Trumponomics and the global impact

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Americans have cast their vote and a new President has been elected. Donald Trump will take the reins of the world's largest and most important economy on January 20th with a transition team setting up Cabinet appointments in the interim. For now, the world must wait to find out what exactly a Trump Presidency looks like on issues of civil liberties, foreign relations, investment and tax. But perhaps most important and pressing for the world are his thoughts on trade.

Trading lower

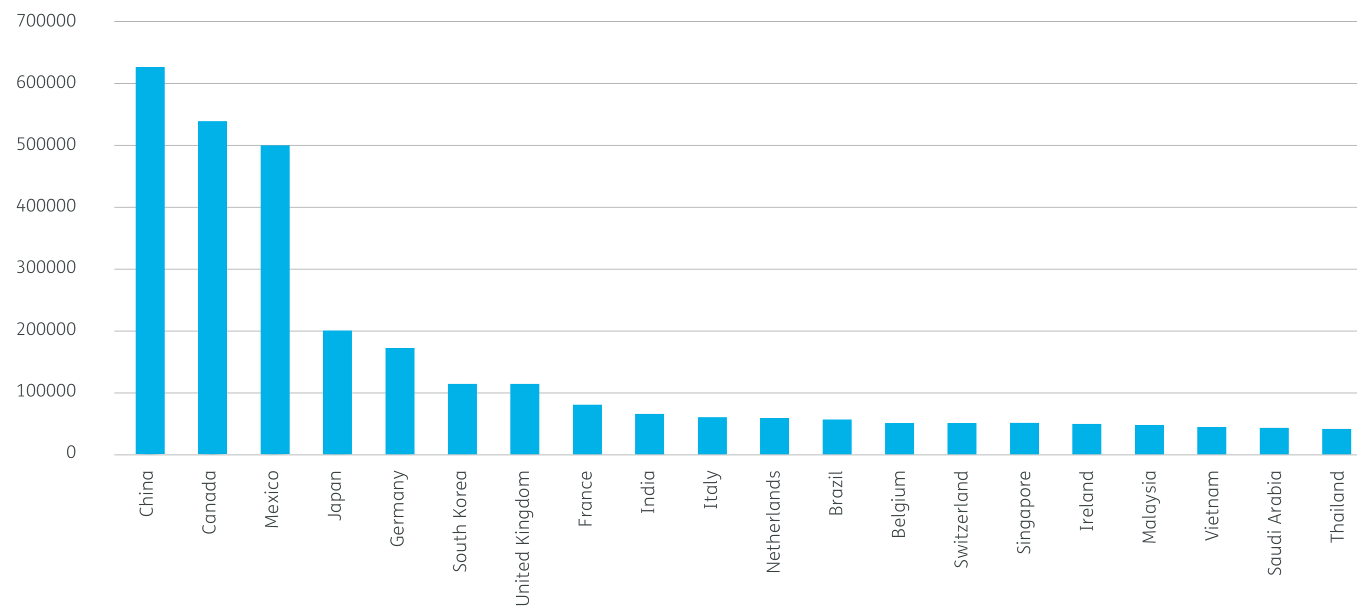
The sounding calls of both large political surprises in 2016 – Brexit and a Trump presidency – were isolationist and protectionist. Both of these political schisms stand apart from globalisation. Free trade and businesses that have flourished on a wave of internationalisation and global productivity must now prepare for a tougher regulatory environment.

That is not to say that global trade imbalances did not need to be addressed in the coming years. The rebalancing of the Chinese economy and the shift in the global economic centre of gravity from West to East meant that ongoing trade difficulties would need attention at some point in this Administration's term regardless of whether it was the Republicans or Democrats sat in the Oval Office.

Trump however represents an almost existential risk to trade. He is an enemy of international trade as done through NAFTA, TTIP and the TPP deals and is set to take a combative stance in trading negotiations with countries seen as rivals and those previously thought of as allies.

Chart one shows the top 20 trading nations with the US in 2015, eight of which – Germany, the UK, France, Italy, Netherlands, Belgium, Switzerland and Ireland totalling $64bn – are here in Europe. To put that in context, that is roughly the same as all the trade that China does with the US. Trump will be more of a problem for China than Europe but a relative basis cannot discount away all the pain.

Total trade with the US ($M)



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The investment community's core belief is that Trump will take the US economy into trade wars and until we hear otherwise from a Trump administration, we must look at his campaign promises as a credo for his Presidency. We would hope to see some softening of his stance as Congress limits a desire to impose 40 percent tariffs on Chinese exports but taxes on trade and barriers to investment are more likely to be imposed and are easier to be levied than something like building a wall, for example.

The dollar

We spent a huge amount of time before the election talking about the likely impact of a Trump presidency on the greenback both in the short-term and the longer term. Our short-term expectations of weakness against the haven currencies such as the Japanese yen, euro and Swiss franc and strength against high yielders proved correct but business decisions are made on longer term trends and not day to day movements. Once again we can look back to the market reaction post-Brexit for a guide to the short term impact. Indeed, the market reaction is playing a very similar tune albeit sped-up—a deep dive lower on risk before a recovery and then an uneasy malaise.

The shortening of the timeframe between decline and rebound could be down to many things but issues around a full Republican control of the Presidency and Congress and therefore the possibility that changes in tax reform, investment and regulation will come through quicker may have helped matters.

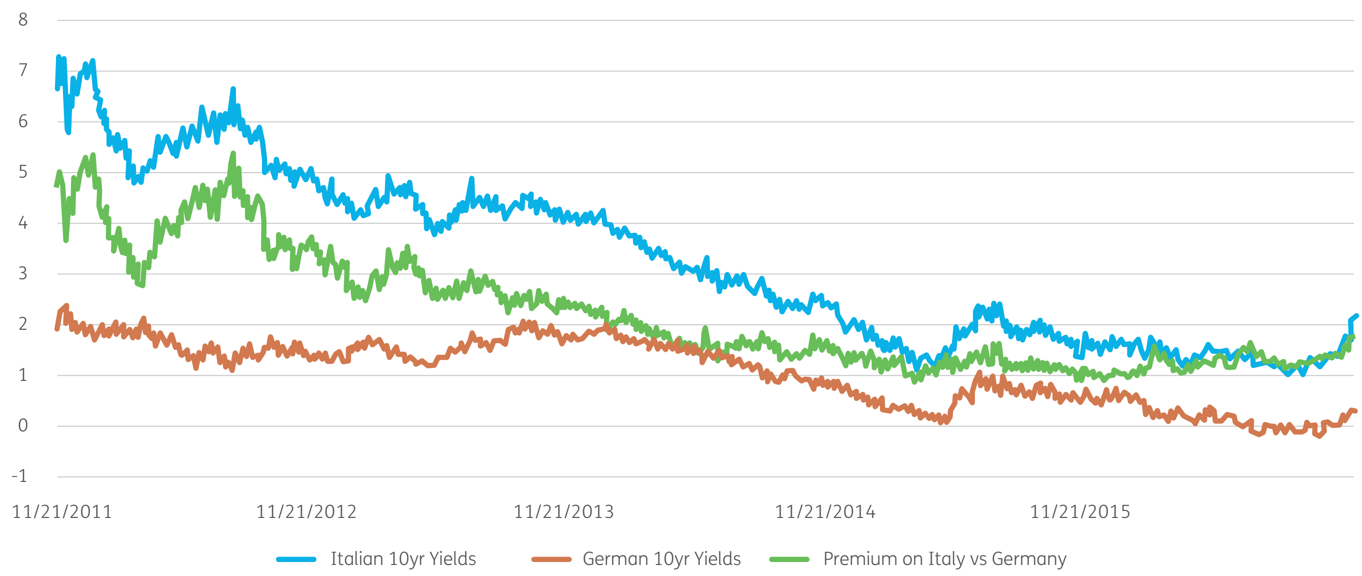
For longer term expectations, Trump has been called an inflation time bomb given his pledges to increase spending. So, we must now look at Fed policy through a new lens and Fed policy may now act as the brake on fiscal stimulation as opposed to being its replacement. Similarly, Trump's desire to allow the opening of a tax window to corporates looking to repatriate dollars could easily prompt large scale dollar gains as a pre-cursor (the Homeland Investment Act) did in 2004.

With higher inflation expectations and likely higher realised inflation coming down the track, courtesy of higher labour costs as well as infrastructure spending heading through the roof, then we foresee a pressure to raise rates and drive the dollar ever higher.

European political risk

As it stands at the moment there are four large political risks in Europe that investors have in the front of their minds when looking at EURUSD and the single currency on a wider basis: the Italian constitutional referendum, and the elections in the Netherlands, France and Germany respectively.

Bond markets pricing in electoral risk



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The Italian referendum on December 4th is designed to allow the Italian government broader powers so as to enable them to pass laws quicker and easier. Italian PM Matteo Renzi has tied his future to winning the vote so a defeat will naturally open up another political air pocket at the top of a European government. It would also point to an inability within Rome to adequately enact reforms capable of driving growth, reducing a huge debt pile or recapitalising banks.

Italy remains the 'I' in the 'PIGS' acronym that defined the Eurozone countries that were pressured on their debt piles through the Global Financial Crisis. And, the situation has not improved despite low interest rates and an accommodative central bank. Figure 2 shows that bond markets have started to ask for higher yields on Italian debt in recent weeks and the spread over German debt on a 10-year frame has risen to around 1.6%. While nowhere close to the levels seen in the depths of the GFC, it is the highest since when the European Central Bank started to buy bonds as part of their quantitative easing plan.

It is in France and the Netherlands however where people are looking for a populist win in an election that may mirror what Donald Trump managed to pull off in the United States. Geert Wilders and Marine Le Pen are the leaders of the PVV party and the Front National in the Netherlands and France respectively and are both in the lead in the latest opinion polls.

During the Brexit campaign, vote and aftermath, the focus on the popularity of the European Union as a whole was front and centre of the European political conversation. Wilders and Le Pen have both commented positively on the Brexit phenomenon and will use lessons learnt from the campaigns to drive engagement and popularity in their respective votes.

The PVV party have lost some of their lead in the polls since Brexit with Prime Minister Rutte's VVD party now drawing level in recent months. Opinion polls in both Brexit and the US election underestimated the popular turnout – the phenomenon of populists not being on electoral rolls or pollster's databases – and so there is a decent chance that the PVV party remain in the lead into the vote.

The Front National and Marine Le Pen have a more difficult route to the Presidency however than Donald Trump ever did due to the French system of two ballots. While she is leading in most polls for a first ballot – amidst a field of 10-12 candidates depending on the pollster – it is the 2nd ballot that decides things. In polling for the 2nd ballot, she is shown as losing by a substantial margin against all other frontrunners apart from current President Francois Hollande who has the worst opinion poll ratings of any French President ever. As with her father in 2002, it is likely that her support in the first ballot will not translate into wider support against a moderate Republican like Alain Juppé or a Socialist such as Manuel Valls.

Similarly, in Germany, we believe the threat to Angela Merkel is rather overstated although the electoral campaign between her Christian Democrats and the right-wing populist Alternative für Deutschland party will grab the headlines as the latter focuses on Brexit and Trump campaign gains on matters of immigration, middle class angst and national pride. While we see Merkel's CDU/CSU party winning out in the end – on the basis of a 'steady hand' amidst issues of a continued Eurozone crisis, Brexit and growing Russian influence - it will be the AfD who 'win' the election by finally getting representatives into the Bundestag.

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What about the euro?

All anyone in markets wants to talk about at the moment is politics and all they want to talk about in politics is markets. We had thought that the euro would act as a safe haven from a Trump presidency in the initial stages more than it has ended up being so as traders, eager to maintain a pattern of political upset, have turned their guns on the single currency.

Indeed, it may be simple and reductive to sit here and say that these impulses propelled both the UK referendum on EU membership and Donald Trump votes but currency markets and particularly those who trade them can be simple and reductive.

As it stands at the moment we think that markets are overstating the longer-term political risk within Europe but near-term we see significant weakness in the single currency, especially against the USD. On our estimates that the Italian government loses the referendum on December 4th we think that December and January will be a tough period for EUR as traders increasingly further populist pressures in the 2017 elections. For now, our estimates remain that centrist, status quo parties actually carry French and German elections with those in the Netherlands more difficult to call at the moment. We see the chances of a populist win (PVV, Front National or a Merkel loss) in the Netherlands at 50%, in France at 25% and in Germany at 20%.

Issues of growth and inflation or the lack thereof in the Eurozone will also act as a persistent pressure moving forward and any moves by the European Central Bank to create either will give speculators another reason to sell. Parity in EURUSD is a common call in times of European angst and we think that the circumstances of a strong, Trump driven dollar and European political issues makes now a better opportunity for that price level to be reached than in the past.

Brexit and Trump: a 'special relationship'?

Trump called himself Mr. Brexit on more than one occasion in his campaign and the anti-establishment anger of both campaigns owe more to each other than passing similarities. A Trump presidency is a difficult outcome to parse into a UK effect although there will be issues over trade and security.

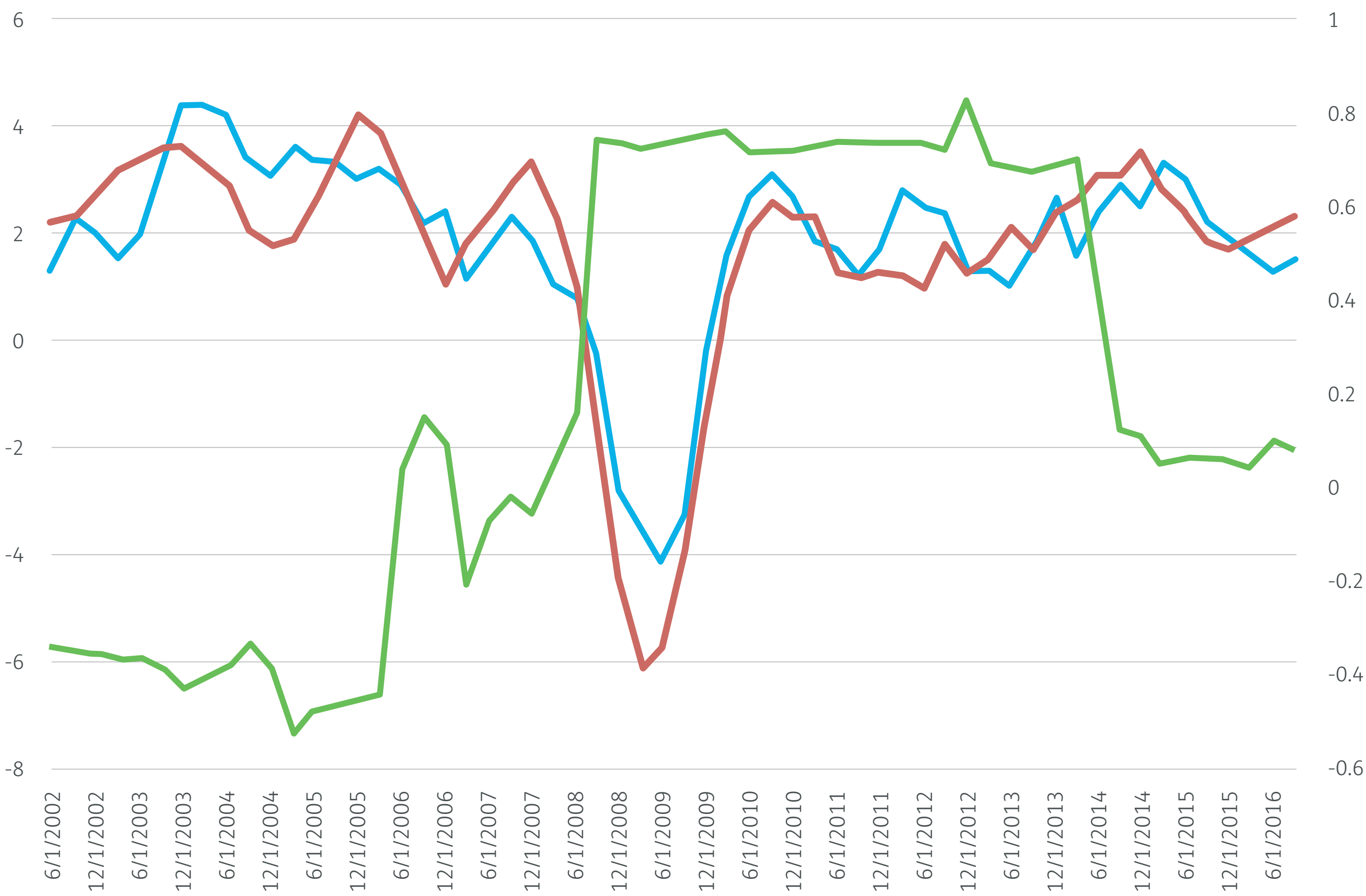
Following President Obama's note during the referendum campaign that a post-Brexit Britain would have to go to the 'back of the queue' for a trade deal with the US, Trump made sure to say that the UK would be at the front of negotiations in his administration. We cannot put much faith behind this gesture however; Trump's campaigning stance was more 'say the opposite of Obama' than a fully fleshed out trade plan.

There are also questions of how many trade negotiations the UK can be part of at any one time. None can take place under EU law until Article 50 has been invoked and we would think that the focus would fall on somewhere like China whose relationship with the US is expected to sour with the UK eager to pick up the pieces.

The election of Trump will give the UK a little more strength in negotiations however given the former's stance on NATO, with wider European security back on the table especially in light of a resurgent Russia. Britain's expertise in the area will be used as an ace card in negotiations with the EU once Article 50 has been triggered.

Growth in the UK and US has a good correlation – one doing well normally means the other does too and vice versa – although this has lessened in recent quarters, as we can see in the below chart. One key characteristic of the wider expectations around a Trump presidency is higher US growth in the short term courtesy of greater infrastructure spending and tax cuts and the hope will be that the correlation continues to bear fruit for the UK. Brexit is such an existential shift in the UK economy however that we could easily see this correlation whither and die.

As one goes so does the other



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The pound however has few ace cards up its sleeve and we expect that the USD will continue to beat up on sterling through the coming months. Article 50 being triggered will be viewed as a sterling negative as will expected stagnation in growth combined with higher inflation.

Conclusions

When I first started in financial markets the abdutive reasoning of the horse test was reinforced on an almost daily basis; if it looks like a horse, sounds like a horse and smells like a horse then it is probably not a zebra. 2016 has seen many a zebra clatter through markets and 2017 will be full of the sound of hoofs. On the electoral stance we see horses and not Brexit or Trump like zebras, but we have a way to be convinced.

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