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INVESTMENT MANAGERS

"TRUMP TESTING" OUR VIEW OF THE WORLD

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The Trump victory has potentially redrawn the cyclical outlook for the US economy and raises broader questions for the global investment landscape. Outside the US, we expect the backdrop of low growth and low inflation to remain. We believe any major fiscal stimulus, subsequent inflation and rate rises to be limited to the US, with loose monetary policy remaining the dominant force in Europe. However, we expect increased political risk in Europe, given the heavy political calendar over the next 12 to 18 months against a backdrop of rising populism.

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EXECUTIVE SUMMARY

The US election result raises the likelihood of a major fiscal stimulus in the country with the potential to provide a significant boost to growth resulting in higher inflation and further strengthening of the US Dollar. However, we believe the outlook of low growth and low inflation remains true beyond the US, as the above policy is unlikely to be mirrored in regions such as Europe given current political realities and resistance to pro-cyclical policies. We therefore expect the status quo of ultra-loose monetary policy aimed at tackling low growth rates to continue outside the US.

So, while the cyclical outlook for the US economy has changed, the global economic picture remains muted, in our view, and the drivers of this secular stagnation remain broadly unchanged. Furthermore, while the exact stance Trump will take on trade/immigration policy is as yet unknown, we expect trade stagnation rather than trade reversal, prompting a more nuanced view on emerging market dynamics going forward. That said, we believe that structural changes in emerging market economies, including steps to reduce their reliance on exports and an emphasis on domestic demand, will help these markets to weather any potential storm.

Our assessment of the key challenges facing bond investors – as discussed in our recent paper "A new paradigm in fixed income markets and implications for portfolio management" – remains broadly unchanged by the Trump victory:

- Interest rates are likely to remain low/negative outside of the US given the weak economic backdrop and reliance on monetary policy measures to boost growth
- Increased market risk associated with, among other factors, longer duration in portfolios was in fact underscored by the market volatility witnessed post the US election
- Similarly, the extent to which liquidity is fractured was also brought into sharper focus after the US election.

A new risk factor is looming on the horizon: the prospect of populism-led political outcomes in Europe. This is something we will be following closely.

MACRO OUTLOOK REVISITED

The expectation of a continued environment of structurally low growth and inflation in advanced economies has arguably been challenged by the outcome of the US presidential election, and, as a consequence, the growing prospect of a Trump-inspired "fiscal bazooka" (i.e. significant debt-financed fiscal stimulus).

The drivers of the low-growth environment expectation can be summarised as a combination of: (1) high debt – according to a McKinsey report, the global economy amassed USD 57 trillion worth of debt during the 2007/14 period, and the figure is still rising; (2) falling productivity, both in advanced economies and key emerging market countries such as China; and (3) changing demographics, giving rise to a structural excess of savings over consumption and investment – in other words, the "secular stagnation" thesis outlined by economist Larry Summers.

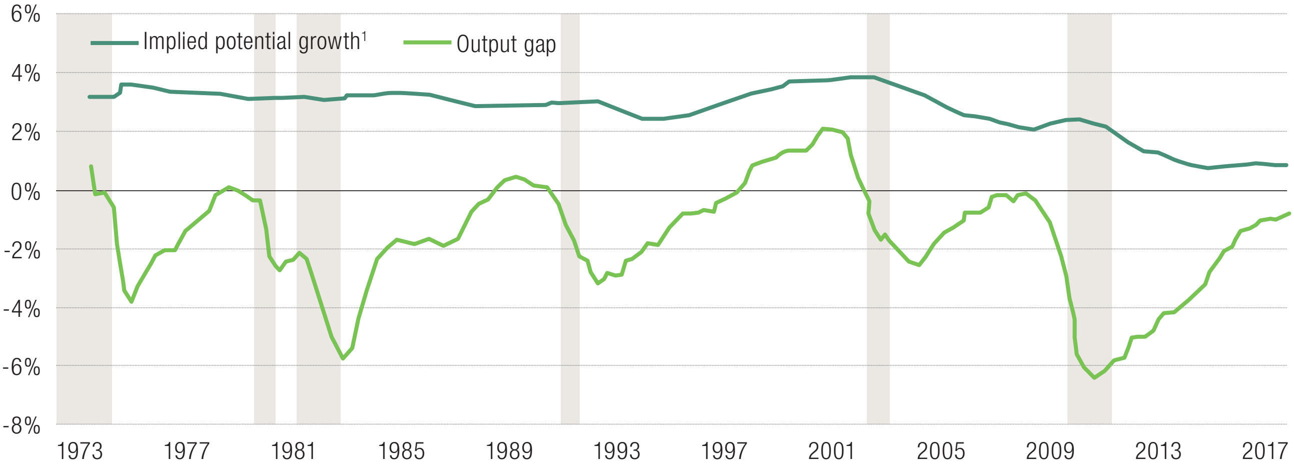
Within this broader context, we have held that a heavy reliance on monetary policies, such as ultra-low interest rates and quantitative easing, to combat low growth and inflation combined with restricted government recourse to fiscal stimulus via spending or tax cuts has led to the "Japanisation" of Europe. This is our baseline scenario.

But the wave of populism that led to Mr. Trump's election victory has potentially changed the mix of these policies going forward. So, considering their large implications for both asset price dynamics and portfolio management, we think it is important to shock test both the secular stagnation and more specifically, the Japanisation of Europe thesis.

First, we re-assess the US policy matrix in light of Mr. Trump's victory and consider potential policy spillovers for Europe. We also assess the key challenges for bond investors that we discussed in our recent paper, "A new paradigm in fixed income markets and implications for portfolio management." Finally, we share some of our thoughts on how the wave of populism we are seeing in the UK and US could shape political outcomes within Europe, where the political calendar is very full over the next 12 to 18 months.

Overall, we think that our Japanisation of Europe base case thesis still holds because we believe a seismic fiscal policy shift remains very unlikely in the single currency union. In contrast, in the US, a Trump-inspired fiscal programme that potentially adds a 2ppt impulse to growth is a real possibility, and we see this as having significant potential for reviving inflation in the world's largest economy given that the country is near full employment, as shown in Figure 1.

FIG. 1 – US ECONOMY IS NEAR FULL-EMPLOYMENT



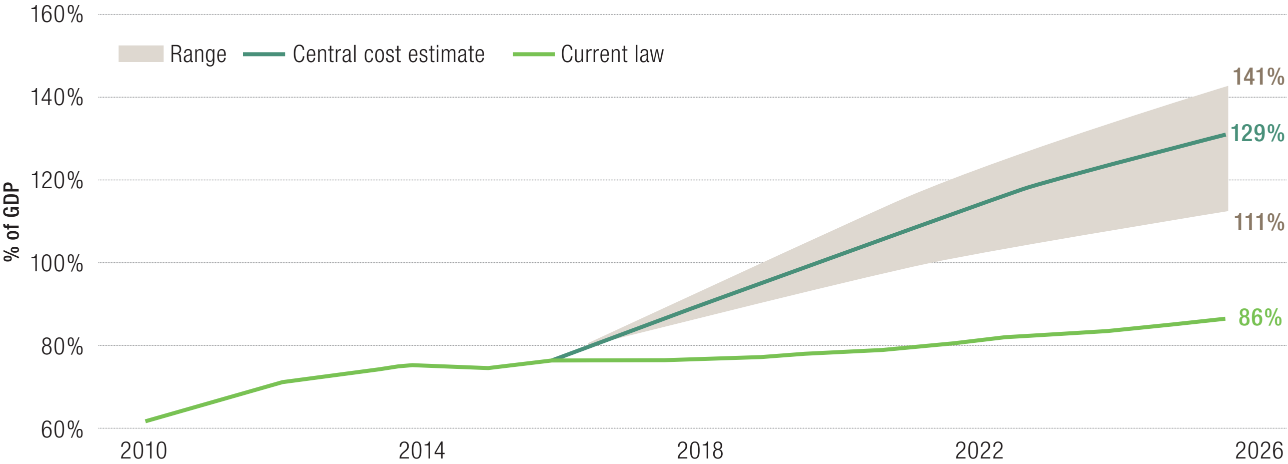
Source: Goldman Sachs. [1] Potential growth implied by range of spare capacity measures and GDP growth.

These divergences have major implications for asset market dynamics, including further potential USD appreciation and upward pressure on US bond yields at a time when new risks, notably a populist political shock in Europe, loom on the horizon.

ASSESSING THE US POLICY MATRIX POST-TRUMP – ARRIVAL OF A “FISCAL BAZOOKA”?

Fiscal policy easing in the US is expected to manifest in a meaningful way because tax cuts and spending increases (mainly for infrastructure) are key planks in Mr. Trump’s domestic economic agenda. Firstly, we have to consider that there is still significant uncertainty surrounding the final shape/scope of the programme given the significant gap that exists between Trump’s campaign rhetoric and the outlines of his post-election policy agenda. On the surface, assuming a fully implemented Trump fiscal stimulus programme, the fiscal deficit would widen to between 5% and 6% of GDP, with public debt projections reaching 129% versus our 86% baseline scenario over the next 10 years (source: Committee for a Responsible Federal Budget, CRFB).

FIG. 2 – DEBT-TO-GDP DYNAMICS UNDER MR. TRUMP’S PROPOSALS



Sources: CRFB calculations based on Congressional Budget Office, Tax Policy Center, and Tax Foundation extimates.

It must be noted that respecting the current debt ceiling is not an issue for a Republican controlled Congress because, under the US Constitution, Congress has a full mandate on taxation and spending. Historically, the debt ceiling was more often than not raised, and currently it is suspended until March 2017, mainly due to a divided government. As noted, Congress has full authority to raise this and we think it is conceivable that it will be used to extract concessions from Mr. Trump on his trade and immigration policy pledges in the course of negotiations over the final shape of his fiscal programme. The boost to US growth under an aggressive Trump fiscal policy programme starting in second half of 2017 is potentially significant and shifts the end of the economic cycle by one to two years, in our view. It is perhaps also worth noting that although Mr. Trump’s proposed policy measures echo Reagan-era supply side economics, the starting point for any potential shift in the direction of the US economy and its debt dynamics is very different, as shown in Table 1.

TABLE 1 – TRUMP’S STARTING POINT DIFFERENT FROM REAGAN

KEY US ECONOMIC METRICS	1981	2016
Unemployment rate (%)	8.2	4.9
Growth rate (%)[2]	1.9	2.2
CPI (YoY %)	8.9	1.6
Public debt-to-GDP ratio (%)[3]	25.9	75.5
Fiscal deficit-to-GDP ratio (%)[4]	-2.4	-3.1

[2] Average of three years ending.
[3] Federal debt held by the public as % of GDP Quarterly Seasonally Adjusted (FDTGDHBP Index).
[4] US Budget Balance.

Specifically, with a much higher unemployment rate, lower debt ratios and a more manageable deficit profile, the early-1980s plan was a counter-cyclical policy deployment that was implemented at a time of significant excess capacity. This is very different from what appears to be a pro-cyclical change in fiscal policy under Mr. Trump. In our view, Mr. Trump's proposed "fiscal bazooka" is without doubt inflationary because the US economy is operating at full employment. Even so, we believe fiscal policy is now in the driver's seat when it comes to US economic dynamics, as eight years of monetary policy predominance in America draws to a close.

TABLE 2 – VERY PRELIMINARY ESTIMATES OF THE TRUMP FISCAL PACKAGE

	USD BILLION/YEAR	MULTIPLIER	GDP IMPACT USD BILLION	GDP IMPACT PERCENT
Income tax	250	0.7	175	0.9
Corporate tax	250	0.2	50	0.3
Infrastructure spending	100	1.2	120	0.5
Defence	50	0.9	45	0.2
Totals	**650**		**390**	**1.9**

Note: These figures are illustrative only. They are taken from J.P. Morgan, the Tax Foundation and other sources.
The mutliplier is an assumed static GDP effect per unit of policy change, with no allowance made for dynamic or monetary policy effects.
These dynamic effects could reduce the GDP impact substantially.

TRADE AND IMMIGRATION UNDER TRUMP

Trade and immigration-oriented pledges were two key, albeit highly controversial, parts of Trump's campaign rhetoric. Of the two, trade is relatively less controversial domestically considering immigration's potential to generate unrest and create divisions between the President and Congress that could damage other parts of Mr. Trump's agenda. When it comes to future US trade policy dynamics, however, we believe that it is important to distinguish between a possible further loss of trade integration (or trade "stagnation") and a possible outright trade "reversal" due to US-led tariff wars.

In the current context, we believe cancellation of the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) imply more of the former than the latter and consider these executive actions to be almost certain. On the other hand, trade reversal (or outright de-globalisation) raises the spectre of trade wars led by the US using import tariffs as its weapon of choice. We believe that because the US is a net debtor to the world, with a significant chunk of their national debt held by China, the possibility of not only bi-lateral trade but outright capital wars has to be considered. Taking into account the confusion around who will be on Mr. Trump's cabinet, there is a lot of uncertainty surrounding this matter. But considering the economically damaging consequences of either scenario for the US economy, there is good reason to think that the establishment wing of Mr. Trump's team will blunt his aggressive stance and instead focus attention on his fiscal policy priorities.

REGULATION AND GLOBAL SECURITY UNDER TRUMP

The steepening of the Treasury yield curve since the vote has already been a big positive for financial stocks, and the possible repeal of key elements of the Dodd-Frank Act has added to this positive sentiment. In addition, Department of Labor rules, and particularly the "fiduciary rule," which requires financial advisers to behave in the best interest of their clients free from any conflicts of interest, are likely to be watered down for the benefit of the investment management industry in the US. It is difficult to see any direct read-through from these changes to Europe, where Basel III and Europe-specific regulation remains on track in terms of official support for their implementation.

Mr. Trump's global security agenda meanwhile appears to be mostly about reshaping the post WWII order and forging a closer working relationship between the US and Russia against so-called ISIS by way of a unified position on Syria. However, a possible reshaping of NATO and US commitments in Asia through a kind of mercantilist rethinking of strategic military alliances presents a potentially important new development in the global order.

POTENTIAL SPILLOVERS FOR THE GLOBAL FISCAL/MONETARY POLICY MIX

In our view, Europe is still far away from a shock-and-awe fiscal programme given the current political realities and resistance towards using a pro-cyclical policy impulse. Pre-Trump, potential fiscal easing was already up for debate in policy circles (for instance, it was a major topic at the annual IMF meetings) after a period of sustained low growth in advanced economies since the 2008/9 crisis. For instance, the UK and Japan have already shown their willingness to expand fiscal easing, although the scope and size is nowhere near what Trump's plan is. Here the key outlier remains the eurozone, where the Juncker and refugee plans are still quite minor in scope and not of the quality which will help quell any further rise in populism. That said, fiscal policy (even modest compared to the US) would be a support factor for eurozone growth next year (given that potential growth is below 1% p.a.) but this is driven by the "fiscal space" created by ECB actions and is mainly monetary policy-dependent/driven.

BOND MARKET CHALLENGES REVISITED

In our report titled "A new paradigm in fixed income markets and implications for portfolio management," we laid out three key challenges facing fixed income investors, which we reassess below in the wake of Mr. Trump's victory.

1. **Widespread low/negative interest rates:** The sharp, US-led rise in bond yields has reverberated across the globe. However, we think diverging economic realities in the US versus the rest of the world limit the potential spillover effect into non-US markets. Here, the effective use of yield curve controls by Japan is an important template. We believe this policy may be deployed by the ECB sometime next year as the scarcity of assets comes back on the table, though the post-election rise in yields has alleviated pressure on the central bank to further extend quantitative easing
2. **Increased market risk:** the risks associated with the extension of duration undertaken by investors in recent years have been underscored by US bond market dynamics; the increased volatility implies the risks associated with this issue will remain firmly on the table, especially if monetary policy uncertainty rises on the back of a changing policy mix
3. **Fractured liquidity:** In the days following Mr. Trump's victory, anecdotal evidence suggests that liquidity conditions in various segments of many bond markets, most notably in emerging markets, suffered severe pressure. Overall, the structural weakness brought about by the low liquidity environment, itself created by tightening regulation and central bank intervention, has been brought into sharper focus over the recent weeks.

MARKET IMPLICATIONS – WE REMAIN CAUTIOUS ON DURATION

The US bond market's bearish curve steepening and US equity market strength since the election, with significant sector rotation, small-cap outperformance and USD strength, is logical and consistent with historical precedent, namely the policy shift in the early 1980s, when Ronald Reagan unveiled a big fiscal stimulus.

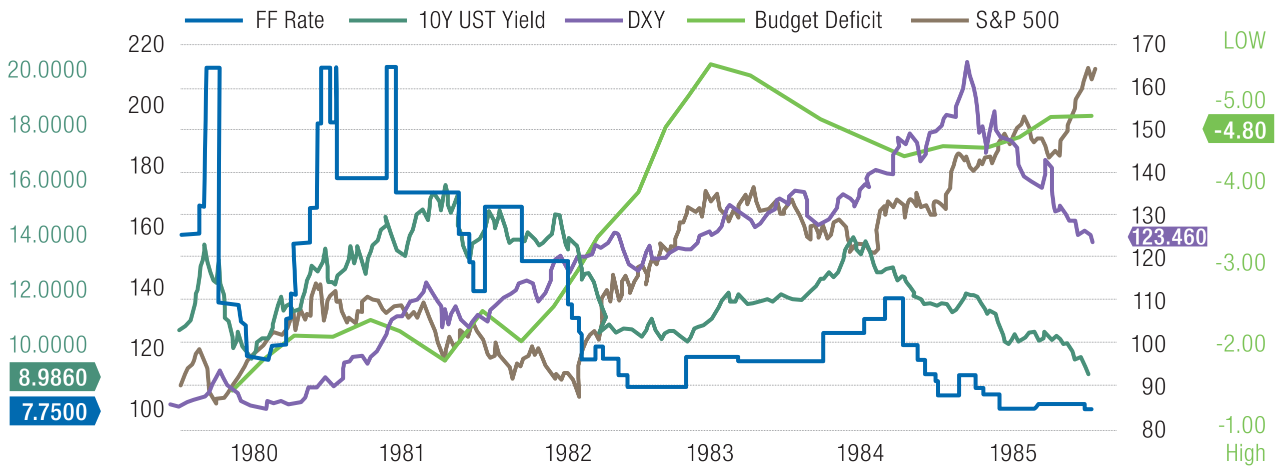
The sustainability of the current moves depend on the exact shape/size/scope of Mr. Trump's fiscal plan, as well as on the Fed's reaction. However, in our view, we have seen the lows for global bond yields in this cycle. Considering this context and potential shifts in non-US monetary policy changes that are in the pipeline – including the potential use of yield curve controls in Europe – we think that the case for accessing credit risk over duration risk has strengthened.

On the equities front, US stocks appear better placed than their European counterparts, taking into account the scope for EU-damaging populist vote outcomes over the next 12 to 18 months. We discuss this issue in more detail below, taking into account weaknesses in the EU's political infrastructure that impede it from coping with such a shock as well as a potentially better macro policy mix in the US.

Turning to emerging markets, the implications of the changing landscape are negative for local currency fixed income, given US bond yield-led pressure and FX (USD strength). However, considering ongoing improvements in emerging markets' fundamentals, in terms of growth, external profiles and strong idiosyncratic stories such as India (which recently demonetised the two largest denomination notes in a bid to crackdown on black economy and push for digitisation), the improvement in valuations would need to be re-assessed after uncertainty emanating from the US election lifts in coming weeks.

That said, implications for the EM equity outlook are more nuanced and dependent on other parts of Mr. Trump's potential policy agenda, namely, trade and immigration, where our views are relatively benign in spite of his campaign rhetoric. On this front, we think that in a trade stagnation scenario whereby no new trade deals are signed, domestic demand drivers of emerging markets, economic growth will become more important both from an economic policy and an asset market dynamics perspective.

FIG. 3 – MARKET DYNAMICS UNDER REAGAN-ERA FISCAL STIMULUS: STRONGER USD IS THE STAND-OUT TREND



Source: Bloomberg and Citi. DXY Currency (Dollar Index Spot) 1980-85 SPX Daily 01 January 1980 – 31 December 1985.

GLOBAL POPULISM MOVEMENT – WILL THE EU BE THE NEXT CASUALTY OF RISING GLOBAL POPULISM?

We end this paper by focusing on a new risk factor that is appearing ominously on the horizon, namely the prospect of populism-led political outcomes in Europe. The Brexit and Trump victories show that popular discontent is starting to shape political, and by extension, economic outcomes in advanced economies. The European Union's political calendar is very full over the next 12 to 18 months, with an Italian constitutional reform referendum, Austrian and French presidential votes, and general or federal elections scheduled in the Netherlands and Germany. These are being held against a backdrop of significant rises in support for extreme right/left parties, and there is now a sizeable risk of a populist government coming to power that will then put membership of the EU on the table. Almost all populist parties we monitor in various European countries have anti-EU or at least anti-Euro agendas.

The main mitigating factor is the electoral design of European countries, which adhere to a more proportional representation structure, thereby reducing the likelihood of a populist government coming into power without mainstream support. This stands in marked contrast to the “first past the post” systems in UK and the US. It was this structure that, along with the electoral college system in the US, allowed Mr. Trump to win the election, even though he lost the popular vote.

Markets have rightly focused their attention on the upcoming Italian referendum on constitutional reforms, where the “No” vote was in the lead, according to the final polls before next week's vote. The referendum has been depicted as a vote on the performance of the current pro-EU government. It is quite possible that Prime Minister Matteo Renzi will resign if the “No” vote succeeds in blocking his reforms, though the prospect of snap elections remains low in our view. A more likely outcome would be for a coalition government to be formed, with elections held in late

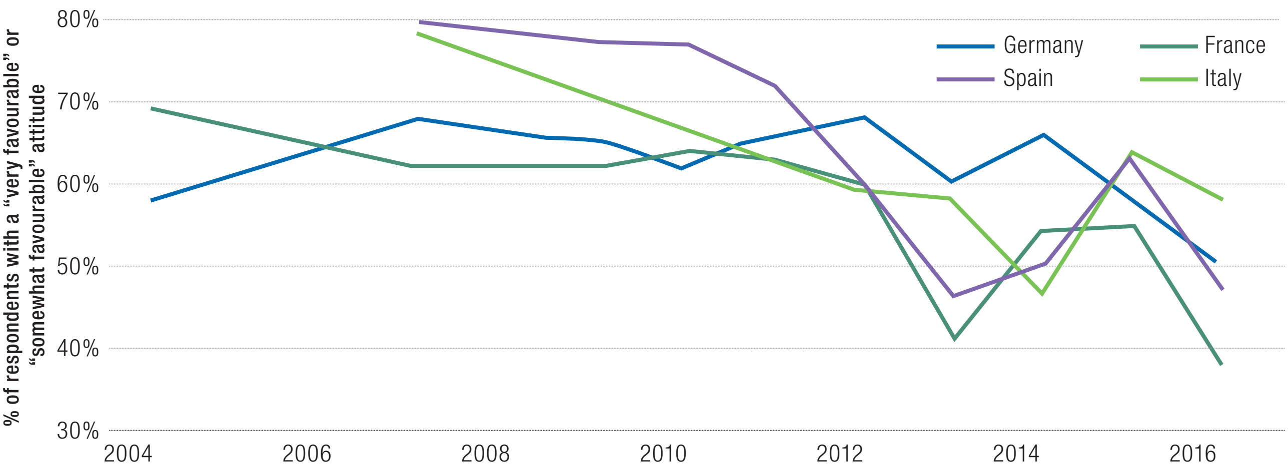
2017/early 2018. The factor to watch beyond the constitutional reform referendum is the electoral law change (which most political actors support). This will move Italy away from the current bonus seat structure, which increases the probability of a “winner takes all” framework (where the largest party is given bonus seats) to a more proportional representation-based system. If this measure passes, we think the likelihood of a populist-led government in Italy declines sharply, despite the Five Star Movement’s strong showing in recent polls. Last but not the least, Article 75 of the Italian constitution bars a referendum on international treaties and instead requires a two-thirds parliamentary majority for such measures to pass. This further reduces the risk of an Italian exit given the backdrop of still relatively high support for EU within the country.

France, by contrast, is a key tail risk because its electoral system doesn’t operate according to proportional representation. Concerns that National Front’s candidate Marine Le Pen could reach past the 50% threshold in the first round and win the presidency outright without a second round of voting have been reduced by the outcome of the French Republican party primary, which saw Francois Fillon beat Alain Juppe with 66.5% of the votes while Juppé trailed with 33.2%. In the previous two-stage French presidential vote, opposition to the National Front led voters to unite behind a single candidate in a historical swing towards the centre. But if polls in France are indeed “blind” to the rising wave of populism in the country, any victory for Ms. Le Pen and her anti-EU agenda would likely mean a referendum on EU membership – a vote that a recent Pew Research Center poll showed could lead to a FREXIT (under Article 11 of French Constitution, the President can bypass the parliament to hold a referendum. Charles de Gaulle took this route in 1962 and then again in 1969).

At this stage, considering the shift to the political right within mainstream parties, with M. Fillon’s primary outcome possibly an early manifestation of this trend, the likelihood of a National Front-led government in France remains low in our view. Even so, this trend requires careful monitoring in the weeks and months ahead, especially after taking into account the EU’s weak political infrastructure for dealing with such shocks.

Beyond the extreme scenario of a populist-led party coming into power in a core-EU country over the next 12 to 18 months, it is also important to acknowledge the risk of a “populist-led” hijack, or reaction, of a mainstream party (similar to the Tory party putting an EU referendum on the agenda) which may lead to an EU referendum in one of the core countries in coming years, especially if growth remains anaemic.

FIG. 4 – ATTITUDES TOWARDS THE EU



Source: Pew Research Center “Euroskepticism Beyond Brexit,” Spring 2016.

CONCLUSION

While the exact shape of a number of important factors such as fiscal, trade and immigration policy remain uncertain under a Trump presidency, we believe the impact of the most probable outcome of the Trump election – a strong fiscal stimulus – is unlikely to have extensive global ramifications. In US, a "fiscal bazooka" should boost growth and lead to higher inflation and faster rate rises. However, in Europe and other key economies, we believe that loose monetary policy is likely to continue to be the weapon of choice against continued weak growth, meaning key investor challenges will remain. Added to this are concerns over rising populism – something that will require careful monitoring in the weeks and months ahead.