November 9, 2016

MARKET UPDATE: US ELECTION

TRUMP ELECTED US PRESIDENT

WHAT HAS HAPPENED?

Donald Trump has been elected as the 45th president of the United States, based on nearly final results announced by US television networks early Wednesday morning. In the congressional elections, the Republican Party has again secured control of both the House of Representatives and the Senate. The combination of a Trump presidency and a Republican-controlled Congress suggests that the new administration may initiate major changes to US fiscal policy and international trade deals, which are likely to increase uncertainty about economic growth and to provoke market instability in the coming months.

MARKET REACTION

Global markets were volatile in reaction to the US election results. As Trump's victory was confirmed, S&P futures fell sharply, while European and Asian stocks dropped. However, by midday in Europe, equity market anxiety had eased somewhat and declines of US stock futures had moderated.

The dollar fell versus the yen, euro and Swiss franc. The Mexican peso tumbled, as the currency has been highly sensitive to Trump's election prospects. Yields on US treasuries were volatile, with longer-dated treasuries selling off after making earlier gains. The price of gold jumped and the yen rose.

ECONOMIC POLICY OUTLOOK

Our economists have been preparing for various post-election scenarios and will convene later today to discuss the potential impact of the results on US fiscal and monetary policy as well as on the economic growth outlook. While it is too soon to know how President-elect Trump's agenda will affect the direction of the US economy, his stated policies during the campaign offer some direction.

Broad tax cuts are the central plank of Trump's economic policy. In a recent blog, our chief economist, Joe Carson, explained that Trump's tax plan is estimated to reduce federal revenue by $9.5 trillion over a 10-year period. This will be achieved by a consolidation of tax brackets and an elimination of the alternative minimum and estate tax. Under his proposals, the top corporate tax bracket would be reduced from 35% to 15%.

Trump's trade proposals would also have big ramifications for the US economy if implemented as proposed. His proposals aim to remove support for the Trans-Pacific Partnership and to tear up existing agreements like the North American Free Trade Agreement. Large tariffs on Mexico and China—two of the US's largest trading partners—are also part of the stated plan.

Federal spending proposals were more vague in Trump's campaign statements. He has said, however, that he would increase military spending and target the elimination of fraud and waste in government programs.

Healthcare is likely to be a primary target for Trump's administration. He is likely to move quickly to repeal Obamacare, with firm backing from the Republican Party in Congress.

Still, even with a Congress that is more aligned with the president, Trump might not be able to push through all of his tax cuts and plans to rewrite US trade accords, given his tensions with the Republican Party establishment. Big, broad tax cuts could provide a boost to US gross domestic product growth. However, we believe that the potential gains from lower taxes could be lost by anti-trade proposals. That's because US multinational companies operate on a global platform, and nearly one-third of US imports flow from foreign affiliates. If President-elect Trump does secure support for his plans to raise the cost of imported goods, we believe that it could put pressure on corporate operating margins and hurt US economic growth prospects.

Trump's policies are likely to trigger an increase in US fiscal deficits and public debt levels. We anticipate that the cumulative effect of his policies would also lead to higher inflation.

WHAT WILL THE FED DO?

Before the election, the Fed had ample grounds to begin to raise interest rates in December. The US economy is at or below full employment, and there's been an uptick in wage growth. Yet given the weakness in other parts of the globe, we expected any Fed rate move to be gradual and moderate.

Following the election results, the direction of the US dollar could influence the timing of a rate rise. Since the US runs a large trade deficit, the US dollar is vulnerable to a quick market reaction in the period of uncertainty after Trump's victory. If a dollar sell-off accelerates, we think it's more likely that the Fed will move toward raising interest rates faster than the market previously expected. However, much will depend on how the US dollar and other currencies move in the weeks and months ahead, as well as how other central banks react to the unfolding developments.

WHAT SHOULD INVESTORS BE THINKING ABOUT?

Trump's election has created significant uncertainty for investors. It will take time before the world has a clearer picture of how he plans to steer the government, and what will be the short and long-term impact on the US economy and markets. During this period of uncertainty, we think it's important for investors to take a wider perspective on what drives markets and securities.

+ **Short-Term Volatility to Persist:** Short-term market volatility often happens during election seasons, and is likely to continue after Trump's win. However, short-term market turbulence doesn't always translate to long-term dislocations. In the coming months, investors will get a better sense of whether a Trump presidency will indeed lead to major changes in US policy that could affect markets dramatically and that would require strategic changes to portfolio allocations and positioning.

+ **Consider Broad Market Drivers:** Stock and bond markets are influenced by many factors that aren't always directly driven by presidential policies. Government finances, central bank policies, oil prices and currency changes all move the markets. Some of these may be affected by Trump's policy changes, but there are other forces at play as well.

+ **Policymaking Isn't Just About the Presidency:** Congress is very important too. The Republican victory in the congressional elections will make it easier for President-elect Trump to push through policy changes. Yet given the divisions within the Republican Party, it remains to be seen to what extent his most radical proposals will have support in the House of Representatives.

+ **Focus on Fundamentals:** Our portfolio managers across asset classes choose securities based on the underlying fundamentals of companies and the industries in which they operate. It's important to consider how potential policy changes could affect fundamentals, especially in industries like healthcare, where Trump is likely to push to repeal Obamacare. But a policy change takes a long time—and isn't always directly relevant to the underlying fundamentals of many companies and industries.

+ **Develop Conviction in Long-Term Opportunities:** The election results have undoubtedly clouded the outlook, which is unsettling for investors. Yet at the same time, many long-term market trends are unlikely to change. In particular, we believe that market returns in general are likely to be lower in the years ahead—and this outlook remains unchanged from before the election. In this environment, enhancing performance with high-conviction insights and active positioning is essential. Of course, increased political risk will be incorporated by our portfolio managers in their analyses of securities, companies and industries while they develop their high-conviction investment theses.