Macro Matters.

Trump – too close for comfort

For professional advisers and trustees only

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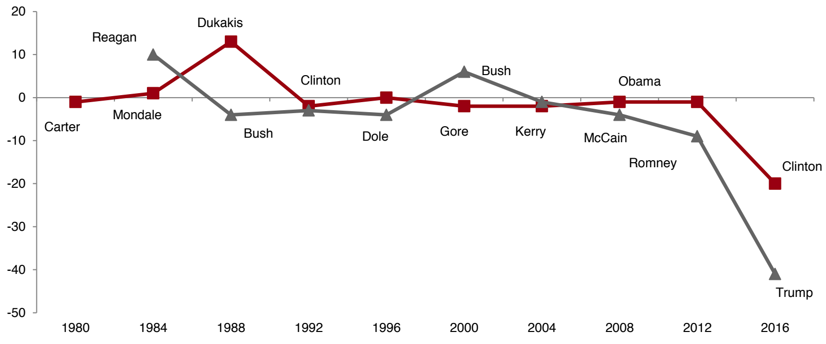
Conventional wisdom says Donald Trump doesn't stand a chance against Hillary Clinton in a general election. With Clinton standing for the status quo, this line of thinking implies that we shouldn't worry about the US election. Although a Trump presidency is not our base case either, its probability seems too high to ignore, with significant potential implications for US assets.

More likely than you think

Betting markets give Trump a one-in-three chance of winning and many pundits and investors see the odds being much lower than that. After all, in his efforts to appeal to the Republican base, he has taken extreme positions that would appear to have alienated too many parts of the electorate to be successful in November's general election. Mitt Romney is widely seen to have lost the 2012 election due to a lack of support from minorities. After the past few months it is difficult to see how Donald Trump could receive greater support than Romney did from the Hispanic and Asian population, or revert to pre-Obama support levels with the African American population. It is also difficult to see how Trump could improve on Romney's share of the vote with women. Throwing into the mix the lukewarm backing by significant parts of the Republican party and his oft-declared dismissal of the data-driven campaign methods that helped Obama secure two victories, the 'conventional wisdom case' sounds reassuringly solid and is a sensible base case.

Unfortunately, conventional wisdom doesn't exactly have an impressive track record on Trump. So let's ask the question: How could Trump win? First off, his approval ratings may be at record-breaking negative levels, but Hillary Clinton's aren't much better, so it's possible they cancel each other out as a factor in deciding who to vote for (see **figure 1**). Also, being quite new to the political game, Trump arguably has a better chance of changing perceptions of himself than Clinton, who voters have formed their views on over her decades in public life.

Figure 1: Net approval ratings of each election years



Source: Roper Center, IBD/TIPP, April 2016

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It is also possible that Trump can boost the turn out of non-hispanic white male voters (where he has a large lead in the polls) to offset his poor polling with minorities and women. The non-hispanic white male percentage of the vote may have steadily declined from 45% in the early 1980s to 35% today, but they still represent the largest share. This is a stretch, but given Trump's success in turning out previously unengaged white male voters in the Republican primaries, it is not impossible.

Then there's event risk. An economic downturn is not impossible and tends to weigh on the incumbent party, in this case Clinton. A terrorist attack could have a similar impact. While it's not a given that this would boost Trump's chances, the precedents of the Paris and Brussels attacks show he has been very skilful at turning such events into increased support by taking a hard-line stance (e.g. Muslim ban).

We could easily add further to the list, but the point is that while winning the Presidency will be an uphill climb for Donald Trump and should not be the base case, the probability seems higher than consensus thinks and certainly too high to ignore. And the experience from history is clear: a significant shift in the probability of a political event can be enough to move markets.

What would Trump do?

Let's assume Trump wins or at least the market re-prices his chances of winning. What would a President Trump do? It's not an easy question to answer given that Trump describes himself as 'totally flexible on very, very many issues', but it's an important issue to think about.

The list in **figure 2** starts with the known knowns, by which we mean all the positions Trump has shown the greatest consistency on over time. It makes for a surprising mix of views from typically conservative positions such as repealing the Affordable Care Act (Obamacare) to right-wing positions (even by Republican standards) on immigration, all the way to quite left-wing positions on free-trade agreements. This is one of the reasons it has been so difficult for many established Republicans to support Trump.

We would have some but less confidence in recent position changes: what we call known unknowns. These include the minimum wage, where Trump has swung around to supporting a federally mandated increase in the minimum wage, and his now much more pro-Wall Street statements on dismantling Dodd-Frank.

The main conclusion is that Trump is clearly not an ideologue with a firm set of core beliefs; there are therefore many unknown unknowns. One can view this as a negative because markets don't like uncertainty, or as a positive because a pragmatist may be more likely to get things done in a partisan Congress. It would also let us discount some of his more extreme positions as only the starting point in a negotiation.

Finally, and at least as importantly, we need to add constraints to the equation. The President of the United States may be the most powerful person on the planet, but he or she is far from omnipotent. The Constitution gives the President more leeway on foreign policy than on domestic affairs, but even on the former there are several checks and balances in place. The White House has some latitude

Figure 2: Trump positions

Known knowns (core beliefs)
Repeal the Affordable Care Act (Obamacare)
Lower and simpler corporate and income tax
Much tighter immigration laws and border security
Renegotiate US trade agreements
Threat of higher tariffs on imports
Brand China a currency manipulator
Increase public spending on infrastructure
Pro fossil fuel and nuclear energy
Strongly pro gun rights
Known unknowns (recent positions)
How to reform healthcare after the repeal of Obamacare
Increase minimum wage
Dismantle Dodd-Frank
Renegotiate the Iranian nuclear deal
No cuts to Medicare and social security
Expand the military
Eliminate tax deductions for wealthy individuals and corporations
Unknown unknowns
Possibility of unexpected announcements
Sudden policy changes
Ill-advised comments

Source: LGIM

to punish countries deemed to be engaged in currency manipulation or other free trade abuses, something to which Trump has alluded. Signing trade treaties, however, requires Senate approval, although it is seen as likely that the President has the authority to pull out of existing trade agreements. Also, Congress must approve all federal spending, which means it could stop Trump's proposals by refusing to fund them. Perhaps the most powerful tool for a President Trump to exert influence is via the office's power to shape and direct the national debate: what President Theodore Roosevelt called the 'bully pulpit'. Trump is likely to be a natural at this aspect of the job. But this type of influence, like the ability to appoint likeminded policymakers and regulators is more gradual and will take time to have an effect.

How much a President Trump could change also depends on his self-professed deal-making ability. A broad range of outcomes is possible on this front. It's possible that he's not overpromising on his ability to compromise and that his mix of traditionally liberal and conservative positions will allow him to draw support for some of his bills from both sides of the political spectrum; an outbreak of bipartisanship. At the same time it's not inconceivable that he alienates both Republicans and Democrats, resulting in even greater gridlock in Washington than in the past few years.

Market implications

Given the unusual lack of visibility about what policy mix to expect from a Trump administration, uncertainty is perhaps the only thing we can be certain of.

In advance of an election, the main influence on the economy comes from political uncertainty: who will win and what will they do? Then, as a (likely) winner emerges, uncertainty declines again. However, this time could be different! Uncertainty could stay higher for longer as even certainty over Trump as President would not erase the uncertainty over policy mix and the unknown unknowns from **figure 2**. It is a cliché that markets don't like uncertainty, but we would expect an increased likelihood of a Trump Presidency to be accompanied by a higher risk premium for US assets.

Offsetting a higher risk premium for equities could be the prospect of increased fiscal spending, providing at least a short-term boost from higher growth expectations. Unlike in the 2012 campaign, fiscal sustainability has not featured much so far this time round. Trump has talked little about balancing the budget, but has instead emphasised measures that would likely add to the debt, such as significant infrastructure spending.

This is naturally a less attractive policy from a sovereign bond holder perspective, especially when coupled with Trump's rather worrying comments on treating bond holders. His repeated boasts of taking on debt as a businessman with the explicit intention of defaulting on it later are a concern and things aren't improved by the various stances he has taken on debt repayment over the past few months. These have ranged from suggesting a default, to renegotiating the debt and printing money to pay the debt. It is likely that Trump's views on this would moderate if he got closer to the Presidency, but at the least it would perhaps question the role of US treasuries as the world's risk-free asset.

Some assets that qualify as potential Trump 'losers' are likely to lie outside the US, where the President's policies are less likely to be reined in by Congress. The prospects of the TPP (Trans-Pacific Partnership) passing into law would decline significantly in a Trump Presidency scenario, which would be another hit to the Abenomics narrative for Japanese growth and equities. A TTIP (Trans-Atlantic Trade and Investment) agreement becomes less likely, it is difficult to see relations and trade with Mexico improve and Trump has floated ideas of significant tariffs on imports from China. A US-China trade war could be more disruptive for trading nations such as Germany and Japan than for the US itself. At a stock level, this could have negative consequences for exporters and importers, both in the US and affected trading partners. Companies that are most reliant on global trade are likely to be the most direct losers of the market attaching a higher probability to Trump becoming president.

Beyond the sugar high of increased fiscal spending, however, Trump's anti-free trade, anti-immigration and pro higher minimum wage policies could weigh on corporate margins. To some degree this could be the case regardless of whether he wins in November or not. The success he and Bernie Sanders have had with their mix of populist positions will be difficult, even impossible, to ignore for anyone else running for office. It is possible that Trump's legacy will therefore be a shift of the centre-ground of US politics to the left; a move away from globalisation, lower taxes and de-regulation.