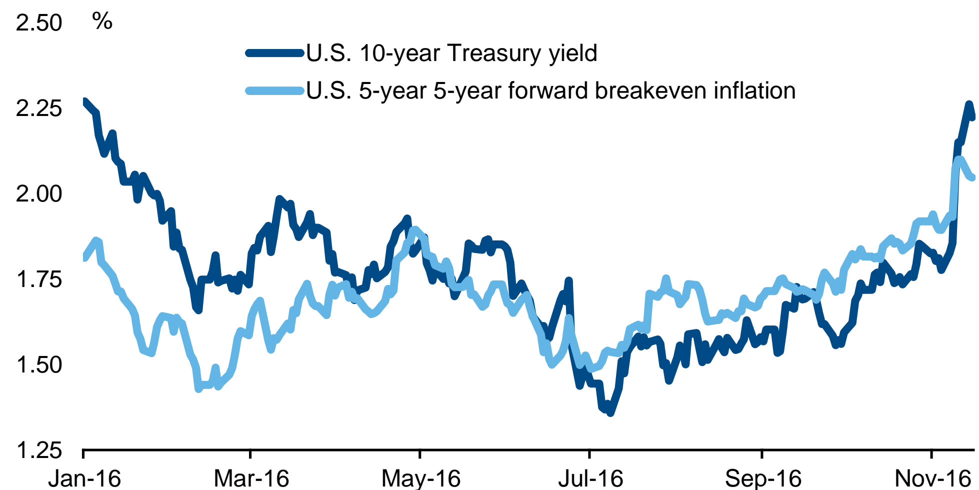
either of his last two predecessors—makes his policy *priorities* in his first 100 days at least as important as the *details* of those policies.

While the country itself is politically divided, the balance of power in Washington, D.C., is not. The Republican majority in Congress and president-elect Trump differ on issues like entitlement reform and trade but share common ground on deregulation, defense and infrastructure spending, and tax reform. The latter list, therefore, is likely to be taken up first in January. Details of Trump's preferred policies on immigration, amending the Affordable Care Act, and renegotiating trade deals are murky, and because those issues are more controversial, they're more likely to be addressed later.

Also of note for investors: it now appears that Janet Yellen will continue her Federal Reserve stewardship through the end of her term in January 2018, despite being personally criticized by Trump during the campaign for her handling of monetary policy. A new president's appointees and staff selections are always closely watched, but given his lack of experience in government, the president-elect's will be subject to even more scrutiny for what they may tell us about his policy intentions.

U.S. interest rates have moved sharply higher as Trump's policies are expected to fuel growth and inflation.

Figure 1. Interest rates spike amid higher growth and inflation expectations



Source: Bloomberg, as of 11/15/2016.

Markets looking on the bright side…for now

Perhaps just as surprising as the election result has been the financial markets' reaction to it. Save for a four-hour panic as the votes were still coming in, global equity markets have largely welcomed the news that the Republicans will once again hold the reins of power in the federal government. The S&P 500 Index rose 1.2% in the first four trading days after the election, while the Euro Stoxx 600 Index rose just under 1.0% in local terms. The U.S. dollar has gained strength against nearly every major currency since Trump was announced as the winner.

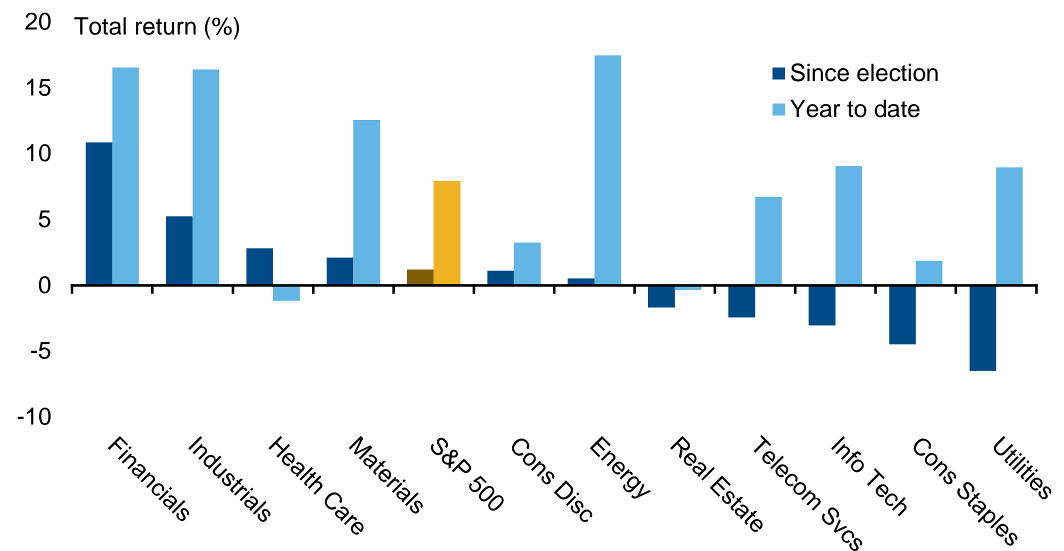
Meanwhile, bond markets have sold off swiftly. As Figure 1 shows, the 10-year U.S. Treasury yield (which moves in the opposite direction of its price) spiked from 1.85% before the vote to 2.26%—its highest level since the start of the year. Some of this has been driven by inflation expectations, as shown on the graph by the 5-year 5-year forward breakeven rate of inflation. This series measures the expected yield differential between nominal 5-year Treasuries and 5-year Treasury inflation-protected securities in five years' time. It is often used to gauge "inflation risk" in the bond market. The promise of fiscal stimulus, via a combination of increased government spending and tax cuts, may contribute to higher nominal growth and enable the Fed to raise interest rates in the coming quarters by more than had been expected.

Markets are optimistic that president-elect Trump will be able to implement a pro-growth and pro-business agenda, spurring the economy and corporate earnings. In addition, the financial, energy, and pharmaceutical industries may face gentler regulatory headwinds, incentivizing more hiring and investment than might have been the case in a Clinton administration. As such, assets primed to perform better in a higher-growth environment (i.e., stocks) have generally received a boost, while those that outperformed expectations during the tepid post-financial-crisis recovery (i.e., bonds) are struggling to find footing.

We see even clearer evidence of the political market impact when we examine the components of the S&P 500 Index. Figure 2 shows the stark contrast in sector behavior in just the first three days after the election versus their cumulative performance year to date. The best-performing sectors (Financials, Industrials, and Health Care) have been those most likely to benefit from easing regulatory pressures and increased infrastructure spending, while the losing sectors (Technology, Consumer Staples, and Real Estate) are those that could be harmed by more protectionist trade policies or a rising interest-rate environment.

Banks and pharmaceutical companies may face fewer regulatory hurdles, while new infrastructure spending stands to benefit industrial stocks.

Figure 2. Performance diverging widely across U.S. sectors since the election



Source: Bloomberg, as of 11/14/2016.

Better "base case," worse "worst case"

If presidencies were controlled experimental trials that we could run 10,000 times to produce a distribution of outcomes, we think a Trump presidency would likely produce better average economic and corporate profits growth than a Clinton presidency. As such, we agree with the prevailing market view that the Trump agenda—if enacted as expected—could allow for better equity market performance, particularly among sectors that have lagged in recent years.

However, the cost of that superior *average* result would probably be a wider *range* of outcomes. Both the best-case and worst-case scenarios (for investors and for the country as a whole) seem more likely under Trump than under Clinton. We don't know, for instance, how efficiently and successfully Trump's policies will be enacted and implemented by a White House short on experience. We also don't know what sort of crises may arise in the world to test our new (and politically inexperienced) president and potentially affect financial markets and/or consumer confidence.

How should investors deal with this distribution of outcomes? We continue to believe that fundamental factors such as economic growth, corporate profitability, and central bank policy will remain the dominant market drivers moving forward. While Washington policies can certainly influence each of these, politics often figures more prominently in headlines than in market returns. As such, we continue to see value in equity markets compared to fixed income, despite the jump in interest rates. As Figure 3 shows, even before the election, U.S. corporate earnings growth appeared poised for a strong recovery in 2017 after five straight negative quarters. To the extent the Trump agenda further boosts this outlook, stocks have the potential to post solid returns.

Expectations for 2017 corporate earnings growth, already rising before the election, now have further upside.

Figure 3. Markets already optimistic about corporate earnings growth in 2017

Source: Standard & Poor's; Dashed line represents consensus forecasts for 2016-17 as of 11/11/2016.

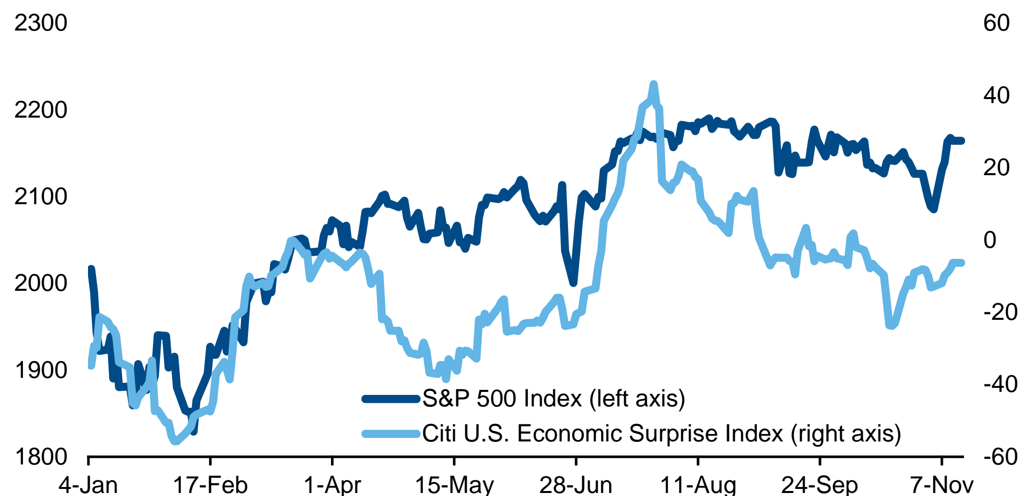
Bottom line: keep calm and focus on the fundamentals

This year has certainly made it clear that election outcomes are difficult to forecast. And for that reason, making large speculative portfolio shifts just before or just after a major vote can be unwise. In fact, we see little historical evidence suggesting that certain balance-of-power arrangements in Washington are better for markets than others. History tells us that equity markets can perform either extremely well or extremely poorly in both Republican and Democratic administrations. For example, voters who were inclined to believe that President Obama would be bad for equity markets when he assumed office in 2009 may be surprised to find that the S&P 500 Index is up 170% since his inauguration. (Admittedly, his entry point was extremely well-timed.)

Even over shorter periods, there's evidence that economic data can alter investor outcomes more than flashier events like Brexit or the Trump election. Figure 4 tracks the Citi U.S. Economic Surprise Index—which rises when data is better than expected and falls when it's disappointing—against the performance of the S&P 500. Stock-market rallies in the spring and summer of 2016 were correlated with positive economic surprises. The improving U.S. economy has been a bigger market driver this year than anything that happened in the presidential race.

Economic data quality has been a stronger driver of equity markets this year than the various high-profile political shocks.

Figure 4. Fundamentals, not politics, still drive equity markets



Source: Citi, Bloomberg, as of 11/14/2016.

Investors who pull back today awaiting more comfort and certainty may find themselves waiting a long time. A diversified portfolio of both domestic and international stocks, bonds, and real estate has for decades been a reliable vehicle for achieving long-term financial goals. While we don't ignore the risks represented by the Trump presidency, given his inexperience and his unusual personal demeanor, we also see reasons to be optimistic that his agenda may provide a boost to long-struggling segments of the economy and financial markets.

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