# US Election

9 November 2016

## Implications for the US economy

The election of Donald Trump to the presidency creates a great deal of uncertainty over both the economic and policy outlook for the US.

In the short term, the key point to consider is how this uncertainty will impact confidence amongst households and businesses.

For the household sector, strong job gains and an emerging uptrend in wage inflation has sustained robust growth in consumption, often in excess of income growth. Uncertainty over what a Trump presidency will mean for main street America is likely to see a more subdued growth pulse for this sector, particularly for purchases which depend on credit such as vehicles. Having seen a moderation of late (in activity more so than prices), housing is also at risk of dampening GDP growth on a six to eighteen month basis, as conditions are re-assessed by both households and construction firms.

For corporates, uncertainty over Trump's agenda is yet another reason to hold off on further investment. As we have continued to emphasise, equipment investment in the US has been persistently weak over the past two years, having suffered a cumulative decline of 2.6%. There is no reason to expect a return to growth materially above zero anytime soon. Likewise, partly the result of weak energy prices, structures investment has fallen 7% over that period and should also be expected to remain weak.

Given that it looks as though the Republicans will control Congress, Trump may be able to pass his intended policies. However, there is always the risk that some Republicans oppose the president-elect, resulting in delays and/or alterations to planned policies. That being said, looking a year or two out, assuming they are enacted, Trump's policies on taxation could be supportive of growth.

Lower federal taxes – reducing the number of federal income tax brackets from 7 to just 3 (12%, 25% and 33%) and potentially removing estate taxes – would aid households' marginal incomes and wealth. Meanwhile, a lower corporate tax rate should incentivise investment in the US. On both fronts however, the concern is that other tax changes could negate any benefit to the economy.

For individuals, the concern is that Trump has also said that, lower outright tax rates would be compensated for by reducing deductions and loopholes, hence the net boost to household incomes could be relatively modest. Also there is little likelihood of cuts to estate taxes funding greater marginal consumption in the short to medium-term. Tax saved is instead likely to be retained by households as intergenerational wealth.

For corporates, while Trump plans to cut the headline tax rate from 35% to just 15%, he has also stated that he plans to remove the deferral of taxes on corporate incomes earned overseas. If this occurred, it could result in US firms running down domestic cash stock piles to pay tax rather than increasing US investment (so as to maintain their offshore capital).

That then brings us to the critical point of trade relations. Both Trump and Clinton have recently outlined their opposition to the Trans Pacific Partnership (which, as an aside, would have benefitted Australia if implemented), but Trump has gone a great deal further on international relations, raising the possibility of tariffs and the re-negotiation of existing trade agreements. Heading down this path would create lasting uncertainty for firms looking to invest in the US and export globally, with good cause to believe that other countries would retaliate. Also, firms may also (rightly) perceive risks to aggregate growth in the US and therefore be unwilling to spend on expanding their domestic production and distribution capacity in the US.

In addition to the above, a number of Trump policies such as building a wall between the US and Mexico; labelling China as a currency manipulator; and deporting immigrants have the capacity to inflame foreign relations broadly, potentially resulting in repeated waves of financial market uncertainty and being to the lasting detriment of the real economic activity as potential growth is curtailed.

**Implications for China**

Arguably, relations between the US and China is where the greatest risks lie for the global economy.

China's development in recent decades has been a boon for the global economy on many fronts, including: the efficient production of manufactured goods, which has helped keep developed world inflation contained; the greater availability of financial capital, as foreign exchange recycled into developed world markets; and for commodity demand. Consequent gains for incomes in China have also seen the ongoing rise of its middle class, which has then brought further benefits for the global economy via increased services trade and financial integration. Nothing is inevitable, but persistent diplomatic tensions between the US and China would put these drivers of global growth at risk, with potential losses not only limited to the US economy. Obviously, Australia is materially exposed to developments both in resources and services demand.

**Implications for the FOMC**

We have long held the view that the US Federal Reserve has been positioning for a rate hike at its December meeting.

However, the uncertainty that this political development will inevitably exert over not only the US economy but also the global economy means that the FED will now hold fire until it can more accurately assess the likely growth profile for the US economy.

The initial focus of markets on the Trump ascension will be on its implications for trade. Those implications are unambiguously negative and that negativity can be expected to persist until we see the results of his "first 100 days"(mid 2017). Once markets have sufficient information to assess the likely extent and "damage" of these trade policies, they will focus on the (likely significant) fiscal policy changes and whether such radical changes will get the support of the fiscally conservative Republican House and Senate.

Markets may flirt with prospects of a huge increase in the deficit and a strong lift in inflationary pressures, but will be reluctant to price such developments until there is more certainty around the new president's capacity to push such changes through the Congress.

**Australia's Growth and Policy Outlook**

For Australia, the key issue will be the impact of potential trade policies on China. Fears about the direct impact on China of these trade policies in the US should not be overstated. As highlighted above, China has been moving towards a service driven economy, and has ample policy flexibility to boost domestic demand to partially compensate for any direct shock to exports to the US.

The impact of global uncertainty on markets as well as business and consumer confidence is a much more specific issue for Australia. Until the new president sets out the specifics of his agenda, business and consumer confidence will falter in Australia.

**Implications for markets**

Markets raised the probability of a rate cut by the Reserve Bank in February to around 25% from 10%. With the FED on hold but global uncertainty likely to weigh on the AUD, it still seems a low probability that the Reserve Bank will use its limited policy flexibility until it is clearer on the nature of future policy directions and the impact of such policies on business and consumer confidence.

A Trump presidency has seismic implications for global trade, geopolitics and the US economy. Markets are likely to trade on a heavy risk-averse footing for some days, if not weeks, going forward. AUD/USD seems set to extend its decline to around 0.74, potentially lower, as markets position for severe clashes over trade between the US and Australia's key Asian trading partners.

We have no reason to revise our earlier view that a Trump presidency would bring about the biggest changes in many decades in existing US arrangements on everything from taxation policy, to trade policy, social spending, immigration and geopolitics. There are still many unknowns, however, Republicans look set to retain both House and Senate, providing the freest hand for a president since Obama's 2009-10 window of full Democratic control. Markets had been priced for a Clinton presidency but constrained somewhat by Republican control of at least the House.

Trump's strict stance on trade and immigration are well known but precise details are sorely lacking. It may be months before we see some clarity on his front. That said, the Trans-Pacific Partnership is set to be shelved, perhaps ultimately scrapped. NAFTA is likely to be renegotiated. Signature parts of Obama's legacy - Obamacare and Dodd-Frank - are likely to be heavily revamped, perhaps dumped.

Asia's trade surpluses with the US will be in Trump's crosshairs. Simplistically, those economies that depend more on global trade are likely to take more of a hit than those that are less open to trade. Trump wrote in a WSJ op-ed during the campaign that "On day one of a Trump administration, the U.S. Treasury Department will designate China a currency manipulator." China will of course not take kindly to such actions.

The Fed is unlikely to hike in Dec, as financial conditions tighten and uncertainty in key areas of the US economy takes hold. Fed officials are likely to await evidence that the US economy is "weathering" the near term uncertainty of a Trump presidency. Pricing for a Dec rate rise has slumped from above 80% to nearer 40%.

EUR should push higher in coming days to the top end of its 2016 ranges, 1.14-1.15. USD/JPY likely breaks 100 in coming days. Longer term, Trump is fundamentally a mercantilist and as such the strong USD policy - notionally held by many administrations - is likely to be jettisoned. Against that, Trump is strongly in favor of another version of the Homeland Investment Act, potentially a significant USD positive as US multinationals take advantage of a temporary tax break to repatriate funds.

Below we update our current market thinking for our core markets on the basis that we do indeed see what is looking increasingly like a Republican clean sweep.

- A$: We have maintained the view that the A$ and NZ$ would likely see similar falls on a Trump victory to what we saw over the UK referendum. Indeed, it seems fair to argue that we should see more aggressive falls in the A$ given Trump's stance on China, trade and tariffs etc. A deterioration in relations between the US and China could destabilise Brexit -weakened east-west trade even further. A sharp deterioration in in US/ Chinese relations could up-end commodity markets too. We see risks of A$ trading down to and through 0.74 as we strive for a better understanding of Trump's stance on China.
- NZD: NZD/USD reversed sharply lower, from 0.7395 to 0.7275, at around 2pm NZT when the unfolding election results started to swing towards Trump. That 1.2c turnaround is less than the 3c day turnaround on the Brexit vote, but there's plenty of time for the reaction to extend today and longer term. There's minor support at 0.7265, but major support not until 0.7035. The NZD will follow the lead of risk sentiment indicators such as equity markets in the near term, but longer term will be sensitive to the impact on global trade.
- USD/JPY: The last couple of days had seen increasing confidence surrounding Clinton's position and thus a market becoming positioned long on ¥ crosses e.g. AUD/JPY well above its 200 day moving average and EUR/JPY testing key resistance at 116/116.50. Trump's victory has therefore generated a sharp reversal. With a heavy run of risk events into the Dec 14 FOMC meeting including the Italian Senate referendum (Dec 4), the Brexit Supreme Court Challenge (commencing Dec 5) and the ECB meeting Dec 11, there are a number of reasons to expect this weakness to continue. Clearly, the market based probability of a Fed hike has slumped too. So we see this move continuing and USD/JPY pushing to and through 100.
- EUR: The EUR is likely to continue its path towards 1.14/ 1.15 in coming weeks. The Fed is unlikely to hike in Dec, as financial conditions tighten and uncertainty in key areas of the US economy takes hold. Fed officials are likely to await evidence that the US economy is "weathering" the near term uncertainty of a Trump presidency. However, the possibility of no vote in Italy and a possible political crisis will likely weigh more heavily on traders mind after the shock Brexit and Trump outcomes. Thus gains in EUR beyond that 1.14/1.15 level should be firmly capped.
- CNY: Both our CNY TWI model and the CFETS basket has weakened in the last week. That suggests that China has been weakening the CNY both versus a strengthening US$ and against a basket of major trading partners. We noted in an earlier piece that Chinese policymakers might be tempted to engineer a quick CNY devaluation in the event of a Trump victory too - before he enters the White House - officials in China potentially calculating that their scope for meaningful CNY weakness would be politically constrained under a Trump presidency. The yuan fixes over the next couple of days represent an important source of risk that needs to be monitored.
- US bonds: So just how far can US 10yr yields fall? Should they re-test the lows (1.32%) sparked by the Brexit decision? For now, we stick with our view (as expressed in the weekly on Monday) that the initial safe haven response could push the yield back down to 1.6% or so, but post-Brexit lows will not be threatened. Eventually, the market should instead move to focusing on the potential for increased fiscal stimulus and supply consequences of the new president's policy platform - although this is likely to be reflected in a steeper curve rather than providing a handbrake to lower yields in the near term.
- Australian bonds: For Australian yields, we suspect that an extended US safe haven rally should widen the AU-US 10yr spread slightly, but the initial reaction has in fact been quite the opposite; AU/US 10yr spread outperforming by 4bp on the day. Our preferred stance is to use "risk-off" widening as an opportunity to enter

narrowers, but markets are not presently providing the window. Some of that is being driven by the front end, where the market has revised the chances of another RBA rate cut from <50% chance to around 15bp of easing now priced into the curve by August next year. As a result, further down the curve, 3yr bonds futures have raced through recent resistance levels with implied yields falling 20bp from high to low so far today. We expect further rallies will not be equally shared across the term structure, but rather will have the effect of flattening the curve (which is presently unchanged on the day).

- NZ bonds: NZ interest rates have also followed the global lead, the 10yr swap rate falling from 3.03% to 2.89%, flattening the curve from 75bp to 69bp. However further flattening is not assured. As noted above, fiscal implications may limit the extent of US treasury yield declines. In addition, the RBNZ will almost surely cut the OCR by 25bp tomorrow, but markets had earlier priced in that as the end to the easing cycle (partially pricing in tightening from 2017). Now, markets may price in some chance of further easing, after the RBNZ's statement tomorrow, which would push the 2yr lower.


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