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2016 U.S. Election and the Markets

# UNCERTAIN INVESTMENT OUTLOOK COMES WITH PRESIDENT-ELECT TRUMP

## KEY POINTS

- With the surprising election of Donald J. Trump as president, T. Rowe Price investment managers are braced for an uncertain investment environment.
- During his campaign, Mr. Trump offered sweeping proposals that would represent significant changes in U.S. fiscal, trade, immigration, and tax policies.
- The firm's experts say that his plans are unlikely to stimulate jobs and economic growth while reducing deficit spending as promised.
- They see the next president as a wild card that may initially create investor fears and a downturn in global markets.
- In the long term, however, investors may settle into managing the shock given the U.S. system of checks and balances.

With the surprising election of Donald J. Trump as the 45th president of the United States, T. Rowe Price investment managers are braced for a highly uncertain investment environment.

During his campaign for the presidency, Mr. Trump offered sweeping proposals that would represent abrupt, significant changes in U.S. fiscal, trade, immigration, and tax policies. If carried out, they could have a potentially strong impact on U.S. and international economies and investments in a wide range of global equity and fixed income sectors.

Several major caveats are important. Mr. Trump has no track record governing. His campaign proposals at times seemed vague and inconsistent, even contradictory. Moreover, there historically have been big gaps between presidents' campaign promises and ultimate actions. Finally and most importantly, investment returns can be affected by many other factors: central banks' actions, commodity price movements, and corporate fundamentals, among them.

The unpredictability of the impending Trump presidency likely creates investor apprehensions that could negatively impact global financial markets, T. Rowe Price economists and investment professionals say.

### CAMPAIGN PROMISES

That said, President-elect Trump has proposed big individual and corporate tax cuts without sufficient offsets from greater revenue—resulting in projections of large deficits that, he predicts, will be made up by faster economic growth.

He has proposed a sharp pivot toward protectionism, by renegotiating the North American Free Trade Agreement (NAFTA), not signing the Trans-Pacific Partnership, declaring China a currency manipulator, and even possibly withdrawing from the World Trade Organization. He also has vowed to curtail immigration to the United States and deport millions of illegal immigrants.

Altogether, Mr. Trump has claimed, these and his other proposals would create 25 million new jobs over the next decade, reduce the annual federal deficit, and raise the U.S. gross domestic product annual growth rate to 3.5% from around 2.0% currently.

However, the consensus among T. Rowe Price economic and investment experts is that the very opposite outcomes may occur if the new president is able to carry out these campaign proposals.

Mr. Trump's plans could drive up annual U.S. budget deficits and its long-term debt and significantly diminish international trade, with negative economic effects here and abroad. They also could slow U.S. job growth, lower the U.S. economic growth rate, and put upward pressure on U.S. interest rates. Ultimately, they threaten to undermine global faith in the independence of the Federal Reserve and the geopolitical standing of the United States.

The unpredictability of the impending Trump presidency likely creates investor apprehensions that could negatively impact global financial markets, T. Rowe Price economists and investment professionals say. "Overall, financial markets may not react well to the outcome of this election," says Alan Levenson, T. Rowe Price chief U.S. economist. "The risk to U.S. growth in the near term is to the downside."

Adds Jeff Rottinghaus, manager of the U.S. Large-Cap Core Equity Strategy: "Markets could go down materially because Trump is such a wild card."

In the short term, says Andrew McCormick, head of the U.S. taxable bond team, the election outcome is a big, surprising event that the bond market had not fully priced in. "Initially," he says, "U.S. interest rates may go lower as investors flee riskier assets, and credit spreads (the yield premium of lower-rated bonds over Treasuries) may widen."

Mr. Trump's election comes at a critical time when U.S. fiscal policies have become more important as the Fed moves away from easing, European banks remain very fragile, and some nations are jockeying for geopolitical positioning versus the United States, says Quentin Fitzsimmons, a T. Rowe Price global bond manager. "Now the world's only superpower is seeing a big change," he says. "That's very concerning, and it could raise volatility."

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While cautioning against making too much of any parallel to the United Kingdom's anti-globalization vote last summer to leave the European Union, Mr. Fitzsimmons notes that "the initial reaction to Brexit was extremely bumpy, but then things calmed down, at least for a while. Similarly, with a Trump presidency, it may be that investors are headed for a prolonged period of shock management.

"The institutional checks and balances on the U.S. president—the president is not all powerful—may mean that global investors ultimately decide to keep their heads down, not overreact, and just try to ride out the next four years," he says.

### PROTECTIONISM

The longer-term risk with Mr. Trump's election, Mr. Fitzsimmons says, is that "apprehension over his protectionist agenda could lead to reduced global growth expectations—because the United States could end up with an adverse mix of slower growth and marginally higher inflation."

Mr. Levenson says he's particularly concerned about the president-elect's protectionism because Mr. Trump has fairly extensive unilateral executive authority to take action against trade partners.

"Trump's trade threats—to Mexico and China—may be no more than opening ploys to secure concessions," Mr. Levenson says. "But the risks of miscalculation are high and could lead to very damaging trade wars—which could have a negative impact across the U.S. economy, not just those areas directly linked to international trade. I am not aware of any country in history that ever isolated its way to prosperity."

Demanding renegotiation of NAFTA, Mr. Levenson adds, "would be particularly damaging—for a president to take such unusual actions with countries [Mexico and Canada] that on the whole are good neighbors with whom we have good relations."

Also potentially negative for the U.S. economy is Mr. Trump's promised immigration crackdown, Mr. Levenson says, noting that economic growth comes from productivity growth and growth in the labor force. "If we slow immigration of working-age adults, there's not enough growth in the rest of the U.S. workforce or the overall productivity rate to grow the economy very fast. Most of our net population growth comes from immigration," he says.

Some of Mr. Trump's campaign proposals—particularly corporate tax cuts, looser regulations, and increased federal outlays for defense and infrastructure—"could be positive, a marginal fiscal stimulus for the U.S. economy in the short term," Mr. Levenson says. "But that could lead to bigger deficits than otherwise and potentially higher interest rates in the absence of economic strength."

### IMPLICATIONS FOR EQUITIES

While Mr. Trump's election likely could create periods of market volatility, some T. Rowe Price managers say his plans could be relatively favorable for stocks in certain highly regulated sectors, such as health care, energy, financials, and industrials. Here's a brief summary:

**Health care:** Given the sector's concerns about drug pricing and regulatory pressures if Hillary Clinton had been elected, Mr. Trump's vow to repeal the Affordable Care Act (ACA) could end up being "modestly positive" for health care stocks, says Ziad Bakri, manager of the Health Sciences Strategy.

While the president-elect has talked about allowing importation of foreign-sourced drugs and permitting Medicare to negotiate drug prices, “his election overall is perceived as good for drug stocks,” he says, adding that some of these companies also would benefit from a foreign profits repatriation deal.

More emphasis on free-market health plans under Mr. Trump likely could aid managed care firms, which have been losing money under the ACA, but could hurt hospitals, which have benefited from greater usage by previously uninsured ACA patients.

**Energy:** Mr. Trump has promised an “energy revolution.” And his anti-regulation stance, his vow to expand energy production including revitalizing the coal industry, and his opposition to the Paris climate agreement and other steps to limit climate change all could be favorable for the energy sector, managers say.

“In a vacuum, more energy production is a good thing—more jobs, cheaper oil, cheaper gas,” Mr. Rottinghaus says. “Less regulation could help energy investments because it could lower companies’ costs to pull resources out of the ground.”

**Financials:** If the market initially sells off with Mr. Trump’s election, financial services stocks are unlikely to rise but the sector may do relatively better than others, says Gabriel Solomon, manager of the Financial Services Strategy.

In the intermediate term, the president-elect’s vow to repeal Dodd-Frank regulations might be positive for some financials if enough safeguards remain in place to manage systemic risks, Mr. Solomon says. “But a blanket repeal of Dodd-Frank would not be positive because some of the regulations are good for managing the risks that led to the 2008–2009 financial crisis,” he says.

Mr. Trump’s promise to then reinstate Glass-Steagall legislation also might be positive for some of the big banks that would have to break up ties between their retail and investment banking functions. “If you take some banks apart, the sum of the parts may be worth more than the current whole,” Mr. Solomon says.

But long term, he says, Mr. Trump’s “deficit spending proposals, in the absence of economic growth, could lead to higher interest rates and inflation that could create structural problems similar to the 1970s, which would not be good for financials.”

**Industrials:** Peter Bates, manager of the Global Industrials Strategy, says two of Mr. Trump’s plans—lowering corporate taxes and loosening federal regulations—could bring back some U.S. manufacturing and jobs. Renegotiating NAFTA and erecting trade barriers—short of triggering destructive trade wars—would be less significant for U.S. manufacturers, he says.

“Industrials are focused on building products the world will consume as cheaply as possible,” Mr. Bates says. “Companies have made significant investments in Mexico. With higher tariffs, more stuff may be made in America on the margin, but companies are not going to shift away suddenly from Mexico. Their higher costs from any tariffs would just get passed on as inflation to consumers. What happens in the long term for industrials depends on relative cost structures, and that’s not just tariffs and taxes.”

Also, campaign promises to raise defense and infrastructure spending are “unlikely to drive a material impact” on the outlook for industrials because the additional spending could be merely incremental to what already is budgeted, Mr. Bates says.

**Technology:** Mr. Trump’s stated immigration and trade policies generally would hurt the U.S. technology sector, says Josh Spencer, manager of the Global Technology Equity Strategy. Technology is one of the most globally competitive U.S. sectors and relies on an influx of highly skilled talent from around the world and global supply and distribution chains.

Lower taxes, particularly on repatriated overseas profits, would be a positive for global technology firms that have billions of dollars parked abroad. “But if you believe what Trump has said, his election overall may not be a good scenario for the tech sector,” Mr. Spencer says.

Nonetheless, three inexorable trends essentially determine the future of technology stocks, he says: the growth of cloud computing, disruption of traditional industries due to the Internet’s increasing pervasiveness, and technologies pushing into new end markets, such as self-driving cars. “Trump’s election does not change these trends,” Mr. Spencer says.

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### FIXED INCOME

While U.S. short-term rates may go lower initially as investors flock to the relative safe haven of U.S. Treasuries, Mr. McCormick says, “There could be pressure for rates to go higher as investors digest the deficit spending pushed by Mr. Trump.”

“You can expect to see more volatility in bonds, but the market is likely to react in an up-and-down, saw-tooth pattern. If U.S. rates go higher, overseas buying could come in and limit rate rises,” he says.

Mr. Fitzsimmons agrees, adding: “Bond markets globally are likely to see upward pressure on yields over the long term, with a steepening of the yield curve. U.S. protectionism would be very disruptive to investment flows and planning.

“We also should take into account potential risks to emerging markets and how they will behave, starting with Mexico, because of the impact of his macro policies on inflation, trade, capital flows, general confidence, and a slower growth trajectory,” he says.

Greater market and geopolitical volatility could induce central banks, including the Federal Reserve, to at least temporarily stall on their path toward tightening, Mr. Fitzsimmons says. “When faced with volatility,” he says, “central banks tend to kick the ball further into the long grass—so they may end and maybe deepen their easing cycles.”

The pressure would be particularly great for Fed Chair Janet Yellen, whom Mr. Trump has already threatened to replace. “The Fed’s credibility is going to be under pressure,” he says, “and that’s an international story, not just a national story.”

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