Strategy

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How a Trump Presidency will Impact Treasury Investment Portfolios

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Abstract

Policy, geopolitical, and idiosyncratic risks are real under the new administration. It is too soon to tell if the next four years will be friendly to cash investors. The economic drag from trade barriers and immigration control may offset some benefits from a federal stimulus and a pro-business Republican agenda.

A potentially bifurcated outcome from the new president makes it difficult for portfolio decisions, but broad diversification and interest rate neutral strategies offer some defense against uncertainties.

Introduction

The upset win by Donald J. Trump as the next president of the United States defied predictions of market disruptions. Risk assets of almost any kind staged strong rallies in the days since the populist Republican candidate's victory on November 8th. Interest rates across the yield curve, on the other hand, rose in rapid succession on expectations of a higher federal deficit, higher economic growth, and higher inflation.

At this moment, little is known about the details of the new President's policies and priorities. In a two-and-half-minute YouTube video (view here), President-elect Trump outlined his "First 100-Day Plan", which includes the withdrawal from the Trans-Pacific Partnership (TPP), removal of policy restrictions on shale oil, increased "clean coal" and other energy production, a plan to secure vital infrastructure from cyber-attacks, and investigations into visa program abuses. Many of his campaign promises that may negatively impact the economy and financial markets are conspicuously missing.

Treasury management professionals are keenly focused on the safety, liquidity and yield objectives of their cash investments. While the unconventional Trump presidency will no doubt cause many changes in society and international relations, our focus is on short-term debt markets and the economic environment for liquid investments. We need to sort through a number of questions and issues to understand how a Trump presidency may impact our investment strategies in the long run.

Why did the market behave differently from earlier predictions?

Market pundits had predicted that a Trump win on an anti-immigration, anti-trade and anti-Wall Street platform could bring disruptions and uncertainties to financial markets. His conciliatory acceptance speech and the Republican Party's majority positions in both chambers of Congress led the market to think that the more traditional pro-business Republican policies, such as infrastructure spending, lower taxes, and less regulation may prevail. Higher inflation expectations from fiscal stimulus and economic growth also led to higher bond yields.

Are recent rallies and higher bond yields justified?

Yes and no.

Financial markets often lead the economy directionally. Recent market activities suggest a higher, if not robust, growth period for the US economy. The unemployment rate is below 5% with signs of wage growth to support consumer spending. Both Trump and Democratic Party nominee Hillary Clinton prioritized infrastructure spending in their campaign pledges, so some form of fiscal stimulus should be forthcoming. Rallies in energy, financial, and pharmaceutical companies reflect expectations of deregulation in their respective areas.

The Federal Reserve was already on track to raise short-term interest rates in December. Reflationary pressures from wage growth, higher commodity prices and the federal deficit suggest an eventual end to the ultra low interest rate environment, which led to the abrupt retreat in bond yields across the yield curve.

On the other hand, the financial markets may be too optimistic that a leadership change will result in immediate and dramatic changes. Fiscally conservative Congressional Republicans may not give their President carte blanche in debt-financed spending and tax cuts; Senate Democrats with filibuster capabilities may not either. The administration's pro-growth agenda may be negated by a strong dollar, trade wars and tariffs, and the reduction of qualified migrant workers. There is also event risk from policy errors by a President without public office experience who is known for erratic behavior and controversial remarks.

In short, the rallies in equities and commodities and the rise in bond yields may not persist. It is too soon to know if the next administration will be net positive or negative for financial markets in the long run. A smooth transition and policy execution in the President's first 100 days may give us a hint.

How will the Trump Presidency impact institutional cash investors?

We can answer this by addressing the two main factors affecting fixed income portfolios – interest rates and credit risks. There are certainly other factors as the result of a new occupant in the White House, but for simplicity's sake, we will focus on these for now. Because of a somewhat unconventional presidential campaign, we also address event risk as a third factor.

Interest rates: It is commonly understood that the Federal Reserve's monetary policies influence short-term interest rates, while the market's outlook for inflation and term risk premium determine long-term rate movements. While most cash portfolios use securities maturing within three years, the medium-term inflation outlook also influences Fed policymakers in their preemptive interest rate decisions.

Credit: The changes in credit cycles and how securities in different countries, asset classes and credit sectors react to interest rate changes will influence the credit performance of portfolio holdings. In many instances, these influences may have offsetting effects. For example, banks tend to benefit from higher interest rates on profitability but suffer on asset quality as borrower delinquencies also increase.

Event risk: By definition, event risk is hard to predict but always present in portfolio management. The lack of policy specifics and sometimes contradictory or controversial sound bites from Trump's campaign introduce uncertainties that may impact cash portfolios after he takes office.

Where are interest rates headed?

Higher…with a caveat.

Short-term policy rates: Before the Presidential election, the Federal Reserve was on track to hike the fed funds rate by 0.25% at its December meeting. The futures market increased the probability of a December hike from

82% prior to the election to 100% today (December 13, 2016). It also suggests two more possible hikes of 0.25% in 2017 - one by June at a probability of 62% and another one in December at 54.9%. These projections coincided with Fed officials' own consensus projection for 2017 at its September 2016 meeting. The futures market previously projected only one more hike instead of two for 2017.

Though criticized by Trump as artificially holding down interest rates to help the current administration, Fed Chair Janet Yellen has indicated she will serve out her current term to February 2018. Vice Chair Stanley Fischer, whose votes are often aligned with Yellen, will end his term in June 2018. Although Trump may fill the two current vacancies on the Board with candidates of his choice in the interim, the Fed's monetary policies may not deviate much from its current stance until after 2018.

It should be noted that, despite his campaign pledge to not reappoint Yellen as the Fed Chair, Trump had previously called himself a "low interest rate person" with his real estate background. As president, his promises of delivering strong economic growth may be hampered by higher rates. Incumbent administrations rarely, if ever, push for higher rates. Signals from Trump's economic transition team suggest that his initial focus will be on infrastructure spending, taxes, trade, regulatory and energy policies rather than operations at the Fed.

In summary, short-term interest rates probably will rise more or less at a pace close to pre-election projections at the Fed. A caveat is that most major central banks around the world are still in quantitative easing mode, combating deflationary forces with negative interest rates. Election uncertainties in Europe, in addition to the official triggering of Brexit from the European Union, may send more overseas assets chasing the dollar in a de facto tightening and slow the Fed's pace to hike rates.

LIBOR rising: Perhaps a more relevant interest rate benchmark for cash portfolios is the three-month London interbank offered rate (LIBOR). The pending prime money market fund reform caused the index to trend up from 0.654% at the end of June 2016 to 0.882% on October 14, the reform's effective date. It stayed within a narrow band of 0.002% until November 9, when it started to climb again to reach 0.924%. The rising LIBOR may send two signals: generally higher short-term rates from the Fed's rate decision in December and higher short-term credit risk premium.

We think that as banks and other short-term debt borrowers adjust their funding needs and maturities away from prime money market funds, the pressure on LIBOR's yield spread to the fed funds rate should abate. LIBOR levels may stabilize or even move closer to fed funds as the dust settles in money market land.

Long-term rates are a wild card: The rise in longer-term Treasury yields is nothing short of spectacular. The 10-year note yield hit a 52-week low of 1.359% on July 8 2016 and is now more than a full percentage point higher at 52-week high of 2.376% just four months later. It is possible that the market grew convinced that inflation will rise as Trump cuts taxes and increases infrastructure and military spending, both of which would widen a budget deficit. Another possibility is that the election was a pivotal moment to solidify the market's long-held conviction that the bull market in bond yields will end sooner or later. Janet Yellen may have helped this sentiment in her post-election appearance to Congressional members that a rate increase is "relatively likely" to occur soon.

But is the speed and magnitude of the rise in bond yields justified? Will the sell-off in bonds continue? We have our doubts on both. It is true that the labor market has been improving and the economy is in better shape than it was a year ago. There is also some common ground on infrastructure spending between Trump and the parties in Congress. Both economic growth and federal spending could lead to moderately higher inflation.

Enthusiastic bond bears may have overlooked the possibility that federal spending and tax cuts may be underwhelming. There remains considerable uncertainty around Trump's stimulus proposals and how they will be received by Congress. Economists estimated the possible US gross domestic product (GDP) impact of the various

Trump campaign packages at between 0.2% - 1% a year, but the more aggressive package has little chance of acceptance by fiscally conservative Republicans, not to mention their Democratic opponents. A more likely scenario is a smaller stimulus package with a more modest impact on the economy and interest rates.

The US economy does not exist in a vacuum, nor does its bond market. A stronger dollar and a more protective trade policy could hurt corporate profits, offset some of the fiscal stimulus and lead to slower growth. With central bank quantitative easing in effect in Europe and Japan, and many of the world government bonds paying negative interest rates, the rise in US bond yields will no doubt attract overseas investors and limit further increases.

Then there is the wildcard. If the congenial President Trump gives way to the unpredictable and populist Candidate Trump and wages trade wars with Mexico and China, clamps down on immigrant visas, or stokes geopolitical skirmishes, growth in the US may slow or grind to a halt. The "Bad Trump" scenario could result in a better than 50% chance of a recession in the next 12-18 months and lead to interest rates stalling or reversing course. Worse yet, there have been more frequent warnings of stagflation since the election on this adverse scenario.

What are the credit implications and where?

Since the election, financial services, healthcare, industrial, and to a lesser extent, materials and energy companies showed strong performance. Utilities, technology and consumer staples were the clear losers. Consumer discretionary and real estate companies appear to be in the middle. International markets, notably Europe, Mexico and most of the emerging markets performed poorly relative to the US on trade concerns. All of these developments have credit implications for cash investment portfolios.

The bifurcated market view on Trump's uncertainty as president makes it hard to forecast credit performance of portfolio holdings. We will discuss the topic in the base case scenario of higher interest rates, more infrastructure spending, less regulation and more restrictive trade policies under the incoming administration.

Banks and financial companies: Banks should perform better given higher interest rates that boost profitability. Trump promised to roll back financial regulations, most notably the Dodd-Frank Act imposed in 2011 after the recent financial crisis. Incoming Senate minority leader Chuck Schumer threatened to put up a strong fight, so a total repeal of the law may be unlikely. A compromise bill may provide some relief to regional banks not designated as systemically important banks (SIBs). The eight largest US banks may not receive much relief, though.

Practically speaking, US banks have not been major borrowers in the short-term debt market so investors may not see much direct benefit other than lower bank compliance costs. Large European, Japanese, Canadian and Australian banks may continue to fund in-market lending here, although cross-market borrowings will become more expensive due to the strengthening dollar.

Better banking profitability provides a cushion for higher credit costs, but higher rates also worsen borrowers' ability to repay loans, especially when rates rise faster than the economy improves. On the consumer side, recent rapid growth of student, auto and credit card loans and subprime mortgages may stress borrowers' abilities. On the commercial side, unsound commercial real estate loans and often-criticized energy portfolios are the trouble spots to watch.

Energy and mining companies: Other than integrated oil & gas companies, most companies in these sectors have credit ratings not eligible for cash investment holdings. Trump's new policies to encourage drilling, reduce production restrictions, and reverse pollution enforcement standards may not have much impact if supply remains above demand. Still, we expect negative outlook or watches placed on the names in these sectors as general economic activities pick up and commodities prices improve.

Capital intensive companies: Integrated manufacturing and capital intensive companies had been under pressure as demand from emerging markets slowed and the booms in energy and construction sectors turned into busts. Many firms in this sector went through reorganization, charge-offs and ratings downgrades. A pro-growth Republican agenda may provide a boost in domestic demand for some firms' products and services, although higher interest rates and trade wars may negatively impact emerging market economies, which are not helpful to the firms' credit standing. Careful investor discernment is required.

Healthcare: Pharmaceuticals and biotech companies got the boost from Trump's victory perhaps less because of him and more from the loss of Hillary Clinton, who has been very critical of the drug companies' price policies. Major insurers sold off as Trump would allow insurers to compete across state lines to keep costs down and allow Americans with pre-existing conditions to keep coverage. Little is known about Trump's healthcare policies, so it is too soon to tell if the sectors will do better or worse. Credit quality of drug companies as a whole has suffered from the lack of growth and from patent expirations. Credit ratings are under pressure as firms resort to mergers and acquisitions and financial engineering to reduce cost and boost profitability. We do not see this trend reversing soon. On the other hand, lower corporate taxes on repatriated offshore profits may benefit this sector.

Technology: Major technology firms face headwinds as many use highly skilled foreign workers and have their products manufactured offshore. Restrictive trade policies may make the logistics of global tech manufacturing more cumbersome and expensive. Anti-immigration policies also may result in drastically fewer work visas for highly skilled foreign workers, draining the Silicon Valley talent pool. Repatriation of offshore cash, on the other hand, may benefit the tech industry the most due to proportionally higher offshore cash held overseas. On the margin, however, we do not view presidential politics as important a credit factor as peer competition and technology obsolescence.

Autos, consumer goods and retail: We see neutral to slightly positive credit performance from the consumer sectors. Improving employment, wage growth and the new administration's pledge to provide tax and spending incentives to working class Americans bode well for firms serving consumers. Higher interest rates may dampen consumer credit and result in higher loan losses, albeit with recent losses at historically low levels.

In summary, we see both positive and negative factors at play that may affect portfolio credit performance. On balance, we expect improved credit quality under a "good Trump" scenario consistent with his post-election speeches and anecdotal evidence. Unexpected policy twists, erratic behavior or prolonged fights among top leadership, of course, could lead to recession and other undesirable credit outcomes.

What could go wrong and how it could impact cash portfolios?

Well, we cannot know for sure, more so with this president than previous ones, given his lack of policy specifics or government experience. Financial markets tend to dislike uncertainty. On that point, the recent stock market rallies look more like an anomaly than the norm.

If our base case scenario of a fiscal stimulus and a roll-back of regulation early next year turns out to be false, the market goodwill the new president enjoys may quickly be unwound. The sectors, industries, and credits perceived to benefit the most from "Good Trump" policies may be under pressure. Volatility may return. Strong-handed approaches towards international affairs, trade and immigration policies and potential discord of Washington politics, for example, the deadline to raise the national debt ceiling on March 15, 2017, could introduce additional uncertainties.

Even if things in Washington do go according to Trump's plans, their positive effect on the overall economy may be less than implied by the recent market rallies. Compromises on spending and tax cuts likely will water down proposals. As bills make their twists and turns in the political process, debates in the public square can introduce uncertainties in the financial markets. Investors should brace for such volatilities.

There could be other sources of "black swan" events in the international arena that are not directly related to, but inspired or emboldened by, the Trump Presidency. Italy's referendum on constitutional change and Prime Minister Matteo Renzi's likely resignation if it fails to pass threaten the solvency of the Italian banking system and, with it, the safety and soundness of many eurozone banks. Populist nationalist movements in national elections could see leadership changes in France and Germany that may negatively impact world financial markets.

In summary, many of the risks to the rosy market-friend Republican policies do not seem to be factored into traders' thoughts today. Should some of the risks flare up, one would expect sell-offs in equities and credit spreads while Treasury yields come back down.

Conclusion

With the new administration, policy, geopolitical, and idiosyncratic risks are real. It is too soon to tell if the next four years will be friendly to institutional cash portfolios. While we expect interest rates to head marginally higher and some domestic industries to benefit from a federal stimulus, the economic drag from trade barriers and immigration control may offset some such benefits under a "Good Trump" scenario. If a "Bad Trump" scenario turns into reality, economic growth may stall with some risk of recession.

The potentially bifurcated outcome makes it difficult for portfolio decisions, but broad diversification and interest rate neutral strategies offer some defense against uncertainties. By the end of the first 100 days into the new administration, we may have a better sense of likely future portfolio impact.

About Us

Capital Advisors Group, Inc. is an independent investment advisor specializing in institutional cash investments, risk management, and debt finance consulting.

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