FEG INSIGHT

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THE IMPLICATIONS OF A TRUMP PRESIDENCY

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Since the waning hours of November 8 when it was becoming clear that Donald Trump would win the U.S. Presidential election, investment markets have been reacting in occasionally volatile and unexpected ways. What does the future hold for a Trump Presidency? Should a long-term oriented investment portfolio be modified to capture new opportunities or avoid impending risks? FEG does not claim to hold all the answers, but observing a few important signs while relying on a fundamental foundation may help guide the way into the unknown.

Economic Implications

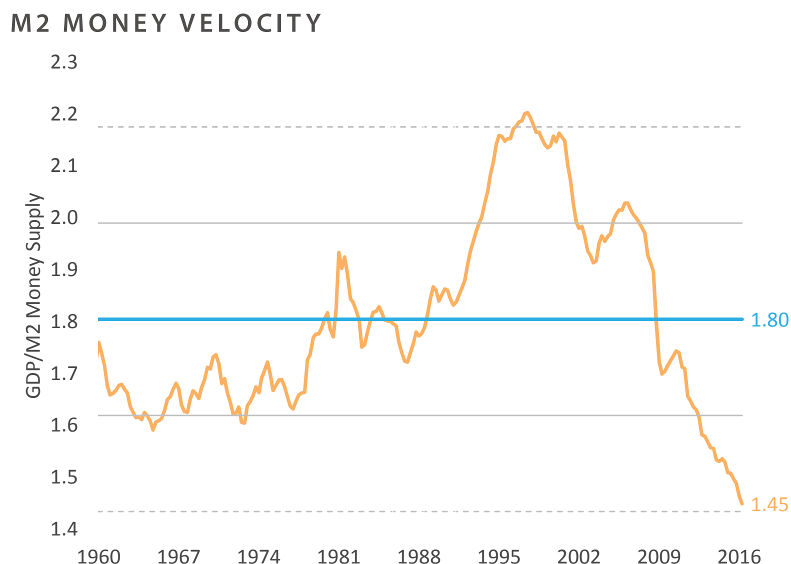
Among a number of other concepts, Trump ran on a set of promises that included tax reform—with particular emphasis on business tax reductions—as well as rolling back a variety of regulations. Infrastructure spending was also a focus and was mentioned in his victory speech. Thus, depending upon the type and magnitude of Trump's initiatives that ultimately come to pass, at least a short-term boost in U.S. GDP might be expected.

Let's consider the potential impact these policy initiatives may have on three economic areas:

I. Inflation
II. Interest rates
III. The value of the U.S. dollar

INFLATION

The U.S. employment picture has improved since the depths of the financial crisis while inflation remains muted with constrained corporate spending and a collapse in the velocity of money. As of the second quarter 2016, M2 money velocity was the lowest on record dating back to the late 1950s. This suggests that broad money expansion since the beginning of 21st century has thus far failed to translate directly into economic growth.



Data sources: BEA, Bloomberg, L.P.; data as of 2Q 2016.

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With the unemployment rate under 5%, the U.S. economy is arguably at, or at least near, full employment. As such, it may experience as much or more inflation as economic growth in response to the size of fiscal stimulus that some are expecting in the first few months of a Trump Presidency, which includes tax cuts and proposed $550 billion of infrastructure spending.[1]

The initial spark from Trump policies could set off a self-reinforcing blaze of new spending, with organizations executing on planned investments sooner than originally anticipated in hopes of predating higher prices and/or interest rates that could come thereafter.

INTEREST RATES

Interest rates reacted almost instantaneously to the Trump victory as the yield on the 10-year U.S. Treasury bond repriced from 1.75% on the eve of the election to more than 2.3%. The swift backing up in rates was in part a recognition that the pathway is now clear for the U.S. Federal Reserve (Fed) to introduce at least one rate hike in December and possibly more in 2017. Markets had already priced in a December rate bump, but might have tempered that forecast had risk assets sold off following the election. As that did not occur, rates have spiked up and could continue at least moderately higher going forward.

U.S. DOLLAR

Inflation, interest rates, and the dollar are all interconnected, but it can be constructive to think of the dollar as being reactive to the other two. Rising interest rates can entice investment dollars to the U.S., which places upward pressure on the greenback. Inflation, however, is consistent with a weaker dollar. Inflation manifests as a deterioration of purchasing power, which is exactly what befalls a weakened currency. Over long periods of time, therefore, inflation and the dollar should be expected to move in opposite directions.

Over short periods, however, inflation might coincide with dollar strength in response to temporary influences. For example, the dollar strengthened during the initial years of Ronald Regan's first term as his administration embarked upon deficit-fueled spending.

In addition, one proposed Trump policy is to allow a tax break on U.S. profit held overseas if brought back stateside, which could boost the dollar. The U.S. last introduced a one-time tax cut for repatriations just over a decade ago under the Homeland Investment Act of 2004. According to Internal Revenue Service data, more than $360 billion was repatriated, helping drive the dollar up 13% against a basket of six major peers in 2005, along with tighter U.S. monetary policy.[2]

The actual impact of repatriation on the dollar will depend on how many companies opt for the tax holiday, how much they actually bring home, and what amount of profits currently held overseas are not already denominated in dollars. Companies typically do not disclose the composition of their overseas earnings, although a 2011 report from Congressional Research Service, drawing on data from 27 U.S. multinational companies, found that 46% of the companies' overseas earnings were in U.S. dollar assets.[3]

Although rising interest rates do not always precede U.S. dollar strength, a functional connection between the two often exists. Assets will tend to flow out of lower yielding areas into higher yielding ones. Given the negative interest rate environment that exists in other parts of the developed world, a "reverse carry trade" may lead to dollar strength as funds seek out relatively higher yields in the U.S.

There is also reason to believe that Trump's protectionist policies—were he to hold true to his rhetoric— enacted to narrow the U.S. trade deficit might add strength to the domestic currency. The dollar may become more valuable if fewer of them were leaving the country upon purchase of foreign goods.

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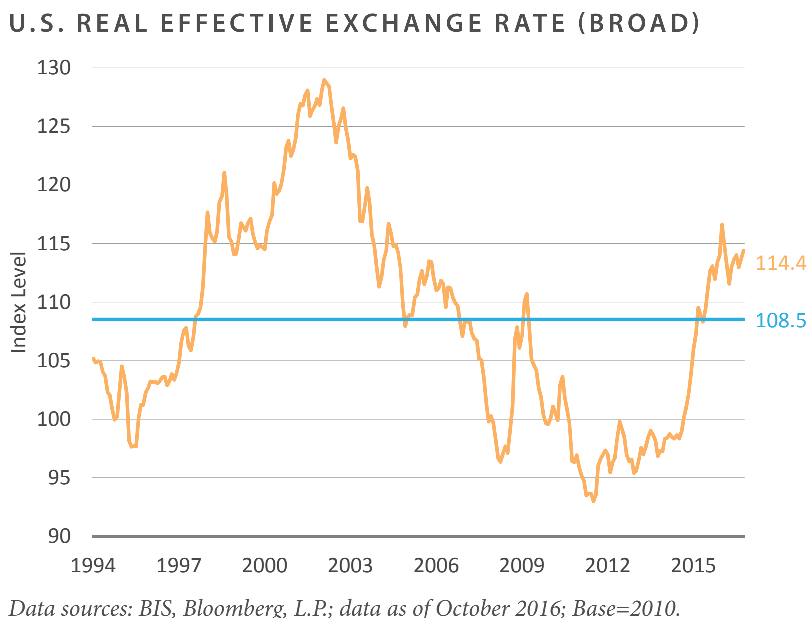
Finally, we should also consider the massive amount of U.S. dollar-denominated debt held outside the United States. Since the global financial crisis, banks and bond investors have increased the outstanding U.S. dollar credit to non-bank borrowers outside the United States from $6 trillion to $9 trillion.[4] Issuers of U.S. dollar-denominated debt are effectively short the dollar because they hold a liability to settle the agreement in that currency. A "short squeeze" can occur when a large number of market participants simultaneously attempt to buy back that which they are short, causing the price to skyrocket. As the issuers of this debt seek to trim losses in a higher interest rate/stronger dollar world, investors must be considerate of the risk of dollar strength.

All that said, a sustained elevation in the U.S. dollar is certainly not a foregone conclusion. A broad basket of the United States' trading peers—covering 61 economies—shows that the dollar is overvalued on an inflation-adjusted, trade-weighted (i.e. Real Effective Exchange Rate) basis by 14% through October 2016.



Data sources: BIS, Bloomberg, L.P.; data as of October 2016; Base=2010.

Investment Implications

The principal, post-election investment-related storylines can be largely related to rising interest rates and a stronger U.S. dollar. Led by small cap stocks, U.S. stock markets have risen to new highs. At the same time, international developed and emerging market stocks have incurred losses. Interest rate-sensitive fixed income securities have come under severe pressure as well.

What can we speculate regarding the future for investment markets post-inauguration? Let's carry the three categories—inflation, interest rates, and the U.S. dollar—forward into the investment implications they may portend, while touching on a few possibilities that pertain to individual asset categories.

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POTENTIAL INVESTMENT IMPLICATIONS FROM HIGHER INFLATION

With the U.S. economy running near full employment, an uptick in inflation would not come as a surprise in response to Trump's suggested tax cuts and infrastructure plans; but structural issues could inhibit the performance of assets typically considered inflationary hedges. Commodities accessed through futures contracts are inhibited by systematic contango on their term structure, and TIPS could be negatively affected by a rise in real interest rates that could arrive in response to a heating economy.

In many cases, inflation is not good for bonds. Therefore, a security providing a fixed coupon should be expected to become less valuable when the utility of that income is diminished by inflation. FEG's near-term outlook for long-duration fixed income, which is at historically low current yields, has been soured further by the prospect of inflation–even if it is muted by higher rates, which itself could represent a drag on fixed income returns.

Equities and their inflated profits might perform well during inflationary periods... for a time. However, this performance could also be short-lived, particularly for those with elevated valuations, such as U.S. stocks. Investors should also expect that inflation may be met with a higher interest rate regime (which is also not good for bonds). Higher rates cheapen the value of future earnings, making higher equity P/E ratios harder to stomach, which could place downward pressure on stock prices.

POTENTIAL INVESTMENT IMPLICATIONS FROM HIGHER INTEREST RATES

An obvious question here is why haven't oil and other commodities—historical beneficiaries of higher rates of inflation—reacted to the renewed fears of inflation? One potential reason is that the market may have already priced in the subsequent rise in interest rates expected to stamp out inflation. In a world of instantaneous information dissemination, the impact of something new is absorbed in a moment's notice. Thus, the second derivative of a Trump Presidency—higher interest rates expected in swift response to inflation—may already be dampening inflation before it has a chance to manifest. For this reason, the investment implications of higher rates must be considered more seriously than inflation.

The Fed would love nothing more than to move rates above the zero bound and provide themselves with traditional monetary policy tools to respond to the next economic-slowdown-driven pop in the unemployment rate.

The path to higher rates will inform the total return of bonds and stocks. The more swiftly it happens, the more painful. But after the initial shock, expected returns may be adjusted upwardly starting from a higher beginning rate. Regardless, the secular trend of lower rates that began in the early 1980s may now have begun a reversal.

If interest rates continue rising, duration-sensitive fixed income investments could suffer, but a period of higher expected returns could follow. U.S. stocks would appear more expensive in a higher rate regime, which would further diminish their expected returns in the near term; however, a retrenchment toward more sustainable valuations would leave them more attractively positioned thereafter.

POTENTIAL INVESTMENT IMPLICATIONS FROM A STRONGER U.S. DOLLAR

From November 8 through November 30, the U.S. Dollar Index (DXY) advanced 3.8%.[5] Based upon the response that could result from a number of expected Trump policies, additional strength in the U.S. dollar appears possible. Deficit spending on infrastructure, higher domestic interest rates, protectionist trade policies, a tax holiday that brings dollars back home, and the potential for a U.S. dollar short squeeze all support a stronger dollar. A stronger dollar could mute profits from large U.S. multinational companies, but if the repatriated cash mentioned earlier is used for stock buybacks, a portion of the pressure on stock prices that a stronger dollar may levy on profits could be offset. Overall, a stronger U.S. dollar could serve as a tailwind for U.S. stocks relative to those domiciled overseas.

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A stronger dollar could place downward pressure on international equities, particularly emerging markets, many of which could face the pain associated with a short squeeze on their U.S. dollar-denominated debt. Potentially counterbalancing the risk that emerging market equities face due to short-term currency fluctuations are their attractive valuations and the potential for a global growth spark that new pro-growth fiscal policies and a reduced regulatory burden could bring about.

POTENTIAL INVESTMENT IMPLICATIONS FROM A MODIFIED REGULATORY ENVIRONMENT

Thus far, the focus of this letter has been on inflation, interest rates, and the U.S. dollar, but it is important to also consider the potential implications associated with possible modifications to the domestic regulatory environment. Small cap stocks have been especially strong since the election, as the market expects them to potentially benefit from domestic stimulus. Fundamental aspects of the energy and financials sectors could allow them to enjoy a potential tailwind from deregulation as well. Infrastructure-related and defense companies are also predicted to benefit from Trump's outlined goals. Large multi-nationals with cash held abroad due to current tax policies have moved higher on the hope that this cash will be repatriated. By contrast, pharmaceutical and alternative energy stocks could face headwinds if Trump steps away from initiatives that supported these industries under the Obama administration.

With a Trump presidency, there could be greater potential for a broader divide between winning and losing sectors of the equity universe. Increased dispersion across sectors and securities could create more opportunities on both the long and short side for hedged equity managers to generate alpha.

The landscape for private equity could change in a variety of ways, in particular for healthcare. Trump campaigned on a vow to replace the Affordable Care Act. Whether that actually comes to pass—in whole or in parts—could affect a wide swath of healthcare-oriented private equity opportunities and risks.

Private energy investments stand to benefit if the regulatory environment is softened. Specific potential examples include rescinding regulations that affect methane emissions, hydraulic fracturing, and greenhouse gas emissions; streamlining permitting requirements for major infrastructure projects, clearing the way for pipelines; opening up public lands for expanded drilling opportunities, and auctioning off drilling rights in the Atlantic Ocean, Arctic Ocean, Alaskan wilderness, and the Eastern Gulf of Mexico.

Finally, there are potential implications on strategies employed by many hedge funds, but these are exceptionally difficult to predict. A general tendency toward softer regulations could bring positive change from the standpoint of merger and acquisition activity, but any direct government intervention to block specific deals could dramatically affect arbitrage opportunities. Only time will shed light on the prospects that hedge fund managers face and whether they will be able to profit from them.

A world of lighter regulations could have wide-reaching implications too numerous to fully cover here. A virtually limitless number of unknowns must be settled before any new regulation would be decided upon, and a potentially longer period of time before it would be implemented and enforced. Even the most speculative projections regarding the impact of regulatory changes would, at this point, be premature.

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If, How Much, and When?

Policies and actions upon which the President-elect will focus and will ultimately be able to execute are the stuff of speculation at this point. Further, the President-elect's nationalistic campaign rhetoric may give way to a pragmatism necessary to effect policy. Even less certain are the markets' reactions to those policies and actions. That said, insight and a sense of direction may be gleaned from developments as they begin playing out, which can then direct action.

One source of insight is to develop a sense of what a Trump administration may look like and anticipate areas of attention based upon those who will be placed in positions of influence. The first few cabinet announcements the President elect has made form a mix of hardliners and loyalists, along with some old guard GOP. One would have to think that he intends to make good on at least some semblance of the promises he made on the campaign trail. He may not, however, have the opportunity to do so fully and completely.

Republican control of the U.S. Senate is razor thin. Senatorial approval is required for treaties and for appointments, including cabinet seats and Supreme Court Justices. Republicans may find it difficult to overcome a filibuster if Democrats all hold the line.

FEG will be watching for any impact the actions and policies of the Trump administration could have on the future trajectory of currencies. Donald Trump's "contract with the American voter" indicates a promise to direct the Secretary of the Treasury to label China a currency manipulator.[6] A trade war could be disastrous in a variety of ways, so the early signs of such must be closely followed.

Trump's disdain for Janet Yellen and the resulting possibility that Fed independence could be reduced is an additional item that bears close observation. Fed Chair Yellen seems stalwartly committed to remaining in her post through the end of her term in 2018. With the opportunity to influence the composition of the Fed over the next few years, investors will certainly pay close attention to any of Trump's actions and appointments that may influence U.S. monetary policy in the future.

Conclusion

The election of Donald Trump as the soon-to-be 45th President of the United States brings with it a host of unknowns. The country will begin traversing down a divergent path from the one it has traveled over the past eight years, but the exact direction is anything but certain.

Although it is virtually impossible to predict the policies and actions upon which a Trump administration will focus—and even less possible to foretell market reaction—looking for signs to shed light on the currently foggy future can help offer clarity. Without perfect foresight into future market activity, thoughtful investors recognize the importance of holding true to a fundamental foundation concentrated on the longer-term horizon that diversifies globally and boldly executes a valuation-driven strategy. The next four years will almost certainly appear wildly different from the past eight. With change comes risk, but also opportunity. With diligence and humility, we endeavor to distinguish between them.

[1,6] www.DonaldJTrump.com
[2] Chelsey Dulaney, "Dollar to Benefit if $2.5 Trillion in Cash Stashed Abroad Is Repatriated", The Wall Street Journal, November 25, 2016.
[3] Chelsey Dulaney, "Dollar to Benefit if $2.5 Trillion in Cash Stashed Abroad Is Repatriated", The Wall Street Journal, November 25, 2016.
[4] Robert N McCauley, Patrick McGuire and Vladyslav Sushko, Bank for International Settlements, BIS Working Paper 483, "Global dollar credit: links to US monetary policy and leverage", January 2015.
[5] Bloomberg

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