# Trump rally - genuine growth or groupthink gamble?

Dominic McCormick | Select Investment Partners | 16 November 2016 |

Like many – including the markets themselves at first – we have so far been wrong to expect a more negative impact on financial markets from the Trump victory. Instead, US markets reacted to the event by bouncing back strongly from initial losses in the days following (albeit with significant divergence across market sectors).

As QBE's deputy chairman and writer John M. Green was quoted as saying of the remarkable turnaround "Maybe it's just that markets have stopped having a clue."

Still, I believe the rapid, religious-like conversion of many market participants to an overwhelmingly positive Trump economic and financial narrative may prove just as mistaken over coming months.

I have read at least a dozen commentaries in the last week which, perhaps comforted by Trump's conciliatory acceptance speech, espoused the view that his "pro-growth" policies will unquestionably be good for US economic growth and the US sharemarket while downplaying major risks of Trump's broader policy platform or even considering the existing ongoing challenges facing the US and global economy and financial markets. Of course, there are plenty of other articles discussing the broader risks of Trump's policies.

But it has been surprising the degree to which financial commentators and market participants have quickly embraced the "pro-growth reflation trade" and downplayed the risks. The large rise in the US sharemarket, a sharp increase in US bond yields and in the US dollar, and a fall in gold in the few days following the election clearly suggests many have bought into this optimistic view. Near record flows into ETFs that track the major US stock indices further supports this.

However, market participants have made a large leap of faith that economic growth and employment in the US are sure to improve substantially and sustainably (and that these translate to a positive stockmarket) primarily from:

1. A large (from $US500 billion to as much as $US1 trillion) multi-year public/private infrastructure program;
2. Lower corporate and personal taxes; and,
3. Reduced regulation, especially in the energy industry and possibly banking.

Of course, this assumes Trump can gain approval for these proposals through a Republican Congress and Senate that has some unfriendly and austerity-focused elements. It is likely

that those elements will be successful in watering down these fiscal proposals and (fortunately) some of his other more extreme policies.

The costs of the three measures are unclear as the basis under which the public/private infrastructure arrangements are defined as "revenue neutral" were provided by Trump's own economic advisers and included such simplistic assumptions as the enormous private debt taken on is borrowed at very low interest rates. The tax cuts alone are expected to lower government revenue by $US4.4 trillion over 10 years, according to Goldman Sachs.

Meanwhile, the direct impact on GDP growth of the infrastructure measures if fully implemented has been estimated at around 0.5% per annum over a 10-year period. However, this far from doubles real GDP growth to the 4% per annum that Trump has talked about.

Politicians targeting specific economic growth levels should raise alarm bells. Yes, Trump is a politician now. For example, what became of ex-treasurer's Joe Hockey's commitment at the 2014 G20 Meeting for all G20 countries to grow GDP by an additional 2% per annum over the following 2 years? That's right - nothing!

Still, even if the fiscal measures are watered down they should provide some stimulus for growth (and inflation) but they cannot be considered in isolation. It also remains to be seen how much of the benefits flow through to the lower and middle income earners who have been most vocal about aenemic wage growth and widening inequality and who helped elect Trump.

There is a strong case for investment in productive infrastructure. Arguably, though, the better time for a large infrastructure stimulus was in the years immediately following the Global Financial Crisis when public debt levels were lower and unemployment was much higher, rather than now that debt levels have grown while unemployment has fallen and US wage pressures are actually tightening in some job areas so the inflationary impact of additional spending could be significant.

However, the more important issue is that many of the ongoing US growth/employment challenges are related to issues not addressed by Trump policies. These include the overhang of high private and public debt levels (with the level and cost of the latter likely to rise sharply, especially if interest rates rise), overcapacity in some industries, structural and technological change and ageing demographics.

Market participants have also downplayed the enormous risks of Trump's broader foreign policy agenda, including increased trade protection, tighter immigration rules and increased US isolationism. Then there are the risks of global trade or currency wars, or even military conflicts, that may result from a retreat from globalisation.

Commentators also seem to ignore the starting point and dynamics of financial markets. Some talk as if the US share market has been depressed and is now, courtesy of Trump's pro-growth policies, setting up for a new bull market. Yet the reality is the S&P500 is at near record highs and stretched valuations - and, as the world's largest market, is already heavily

owned by investors. New major bull markets don't start from such dynamics. Rather, bear markets usually do, especially if long-term interest rates are rising as they are now. Add the possibility that some of Trump's other policies undermine globalisation and free trade (a supporting foundation for strong equity markets for decades), and the risk of a bear market grows.

Beneath the headlines, it is interesting that, following the election, emerging economy share markets (and currencies) have generally sold off, partly reflecting these broader risks. Indeed, it is also interesting that we are witnessing a "Trump" US share market rally just weeks on from Trump calling it a "big fat ugly bubble"!

In any case, while the possibility of higher economic/earnings growth should improve the case for equities, an argument can be made that this benefit could be more than offset by the higher equity risk premium required due to expected higher interest rates and increased future uncertainty.

In one respect, aren't some of the key Trump policies simply a case of piling more debt on already high debt levels and hoping that leads to growth? Isn't that what caused the GFC? Aren't high debt levels one of the major constraints to growth now, especially if interest rates rise? Isn't that just replicating what China has recently done, which many expect to end up in disaster?

I wonder whether this post-Trump market rally and associated bullish economic and market narrative will come to be seen as one of the more prominent historical examples of poorly timed and lazy market groupthink.

While it is understandable that markets are desperate for clarity on the implications of a Trump presidency, given his unpredictability, the truth is we don't know and won't know much about actual policy implementation and implications until well into 2017 and beyond. But the current simplistic reflation narrative seems to have at least temporarily filled the void which would normally have resulted in a more cautious market response to an event as uncertain as Trump's election.

Market participants, desperate for winning investment ideas in a very challenging environment, are tempted to chase popular stories and trends without much reference to market valuation or risks. Pressure to do so has grown given the recent difficulty of getting macro calls and security selection right and the poor performance of hedge funds and active, long only managers in recent years.

Time will tell. But if, as I expect, this Trump narrative does come to be seen as overly simplistic groupthink, it may set markets up for a nasty period of disappointment as the supportive caution of recent months has dissipated and the pro-growth/reflation enthusiasm has grown. After the initial flurry, buying impetus may quickly subside. In addition, the selloff in bonds itself provides a major constraint going forward as yields

become more competitive to shares and the stronger US dollar may further weigh on large company earnings. There could well be a painful hangover to the Trump party.

As noted above, the sectoral divergence in the US rally has been significant, leading to near record numbers of stocks hitting both new yearly highs and new yearly lows at the same time. This is a technical feature which historically has generally preceded negative returns for the overall market for following months and years.

Some of the moves may make sense. Global financials may benefit from a steeper yield curve, increased borrowing appetite and possibly looser regulation. The secular bull market in bonds may be over, irrespective of who is in the White House. For some time, we've been concerned that the chase for yield had gone too far. The further post-election selloff in some of these yield-focused investment areas as rates have risen is rational, if more aggressive than expected. Even under a Clinton win, this selloff may have continued, albeit more gradually.

So what can we really know about the impact of Trump's policies?

Well, I suppose we can be reasonably confident that inflation and nominal growth will be higher than they otherwise would have been. However, whether these will lead to significantly and sustainably higher real economic growth leves in the future, or a higher stock market, is far from clear when all the other elements are included in the mix.

Further, while nominal interest rates would probably be higher, it is unclear whether real interest rates would be and the difference has significant implications for asset class valuations.

While the great secular fall in bond rates is probably over, there will be cyclical forces that don't make higher rates a one way bet. Therefore, it may be premature to completely write off the "lower for longer/chase for yield" environment in favour of fiscally-inspired reflation/higher growth levels. The deflationary and slow growth forces mentioned could continue to limit the ability of rates to rise without very negative economic and financial market impacts.

Given the mix, perhaps one cannot rule out a more stagflationary scenario where fiscal spending, debt and trade protection lead to higher inflation but real economic growth remains low due to secular forces, and central banks are forced to keep real interest rates very low or negative. Assets that benefit from some inflation but still low or negative real interest rates - such as inflation-linked bonds, agriculture, resources, commodities and gold - could warrant a bigger place in portfolios in such an environment.

While some scenario planning makes sense following the US election, it is probably wise to wait before making major changes in outlook or portfolio positioning, to discern the true long-term winners and losers once it is clearer what policies will actually be enacted, not to mention the broader economic, financial and geopolitical environment at that time.

Given the ongoing uncertainty, the aim should be to create portfolios that can survive a range of environments rather than just betting on one.

Complicating the picture is the Federal Reserve which has flagged a December rate rise and may come under pressure to implement a more rapid series of rises in the future if there is greater fiscal stimulus. Yet this too is not certain as the Federal Reserve is also likely to react to the broader impact of Trump's policies, the progress of economic data, and the behaviour of key financial markets.

My opinions here are not reflective of any particularly strong view on the skills, ethics or personality of Donald Trump. As one who saw the election as primarily a battle between change and the status quo, I thought the media's obsession with personalities was missing the point. But voting for change is one thing. Achieving the extremely ambitious objectives of this change in an economy subject to major structural and cyclical challenges is something else entirely – and it's far from easy.

Some have supported their enthusiasm for Trump's policies on the basis of a benefit of having "a businessman in the White House." Yet our own Prime Minister is a successful businessman and, after 14 months, what difference has that made? Trump will be inaugurated as President on 20 January. His current honeymoon period with financial markets is unlikely to last long.

Markets and economies are much bigger than any one man or even a government as a whole. Yes, Trump is good at making the challenges ahead look easy – he was a reality TV host, after all. The positive market reaction so far can be partly explained because he has behaved more presidential than most thought would be the case, and because expectations were so low. But arguably, the stockmarket, at least, has quickly moved on to now expecting too much. The risk of disappointment is high.

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