

A U.S. Election Shock — Take A Deep Breath

In yet another blow to the pollsters and pundits following failures to predict the UK general election and Brexit outcomes, the Republican Party has swept the U.S. Congress and the Oval Office with President-elect Donald Trump winning the election. The 115th Congress and the White House will be controlled by the GOP for the first time since the 109th Congress in 2009-11 under then President George W. Bush. Global financial markets are taking it negatively as the world economy suffers a blow to confidence and uncertainty escalates. It is important at times like this, however, to inject a note of caution to such knee-jerk reactions. There are clear negative consequences for parts of the global economy and markets, but there are important mitigating offsets that may get lost in the immediate aftermath only to be reconsidered later. As the net effects are digested by markets, political and policy guidance will be of paramount importance from world leaders including but not limited to the newly elected US President in the very near term and through the first 100 days of the new administration.

THE GLOBAL FINANCIAL MARKET RESPONSE

The first order concern for our clients, however, entails a quick survey of the immediate financial market consequences. Stocks in Asia are down across the board as we write this note. Tokyo is about 5% lower, Hong Kong is almost 3% lower, and other exchanges lie to either side of this reaction including mainland China. Dow futures are currently over 500 points lower at the time of writing. If the pattern of past shocks during the GFC is any guide then the North American opening bell could add to this decline. Alternatively, note that the initial shock is already being reined in given that at its worst Dow futures were down by almost 1000 points. Flows are aggressively moving toward safe havens including a bull steepener in US Treasuries as 2 year note yields decline by about 8bps and 10 year US Treasury yields decline by about 5bps. Gold is over US\$40 higher and WTI oil prices are down by under \$1. Across currencies, the Mexican peso is taking it the hardest (down 10%) with the other NAFTA currency — CAD — under 1% lower. Across multiple asset classes, the instant reaction in Asian financial markets is being tempered as we release this note and it is unclear where they will ultimately rest.

Such market reactions carry negative and positive influences as markets introduce first-response automatic stabilizer effects.

- Lower bond yields should translate into lower borrowing costs for instance. With already low borrowing costs and offsets upon savers it is not clear exactly how powerful this influence may be.
- Lower oil prices introduce another negative shock to oil producing regions that transfers wealth to net consuming regions.
- Currency adjustments will assist the adjustment to the shocks by improving export competitiveness at the margin for countries like Mexico and Canada. Outside of Mexico, however, it is unlikely that the currency response will be as powerful as, say, the Brexit impact upon pound sterling.

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- Most of the negative shock to equity wealth should be concentrated upon upper income earners with lower propensities to spend out of wealth than lower- and middle-income earners. Much of the equity shock so far is fairly limited in the context of the strong gain to start the week. At present and from Monday's intraday peak, the Dow is tracking under 5% lower.

THE NEGATIVE SIDE OF THE SHOCK

At its root, however, and judged at first blush on the basis of election rhetoric, this shock should work its way through the global economy primarily as a negative adjustment to confidence, investment prospects and global trade. Companies already uncertain about the need to expand capacity in the face of ongoing global risks will feel even less confident about doing so amidst great uncertainty over the rules of the game in the NAFTA economies and abroad. The very nature of a shock of uncertain magnitude to the rules of the global trading regime will further delay the prospect of capital investment becoming a material driver of global growth over our forecast horizon.

The first test of the impact on households will come with the US Thanksgiving, Black Friday and Cyber Monday sales that lie just two weeks ahead. Will spending go down in the face of heightened uncertainty, or up in anticipation of permanent tax cuts and rhetoric surrounding "making America great again" as Trump is fond of saying? At a later stage — if the effects are not offset and outright arrested — then a negative shock to incomes, jobs and consumption is likely to follow with more upward pressure upon saving rates. Like Brexit, it is not clear that the effects will be immediately felt in nearer term readings on the economy rather than over the longer term. It will be important to bear this in mind as economic indicators roll out in the wake of the US election results.

Overall, however, whereas we had previously expressed confidence that global growth had bottomed after a smoothed six-year declining trend, we can no longer express confidence that global inflation-adjusted GDP growth will remain above 3% over our forecast horizon. As the nature of this shock is further evaluated in the context of critically important guidance from the incoming US administration, we will be more thoroughly revising our forecasts for economic and financial market variables.

Among those considerations will be the fiscal part of the equation that will be watched by forecasters and bond markets alike. While a Republican Senate and House of Representatives can reasonably be expected to moderate Trump's policy initiatives, and thus limit the widening of the U.S. deficit, a budget shortfall easily moving through 3½% of GDP in the next couple of years is still forecast. The U.S. Committee for a Responsible Federal Budget estimated in late September that Trump's election platform would push the federal debt to 105% of GDP by FY26. This is likely a significant overstatement if a balancing role is assumed for Congress. However, by FY20, the U.S. is expected to have significantly less fiscal flexibility. In part this results from the potential absence of entitlement reform during Trump's first term.

BROADER RISK MITIGANTS

We do not yet know which policies will be pursued by the Trump administration. His platform contains elements which could boost growth, and others that have the potential to seriously undermine US and partner country growth prospects. For instance:

- On the positive side, corporate tax reform, in part to fund a significant reduction in the general corporate income tax rate from the current 35% will resonate with Republicans majorities in the Senate and the House of Representatives. Promised measures such as increased expensing of machinery & equipment purchases also would be positive for business investment. Some personal income tax relief is possible, supporting the consumer spending outlook that we already believed was solid, and increased federal infrastructure outlays are promised.
- Likewise, Banks and the broader financial services industry may face the prospect of regulatory relief compared to sundry measures that have restricted growth in recent years. At the top of the list may be Dodd-Frank.
- Further, energy sector investment should face more favourable treatment going forward at the potential expense of environmental agendas. It is likely, for instance, that the Keystone pipeline will be approved by President Trump with little effective opposition from the GOP-controlled Congress. For countries such as Canada, embarking upon ambitious GHG reduction strategies, the competitive consequences are intensified.

On the negative side, these potential positives may be more than offset by the Trump administration's disruptive attitude towards trade, even if Congress retains the power to decide tariffs. The resulting uncertainty, in both the U.S. and around the world, will deter corporate investment decisions and strategic business decisions. Reduced potential growth in the US labor force through anti-immigration policies may also put additional downward pressure upon longer term potential growth rates.

The extent to which Trump favors one set of policies or the other has the potential to significantly alter the economic impacts on his Presidential agenda. Given that uncertainty over the way forward and its implications for economic activity is likely to remain high until the President-elect makes clear his approach, we consider the following to be likely and/or potential policy implications of the electoral result:

- The Federal Reserve may delay expected interest rate increases until it can evaluate the potential consequences of the electoral results. An already challenged path back to price stability around the Fed's 2% inflation goal will be hampered by upward pressure on the dollar and the risk of a negative shock to world growth and commodity markets that lessens the attractiveness of seeking inflation protection across major markets at least in the near term. Pending the evolution of this shock, we would assume that monetary policy will be tailored as needed with the door open to renewed easing if necessary. Indeed, a great irony could be that Trump's threat to shape a more hawkish Fed over his term may now actually necessitate a more dovish rate outlook.
- In countries affected by these developments, additional fiscal stimulus may be possible. This is the case in Canada given the potentially larger impact on NAFTA countries than others. Canada has ample room for applying additional stimulus in our view.
- A renewed round of global central bank easing is more probable including QE extension by the ECB beyond the March 2017 timeline, additional stimulus from the Bank of Japan and Bank of England, and particularly via adjustments in NAFTA economies. Next week's Banxico meeting had been thought to be marked by inaction but the central bank's inflation mandate is more seriously compromised with risks tilted toward rate hikes to stem the peso's decline and its inflationary consequences to what was already a growth-challenged economy. The risk of acting before the scheduled meeting is high in our view. The Bank of Canada's easing prospects also went up such that the pre-election OIS probability of under 10% odds of a rate cut in December and only moderately higher thereafter just went up sharply in our view. Monetary policy will remain the first line of defence in the wake of this shock as central banks are once again called upon to inject stability within their mandates.

If we may leave you the reader with one message to conclude, it is to resist the temptation to make rash adjustments. Shocks like this rarely unfold in unidirectional fashion without other moving parts of the picture acting to offset or massage the consequences. We would hope that a high sense of responsibility over the economic livelihoods of Americans locked in arm with the global economy and markets will prevail throughout this period of adjustment.

For a review of the main elements of both the GOP and Democratic election platforms please go [here](#).

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