SGH20 Insights

CHANGING LEADERSHIP

There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. *Niccolo Machiavelli, The Prince (1532)*

The US election has been the latest in a run of surprises during 2016. Much uncertainty still exists around what a Trump victory means, and the implications for the US economy and global markets. In the near term the only real certainty seems a heightened level of volatility as investors come to grips with the key policies and views proposed by the President-elect and his administration. Markets have initially embraced Trump's pro-growth domestic policy thrust, largely looking through the risks, and focusing on a rise in in inflationary expectations. Longer term the question is whether this marks a changing of the guard and new order in the political and economic landscape, and more entrenched change in market leadership.

Trump's victory is a clear expression at the ballot box of the rising feeling of inequality across society, and is a vote for change. Extreme monetary policy initially saved a deep recession, but as central bank debt has grown the velocity of money has not transmitted into higher economic activity, productivity and wages. Instead it has morphed into unrestrained price inflation in financial assets, increasing the inequality between asset owners (the elite) and the bulk of the working population. According to the World Wealth and Income Database, the real income of the average male worker in the US is now below what it was in 1972, whilst the top 1% has enjoyed a 300% wage rise and strong financial asset returns over the same period.

Many of the views and policies expressed by Trump during the election campaign, particularly around trade protectionism and restricting immigration, sought to tap into the growing movement of people disenfranchised with the rising level of inequality and failure to get ahead in life. The degree to which these were simply electoral prognostications versus ultimately those that will become policy, is likely to test Trump's ongoing popularity, and the downside risks to growth (which the market has largely glossed over to date).

Importantly the Republicans now control the House and Senate. In theory this removes the gridlock that has gripped the US political system for the last 8-years and provides Trump the opportunity to implement his agenda. The last time a Republican president controlled both chambers of Congress by such a substantial majority, as President-elect Trump does, was in 1928 under Herbert Hoover.

On the domestic front Trump's policy agenda comes with the promise of significant tax cuts and infrastructure (fiscal) spending to boost economic growth. There has been talk of spending one trillion USD over the next decade, the equivalent of around 0.6% of GDP per annum. There has been little detail over the timing and structure of programs, although with US public construction spending as a percentage of GDP at all time lows, and the American Society for Civil Engineers suggesting there is US$3.3 trillion needed over the next ten years to bring US transport system up to standard, there is a growing practical need to upgrade America's aging capital stock as well as broader economic imperative.

For an economy that is recovering and already operating near capacity, the risk of a large fiscal package at this point in the cycle is that it closes the output gap sooner than expected driving inflationary pressures (which is what has driven the recent sharp rally in bonds yields) and higher interest rates. The market is now pricing in a 94% probability of the Fed raising rates in December 2016 and a Fed funds rate of 1.2% by mid-2019, up from 0.97% prior to the US election and 0.75% in July.

It is the shift in inflation and interest rate expectations that potentially has the most profound implications for equity valuations and stock market leadership. At the end of the day equity valuations are driven by the discount rate used to determine the present value of future cash flows. If interest rates rise, the cost of debt and discount rate increases. This disproportionately impacts companies with higher borrowings and/or longer duration cashflows i.e low volatility, high growth, stable earnings and dividends.

In the current environment, the risks are a shift in inflationary expectations and rotation in market leadership, is being amplified by:

- the long-standing outperformance of low beta and high quality stocks, on the back of 7 years compression in global bond yields. This has seen investor overcrowding and valuation dispersion stretched to unprecedented levels. Valuations and asset bubbles work in extremes, and when consensus positioning is polarised it doesn't take much to see a sharp rotation (as recently seen in the REITs and infrastructure stocks).

- growing concerns around the dysfunctionality of extreme monetary policy (eg negative rates and malinvestment) and increasing view in the developed world that the public sector must play a larger role in sponsoring growth directly, and move from monetary to fiscal policy.

In a rising bond yield environment short duration sectors such as cyclical and financials are well placed to outperform. Resources in particular stand to benefit from an upsurge in fiscal infrastructure spending. However, the risk is sentiment runs ahead of reality. Details of Trumps' fiscal policies are still lacking and legislation will take time to pass. Increases in infrastructure spending may not materialise before 2018, and the economic effects could take even longer to be recognised. Trump may be better positioned to pass his agenda given the Republicans control the House and Senate, but it is worth remembering Obama's US$800bn 'shovels ready' program in 2009 had achieved very little by 2012-13.

Even with a strong upsurge in infrastructure spending, we are cautious as to how it will feed through to underlying commodity prices. If the US dramatically increases its crude steel production by 25% (i.e 20mt) it would equate to around 1.5% of global steel production. The post-election rally in iron ore suggests the market is pricing in 60mt of additional annual iron demand (based on the 90th percentile of the cost curve), more than five times the size implied by the Trump infrastructure spending plan. In our view China is still the main game for commodities - it imports 70% of all seaborne iron ore versus the US just 4%. Resource company earnings and prices for the foreseeable future are likely to remain intrinsically tied to Chinese policy. The Central Government's decision to embark on a new round of targeted policies aimed at relaxing lending standards and stimulating housing and economic activity, and 276-day annual operating limit on Chinese coal mines, announced earlier this year, have been the key drivers for resources outperformance this year. In our view, Chinese Government policy risk remains high and decisions aimed at managing civil order and production targets are bound to overshoot regularly in both directions.

The risk to higher US interest rates is a renewed increase in the USD. Whilst a headwind for US domestic growth and earnings, it would be a tailwind for Australian USD exposed offshore earners. Trump's tax plan to cut the corporate tax rate from 35% to 15% would also be positive for US companies, but given the loss to US Government revenues (estimated US$4.4-5.9bn including the personal tax cut plans over the next decade) and already extreme level of government indebtedness, it becomes a complicated set of policy trade-offs, and hard to definitively forecast what policies see the light of day.

There are too many unknowns at present to be more definitive about the implications of a Trump Presidency, least who will fill the key administrative roles and what will be nature of the Fed leadership. Ultimately, this may mark the start of a new reflationary order of higher interest rates and more permanent change in market leadership. The issue we face is, when the private sector yield curve steepens, it usually implies more vigour and 'animal spirits'. However, when the rise in bond yields is being driven by the Government trying to stimulate aggregate demand by cutting taxes and spending on infrastructure, and with much of the outstanding paper on central bank balance sheets, it is far less clear what it actually means. To our mind, there is a real question as to the extent the Fed will be able to raise rates given current debt levels. If interest rates rose to 5% the US Government the interest bill would rise to 22% of total revenues (from 7% currently).

We continue to believe the best course of action is to continue to focus on stock fundamentals and value companies based on their future cashflows discounted at an appropriate margin of safety. At a portfolio level, over the last 12 months this has seen some reduced exposure to long duration defensive assets and increase in shorter duration cyclical stocks, but with a strong focus on valuation and where we believe we have insight.

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