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## A Consequential Vote for Change

Eric Lascelles – Chief Economist, RBC Global Asset Management

Krystyne Manzer, CFA – Portfolio Specialist, RBC Global Asset Management

The U.S. made history last night by electing Donald Trump as the next President of the United States. In so doing, he becomes the first winner without a political or military background, and he represents a return of the Republicans to the White House after an eight year absence.

While many are describing his victory as “stunning,” this isn’t completely accurate. Serious political forecasters had looked for Democratic candidate Hillary Clinton to win, but still granted Trump a roughly 30% chance of victory on Election Day. We argued throughout the election race that his prospects were even a bit better than this, though certainly not to the point of outright victory as a base case. To understand how unshocking this is, imagine rolling a six-sided die. Now imagine it coming up with a “one” or a “two”. It happens all the time. That was the likelihood that Trump would win.

The proper descriptor for this election result is “highly consequential.” The two candidates campaigned on almost diametrically opposite platforms, and Trump in particular brought a host of populist ideas that are very different than the long-standing U.S. policy mix.

In a strange sort of way, Trump’s victory is a bit like Barack Obama’s win in 2008, despite the fact that the two embody very different visions of the world. Both were/are candidates promising change from the status quo, and managed to find support in a large base of voters who felt disenfranchised. U.S. voters are clearly still casting about for a better path forward after decades of rising inequality and years of sluggish economic growth.

### Trump’s path to victory

With a handful of states still in play, Trump has managed to capture 290 of the 538 electoral colleges. His path to victory required virtually all swing states to go his way and indeed they did, despite seeming to lean toward Clinton on election morning. These included Florida, Ohio and North Carolina. He also snatched states that were thought to be in Clinton’s grasp, like Pennsylvania, Wisconsin and likely Michigan. In general, it was a surge of rural voters supporting Trump who put him over the top in many such states.

Just as consequential as Trump’s big win is that the House and Senate also remained the domain of the Republicans. This was not expected either, and means the Republicans have swept both Congress and the White House. This creates the potential for serious action. Looking back to Obama’s first two years in office when Democrats swept the halls of power, Obama and Congress passed Obamacare, a major financial stimulus plan and banking reform. Before that, George W. Bush had a four-year stint with a Republican sweep and managed to deliver major tax cuts. However, a sweep does not provide unlimited power. The Republicans in Congress are ideologically different from Trump, which could limit policy action somewhat. Even the Democrats struggled to get many things done between 2008 and 2010, failing to deliver tax or immigration reform given the need for 60% support in the Senate to easily pass legislation – a threshold the Republicans fell short of in the Senate this election – and given the myopic concerns of Representatives working on a manic two-year election cycle flywheel.



## Financial market implications

As expected in this scenario, equities have reacted negatively, with European and Asian equities off around 2-3%, though Japan's stock market fell around 5%. Futures had initially indicated a large decline in U.S. stocks, but the actual outcome has been a modest gain. This may be because the Republican sweep could enable favourable corporate tax reform, besting economic concerns for now. Modelling in the lead-up to the election had suggested that a Trump win could send equities as much as 10% lower, but perhaps the experience of Brexit in June – a huge stock market selloff that was very quickly reversed – has convinced the market to tread more gingerly. That may make the following insight slightly less useful than otherwise, but historical “event” shocks like these have tended to exert their maximum effect on markets over the first two days after the event, and then rebound to prior levels by day 10. In other words, markets often overreact.

The U.S. dollar has weakened modestly relative to the euro, British pound and Japanese yen. This was always a tough one to call as safe haven flows argued for a stronger dollar whereas the economic implications and central bank implications argued for a weaker dollar. The latter appears to be winning. On the other hand, it is no surprise at all that the Mexican peso and Canadian dollar are lower given talk of dismantling NAFTA.

## Yield rebound surprising

Meanwhile, after a safe haven bid that initially sent U.S. yields lower, longer-dated Treasuries have since reversed and yields now appear to be modestly higher. To be honest, this is somewhat surprising. There are undeniably competing forces at work, but we would have thought that a safe-haven bid paired with the prospect of slower economic growth over the long run would dominate debt and inflation concerns in the initial response. However, this has not been the case.

In contrast to long-dated Treasuries, short-dated yields are notably lower as the odds of a U.S. Federal Reserve rate hike in December have just plummeted from quite likely to debatable. This makes sense given growth and volatility concerns. That said, over the long run, the Fed could eventually find itself having to tighten rates by more than otherwise expected if inflation starts to creep into the U.S. economy – a not-unusual outcome when populist policies are at work. Finally, and much more speculatively, the long-standing Republican desire to “reform the Fed” could become a reality with the Republicans firmly in control. What this precisely means is subject to debate.

## Short-term economic implications

It is debatable whether the short-term economic effect of a President Trump is negative or positive. On the positive side of the ledger, Trump is promising a great deal of fiscal stimulus in the form of tax cuts and infrastructure spending. The exact amount remains to be determined through negotiations with Congress. We assume this translates to something like a 0.8% boost to GDP per year for the next two years, all else being equal. Conceivably it could be more.

However, there are a number of short-term economic negatives as well, though they are hard to quantify. An elevated feeling of uncertainty could impede economic growth activity, given that he is an unknown political leader, his ideas are only loosely sketched out and they are quite different from the status quo. For all of these potential dampeners on short-term economic growth, we should acknowledge that the Brexit vote has seemingly not discouraged British economic activity very much at all.

The short-term economic effect also depends on the extent of the market response. The moves so far are fairly tame and so not worth seriously entertaining as constraints on economic growth. But if markets were to become more grim, that could impede spending and investment too.

Overall, the short-term economic effect is ambiguous, though we will charitably assume that it is a slight positive at this early juncture, reserving the right to revisit as additional information rolls in.



## Longer-term economic outlook more negative

The longer-term economic implications of a Trump presidency are clearly negative relative to the current trajectory. Put simply, Trump's anti-trade and anti-immigration platforms are negative for economic growth. Quantifying the hit to growth is largely dependent on how much trade is reduced and how much immigration is impacted. We provide a rough sense for the sorts of numbers that could be in play:

- If Trump were to actually deport America's 11 million illegal immigrants – setting aside the logistical nightmare and the improbability of this actually happening on a large scale – the U.S. population would shrink by a whopping 3%. This would cumulatively subtract a few percentage points from GDP across the period over which it occurred – a painful economic blow.
- Slicing the pace of U.S. immigration growth by half would subtract 0.1 to 0.2 percentage points from U.S. economic growth per year. This doesn't sound like much, but it adds up over the years – that's 2 to 4 percentage points of lost economic growth after twenty years.
- Modelling by the non-partisan Peterson Institute calculates that a full blown trade war with China and Mexico could subtract around 4% from GDP in fairly short order. If actually implemented, that could clearly represent a recession. Of course, to the extent that Trump's actions are likely to be tempered by Congress, advisors and bureaucrats, the impact might not be quite as dire, with initial models indicating a 1-2% hit to growth.

Of course, so much depends on how Trump chooses to flesh out many of his vaguer platform positions, whether he receives cooperation from Republican leadership, whether he takes their guidance, whether he shifts even slightly toward the centre of the political spectrum and a myriad of other factors. Political platforms are usually watered down by the time they are actually implemented.

## Foreign Policy

Foreign policy has only an indirect effect on economic growth, but it is nevertheless relevant to our analysis for two reasons. First, regardless of the impediments put up by Congress on other matters, presidents enjoy a considerable amount of discretion in the conduct of foreign policy. Thus, a candidate's foreign policy platform has a better chance of implementation than most other proposals and so deserves serious attention. Second, foreign policy can have an economic and financial market effect to the extent that it materially alters military spending or dramatically changes the perception of geopolitical risk in the world.

On this front, there is a considerable amount of uncertainty around the policies a President Trump would plan to enact. He is quite isolationist in some ways, and rather expansionist in others. The common theme is a very high level of geopolitical uncertainty going forward, particularly in the early months.

## Bottom Line

We finish with a few last thoughts.

The first is that this constitutes another undeniable victory for the forces of populism in short order, coming after Brexit in the U.K. Let us not underestimate the potential for additional populist victories, with the greatest obvious risk in Europe where there are many nations dissatisfied with their lot in life and a host of major elections over the next year. Italy and Austria have an opportunity to express their own dissatisfaction in (unrelated) votes on December 4<sup>th</sup>.

Second, populism usually means less economic growth and higher inflation. This growth implication might not be true in the U.S. in the short run given the prospect of fiscal stimulus, but it appears probable over the longer run.

Finally, let us understand that voters generally course-correct over time. If this presidency goes well, they will understandably seek more of it. If it doesn't, they will probably swing back in the opposite direction. Nothing is forever in politics.



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