17. November 2016

https://blog.en.erste-am.com/markets-assume-president-trump-will-deliver/

Markets assume President Trump will deliver

Peter Szopo

© © iStock

The outcome of the US election last week, together with the Brexit-vote in June, was the second major political event this year that shook financial markets. In both cases the outcome was different to what pollsters, the media and investors anticipated. Unsurprisingly, markets – across asset-classes and geographies – reacted strongly and in some cases completely different to what was expected before the event. Donald Trump's win is seen as game-changer, reflecting the next president's pronounced views on free-trade and immigration, his geo-political positions and his domestic economic agenda including a massive fiscal boost to upgrade the country's infrastructure, tax cuts and deregulation.

After a very short period of confusion in the early morning hours after the vote, markets started falling in line with the gist of what investors and the wider public assume a Donald Trump-presidency will entail. However, it is important to note that in a number of areas, the election outcome merely accelerated trends that were already evident before. Particularly as far as the "reflation trade" is concerned – the view that equity market will be moved by accommodative macroeconomic policies and rising inflation – Mr. Trump's success seems to strengthen already existing trends rather than changing the game.

The following charts show in more detail what has happened before and after the election:

1. **Long-term government yields soared by more than 40 basis points** (see Fig. 1), reflecting the incoming president's announcement of a massive fiscal stimulus. Gavyn Davies, in his blog in the Financial Times, estimates that Trump's proposed tax cuts and extra spending will lift the US fiscal deficit to 6% of GDP by 2018. Bond investors, apparently, have taken notice.

fig1_trump

2. Inflation expectations are gaining momentum. Similarly to bond yields, inflation expectations have been climbing for several months on the back of rising actual inflation rates. Consequently market sentiment shifted, with "deflation fears" fading away and investors starting to focus on the "reflation trade". Given Mr. Trump's expansionary intentions, this shift has gained momentum as the jump in inflation expectations last Thursday showed (Fig. 2).

fig2_trump

3. The combination of a fiscal stimulus and the Fed's tightening bias is supporting the Dollar (Fig. 3). While the US currency was already strong before the election, since the eve of the election it gained another 2% and is now trading close to its 5-year high (100.5 on Dec 2, 2015). How this will affect the interest rate decisions of the Federal Reserve Bank going forward needs to be seen. A rate hike in December seems to be almost a certainty according to market consensus (92% probability), but if the Dollar continues strengthening, the Fed's further rate policy will likely to be even more subdued than assumed earlier this year.

fig3_trump

4. Equities: Developed markets (DM) benefit from cyclical upside, while emerging markets (EM) suffer from structural threats. Post-election US equities have strengthened (Fig. 4) and a number of cyclical sectors even rallied, whereas EM currencies and equities have corrected. Apparently, equity investors in the US as well as in other developed markets have been buying into the stimulus story while ignoring the risks related to the protectionist ingredients in Donald Trump's economic agenda.

On the positive side, the fiscal measures announced during Trump's election campaign (and reiterated since then) could lift US growth by 1% both in 2017 and 2018 according to estimates by Gavyn Davies which would be clearly supportive for equities. It is no surprise that particularly cyclical stocks related to construction, infrastructure and transport massively outperformed the market in recent days.

On the other hand, the other key elements of Mr. Trump's agenda are definitely not equity friendly: a stricter anti-immigration policy will likely hurt profitability, and the adoption of a widespread protectionist stance will negatively affect productivity in the long run. Together they can be seen as negative supply shocks for the US economy.

fig4_trump

While for DM equity investors the cyclical upside in the near term seems to outweigh longer term structural concerns, EM investors immediately reacted to the fallout from the next president's protectionist agenda. EM equities, which outperformed DM stock markets by more than 10% in the first ten months of the year, lost about two thirds of their relative gains after the election (Fig. 5). International trade and economic growth in emerging markets are closely linked. Therefore, the risk of the world's largest economy introducing trade obstacles and retreating from international trade arrangements is a serious threat to the EM corporate sector.

fig5_trump

Conclusion

Overall, market movements were massive in the first couple of days after the election, although in terms of direction they were mostly in line with pre-election trends. DM equity markets in particular seem to have digested the political shift without major hiccups, with implied volatilities quickly returning to pre-election levels.

The key message implied by the post-election performance of currencies, bond yields and stock indices is: investors believe that President Trump will deliver on what he announced during his election campaign. This is a key difference to the Brexit-referendum, which markets (probably wrongly) apparently considered almost as a non-event. While it is still early days, investors are less relaxed this. What markets are saying is: the Donald Trump-presidency will unlikely turn out to be a non-event.

Peter Szopo

Peter Szopo has worked as chief equity strategist at the Erste Asset Management since March 2015. Before he already worked as a consultant for equity fund management at Erste Asset Management for Central and Eastern European equity markets. From November 2009 to April 2013, he was head of the research department at Alfa Bank in Moscow.

After his research work at WIFO (Austrian Institute of Economic Research) from 1978 to 1990, he worked as a securities specialist in various management functions at internationally renowned investment banks. During this time he held the position of Head of Research at such institutions as Creditanstalt Investmentbank, UniCredit Bank Austria, Robert Fleming Securities, and at Bank Sal. Oppenheim.

Along with his analysis activities, he worked from 1997 to 2000 at Eastfund Management as the fund manager for Central and Eastern European equity.