

Focal Point

What is at stake with Trump as new US President?

November 09, 2016

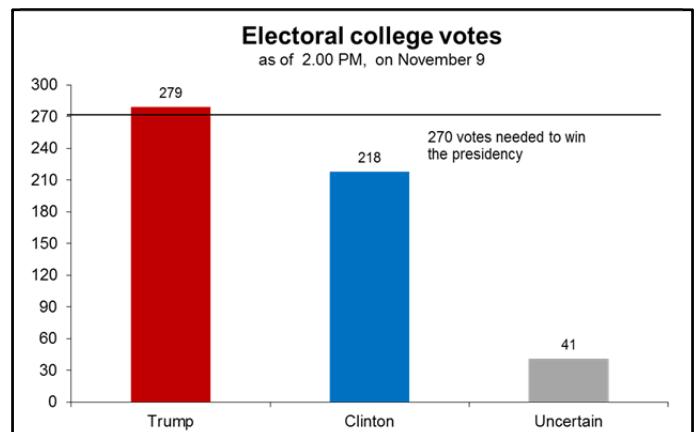
Authors: GI Research

- Donald Trump has been elected US president and will be backed by a Republican majority in Congress.
- As details on his policy agenda and the composition of the new administration (including his economic team) are still unknown, uncertainties will remain on an extraordinary high level for the time being.
- This will likely weigh on the US economy, with the risks to investment activity particularly high.
- In case of a longer spell of global market volatility, the Fed may take an even more cautious stance, even though a December rate hike remains feasible.
- While financial markets initially switched into a risk-off mode, they have largely recovered over the course of today. As long as Trump's political roadmap remains vague, however, uncertainty is likely to prevail and volatility on financial markets will remain high.

In a historical move, Donald Trump has been elected as 45th president of the USA, upending predictions of pollsters. Trump's economic plans have not yet been spelled out in detail. In his statements over the next weeks it will be crucial to see to what extent the extreme views he presented during the campaign will be converted into actual measures. Equally important will be the choice of the presidential staff, as the Republican Party did not provide much input in terms of advisors. Trump has conducted the campaign without a dedicated economic team, but rather seeking advice from quite a loose and diverse group. Most of his advisors are CEOs of firms from financial services, energy, manufacturing and tobacco sectors. The only people with experience outside business are two former chief economists at Bear Sterns, which also worked in the Reagan and Bush Sr. administrations, and an academic specialized in trade. Broadly, they share strong beliefs in low taxation and supply-side policies and a very hostile approach to free trade, especially with China.

What is known is that Trump's plans for the first 100 days include a renegotiation of the NAFTA trade agreement and the withdrawal from the Trans-Pacific Partnership. The more comprehensive program he sketched entails large cuts to corporate and income taxation and a step up in defense and infrastructure expenditure, without any reduction to other budget items. On trade, he threatened to impose tariffs on imports from China and Mexico. On regulation he aims to scrap the Affordable Care Act and deregulate financial institutions and energy providers.

The President has strong power in terms of foreign trade measures and his views on regulations are broadly in line with those of the Republican Party. However, any measures that increase the budget deficit will likely face some opposition from the fiscally conservative wing of the Republican Party and will not be decided upon and implemented neither soon nor in full. His plans of mass deportation of undocumented foreigners have been watered down recently.



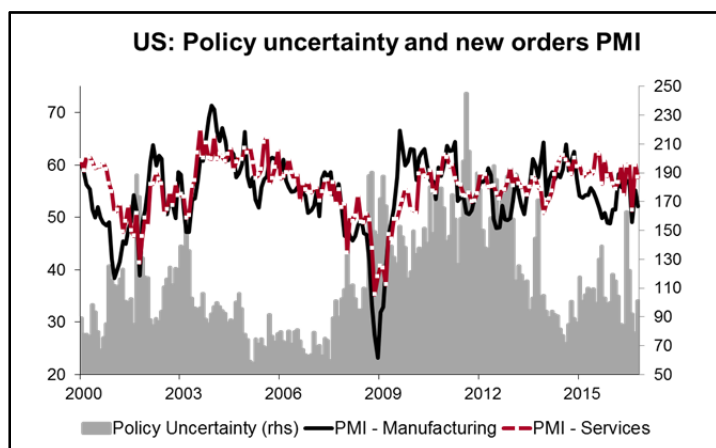
The likely macroeconomic impact of Trump's victory can be best described sequentially.

1) First of all, during Q1 2017, high uncertainty over future policies is likely to dampen the nascent recovery in investment and possibly to slow down employment growth.

By contrast, we do not expect a big initial impact on consumption; while uncertainty may depress sales, expectations of lower taxes and the broad public support to Trump (implying only muted concerns about economic impacts) should bolster consumption.

2) By around mid-2017, Trump's trade policy will become clearer and this will shape corporate decisions. A tough stance (repeal of trade agreements and imposition of tariffs) could disrupt the investment plans of exporters and of firms outsourcing a large part of the production process abroad (e.g. electronics).

3) Some fiscal measures would be announced in the first months of the presidency. However, the lack of a plan prepared in advance and the need to bring into line the more fiscally conservative part of the Republican majority would not guarantee an easy implementation. Moreover, the slim (3 seats) majority Republican enjoys in the Senate keeps any measure vulnerable to delays imposed by the opposition. For these reasons we expect some months to elapse between the announcement (including the repercussions on financial markets) and the implementation (likely in H2 2017). Therefore, while it is reasonable to foresee that the new budget will deliver a non-negligible fiscal stimulus, this macroeconomic impact is unlikely to be seen before the end of next year.



In terms of GDP growth, all this constitutes downside risks to our 2.2% forecast for 2017. The inflationary impact of these policies will creep up more slowly - reasonably after mid-2017 - to the extent that trade restrictions will harm potential growth and push up import prices.

With the election of Trump as US President and the resulting global market turmoil, the prospects of a Fed rate hike in December have eased. Already earlier this year (following the market sell-off on China concerns in January/February and the Brexit vote in summer), high market volatility – or at least the fear of it – was an influential factor for the Fed to forego a second rate hike after the one delivered in December 2015.

The bar for foregoing a rate hike is thus high. That said, the hurdles for foregoing a December rate hike remain high this time. Following reassuring recent data on US GDP (+2.9% saar in Q3), the labor market (161k added payrolls in October, hourly wages up by 2.8% yoy) and gradually recovering inflation (headline CPI at 1.5%, core PCE at 1.7%), fundamentals may well justify this move. This was also reflected in the FOMC November statement, which

stated that “the case for an increase in the federal funds rate has continued to strengthen”.

In case of a protracted sell-off in risky assets the Fed may argue that deteriorated financial conditions have burdened the economic outlook, justifying its stay on hold. If market turmoil proves shallower and shorter-lived, however, the Fed's credibility may be harmed if it chooses to stay on hold after carefully guiding markets to a hike. Against this backdrop, we think that while odds have come down, a December rate hike is still a distinct possibility.

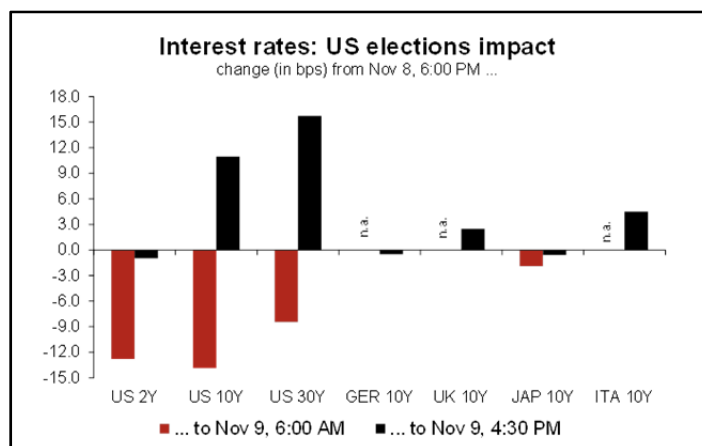
Impacts on China and euro area

One of Trump's most controversial proposals has been a 45% tariff on all imports from China. China's export share to the US amounts to 19.5% of merchandise exports or about 4.5% of GDP. The impact on China could thus be meaningful, hurting predominantly electronics, which amount to 50% of exports. As electronics are typically assembled with components from all over Asia, other Asian economies would be affected, too. That said, the actual implementation of tariffs is not yet a foregone conclusion, given the risk of rising electronics prices in the US, the strong dependence of US supply chains and the risk of retaliation measures.

For the euro area, the major and most direct impact of the US election outcome would result from increased financial market uncertainties as well as the future shape of trade relations between the US and the rest of the world. For the ECB meeting in December, the repercussions of the Trump victory will be another argument in favor of extending QE until September 2017. Moreover, European populist movements may gain in support; here the Dutch (March 2017) and French (April 2017) elections are key sign posts to watch.

Financial markets reactions

The forthcoming presidency of Donald Trump and a Republican majority in Congress has caught financial markets on the wrong foot and triggered a risk-off mode initially. Global stock markets fell strongly, core bond yields dropped and the USD depreciated against most G10 currencies, but appreciated against most EM currencies – particularly the Mexican peso. Over the course of today, however, risky assets broadly recovered from their initial losses while Treasury yields even rose by the afternoon.



Bonds: A steeper US yield curve

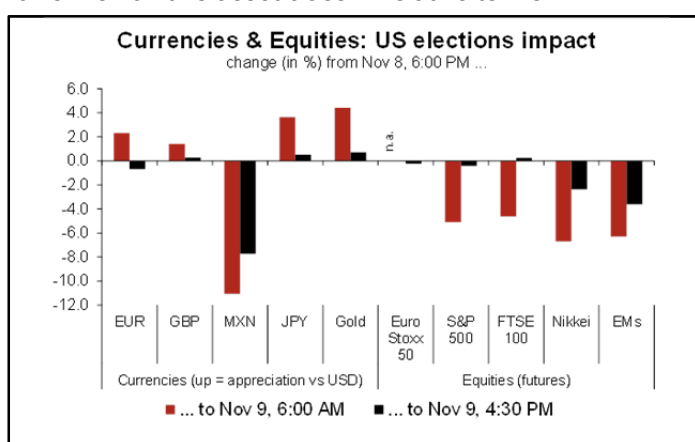
US government bond markets reacted with large volatility to the surprising election result as several contrasting fac-

tors will impact the future course of US yields. While the risk-off mode on financial markets, a less certain Fed hike in December, and an upward shift in uncertainty argue for lower yields, prospects of higher inflation and a more aggressive fiscal spending plan speak for higher yields.

Despite all uncertainty, the steepening of the US yield curve (2-year/30-year spread up by 17 bps since yesterday's closing) has most likely not run its course yet.

In contrast, the euro area yield curve has on balance shifted downwards only modestly. Temporarily, 10-year Bunds fell by up to 10 bps, but due to the stabilization on financial markets over the course of the day, they have given up almost all their gains. The risk-off mode triggered a moderate spread widening of peripheral bond yields. But, the widening was less strong than after the Brexit vote in June and it has already reversed to some extent.

Euro area IG corporate bond spreads have widened moderately as well. The iTraxx Europe rose by up to 6 bps to 79 bps (current level 75 bps) – compared to an increase of 19 bps after the Brexit vote. The support by the ECB and the solid euro area economy is likely to prevent a further spread widening of non-financials going forward. In addition, financial spreads are likely to move sideways in the coming days, waiting for more clarity on Trump's team and agenda. US High Yield appears more exposed to setbacks over the medium term amid the increased economic uncertainty, while the contained widening seen this morning in EUR High Yield spreads – less than 20 bps compared to almost 100 bps in response to the Brexit – suggests a lower risk on this asset class in relative terms.



Equities: Continued volatility going forward

During the election night, equity markets fell sharply initially (-5% to -6%), but then recovered broadly. While volatile, we can expect markets to not have a clear direction for the time being. But there are reasons to caution against too defensive stance. The Brexit experience shows that political shocks can be digested by markets and the global economic momentum tends to prevail at some point. Furthermore, we can expect some clarification by Trump on his program over the coming weeks which could reassure markets in part. But uncertainties about the detrimental impacts from potential protectionist measures and immigration curbs will also continue to linger. Energy producers, Pharma and Financials could benefit in relative terms from a much looser regulation. Especially Financials and Pharma seem advantaged as their relative valuation looks less upbeat. Moreover, Trump plans to increase expenditures in infrastructure and defense which will benefit the

corresponding sectors. On the contrary, his fierce anti-trade stance would harm firms more exposed to the global market, like exporters and Electronics. Industries employing immigrants, like Construction and Agriculture, could face labor shortages and higher costs if any anti-immigration policies are implemented. For the time being, we do not have reasons to change our cautious stance on the US stocks. Other than political uncertainty, higher wages put pressure on corporate margins.

FX: Prolonged US dollar sell-off less likely

Foreign exchange markets reacted to the US election results with a sharp drop in the Mexican peso (with the MXN/USD temporarily down by 13%), exacerbating fears that harsh trade and immigration curbs pursued by Donald Trump will harm the Mexican economy. The US dollar initially dropped against other major currencies on mounting evidence of a Trump victory, but more than pared the losses against the euro and recovered against the yen over today's trading.

Looking ahead, high market volatility may continue to weigh on the USD/JPY and to some extent also on the USD/EUR in the near term. However, with a rate hike by the Fed in December still a non-negligible possibility, the monetary policy outlook is likely to remain – even though a weaker – source of support to the US dollar, making a prolonged sell-off of the Greenback unlikely. We anticipate continued high volatility for the MXN/USD, given that any more specific news on planned NAFTA renegotiations and immigration plans may continue to affect the outlook for the Mexican economy.

Imprint

Head of Research (*ad interim*): Santo Borsellino (santo.borsellino@generali-invest.com)
Deputy Head of Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team: Luca Colussa, CFA (luca.colussa@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Frank Ruppel (frank.ruppel@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri (paolo.zanghieri@generali.com)

Edited by: Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Tamara Hardt (tamara.hardt@generali-invest.com)

Issued by: Generali Investments Europe Research Department
Cologne, Germany · Trieste, Italy
Tunisstraße 19-23, D-50667 Cologne

Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

In Italy:
Generali Investments Europe
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

In France:
Generali Investments Europe
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Investments Europe
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com

This document is based on information and opinions which Generali Investments Europe S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Opinions expressed in this document represent only the judgment of Generali Investments Europe S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Investments Europe S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments Europe S.p.A. Società di gestione del risparmio may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Investments Europe S.p.A. Società di gestione del risparmio. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiane. Generali Investments is a commercial brand of Generali Investments Europe S.p.A. Società di gestione del risparmio.