U.S. Election Implications

November 2016
Executive Summary

- Donald Trump’s surprise victory has created additional uncertainty in the global economy and financial markets.
- In our and many others’ opinion, economic growth in the U.S. has for many years been hindered by political gridlock. Given the decisive victory by the Republican party across the House of Representatives and Senate, we feel that there is a greater chance of structural reforms being enacted in the coming years and a greater chance of expansionary fiscal policy.
- The tone of international relations, both economic and political will be important. Potential disruptions to U.S. trade policy and a deterioration in foreign relationships may create economic challenges.
- Despite the potential for global capital market volatility, U.S. economic fundamentals remain sound relative to other developed market economies and an interest rate hike in December remains a possibility, barring greater financial market volatility.
- We continue to encourage investors to focus on the long-term and look beyond short-term market volatility.

Introduction

Donald Trump’s victory in the U.S. presidential election was a surprise to many market participants, resulting in increased market volatility immediately following the election. There is a level of uncertainty with this result as Trump has put forward fewer policy specifics than most Presidential candidates. In addition, because he has no experience in government, we cannot look to prior votes or proposals to better understand his views. Despite the level of uncertainty, we believe it is important to take a longer-term view. The balance of this paper will review what we believe to be the critical issues which will drive markets over the coming months and years.

Issues Impacting Markets Long-Term

As Trump continued to pick up electoral votes, markets began to sell-off materially before rebounding. In a recent Rocaton Insights, we pointed out that market volatility should have been expected given that markets (and polls) were predicting a Hillary Clinton victory and that market participants largely saw a Clinton victory as “business as usual.” We believe it is more prudent to take a longer-term view and to ignore short term market gyrations. Recently, Michael Porter and the Harvard Business School published a study on U.S. competitiveness. One of the primary conclusions from that research is that U.S. competitiveness has been eroding partly due to political gridlock. For better or worse, political gridlock in the U.S. may decrease given the recent election outcome. Below we outline key issues which may impact markets over the coming years.

Tone of Transition – One issue that will be addressed in the short-term is the transition of power from President Obama to President-elect Trump. In his acceptance speech following the election, Trump struck a conciliatory tone signaling that a diplomatic transition may take place. However, markets will likely remain choppy over the coming weeks as this dynamic plays out. Investors should be mindful of this as they plan for portfolio transitions and/or rebalancing of significant size.
**Tax Reform** – Trump proposed sweeping tax reform during his campaign which included a proposal for three income tax brackets for individuals and a significant reduction in the corporate tax rate (15%, down from the current 35% rate). The Michael Porter study we referenced earlier suggests that tax reform has the greatest potential for an immediate impact on the economy, noting that corporate tax policy has become a key obstacle to U.S. competitiveness and economic growth.

**Infrastructure Spending** – Given America’s worsening infrastructure, spending to fix the country’s bridges and roads appears to have bipartisan support. This topic was supported by both Presidential candidates during the campaign and seems likely to be enacted at some point. The size and timing of the expenditure, however, remains uncertain and the funding of an infrastructure building campaign would be problematic for fiscal conservatives.

**Trade Policy** – The North American Free Trade Agreement (“NAFTA”) was cited frequently during the Presidential debates with Trump a strong critic of the agreement. Trump also threatened to impose significant tariffs on Chinese imports. Although unlikely in our opinion, significant changes to NAFTA or other U.S. trade agreements could drive up the price of imports, lower U.S. profits, slow the economy by reducing markets for U.S. exports and generally harm business confidence.

**Foreign Policy** – Perhaps one of the biggest uncertainties is how Trump handles foreign policy. Notably, Trump questioned the need for the North Atlantic Treaty Organization (“NATO”) suggesting it was obsolete and that the U.S. would potentially leave the alliance if certain conditions weren’t met. A breakdown in U.S. relations with our foreign allies has the potential to weigh on markets.

**Interest Rate Hikes** – Continued market volatility and uncertainty reduces the probability of a December interest rate hike by the Federal Reserve. We believe market fundamentals remain sound and a rate hike in December would be prudent. However, despite the Fed’s claim that it is data driven (unemployment and inflation), it appears it is easily influenced by the gyrations in financial markets. Fed Funds futures, while volatile, are pricing in a >80% probability of a rate hike in December.

**Conclusion**

Overall, market volatility could remain elevated over the coming days and perhaps weeks. In the long run, there may be bipartisan support for fiscal stimulus in the form of corporate tax reform and infrastructure spending. However, potential disruptions from changes to U.S. trade and a deterioration in foreign relations may hinder economic growth. We believe that part of the slow economic growth in the U.S. can be attributed to a lack of structural reform due to a divided Congress and executive branch. As such, Republican control across all three branches of government may put an end to the political gridlock that has limited structural reforms in recent years. We continue to encourage investors to remain focused on their long-term investment objectives and remind investors of the difficulty in predicting short-term movements in capital markets.
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