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Trumponomics, Debt Ceiling Rollercoaster and Geopolitics

Three Trends to Watch in 2017

Abstract

We select Trumponomics, the debt ceiling rollercoaster and geopolitics as three main themes to watch in 2017. Federal stimulus may in fact be underwhelming and a stronger dollar and trade wars may further erode the effect of increased government spending. The immense size of government money market funds ($2.2 trillion) may present challenges throughout the upcoming debt ceiling rollercoaster ride. 2017 may also bring multiple geopolitical risks from various parts of the world. Longer duration, higher credit quality and increased liquidity are advised for cash portfolio construction.

Introduction

Few years in recent memory have rivaled the events of 2016 - from Brexit to the Trump presidency, from multiple terror attacks and a migrant crisis in the fractured European Union to racial tensions and home grown terrorism in the United States. Still, a much feared "hard landing" scenario in China did not materialize and equity investors rode a Trump victory to record high valuations. The Federal Reserve projected four but delivered just one rate hike of 25 basis points. Crude oil futures fell to $26 a barrel in February but almost doubled by the year's end.

At the start of each year, we typically take stock of some of the major events and trends that we believe will impact the short-term debt markets. It's no understatement that the one word that comes to mind for 2017 is "uncertainty", and the year could go very well for the economy and markets, or very badly instead.

Last year, we identified a gradually higher interest rate trajectory, navigating through money market fund reform and a turn in the credit environment as the three main themes. Out of many subjects that qualify this year, we pick Trumponomics, the debt ceiling rollercoaster and geopolitics as our three major themes.

Trumponomics – Great Fanfare or Disastrous Outcome?

In last month's newsletter, we discussed the likely impact of a Trump presidency on treasury investment portfolios. Many of the details of Trumponomics remain murky, as the President-elect's announced policy priorities include a retreat from global trade pacts, deregulation of energy and environmental policies, strengthening of cyber security and tightening of work visa programs.

Nonetheless, Trump's campaign pledges and new cabinet selections signal the introduction of a fiscal package consisting of tax code reform and increased infrastructure spending. The rollback of financial regulations, labor laws and Obamacare, and a possible intent to influence Federal

Reserve policies by governor appointments also may be on the agenda, although of lesser priority.

The new administration's economic initiatives may impact short-term debt markets on both the interest rate and credit fronts. Short-term rates were expected to move higher regardless of the presidential election outcome. Following the Fed's rate hike last December, the market currently expects two to three more hikes in 2017. Quick nominations of the two vacant seats on the Federal Reserve Board may tilt the central bank's bias to a more aggressive Fed, but more than three rate hikes in 2017 is unlikely unless there are clear signals that the economy is rapidly overheating.

Longer-term interest rates, on the other hand, remain a wild card. At face value, Trump's potential spending and tax cut proposals will widen the Federal deficit and stimulate the economy, which normally lead to higher inflation and bond yields. Ironically, a Republican controlled congress may significantly water down the new administration's spending proposals. Also, recall that the 10-year benchmark Treasury yield has climbed by more than a percentage point on the prospect of Trumponomics and such a lofty increase in a short time has left a high hurdle for rates to climb much further.

Turning our attention to industry groups, broadly speaking, more heavily regulated industries such as banks, energy and healthcare companies may have improved prospects over the next four years. Export-reliant industries and those employing high-skilled foreign workers such as technology companies may suffer the consequences of a stronger dollar, trade barriers and labor shortages. Many borrowers in the short-term debt markets tend to be multinational corporations, who must face the tug of war of both the benefits and downsides of Trumponomics. We caution that the potentially bifurcated outcome of the Trump administration complicates portfolio analysis and decision-making. One will likely have to wait through the first 100 days of the new administration before a clear picture of its direction becomes apparent.

Portfolio implications: We think the positive effect of Trumponomics is largely reflected in current market conditions and this may leave room for negative surprises from failed proposals or underwhelming efforts. We have a more conservative outlook than the two to three interest rate hikes in 2017 projected by the Federal Reserve, expecting two at the most. As a result, we remain comfortable with taking limited duration risk by extending out on the yield curve within short-term parameters. On the other hand, a reversal in rates from market disappointment may coincide with credit spread widening and poor market liquidity. We prefer to target higher quality names for long positions on the curve and we remain more defensive with respect to duration for lesser creditworthy issuers.

The Debt Ceiling – A Rollercoaster Ride for Government Money Market Funds

A topic that has been on the back burner of debt investors' mind for the last two and half years will once again be front and center come March 15, when the suspension on the federal government debt ceiling expires. Those who experienced the debt ceiling fights in 2011 and 2013 know that political swashbuckling in Congress is bad business for US sovereign debt. Even though both battles were eventually resolved amicably, many investors chose to step away from Treasury securities maturing around the projected technical default dates.

This time around, things may improve a bit due to the Republican sweep in Congress and a Republican President. Still, we expect another rollercoaster ride in Treasury debt supply around the debt ceiling time that may present challenges for Treasury money market funds and for cash investors due to increased demand for such securities this year.

If history serves as an example, the Treasury Department's debt ceiling management will unfold in a trilogy of events by late fall. First, assuming no new agreement is in place by March 15, the Treasury must aggressively spend its roughly $390 billion cash balances down to $25 billion by that date. The street estimate places the reduction in Treasury Bills issuance at $125 to $180 billion during this period.

Secondly, once a ceiling is back in place, Treasury will employ its "extraordinary measures" to keep the government running by ceasing the issuance of debt to government entities and by halting reinvestments in the "G fund" to return to $300 billion borrowing capacity. Due to tax refund schedules, federal spending tends to be back-loaded in the second half of the year as spending picks up and revenue flattens out. If the debt ceiling fight wears on, the Treasury will face increasing pressure for more funding capacity.

Act three potentially concludes with the re-suspension or an increase of the debt ceiling, at which time Treasury could restock its precautionary cash balance to $300 billion. Based on projected 2017 federal deficit, Treasury has a net borrowing need of $650 billion for the year, $230 billion of which is new Bills supply. All in all, we will see net new Treasury supply, but how the Treasury Department manages through this rollercoaster ride will be further complicated by the more than $1 trillion net new demand resulting from 2016 money market fund reform.

Last year's environment was accommodative to government money market fund supplies. The Treasury Department proactively increased Bills supply and the Federal Reserve made available up to $2 trillion in balance sheet capacity through its reverse repo (RRP) facility. If we face a debt ceiling fight in 2017, supply alone may not be a big issue as the Fed's facility remains open as a last resort.

On the other hand, treasury and government money funds, at $2.2 trillion in net assets at the end of 2016, essentially doubled their size from their $1.1 trillion position at the end of 2015. If history serves as a guide, investors may become wary of government and Treasury funds owning securities maturing near the "judgment day". Some funds may sell these securities outright, and Treasury repos backed by such securities may be questioned. A crisis of confidence in Treasury money market funds may develop, if only for a brief period. With more than $2.2 trillion at stake, we hope cooler heads will prevail.

Portfolio implications: We hope this round of the debt ceiling fight will be more civilized than previous episodes. Still, how the Treasury Department manages through the ups and downs in Bills supply will impact the demand for the Fed's RRP, agency discount notes and other government instruments. Although we expect higher net Bills issuance, the yield impact is expected to be on the down side for much of the year. In later stages of the fight, aversion to certain Bills may develop. We are uncertain how large treasury money market funds will navigate through these disturbed waters and how their shareholders will react. We would advise investors to store some alternative liquidity in addition to their treasury fund shares. For the more adventurous, this period also presents some yield opportunity in picking up securities that could face technical defaults.

The Year of the Rooster with Fat Tails? – Geopolitics Have Portfolio Consequences

Geopolitical risk has been a recurring theme in recent years. From the Middle East to the Balkans, from the South China Sea to cyber-attacks, the list goes on and on. What promotes geopolitics to the top of our list this year is our belief that the new administration's vastly different visions of international politics from those of the Washington establishment may have profound market implications.

In some sense, the Trump victory is more of an effect than a cause of a new world trend towards the reversal of globalism and political correctness as the masses in most of the western world have yet to materially recover from the financial crisis of 2007-2008 despite the passage of nearly ten years. With a billionaire businessman without government experience at the helm of the world's sole superpower, surrounded by like-minded business executives and political outsiders in his Cabinet, geopolitical risks have risen to the top of many market participants' minds.

The Eurasia Group labeled 2017 as a period of "geopolitical recession." Among the Top 10 risks it lists, Trump's unilateral pursuit of American national interests and the resulting unpredictability of US foreign policy took the top spot. Other top potential risks include potential Chinese overreaction to its territorial claims during leadership transition in the fall of 2017, a weakened EU leadership under Germany Chancellor Angela Merkel,

a trend towards weakened governments in the Middle East due to technological advancements in energy production and telecommunications, the polarization of central banks around the world, shouting matches between the White House and the Silicon Valley, failed reforms in Mexico, and trouble spots in Turkey, North Korea and South Africa[1].

In recent years, we've heard a great deal about "risk-on" and "risk-off" trades, phrases that describe the tendency for investors to move in and out of seemingly uncorrelated risk asset classes in tandem. Some of the forces behind these trades were explained by the quantitative easing bias among major central banks. Now that there has been some divergence in central bank policies, we hear these phrases less often; however, geopolitical risks in 2017 could tilt the market's risk bias to the "risk-off" position from the glowing optimism we have witnessed since the presidential election.

Portfolio implications: No portfolio is bullet proof when it comes to geopolitical risk, nor should it be. The primary goals for cash investment portfolios are principal preservation and access to liquidity, thus upgrading portfolio quality and liquidity characteristics, which offers better protection than attempts to eliminate geopolitical risks. Since we think that 2017 may face more than its fair share of geopolitical risks, we urge caution regarding securities with long credit duration and poor access to secondary market bids. This is especially the case when the market is priced for perfection. We are more sanguine on extending duration on government securities as "risk-off" trades could likely force investors back into safe haven assets, causing them to become more valuable and more liquid.

From Normalization to Seeking a New Normal – Keep an Eye on Liquidity

2016 was a year of transition on many fronts for corporate cash investors. Money market fund reform is behind us and the prime and government MMF chips have fallen where they lie. The Federal Reserve is firmly on a path towards interest rate normalization with up to two or more rate hikes this year. Regulation on several industries likely will slow down or even reverse direction, injecting new hope for better profitability and long-term prospects.

Although skeptics by training, we are hopeful that tax reforms and infrastructure spending could propel consumer spending, lift core inflation expectations higher, and boost corporate profits into higher gear. Policy uncertainties and geopolitical risks, however, give us pause before we jump on the "all-is-clear" bandwagon. While we aim to take advantage of the higher rates that are currently available for our portfolios, we are more mindful than ever of the downside risk to lower credit names in the event of policy misfires or geopolitical risk outbreak. Preserving portfolio liquidity remains the number one job for portfolio managers.

[1] Eurasia Group: Top Risks in 2017: The Geopolitical Recession, January 3, 2017.
https://www.eurasiagroup.net/files/upload/Top_Risks_2017_Report.pdf

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