NATIONAL BANK
FINANCIAL MARKETS
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SPECIAL REPORT
Economics and Strategy

November 10, 2016

THE TRUMPQUAKE

Summary

- ***The Republican Party is in a good position to advance its agenda after winning the White House, the Senate and the House of Representatives for the first time since 2005. A combination of tax cuts and spending increases should lift U.S. GDP growth.***

- ***A larger budget deficit and potentially higher inflation pressures could not only move the U.S. yield curve up but steepen it.***

- ***Given Trump's campaign rhetoric against free trade, there are concerns about a ramp-up of protectionist measures. But considering the likely fallout, it's unclear to what extent the Trump administration will move in that direction.***

- ***Canada, like many exporting nations, stands to lose if trade barriers are erected. It could be challenging to find other takers for our exports. Policymakers will need to find ways to make Canada more competitive and ensure that we do not lose access to global markets.***

- ***Risky assets have reacted positively to Episode 1 of the new Trump reality show. We like the fiscal stimulus story. But there are many more episodes to come, with plots that will surely keep investors on the edge of their seats. At this juncture, until we get to know the actors a little better, we prefer to keep our asset mix unchanged with an above-average weighting in cash.***

Are you not entertained?

There are perhaps no better words to describe the drama of a U.S. election night in which Donald J. Trump pulled off a stunning upset, winning (at this writing) 279 electoral votes to 228 for Hillary Clinton, and the Republican Party retained control of both houses of Congress. Entertained we will continue to be, as President Trump's reality show becomes a fixture of U.S. society for at least four years. Since the new president was elected without the backing of an establishment, he is likely to govern differently. So despite the checks and balances of the U.S. political system that traditionally guard against dramatic swings in foreign and domestic policy, an element of unpredictability is bound to persist. In one of the most extraordinary regime changes in generations, investors need to remain alert to developments. We doubt very much that the transition to a Trump presidency will be business as usual for Mr. Market. Opportunities as well as challenges lie ahead.

The markets like the show, for now

The news of a Donald Trump presidency was initially ill-received by financial markets (stocks down, bonds and safe-haven currencies up). Then they realized his agenda was not necessarily doomsday for the global economy. In his acceptance speech the president-elect was conciliatory about protectionism (at least for now). What figured at the top of his agenda was rather the need for large-scale fiscal stimulus in the form of infrastructure spending. "We are going to fix our inner cities and rebuild our highways, bridges, tunnels, airports, schools, hospitals," he said after a few introductory remarks. "We're going to rebuild our infrastructure, which will become, by the way, second to none. And we will put millions of our people to work as we rebuild it." So after relying almost exclusively on monetary policy to stimulate growth in recent years – government spending as a share of GDP is at a 50-year low – the U.S. now has a very good chance of turning to large-scale fiscal stimulus (in Trump's campaign he proposed $500 billion). This strategy is likely to gain support**:** the public capital stock in structures is currently growing at the slowest pace since World War II (chart).

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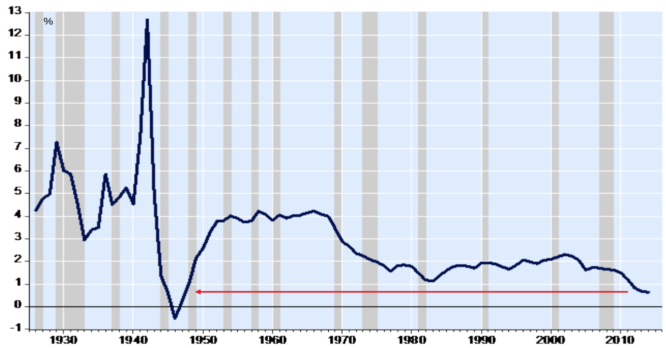
U.S.: Public capital stock in structure rising the least since WWII
Net public stock of capital in structure (% annual change)



NBF Economics and Strategy (data via BEA)

Republican control of both houses puts Mr. Trump in a fairly good position to advance other parts of his pro-growth agenda, including tax cuts for corporations and individuals and reduced environmental and business regulation. In our view, U.S. economic growth will get a boost as President Trump's agenda is implemented, but not before the second half of 2017 at the earliest. A combination of tax cuts and spending increases could lift U.S. GDP growth above 2.5% but we think that this is more likely to be a 2018 story. A larger fiscal deficit and potentially higher inflation – possibly intensified by protectionist measures – could prompt the Fed to speed up its rate hikes. The FOMC currently expects one hike this year, two in 2017, three in 2018 and three in 2019. So the U.S. yield curve could not only move up, but steepen (chart).

U.S. Treasuries discounting larger deficits and stronger inflation

NBF Economics and Strategy (data via Bloomberg)

For the stock market, faster economic growth heralds faster earnings growth. The sectors most likely to benefit from a Republican administration – health care (with the revisiting of Obamacare), banking (with likely repeal or dilution of Dodd-Frank) and energy – did especially well the day after the election (chart).

S&P 500: Perspective on sector performance

Name	%Chg	Up
1) All Securities	+1.11%	65.3%
2) > Financials	+4.07%	93.8%
3) > Health Care	+3.43%	62.7%
4) > Industrials	+2.43%	88.1%
5) > Materials	+2.13%	76.9%
6) > Energy	+1.52%	91.7%
7) > Telecommunication S...	+0.87%	80.0%
8) > Consumer Discretionary	+0.18%	69.0%
9) > Information Technology	-0.24%	59.7%
10) > Consumer Staples	-1.33%	21.6%
11) > Real Estate	-2.28%	25.0%
12) > Utilities	-3.68%	3.6%

NBF Economics and Strategy (data via Bloomberg)

What about protectionism?

Much of the economic uncertainty triggered by Trump's victory stems from fears he will rip up trade agreements and spark a global trade war. While we think it is highly unlikely that the new president would flat-out withdraw from NAFTA or any other trade agreement – see our October 19 Geopolitical Briefing, "A Trump or Clinton victory is not a return to business as usual" – there is little doubt that he will take a more protectionist stance than his predecessor. A president has legal authority to impose tariffs or quotas on virtually any sector without the approval of Congress.

The outlook for global growth thus depends in part on the extent to which the Trump administration will embrace protectionism. It's hard to gauge the effect on global growth with any precision because the damage depends on factors such as type of measures imposed, the country they are imposed on, their timing (e.g. during a recession? during an expansion?) and the policies in place when they are imposed. But there is general consensus that protectionism is bad for growth. For example, the IMF found an average productivity gain of about 1% after a 0.5% drop in tariffs. Unfortunately, the converse also applies.

Global economic growth has averaged about 3.2% in the last eight years, about half a percentage point below the pre-recession average. This growth ramp-down coincides with rising protectionism since 2009. And this year is on track to be the worst in years, with discriminatory measures vastly outnumbering trade-liberalization measures (chart).

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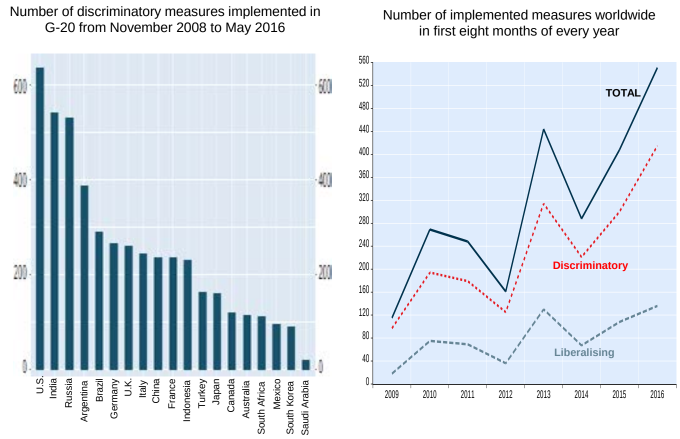
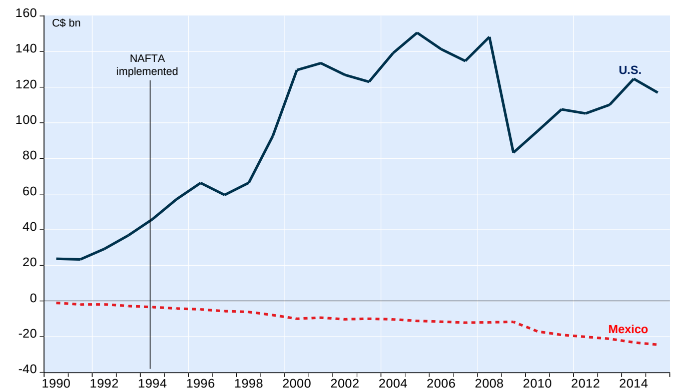
World: Trade protectionism on the rise



NBF Economics and Strategy (source: Centre for Economic Policy Research)

Canada: Since NAFTA, trade balance improved against U.S.

Merchandise trade balance, by year



NBF Economics and Strategy (data via Trade Data Online)

Further movement in that direction would heighten risks to the sustainability of global growth, considering how integrated the world economy has become through global supply chains and hence trade linkages. Export-oriented economies such as those of emerging countries are most at risk. Considering the likely fallout, it is unclear to what extent the new Trump administration will immediately follow through on his protectionist rhetoric given that the relatively good state of U.S. labour markets (jobless rate at only 4.9%).

This being said, the one-two punch of the Brexit and a Trump victories could further increase the popularity of anti-establishment parties in Europe. Elections or referendums will be held over the next 12 months in Austria (Dec. 4), Italy (Dec. 4), the Netherlands (March 15), France (April 23) and Germany (Oct. 22). Euroskeptic parties, many with a negative view of free trade, are expected to do very well in all of these contests. Europe's long period of sluggish growth and the migrant crisis leave it particularly vulnerable to the rise of political parties on the far right and far left of the political spectrum

Implications for Canada

For the progress of the Canadian economy, with its limited upside for domestic demand after the debt binge and housing surge of recent years, much is riding on exports. Canada has benefited enormously from access to the U.S. market, exports to which have more than doubled since 1993. Canada's merchandise trade surplus with the U.S. has risen from about C$37 billion in 1993 to roughly C$117 billion last year.

With the U.S. taking more than 75% of Canada's goods exports, a push by President Trump to let air out of NAFTA tires would be bad news for Canadian growth.

If the U.S. were to erect trade barriers, could Canada find other takers for its goods? It's unlikely exporters could promptly reduce their exposure to the United States. Trump's victory leaves the Trans-Pacific Partnership effectively dead in the water. Even the Comprehensive Economic and Trade Agreement provisionally approved by the Europeans may be in jeopardy if a similar wave of populism runs through upcoming European elections. All in all, while Canada would benefit from the likely approval of the Keystone pipeline by a Trump administration, that would be unlikely to offset the effect of trade barriers for manufactured goods.

Expect the changing political landscape stateside to affect Canadian policy. For instance, for Canada's environmental protection policies to be feasible, they have to be compatible with the U.S. President-elect Trump has said he does not believe in climate change and has repeatedly scorned the U.S. Environmental Protection Agency. That puts into question the green initiatives taken by the Trudeau government and provinces because those policies could place Canadian corporations at a competitive disadvantage vis a vis their American counterparts.

The takeaway**:** policymakers urgently need to find ways to make Canada more competitive. The Bank of Canada will do its part by depreciating the loonie via loose monetary policy, but that may not be enough.

S&P TSX: Perspective on sector performance

Name	%Chg↑	Up
1) All Securities	+0.71%	60.7%
2) > Health Care	+4.01%	50.0%
3) > Information Technology	+2.16%	58.3%
4) > Materials	+1.74%	74.5%
5) > Energy	+1.54%	84.0%
6) > Industrials	+0.77%	76.0%
7) > Financials	+0.57%	70.4%
8) > Consumer Staples	-0.33%	27.3%
9) > Real Estate	-0.80%	22.7%
10) > Telecommunication S...	-0.93%	25.0%
11) > Consumer Discretionary	-0.98%	47.8%
12) > Utilities	-1.42%	0.0%

NBF Economics and Strategy (data via Bloomberg)

Bottom line: More to come

Risky assets have reacted positively to Episode 1 of the new Trump reality show. We like the fiscal stimulus story. But there are many more episodes to come, with plots that will surely keep investors on the edge of their seats. Will we see a Trump-Putin bromance and an easing of trade sanctions against Russia? What about the episode where the U.S. must decide whether to build a wall on its border with Mexico? Just last night we saw news that Mr. Trump may declare China to be a currency manipulator as soon as he takes office. At this juncture, until we get to know the actors a little better, we prefer to keep our asset mix unchanged with an above-average weighting in cash.

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