Crossbow Partners
Experience & Discipline

New York Trip Report

The U.S. Elections – Before and After the Event

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Executive Summary

The Trump presidency, the Italian referendum, the OPEC summit, the Fed decision, the impending Brexit negotiations, as well as the upcoming elections in France, the Netherlands and Germany in 2017 create considerable political event risk, implying a wide range of outcomes and volatile markets

Managers believe that we could see a shallow US recession in the latter half of 2017 unless fiscal stimulus is rolled out, as monetary policy has more or less reached its limits

As inflation is picking up and the Fed behind the curve, a substantial re-pricing of bonds seems possible and it is essential to size positions appropriately

In the HY bond market we experience a "cycle within the cycle", as energy and commodity-related names come out of a sharp recession and benefit from credit repair, while most other sectors look vulnerable and expensive

Poor liquidity, poor performance and new rules and regulations in the structured credit and CLO markets could lead to a sharp re-pricing of structured credit and to a manager shakeout in 2017

Equity hedged managers position themselves in a neutral to slightly defensive way and pursue an opportunistic, trading-oriented investment approach, as visibility remains low and they seek to protect capital after a difficult year

Innovation in biotech and healthcare remains strong, while valuations are modest and the sector is poised for a re-rating due to industry consolidation and heightened M&A activity

Macro and Equity View

1. Are The U.S. Elections A Game Changer?

President-elect Donald Trump makes his transition to the White House. He and his team have started to select key cabinet positions. While his agenda and his policy plan for the first 100 days are still largely in the dark, U.S. equity markets have risen since the presidential elections in what commentators have dubbed the “Trump rally”.
Contrary to the predictions of many experts, the Trump win did not trigger a large stock market rout nor a rush into low-risk government bonds. While markets initially reacted less favourably to the prospects of a Trump presidency, the mood changed in the election night when it became clear that the GOP had won the presidency and both houses of Congress. For only the second time in the past 88 years, the Republicans will control both houses of Congress and the presidency. Markets were obviously pleased that the stalemate between a Democratic president and a Republican Congress has come to an end. With the removal of a divided government, there is an opportunity to pass needed fiscal and regulatory measures. Markets cheered up, as Trump and the GOP were handed the power and the mandate to change policy direction and to follow through on both the Trump and the Republican agenda. From this perspective, the Trump-led Republican sweep can be considered nothing less than a game changer.

While the priorities, details, and the financing of Trump’s blueprint remain unclear, the short-term economic implications of his policy proposals are strongly pro-growth. In particular, Trump’s policy is likely to end an era of monetary easing in the U.S. He seems determined to herald a new cycle of reflation and a regime of fiscal and supply-side stimuli. This must be assessed against the backdrop of an economy which comes as close as possible to a “Goldilocks” economy - with GDP expected to grow at 2% or more in 2017 (according to the IMF), operating at full employment and with an expected inflation rate of 1.9% in 2017. In addition, the Fed is likely to stay the course and to normalize interest rates over the next few quarters. Thus, any fiscal stimuli will boost growth in an economy which is already running almost full steam ahead.

The fiscal stimulus measures should come through tax cuts, and a “tax holiday” to allow for the repatriation of overseas corporate profits, which are currently estimated to be over USD 2.1 trillion according to Reuters. Expectations for broad corporate and personal income tax cuts – probably through some combination of Trump’s plan with that of Paul Ryan and the GOP – are running high. With a corporate tax cut reduction from the 35% to the 15% for which Trump has advocated, net earnings will increase 29% (for companies in this tax bracket) and the 20.0x P/E multiple on the S&P 500, in theory, will become a 15.5x P/E multiple, as Select Equity Group, one of our fund managers, has calculated.

If we add in the opportunity to repatriate about USD 1 trillion in US corporate cash overseas at a proposed one-time rate of 10%, the stimulus effect becomes even stronger. In the past, companies were faced with the high cost of repatriating foreign earnings and often chose to redeploy overseas profits into foreign investments. For every dollar of US corporate cash parked overseas, the current choice is to either invest that cash into 1 USD of overseas investment or bring it back and, at the current rate, use an after-tax 0.65 USD to invest in the US.

Now, redeploying cash domestically under the new proposed rates will be a game changer. The Trump plan would allow after-tax 0.9 USD on the dollar to return to the US and to be invested in US plants and employees, acquisitions, buybacks, debt reductions or dividends.

Consumers, on the other hand, will also benefit from lower personal income taxes, as the seven tax brackets will be reduced to three at lower rates. Select Equity Group assumes that the average American household will most likely enjoy more than USD 2'000 of additional expendable after-tax income. This amounts to an estimated 5% increase in the average US household's expendable income – to be spent, saved or used for debt reductions.

While initial estimates of a USD 1 trillion infrastructure spending package seems unlikely to materialize, the supply-side measures are predicated on pro-business deregulation, infrastructure spending, energy independence, and rebuilding the US defence sector. Thus, some of Trump's initiatives will benefit specific areas of the domestic economy. Fostering energy self-efficiency by unleashing America untapped energy reserves will give a boost to oil and gas exploration, but could also lead to an oversupply and lower prices. An important contributor to the decline in productivity and growth has been the increase in regulations. Dodd-Frank has imposed massive regulatory burdens on the financial industry and led to distortions in financial markets, as banks and brokers were forced to virtually withdraw from market-making and lending to certain homeowners. There is also widespread support for reforming Obamacare. One of the likely winners is pharma/biotech, as the Republican sweep and the defeat of California's Proposition 61 takes drug price controls off the table. Other likely beneficiaries of a Trump presidency will be the defence sector (increased spending), and domestic non-residential construction (major infrastructure programme).

Lower taxes, more fiscal stimulus, and regulatory reform should raise growth rates. If Trump's policies were to generate faster growth, it should generally be positive for global growth. Commodity exporters should benefit from higher prices, and consumer goods exporters from higher US demand. But with an economy operating near full employment, these measures will also increase inflation and interest rates in anticipation of faster growth and higher deficits. Cleary, the long-term economic costs in the form of reduced government revenue due to a lower tax base and areas of increased spending will require offsetting fiscal discipline in other areas or result in widening deficits and government debt.

The U.S. federal government debt will have surpassed the threshold of USD 20 trillion before Obama leaves office in January. If one adds in local and state debt of another c. USD 3 trillion, government debt totals more than USD 23 trillion at the beginning of the Trump presidency. In just eight years, debt has risen roughly USD 10 trillion under Obama.
By contrast, the U.S economy will have produced goods and services of about USD 18.5 trillion at the end of the year. Thus, the debt-to-GDP ratio is expected to rise to more than 120%.

More immediate market risks could come from Trump's trade and foreign policy, as he favours a more local and less global approach. Moving away from globalization and toward lower global trade could lead to higher inflation and slower growth. One of the first casualties could be the TTP (Trans-Pacific Partnership), where the US could withdraw even before ratification – but which would also reduce US influence on Asia. The renegotiation of the NAFTA (North American Free Trade Agreement) appears to be another potential target on Trump's agenda and could lead to lower trade with Mexico and Canada. One of the key risks will be the future US relationship with China, which Trump has labelled a currency manipulator. He might be inclined to impose tariffs and curb trade with China – which could ultimately lead to a trade war and protectionism - with no winners on either side.

2. Investment Implications

Against this backdrop, we remain positive on the US economy and US markets – provided that Trump delivers. Risk assets should benefit if he boosts fiscal spending and cuts taxes both on businesses and individuals. We therefore favour equity funds over bond vehicles. Among bonds, TIPS should outperform. Within equities, main beneficiaries will be companies and sectors geared toward domestic growth. Market leaders in sectors with tailwinds (cyclicals, financials, defence/security-related names, commodity-related companies, healthcare, and consumer, etc.) should do well. Yet Trump has already caused a large sector rotation so that part of the gains are already priced in.

In emerging markets, countries that can benefit from higher US growth, but are less exposed to potential US protectionism and trade retaliations (i.e. Russia, India, and Brazil) should outperform. Trade partners with a potentially more antagonistic relationship (i.e. China, Mexico) might struggle.

Conclusion: Great expectations are already baked in a Trump presidency, as his agenda has the potential to be a game changer. However, there are still many unknowns, implying a wide range of outcomes. Until there is more clarity around the new policies and their implications for the global economy, financials markets will likely remain volatile and investors should prefer a nimble, trading-oriented investment approach. Clearly, there will be a lot of opportunities both on the long and the short side during the Trump administration and investors should position themselves appropriately for such an environment. And, typically, stock market rallies tend to end with a bang, not with a whimper: The policy actions of the Trump administration could provide the missing explosive, last leg up of the equity market rally…