# The Trump Effect: what a new era of US politics means for long-term investors

As Donald Trump stands poised to take control of the White House, *Emma Cusworth* considers how his presidential tenure might affect institutional investment.

Back in 2000, the writers of the satirical US programme *The Simpsons* predicted not just Donald Trump's election as president, but also what would follow. Lisa Simpson, who succeeds Trump to the Oval Office during the 'Bart to the Future' episode says: "As you know, we've inherited quite a budget crunch from President Trump." Secretary Milhouse Van Houten responds: "We're broke."

With Trump's penchant for leverage and election campaign rhetoric suggesting his presidency would see a significant change in fiscal policy, some experts suggest Milhouse's predictive powers may not have been too far from the mark.

And even though four, or even eight, years may seem like a short period, Trump's approach to government debt, foreign policy and climate change, coupled with his unpredictable personality, could turn out to have long-lasting consequences for investors.

Early evidence of key White House appointments suggests Donald Trump is likely to take a fairly hard-line approach to delivering on some of his key election promises. He is also likely to be able to achieve a considerable change in US fiscal policy to fulfil his plans to cut corporate and personal tax rates, and increase spending on defence and infrastructure. Financial market regulation in the form of Dodd-Frank is expected to be largely rolled back and, although he will not repeal Obama Care entirely, he is likely to make significant changes to the Affordable Healthcare Act. The latter could prove highly damaging for the nation's fiscal strength.

According to Saker Nusseibeh, CEO of Hermes Investment Management, markets are not thinking carefully enough about the extent of Trump's ability to push through change. "He has both houses supporting him," Nusseibeh says. "That puts him in a stronger position than many presidents have been in for a long time. He will be more able to push through his policies and I'm not sure if markets fully understand the consequences of that."

## FISCAL POLICY AND INFLATION

Trump's infrastructure spending appears to make a lot of sense given the considerable need for America to both maintain existing infrastructure and build new projects. Figures from the Congressional Budget Office show real spending on transport and water infrastructure, for example, fell 9% between 1985 and 2014. The average age of transport and water infrastructure has also deteriorated markedly, increasing from an average of 19 years in 1960 to 26 years today. This trend has accelerated in the post-financial crisis era due to budget cuts.

The scope to spend on repairs and maintenance, as well as building new projects, creates a large number of 'shovel-ready' opportunities for Trump's administration to deploy its planned $1trn on infrastructure over the next 10 years.

But there are two underlying problems with his plan. First, his ability to finance this kind of project through some form of public-private partnership is limited as investors are less interested in the types of assets this involves. Second, with the US economy at near-full employment (4.9%) and tens of thousands of jobs still unfilled in the construction industry, it is not clear the right people are in the right places when it comes to creating jobs for America's disillusioned masses – Trump's electoral base.

Three likely consequences arise from this strategy: increased pressure on wages (which will only be exacerbated if Trump also pushes through anti-immigration reforms as immigrants have traditionally made up a significant proportion of the infrastructure-based workforce), a marked increase in public debt and inflationary pressure.

Now consider the tax cuts. The US economy that Trump will inherit is in fairly good shape. Real economic growth has begun to pick up, S&P500 earnings have rebounded from their oil and dollar-fuelled lows of 2015 and inflation is still moderate.

"In 2010, that plan would have been fantastic," says David Stubbs, global market strategist at JP Morgan Asset Management (JPMAM), "but it is the wrong time for major tax cuts today."

Tax cuts would have a positive effect on consumption, further adding to inflationary pressure.

According to Pimco's global economic adviser, Joachim Fels, although the Fed might initially welcome higher inflation and tolerate an overshoot of the target for some time, the Fed would eventually likely need to raise rates more aggressively than in a scenario without fiscal stimulus. This could "end in tears", Fels says, as it may push the economy into recession in 2019 or 2020.

The likelihood of this outcome unfolding would be considerably higher if Trump deregulates the financial sector by gutting Dodd-Frank. "Whatever changes they make will make it easier and more attractive for banks to lend," JPMAM's Stubbs explains. "Credit growth is a key driver of inflation. At the moment inflation is perfectly manageable, but it could quickly go off the radar."

## BOND RIOT

The market has already spoken to some degree when it comes to the outlook for US inflation with $1trn wiped off the value of bonds in the first few days after the surprise election result became clear – an undoubtedly painful period for any investors holding long bond positions.

Christopher Wood, chief strategist at CLSA, expects the 10-year Treasury bond yield will "break out" and bond prices will move lower as part of what he called the "ongoing bond riot" in anticipation of Trump's policies.

JPMAM's Stubbs says: "Holding short-dated government paper seems to be a dangerous place to be." He expects to see bear flattening over the next 12 months as short rates increase more than they do at the long end.

Investors also risk being caught out if the Fed does follow the more aggressive stance on rate rises that Pimco believes it will have to take. Although early suggestions following the election suggested a Trump victory would lead the Fed to take a more cautious approach to a potential December hike, his inflationary policies are increasingly expected to have the opposite effect, bringing forward any future rate hikes. Yet markets appear to be at risk of complacency regarding the potential speed and scale of hikes.

By mid-November, markets were pricing only an 18% chance of the Fed hiking once in December and twice more in 2017. "That seems very low," JPMAM's Stubbs says.

## POLITICALLY-DRIVEN VOLATILITY

In theory, at least, Trump's victory and likely policy direction should mark the end of the 30-year bond bull run, but that view doesn't take account of political uncertainty.

And on this score the early evidence is not very promising. Trump's attitude towards President Vladimir Putin is perhaps the starkest example. The chances of the US and Russian premiers agreeing a deal is unlikely without compromising the sovereignty and security of some central and eastern European countries. The alternative is a hard-man stand-off that could raise a significant nuclear threat.

According to Hermes' Nusseibeh, markets are not paying close enough attention to the potential for political instability in developed markets, to which the Trump-Putin axis will prove key. "If Trump signals to Putin that he can continue to expand in Europe, the risk premium in Europe will go up. Markets are not discounting that," he says.

Trump's foreign policy decisions could also have a meaningful – although as yet less clear – effect on oil price volatility depending on how they affect developments in the Middle East.

Many experts had been watching to see who Trump would appoint as his closest advisers – appointments that don't require Senate confirmation – and the early evidence is not reassuring. Stephen Bannon's appointment in particular has sparked widespread protest among human rights groups and both Democrats and Republicans, given his reportedly white-supremacist stance. A weak Chief of Staff in the form of politically inexperienced Reince Priebus adds strength to the ability of Bannon and Trump to set the agenda. Other hardliners, including Jeff Sessions to head the justice department and Mike Flynn as national security adviser, suggest the next administration will err on the more extreme side of Trump's election rhetoric than many market participants had hoped.

While it is still difficult to predict what Trump's foreign and domestic policy path will be, if he does take a more protectionist stance, particularly with China, the shock-waves will be felt across many emerging market economies.

What is likely, however, is that political uncertainty will be significantly elevated. His presidential tenure is likely to be fraught with tensions both within and outside the US. Previous attempts to raise the US debt ceiling, for example, have proven troublesome for markets and future efforts could be even harder to negotiate given the arguably needless tax cuts will add significantly to the overall debt burden above and beyond meeting interest payments. It is also not clear how Trump's policies will de-rust the Rust Belt, which could have its own consequences if angry dissent sets in across Trump's supporter base.

Trump has already proven himself to be easily baited even since his election victory, adding to the unpredictability of his leadership.

## TURN OFF YOUR SCREENS

With the Trump era about to get underway, politics has returned as the key driver of markets. Volatility will most likely be higher for the foreseeable future. And politically-driven volatility is even harder to time than volatility linked to the economic cycle.

"Trading around political risk is very difficult," says Royal London Asset Management's head of sustainable investment, Mike Fox. "The chances of a Trump victory or a vote for Brexit looked very unlikely early in 2016."

Where does this leave investors? Nusseibeh believes this environment, driven by political uncertainty, should strengthen the case for a buy-and-hold approach.

The investment community has become used to an investment strategy that focuses on tactical asset allocation, best seen in the endowment model made famous by Yale and Harvard.

"You cannot do tactical asset allocation in a framework that is dominated by politics and politics has come back to loom large," Nusseibeh says. "You can't time volatility like this.

"Investors would do best to ignore the noise, ignore the volatility, take a 10-year view then switch off their screens," he says. "And keep watching *The Simpsons*," he adds.

## INVESTORS NEED TO SET THE AGENDA FOR ADDRESSING CLIMATE CHANGE

President-elect Trump's approach to climate change counts among the more alarming aspects of the US election outcome. Any threat to the COP21 agreements reached in Paris could have serious consequences for the fight to maintain global warming to two degrees.

"We have only got four years to achieve this goal," says Saker Nusseibeh, CEO of Hermes Investment Management. "If Trump blows that out of the water, we have no chance."

Royal London Asset Management head of sustainable investment, Mike Fox, points out, however, that there is already significant momentum behind the transition to a low-carbon economy, that, he says, "goes beyond politics".

The fact that China, historically one of the most resistant to climate change policies and one of the heaviest polluters, has urged Trump not to renege on COP21 demonstrates the strength of feeling globally on the issue and how much progress has now been made.

Even at home, around 75% of all economic activity in the US derives from liberal, climate change believing states – California being the most obvious example. As long as Federal policy is not translated into state legislature, much of the potential harm Trump could wield can be limited.

But, even so, it is now more important than ever that capital allocators redouble their efforts to forge the kind of future the savers of today and tomorrow want to retire into. According to research by Legal & General Investment Management, 81% of investors agreed that they wanted their pensions to be invested in responsible companies that will improve life for future generations.

"If governments are not going to act [to address climate change], then the owners and allocators of capital have got to step up," Nusseibeh says.

> **"Investors would do best to ignore the noise, ignore the volatility, take a 10-year view then switch off their screens. And keep watching The Simpsons."**
>
> Saker Nusseibeh, Hermes Investment Management