US presidential election commentary

11 November 2016

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Trumped! Positioning portfolios for The Donald

Donald Trump's surprise victory in the US presidential election was not just a defeat for Hillary Clinton, it was another crushing blow for pollsters hard on the heels of the Brexit referendum upset. I have not deviated in my approach to unforecastable political events. Thus, I did not build in a bias towards a particular outcome when making asset allocation decisions in advance of the US vote. In recent weeks, I have, however, taken profits from investments in equity funds because I thought equities could prove vulnerable to both the uncertainties of US electoral politics and a potential US interest rate rise later in the year.

One surprising consequence of Trump's win was the response of equity markets. The initial reaction to the news of his gathering victory was negative. Asian markets fell sharply, with Japanese equities down 4.57% in local currency although this loss did not exceed the Tokyo fall after the Brexit vote. In the hours after the polls closed and expectations rose of a Trump victory, US equity market futures anticipated a sharp fall for US equities. In the event, the bargains were short-lived. In contrast to initial expectations, US equities rose 1.11% on Wednesday, the day after the election. Japanese equities rebounded 5.78% in local currency on Thursday, more than erasing the previous day's loss. The more sanguine investor response compared with the Brexit vote may reflect a greater degree of preparation and higher cash levels in portfolios as well as more cynicism towards political pundits but investors are undeniably warming to the prospect of a Trump presidency. So what does Trump's victory mean for investors?

Monetary policy

The Federal Reserve chair, Janet Yellen, was appointed by the Democrats but her current term of office runs until 2018 and is unchanged by the election of a Republican president. Unless she resigns, the Fed's framework for setting monetary policy is unlikely to alter radically before then. Interest rates are likely to increase at a slow pace subject to economic data. If she is not reappointed in 2018, a Republican-leaning Fed chair might raise interest rates more swiftly but Republicans and Democrats are much closer on this issue than they were at the time of the 2008 credit crisis and change is likely to be evolutionary rather than revolutionary.

Fiscal policy

Clinton and Trump both pledged tax cuts and more infrastructure spending. In the Congressional elections, the Republicans preserved their majorities in the House of Representatives and the Senate, a result that should aid Trump in getting his policies enacted. Personal and corporate tax cuts and increased state investment should enhance economic growth and inflation, potentially leading to gains for US equities.

"Putting America first"

This was how Trump has described his approach to the "world community". While he was on the campaign trail, many interpreted this as "protectionism", forecasting that barriers to free trade would be raised under a Trump presidency. I believe in the benefits of free trade and fear that Trump's policies may ultimately damage global growth. I have been reducing clients' allocations to emerging market equities through profit-taking. I have thought US equities were overvalued for some time but I will now look for opportunities among small and medium-sized US companies, which might outperform larger stocks if Trump's trade policies result in stronger profits growth for domestic US companies.

Inflation or deflation?

Since the 2008 credit crisis ushered in the current era of exceptional monetary policies, debate has raged on the subject of whether such measures will be defeated by deflationary forces or ultimately prove inflationary. In recent years, the "deflationists" have won the argument.

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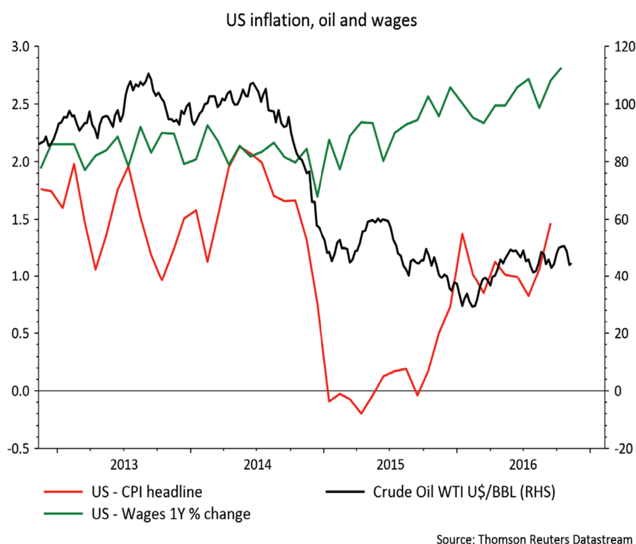
Chinese currency depreciations in August 2015 and January 2016 and the oil price fall since 2014 have fed fears of deflation at a time when central banks were perceived to be running out of policy tools to prevent it. Central bankers have consistently called on politicians to support monetary stimulus with expansionary fiscal policies but governments have generally been slow to act.

US bond prices fell in the immediate aftermath of the election, pushing up yields. US inflation has been stirring for some time as a result of rising commodity prices and some signs of recovery in wage growth, as the chart below illustrates.



Trump's fiscal plans may prove inflationary and the sanguine market response to his victory gives the Fed no reason to stay its hand from raising rates in December. I recently reduced clients' investments in longer-dated bond funds as appropriate to the investment strategies, replacing them with investments that might benefit from rising inflation and interest rates. US financial companies, for example, should benefit from improved profitability as a result of rising longer-dated bond yields.

Increased inflation and an attendant rise in interest rates may also herald a change in leadership in equity markets. In recent years, so-called "bond proxies", those companies with relatively predictable earnings and strong and stable cash flows, have been in demand among income-seeking investors and valuations now appear stretched. These companies may now underperform more cyclical businesses as bond yields rise. I will look to increase clients' investments in active funds where the managers focus on value investing as well as in index-tracking funds, which have more exposure to cyclical and unfashionable businesses, if this change in market trends becomes established.

Important information

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