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Weekly Market Flash

One Question Answered, Three More On Tap

November 11, 2016

In this space last week we presented a case for "guarded optimism" in risk asset markets, regardless of the outcome of the presidential election. Then the Tuesday Surprise happened. It would be reasonable for one to ask us whether we are still of that cautiously optimistic view we expressed one week ago, and that will be our theme this week.

Sound and Fury

First of all, let us be crystal clear about one thing. When the subject of politics comes up in any of our weekly commentaries, our discussion is limited to how we perceive the directional impact of political events on equities and other risk asset markets. Donald Trump's Electoral College victory has major potential implications for the U.S. and the world at many levels. Both of us have our own personal views about the outcome. But our focus here, as it is with any subject we present in these pages, is simply to share with our clients and other readers our assessment of how this development may affect their long-term investment portfolios.

As of today, our view is very little changed from where it was one week ago. Yes – futures markets plummeted through circuit-breaker levels as the results trickling in from North Carolina and Florida illuminated Trump's path to 270. And yes – a few inclusive-sounding words by the President-elect, delivered in a relatively calm, measured tone in the wee hours of the morning, succeeded in reversing those overnight losses ahead of a Wednesday rally. That's short-term noise, and while we could see more of that play out over the next couple weeks, we do not see as likely any sustained directional trend one way or the other proceeding from the simple fact of Trump's victory.

Beyond the short-term sound and fury, we see three critical questions that could set the tone of markets in the first half of next year and beyond. First, will the new administration insert itself into Fed Chair Janet Yellen's realm of monetary policy in a way that upsets central bank-dependent asset markets? Second, how will the economic priorities of Team Trump impact particular industry sectors and, by extension, the sales and earnings prospects of publicly traded companies? Third, will those same economic priorities live up to the often inflammatory, dangerous rhetoric on foreign trade that came up in the course of the campaign?

The Last Democrat

Among her other claims to fame, Janet Yellen now has the dubious distinction of being the last Democrat in Washington, D.C. with any meaningful power. The President-elect's personal distaste for her is well-known and was featured prominently in the campaign's closing ad messages. We think it unlikely, though, that the new president would play footsie with a possible market crash by taking concrete action in his first year to limit the Fed's ability to independently execute monetary policy. Yellen's term expires in January 2018, and odds are better than not that she will be replaced then by a Republican Fed head. Trump would have little to gain, and a great deal to lose, by stirring up trouble in the Eccles Building any time before then.

That is not to say that the risk of a White House – Fed confrontation does not exist as a possible 2017 surprise. In particular, it will be interesting to see how Trump and his new economic advisors react if, as expected, the Fed reactivates its rate hike program starting in December. Notoriously unpredictable as a candidate, it remains to be seen how restrained Donald Trump will be as president. We will be studying the tea leaves of formal policy speeches and off-the-cuff Twitter remarks alike in the coming weeks to get a better sense; for the time being, anyway, we would expect a more pragmatic approach to relations with the Fed at least within the next twelve months.

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The Return of Fiscal Policy?

One of the first ways we expect 2017 to be unlike every one of the last eight years is that fiscal policy – i.e. actual legislative action targeting areas of economic stimulus – will be a real part of the conversation. In 2009 the Republican Congressional leadership more or less designed a tactical program around denying the Obama administration opportunities to implement economic policy. They didn't always succeed – most notably in the 2009 stimulus package responding to the Great Recession and then in the 2010 passage of the Affordable Care Act – but by the time of Obama's reelection in 2012 fiscal policy was by and large not a viable part of the economic equation. That has changed with the looming imminence of one-party rule. When we hear various ideas floated around – infrastructure spending, corporate tax reform, and stimulus programs for coal and other non-renewable energy sources are examples currently making the rounds – we have to assume they can actually become law and have an impact for better or worse.

One practical consequence of this is that sector picking may be back in vogue, as armies of quants tinker around with algorithms designed to follow the direction of putative fiscal policy initiatives. We already see signs of how this will play out; just since Wednesday morning, for example, the healthcare sector has been cleaved into subsectors with very distinct, uncorrelated trading patterns. Republicans on the Hill are baying for an immediate repeal of the Affordable Care Act, with little sense of what if anything is to replace it. That exposes health insurers to much uncertainty. On the other hand, expectations of an ultra-light regulatory touch are boosting the shares of drug manufacturers and biotech firms.

Trade or No Trade?

Ultimately, corporate earnings will depend on far more than U.S. fiscal policy. The IMF revised its estimates for global growth next year down in its most recent quarterly assessment. Both output and demand remain below historical norms in most developed as well as emerging markets. Weak foreign demand and a strong U.S. dollar are likely to continue to weigh on earnings and profit margins. That was going to be true regardless of who won on Tuesday night. Both campaigns took a relatively hard line against global trade; again, though, the fact that the executive and legislative branches all went Republican means that – to be blunt about it – if the new administration wants to start a trade war then it will be well within the realm of possibility to implement protectionist legislation.

Somewhat along the lines of our thinking that Trump would not likely rush into an immediate monetary policy confrontation with Janet Yellen, we think it less than probable that he would strike up a trade confrontation with China as an opening economic policy salvo. We have to imagine that somewhere in his economic transition team are voices to convince him of the unfavorable cost-benefit equation of such action.

There will be plenty of pressure from outside Washington to live up to his campaign rhetoric, however. It is not lost on anyone, least of all on traditional conservative free-traders who populate D.C. redoubts like the American Enterprise Institute and the Heritage Foundation, that the margin for Trump's victory was delivered by voters who have largely been on the losing side of the global economy's distribution of fortunes. The President-elect will soon enough have to confront the dilemma of pro-trade, pro-growth policy versus the strong protectionist impulses of the newly-empowered working class Republican base.

So there they are: monetary policy, fiscal stimulus and approach to trade are the three open questions at the top of our list of priorities. As we said last week, connecting the dots between the current direction of macroeconomic trends and corporate sales & earnings – i.e. the overall narrative that long predated the election – offers enough grist for at least a cautiously optimistic take on asset markets as 2017 gets underway. Whether we stand by that view as the year progresses will depend in no small part on how we see the evidence shaping up to provide answers to these three questions.

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