If Trump Had Won And Then… How Markets Might Have Reacted

If in the immediate aftermath of Donald Trump winning the US election, equities had crashed, credit spreads had widened, bonds had sold off, the dollar was strong yet gold had surged. And held on to these trends for more than a day. What would the present look like?

The only resemblance to the above scenario to the current reality is that bonds had fallen as inflationary expectations rose, driven by Trump's spending plans and tax cuts. What might the analysis of this alternate reality look like?

The outlook for equities is poor. US equities are already facing a profits recession if not an economic one. The economic cycle is advanced and a slowdown is probable. Add to this higher debt costs and the impact on balance sheets which have in the last 5 years been expanded to take advantage of low rates, buy back shares and pay dividends, and the prospects for business look poor as debt service rises, leverage rises organically, and the refinancing becomes more expensive and difficult.

Equities will not be the only ones to suffer, credit spreads are likely to widen as credit quality deteriorates.

USD will likely be strong. The low repatriation tax and subsequent lower tax on foreign earnings is likely to encourage inflows. Interest rate differentials across the curve support the USD. As a net importer, the retreat from trade is net positive for USD.

The market reaction to a Trump victory would prompt the Fed to delay raising rates and to generally adopt a dovish stance.

While this is at odds with the President's wishes, the Fed will want to demonstrate its independence, stave off recession, or worse, stagflation, and would be tempted to consider resuming QE. That said, reviving QE would be controversial, so the immediate action is to do nothing. The yield curve steepens as capital seeks low to no duration risk free assets.

The picture for emerging markets would be complicated. As strong USD would be good for terms of trade, which are very important for export nations. However, countries with significant USD debt would face rising debt and debt burdens as rates also rose. High risk aversion is generally bad for emerging markets and the net impact would be bad for emerging market assets.

Ceteris paribus, the situation for Europe would be less poor. A weak EUR would be reflationary. While European yields would rise in sympathy with USD yields, the fact that Europe was deleveraging and Europe can raise debt in EUR, and the ECB remains in QE mode, cushion the blow on Europe. Any sell off would be a buying opportunity.

With the long duration USD assets off the table, the attention would turn to bunds and JGBs. Non USD duration would rally. Since short term rates dispersion was low, cost of FX hedging is also low. European rates would remain low and be capped even at the long end. For Japan, the aim of maintaining a steep yield curve beyond 10 years will become more challenging leading to a selloff in banks.

In summary:

US equities fall – economic cycle peak, earnings peak, higher debt service, pressure on multiples.

US credits widen – as above.

USD curve steepens – inflation fears pressure the long end.

Fed holds the short end.

USD strong – Inflation, capital flows from tax changes, interest rate differentials.

European equities outperform – Weak EUR, less levered than US, lower debt service, re-rating potential.

European credit outperforms – as above.

EUR curve flattens – demand for duration not met in USD, FX hedging costs low, low inflation.

EUR weak – dual of strong USD.

Japanese equities maintain bifurcation along JPY lines.

JGB curve flattens – demand for duration not met in USD, FX hedging costs low, low inflation.

JPY weak – dual of strong USD.

Gold strong – Risk aversion and inflation hedge.