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The Celebrity Apprentice

Equities soared on Trump's surprise victory;
Governing will be harder than campaigning

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It was a huge surprise, and one wonders if most professional pollsters and pundits, to quote a phrase frequently used by President-elect Trump, "should be ashamed of themselves." Market strategists had also overestimated the anxiety over heightened policy uncertainty of a Trump victory; many had predicted that markets would sell off as a result. They were correct for a few hours as Asian markets tanked and U.S. equity futures were halted limit down when it became increasingly clear on election night that a huge upset was in the making. However, President-elect Trump's conciliatory victory speech and the Republicans retention of control of both chambers of Congress suddenly gave hope to investors. Equities surged on the optimism that the new administration will be able to implement highly pro-growth policies – tax cuts, offshore cash repatriation, lessoning of regulatory burdens, and a $1 trillion infrastructure spending program. Equity indices, led by the Russell 2000® Index, the benchmark for U.S. small cap stocks, went on a tear to new heights. Treasury yields, however, gapped up on the realization that the combination of tax cuts and big fiscal spending would likely lead to more budget deficits and national debt. All of a sudden, the rates-staying-lower-for-longer thesis was ditched across the globe, and rising inflation expectation became the new mantra. The prospect of accelerating growth, repatriation of offshore cash, and higher Treasury bond yields lifted the U.S. Dollar Index (DXY) to 14 year highs. Most commodity prices also surged on the expectation of rising demand from the U.S. infrastructure spending program, but precious metal prices retreated as

Equity Markets Indices[1]	10/31/2016 Price	11/30/2016 Price	MTD Change	YTD Change
MSCI All Country World	411	413	0.6%	3.5%
S&P 500	2126	2199	3.4%	7.6%
MSCI EAFE	1666	1630	-2.2%	-5.0%
Russell 2000®[2]	1191	1322	11.0%	16.4%
NASDAQ	5189	5324	2.6%	6.3%
TOPIX	1393	1469	5.5%	-5.0%
KOSPI	2008	1983	-1.2%	1.1%
Emerging Markets	905	863	-4.7%	8.6%
Fixed Income				
2-Year US Treasury Note	0.84%	1.12%	27	7
10-Year US Treasury Note	1.83%	2.38%	56	11
BarCap US Agg Corp Sprd	1.32%	1.29%	-3	-36
BarCap US Corp HY Sprd	4.77%	4.55%	-22	-205
Currencies				
Australian (AUD/$)	1.31	1.35	-3.0%	1.3%
Brazil Real (Real/$)	3.19	3.39	-5.7%	17.0%
British Pound ($/GBP)	1.22	1.25	2.2%	-15.1%
Euro ($/Euro)	1.10	1.06	-3.6%	-2.5%
Japanese Yen / $	105	114	-8.4%	5.1%
Korean Won / $	1144	1169	-2.2%	0.5%
Commodities				
Gold	1277	1173	-8.1%	10.5%
Oil	46.9	49.4	5.5%	33.5%
Natural Gas, Henry Hub	2.79	3.30	18.0%	42.5%
Copper (cents/lb)	221	262	18.9%	22.8%
CRB Index	186	189	1.6%	7.4%
Baltic Dry Index	857	1204	40.5%	151.9%

SOURCE: BLOOMBERG

the need for investment safe havens would likely diminish if growth indeed re-accelerates.

A Contentious Election

Many people probably breathed a sigh of relief that the contentious election that divided the country was finally over. Some quipped that Americans were forced to choose between the lesser of two evils – a reputedly intellectually lightweight celebrity vs. an uninspiring policy wonk with foreign policy setbacks in the Middle East. In the end, Americans decided to roll the dice with an outsider who promised to "Make America Great Again". Republicans not only captured the White House; their down-ticket candidates also benefited from the coattail effect, as prominent Democrats, like Senator Bayh of Indiana, were soundly defeated.

A 1980's campaign relic (Source: Wikipedia.org)

I was not old enough to vote in that consequential 1980 election. As an idealistic but naive high schooler, I had taken an interest in the Socialist Party's platform of re-distributing wealth, cutting defense spending, and nationalizing oil companies. Of course, these ideas were so far outside the mainstream that David McReynolds, the country's first openly gay and atheist presidential candidate, wound up getting less than 7,000 votes; I wonder if Bernie Sanders' was among them.

Heading into the Election Day on November 4, 1980, most pollsters had called the race between President Jimmy Carter and Ronald Reagan "too close to call." However, Reagan wound up winning by a landslide (50.7% to 41% in popular vote, and 489 to 49 in electoral votes), and his strong coattails resulted in a net Republican gain of 12 Senate seats from the 33 that were up for election. Nine incumbent Democrats were defeated, including Senator Birch Bayh of Indiana, whose run for a fourth term was foiled by 33-year old Dan Quayle. Birch Bayh is the father of Indiana's two-term senator Evan Bayh, who had never lost an election until this November. History rhymes.

Morning in America Again?

The similarities between the 1980s and this year's elections led some to suggest that President-elect Trump may turn out to be a Reaganesque figure. There are, however, some substantive differences.

Ronald Reagan was a two-term governor of California, the eighth largest economy in the world at the time. Donald Trump is a novice in government – the first ever U.S. president without any prior public sector or military service experience. However, some may view that outsider status as a plus, as he could take a fresh approach to "drain the swamp."

President Reagan inherited an ailing economy, but had more space to maneuver. When he was sworn in on January 20, 1981, inflation was 12% and the unemployment rate was 7.4%. It took a 16-month recession to finally break the back of inflation, which then started a 35-year decline of U.S. Treasury bond yields. Budget deficits were widening due to big increases in defense spending, which eventually paid off with a huge peace dividend in the form of the Soviet Union's collapse. Yet the U.S. gross federal debt-to-GDP remained manageable, rising from 31% when the Gipper came into office to 50% at the end of his second term. Demographically, baby boomers were entering their prime spending years, a very positive driver for consumption growth.

In contrast, Donald Trump will likely have less flexibility. With the gross national debt having doubled from $10 trillion to $20 trillion (74% to 105% of GDP) during the Obama presidency, Republican fiscal hawks in the Congress may not be willing to rubber stamp the new administration's big tax cuts *and* the $1 trillion infrastructure spending program. Indeed, should bond vigilantes really wake up from their long hibernation to push rates even higher, the real economy – the housing market, for example – will start to get crimped by the tightening financial conditions.

President-elect Trump is also inheriting an economic expansion that has taken the unemployment rate down to 4.9%. The unemployment rate among U.S. construction workers has fallen from a peak of 27% in February 2010 to 5.7%, which is at the low end of the historical range going back to 2000. Faster economic growth in combination with more restrictive immigration policies will likely lead to labor shortages and increasing wages. This will be a high class problem, as American workers deserve a raise after years of wage stagnation. However, it is also likely to push the Fed into a more aggressive tightening mode, which is how most expansion cycles eventually hit the wall.

As for the much ballyhooed $1 trillion infrastructure spending program, which has already lifted interest rates and prices of related stocks and base metals, the details are sketchy, and its impacts are not likely to be felt until 2018 the earliest. Simply put, it takes a long time for infrastructure projects to work through the tendering and other bureaucratic processes. As a case in point, the $831 billion stimulus program unveiled in 2009 was supposed to fund shovel ready projects. The California High Speed Rail project, which commenced in 1996, got the federal funding in 2010 and held the groundbreaking ceremony in *2015*.

We believe the biggest market impact of the Trump victory is that his pro-growth initiatives will substantially diminish the odds of recession in the next couple of years, thus supporting equity prices. Longer term, the country's aging demographics will continue to push up the entitlement and debt burden. While President-elect Trump has vowed to repeal and replace Obamacare, there are still other daunting issues looming for Medicare and Social Security. An inflationary and higher interest rate environment will exacerbate the challenges.

Time to Get Tough?

The one issue that equity rallies appeared to overlook at the moment is the protectionist tendency of Trumponomics. President-elect Trump's economic platform has specifically named Mexico and China as two of his targets. The platform calls for renegotiating the North American Free Trade Agreement (NAFTA), eliminating "sweatshops in Mexico," labeling China a currency manipulator, and applying tariffs to remedy trade disputes with the country.

We suspect Mexico will have to make some concessions as the U.S., being a much larger market, has more negotiation leverage. With Mexico having developed into a manufacturing hub, especially for the automotive industry's global supply chain, the impact would be felt beyond the shores of the U.S. and Mexico.

The real test will be how the Trump administration deals with China. While China exported more than four times what it imported from the U.S. in the bilateral trade ($483 vs. $116 billion in 2015), their market is big enough that they could potentially take effective retaliatory measures against the U.S. How would a trade war affect the sales of iPhones and Boeing planes in China? China's domestic car market is approaching 30 million units per year and growing, compared to less than 18 million in the U.S. Do American car makers want to cede market share in China to Japanese and European auto makers? As for the currency manipulation charge, it is widely known that, over that last eighteen months or so, the renminbi would have been even weaker if not for Chinese government's intervention. So what remedy will the Trump administration seek with regard to the renminbi? Intriguingly, as a protagonist in the Art of the Deal, President-elect Trump could opt to start out the negotiation with an outrageous position. By labeling China a currency manipulator, it would not trigger any immediate punitive measures against the country, but would please the president-elect's base and send a clear message to our trading partners to think twice before using currency to boost exports. The administration could then seek to work out a deal that enables both sides to claim victory to their constituents. However, markets are not likely to react calmly as the shock value of such a move could take a toll on sentiment. In short, financial markets' initial euphoria is likely to be tested as the president-elect seems to enjoy being theatrical and unpredictable.●

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[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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