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US elections – Playing the Trump card

IN BRIEF

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When Donald Trump launched his presidential campaign in June 2015, some saw it as the biggest joke of the year. Now, with the US elections less than one month away, a Trump presidency seems like a very real prospect.

Luca Paolini and Supriya Menon from the Pictet Asset Management Strategy Unit consider what that would mean for markets.

THE PICTET ASSET MANAGEMENT STRATEGY UNIT (PSU)

is the investment group responsible for providing asset allocation guidance across stocks, bonds, cash and commodities.

When the world wakes up on 9 November, it will be waking up to one of two very different scenarios.

In the first one, Hillary Clinton wins the US presidential election, which should pave the way for the broad continuation of the status quo for the economy, monetary policy and financial markets.

The second scenario – a victory for Donald Trump – would bring significant change, especially in areas such as taxation, healthcare, energy, immigration and, potentially, the functioning of the US Federal Reserve.

Perhaps the likeliest market response to a Trump victory is a rise in the gold price, which would reflect investor uncertainty over the future relationship between the US and the rest of the world. As far as other asset classes are concerned, the outlook is much less clear.

Lower corporate taxes, higher bond yields

For equities, the higher policy uncertainty would justify a higher risk premium. However, historically the S&P 500 stock index has rallied in the three months after US presidential elections (after selling off in the run-up) and some of Trump's policies should be positive for equities. In particular, he has suggested lowering corporate tax rates to 15 per cent (from the current 35 per cent) and significantly reducing the top personal income tax rate to 33 per cent (from 39.6 per cent). He has also pledged to spend at least double the amount promised by Clinton on infrastructure, which would work out at USD550 billion over five years.

While this could be good for equities, it is bad news for the bond market. The Tax Foundation has calculated that headline Trump tax and spend proposals could add USD10-12 trillion of debt – equivalent to 50 per cent of GDP – versus currently projected borrowing levels over a decade.

Even if the size and scale of fiscal expansion is tempered by a Republican-controlled Congress, high borrowing is likely to raise concerns about the sustainability of the US debt pile, potentially discouraging some investors and further pushing up US government bond yields.

Uncertainty over Fed policy – and the US dollar

The outlook for monetary policy under Trump is murky, particularly as the role of the Fed has been an area of major policy disagreement between him and Clinton. Trump has called attention to the supposed "politicisation" of the Fed and criticised Janet Yellen's leadership of the central bank. We are therefore highly sceptical that he would lengthen Yellen's term beyond its 2018 expiry. At the same time, Republicans have called for annual Fed audits, which raises questions about the future of the central bank's independence.

It is not clear if looser fiscal policy and the threat of greater Fed oversight will result in a steeper or more shallow interest rate path than currently priced into the market. While there is an argument for the Fed to tighten monetary policy in the medium term to offset the Republicans' looser fiscal stance, there is equally a case in the shorter term for the Fed to defy market expectations and keep rates on hold in December if financial conditions tighten in the wake of a Trump victory.

The uncertainty over Fed policy also makes it hard to assess the likely trajectory of the US dollar. The short-term, knee-jerk reaction to a Trump win is likely to be a sell-off. Beyond that, more weakness could ensue if the Fed does not hike rates in December, or if foreigners sell US Treasuries. On the other hand, a rise in risk aversion in global markets could lead to US dollar appreciation due to its long-established status as a safe haven (even during periods of stress which originate in the US). Trump's more protectionist, fiscal policy-heavy agenda would also point to a higher dollar.

Trade policy likely to weigh on exporters, emerging markets

The biggest risk surrounding a Trump presidency concerns trade. This is where his rhetoric has been quite extreme. While some of the most radical proposals – such as a 45 per cent tariff on Chinese goods and renegotiating the North America Free Trade Agreement (NAFTA) – are unlikely to materialise, there is still a risk of an escalating tariff war with China or another trade partner. Higher tariffs would lead to higher inflation and disrupt supply chains – developments which are undoubtedly negative for equities. Upward pressure on inflation and/or downward push on corporate margins will increase thanks to the proposed curbs on immigration.

As a result, within the US equity market, domestically-focused companies are likely to outperform those who export and manufacture overseas. Further afield, emerging market assets will suffer from a Trump win – via lower trade and, potentially, a weaker Renminbi.

Trump good for energy and defence, bad for renewables

When it comes to assessing the prospects for equity industry sectors, energy, defence and financial companies would fare better in a Trump regime. His promise to deregulate energy production and exports should be positive for oil services and equipment companies, even as it increases supply.

In healthcare, a Trump win would probably mean the end of Obamacare. However, regardless of who becomes president, the pricing of healthcare drugs, now under close public scrutiny, will likely evolve in a less favourable direction for the sector.

Lessons from the Brexit referendum

The lesson of Brexit and of other recent political upsets is that investors tend to underestimate the risks in the run up to a major event, and then exaggerate the implications of the outcome once it happens.

The best course of action is therefore to reduce risk ahead of the elections by taking profits where possible, as we have done. The next stage is to look for opportunities to exploit the likely market overreaction in case of a Trump victory by re-entering some positions.

Defence and oil service stocks will likely benefit from a Trump win, while US bonds suffer.

FIG.1

Investment implications: Trump vs Clinton

	BUY	SELL
TRUMP WIN	Gold Oil services Defence Tech Banks Steel	Renminbi Mexican peso and equities US bonds
CLINTON WIN	Renewables Low-end retailers Social media	Pharmaceuticals Banks Oil

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