Markets under Trump: higher bond yields, sector rotation and volatility

Are equity markets learning to love Donald Trump? Or trying too hard to focus on the positives? With Donald Trump sounding more presidential and magnanimous since his victory speech, markets have started partially pricing in what they regard as the more favourable parts of his policy agenda. That is: 1) personal and corporate tax cuts, 2) increased infrastructure and defence spending, 3) the potential winding back of Obamacare and the Dodd-Frank financial reforms, and 4) a more supportive disposition to the coal, gas and energy industries. Of course how much of the program is finally enacted, and when, remains unclear despite Republican majorities in Congress and the Senate.

Concurrently the markets have played down the negative risks (such as on trade policy) on the assumption that, in office, he will act rationally and take advice. We have assumed this too, but we are reluctant to get too euphoric about the equity market's prospects under a Trump presidency because the downside risks of a trade policy mistake (if it escalates to retaliatory tariff increases) are potentially significant. Footnote on trade policy: Trump does not support the Trans Pacific Partnership (TPP) and intends to "renegotiate NAFTA (North American Free Trade Agreement) or withdraw from the deal." For now, tariff increases currently seem consigned to the realm of campaign rhetoric. In an environment of heightened policy uncertainty, however, how confident can we be that this will remain the case if he struggles to gain traction on other policy initiatives and his poll ratings decline?

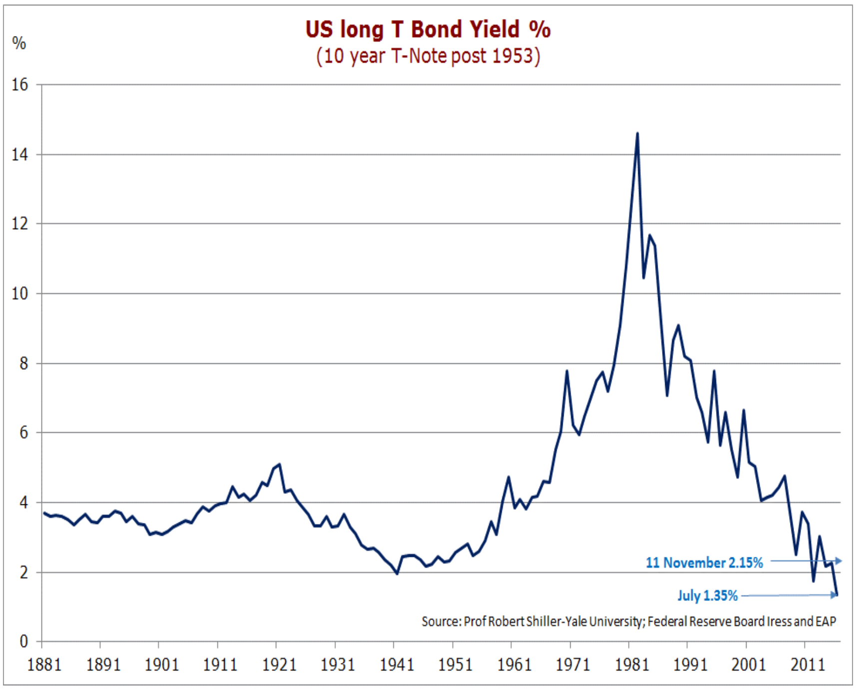
Initial equity sector rotation into cyclicals from "reach for yield" beneficiaries: Last week saw the US 10 year bond yield increase more than 30 basis points and Trump's stimulatory fiscal and perceived pro-business approach drive a switch out of defensive yield driven sectors (REIT's, Utilities, Listed Infrastructure) and into cyclical sectors and steeper yield curve beneficiaries (Materials, Energy, Capital Goods, Transport, US Banks) in addition to Health Care.

	10 yr GOV BOND %	1 yr CORE CPI %	REAL YIELD %
AUSTRALIA	2.6	1.5	1.1
U.S	2.2	2.2	0.0
U.K	1.2	1.5	-0.3
GERMANY	0.3	0.7	-0.4
JAPAN	0.0	-0.5	-0.5

Source: Datastream, Iress 11 Nov 16

Based on 12 month trailing Core CPI's, real yields are still broadly zero to negative across the major western economies (chart left). Normalisation (to whatever level that is estimated to be these days!) will likely take years, and it is still early days. It is worth re-iterating that if we are moving in to a rising bond yield environment, equities need to provide an expectation of earnings growth.

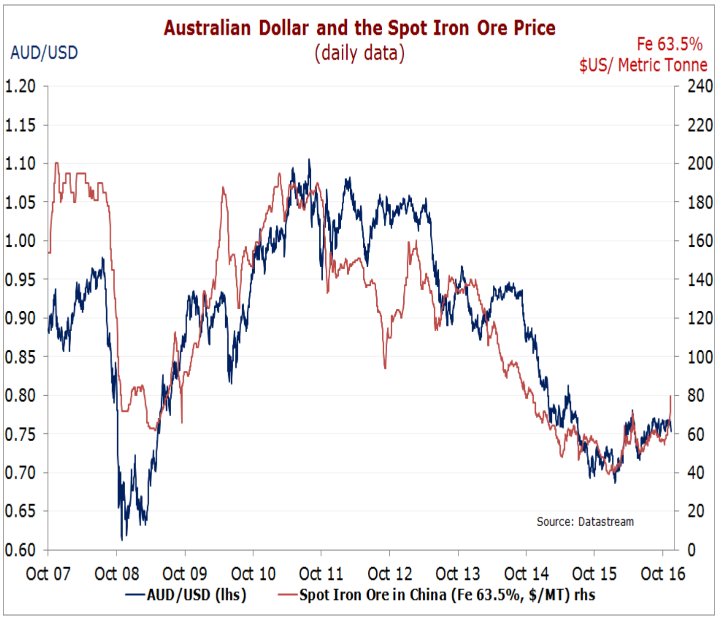
Is the 34 year secular decline in inflation and bond yields in the US is now over? We now have the world's two biggest economies seemingly committed to expansionary fiscal policy to achieve their growth objectives. At a global level, the efficacy of monetary policy stimulus at the margin suggests it has reached its useful limits. After years of reliance upon monetary policy, the axis globally is now starting to tilt toward fiscal policy. Free trade and globalisation appear to have passed their peak downward influence upon inflation; global trade volume growth is forecast to be below global GDP growth in 2016.



Absent a US recession, it appears to us that the US 10 year government bond yield troughed in July 2016 at ~1.35% (compared to ~2.2% currently). The magnitude of last week's increase in bond yields was likely an unexpected shock adjustment, but we do expect yields to continue to move higher in the years ahead. The 34 year secular decline in inflation and bond yields in the US is now over, in our view. What does this suggest for equities? At face value it implies the end of PER multiple expansion from lower long bond yields, and possibly the risk of PER derating. (Although to be fair, we should point out the bond yield /equity yield gap suggests equities have not fully priced in the extraordinarily low level of prevailing bond yields evident for some years now. (Chart of US Bond yields since 1881 left).)

Commodity prices and the AUD/USD post the US elections: For most of the past twelve months, the AUD/USD and the spot iron ore price have moved pretty much in tandem. This has not been the case in the past week, however as both the US Dollar and the iron ore price rose in response to the perception that growth in the US would be stronger, potentially providing scope for US monetary stimulus to be unwound somewhat more quickly than otherwise might be the case.

The strength in the iron ore and copper price may be linked to a pre-emptive view of a pick-up in demand from the US infrastructure program, but is quite likely to be speculative demand emanating from China. We still expect the Fed to lift the Fed Funds Rate by 0.25% at the December FOMC (14 December), but this is quite fully priced in by the market. Together with a still dovish statement and Fed participants' Fed Funds rate forecasts, the US Dollar will likely remain relatively stable. Unless the US Dollar subsequently strengthens further, a weaker AUD/USD may therefore require a weaker iron ore price, which in turn may not transpire until a meaningful increase in iron ore supply in the June Q 2017.



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