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What We Think...

Trump

The Trump Presidency has not yet begun, but already the President-elect has left his mark on Washington and the markets. There are still many who doubt the promise of the Trump Presidency, and that is why we think the bond market re-pricing has been mostly about putting some symmetry back into the risk around bond prices. It is the possibility of success rather than its probability. We note that the prevalent belief amongst commentators seems to be that markets are vastly overdone – but surely, there would have to be some investors of the same view. Speculative bond market positions do indicate an element of investor optimism surrounding growth and inflation, but after years of one-way Fed support, it is difficult to know how good a signal this is. Regardless, we are seeing the focus of investors shift from the Fed to the President, after years during which Yellen overshadowed Obama.

The problem with trying to predict the effect the new government will have on the economy and markets is that "Trumponomics" is not a very well defined branch of Economics. Loosely, its main elements are trade, taxation, infrastructure, regulatory and immigration policies. For each of these areas, there is no definite or accepted policy position, but rather a confluence of contradictory quotes or tweets. However, it is still useful to examine the possible policies that will affect jobs, growth, inflation, deficits and ultimately markets in the United States and abroad.

Trade

We have already seen the whites of Trump's eyes on this file and they leave little doubt where his heart lies. There have been already several announcements with respect to Mexican-US off shoring – Carrier & Ford were the most high profile – that suggest "keeping manufacturing jobs at home" will remain a hot-button issue with lots of pressure exerted on possible perpetrators. Although neither of the preceding announcements can definitively be attributed to actions of the President-elect, stopping high profile factories from moving to Mexico must be viewed as low hanging fruit in US trade battles. Preventing smaller moves will be far more difficult. However, the toughest challenge lies ahead – fighting China and other Asian exporters, given the reciprocity of trade and investment flows.

It is hard to view enacting trade barriers as pro-growth, so at best, we would be neutral on the GDP benefits of protectionism. In terms of inflation, saving high paying factory jobs is inflationary only on the margin; while repatriating high paying factory jobs (vastly more difficult), would be inflationary overall. Although unemployment levels are low, we would expect manufacturing job gains to exert more pressure on the participation rate than on wages, at least in the short to medium term.

Finally, from a Canadian perspective, we may benefit from a dust-up over NAFTA, but can just as easily get side-swiped along the way. Robert Lighthizer, a noted "China-critic" is Trump's pick for trade representative, so it is reasonable to assume that there will be substantial focus on China, but it is not sound to assume that the focus on NAFTA will disappear into the shadows. In any event, we are likely to see significant change from the trade environment of the last eight years.

Taxation & Infrastructure

During the election, Donald Trump made the case for job creation through better trade deals, lower taxes and infrastructure construction. Both taxes and infrastructure have difficulties with timing and deficits that make their passage through the antagonistic US political system difficult to predict, especially given the complex relationship between the president-elect and the Republican Party. In March of last year, Trump said "We've got to get rid of the $19 trillion in debt… I think we could do it fairly quickly… over a period of eight years.[1]" Lower corporate and personal taxes will

[1] Washington Post, April 2, 2016 – Interview of Donald Trump by Bob Woodward & Robert Costa

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have an upfront budget hit that will make any deficit reduction hard, but ultimately supported by most Republicans. Infrastructure spending will take time to unfold, given state input and approval, and will very likely materialize just as the dividends from lower taxes are realised. Extending budget deficits will be unpopular with the GOP, but we have already witnessed Trump's willingness to confront House Republicans over the Congressional Ethics Committee action, and we doubt he would retreat from any fight over his infrastructure ambitions.

Ultimately, we think that fiscal policies are necessary to take the pressure and attention away from inadequate monetary policy that has been the sole policy tool used to generate target growth and inflation. Ironically, "tax cuts" are the preferred action of Republicans, while infrastructure spending that of Democrats, which should make Trump seem like a centrist. Unfortunately, personal tax cuts and infrastructure spending have historically been an inconsistent means of precipitating growth, and a far more reliable method of generating deficits. Corporate tax cuts however, should prove beneficial to the business sector and be at catalyst for higher growth – this is certainly responsible for some of the current optimism in equity markets.

<u>Regulation</u>

Healthcare, financial and environmental regulation has been an anathema to Republicans during the Obama administrations and is a visible target of the Trump Presidency. Of course, Obamacare has been the biggest source of displeasure, but claims of economic costs are difficult to determine. In the financial sector, Dodd Frank is the most visible source of disgruntlement, but while there is little doubt that its implementation has reduced the flexibility of financial institutions, again it is difficult to assess its impact, particularly given the aggressive policies pursued by the Fed since the credit crisis. Finally, environmental policies such as the decision to not permit construction of the XL pipeline have theoretical impact that, while real, are also not easily quantified. It is difficult to say what policies will be unwound, by how much and when – however, in general, reversals will likely support higher growth.

<u>Immigration</u>

The US election was not fought on immigration to the same degree as the Brexit vote or other European elections, however, it was certainly an element of Trump's platform and we would expect him to eventually make policy changes that reflect this – again, at this point these changes are difficult to predict. At a time when the US workforce is aging and women are opting out for familial reasons in greater numbers, we would note that the US needs more immigration, not less. At the current pace of immigration, the US labour force (according to the BLS) is projected to grow only by 0.5% per year over the next 7 years – reduced immigration will only exacerbate the problem.

Many policy ideas have been floated going into the Trump Presidency, and many will land unpredictably. Some analysts assume Trump will have as much success enacting policy as his predecessors on average, but, in theory, he is starting with a supportive House and Senate, which is not typical of recent presidencies (no president since Jimmy Carter has had this support for an entire term). Other's look at Trump's track record as a "bully" and conclude that policy success must follow. We will not commit on presidential success, but we do believe that on the surface, Trump's policies would give a boost to growth, inflation and likely real and nominal yields from their current levels.

Real Yields & Inflation Expectations

The graphs below (Figure 1) show 15-year histories of Canadian and US real yields and inflation expectations (which sum to nominal yields) for long-term bonds. The series are derived from the respective long benchmarks bonds: Canadas's and Real Return bonds in Canada and Treasuries and TIPS in the US. Perhaps

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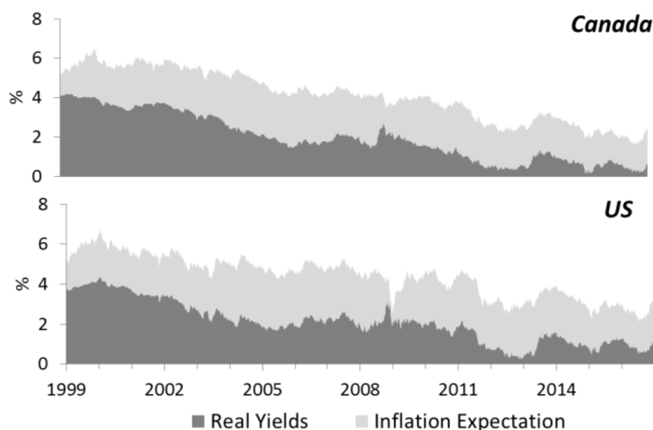
the most striking, but often overlooked fact conveyed by the graphs is that the decline in real yields is the main factor behind the decline in nominal yields since the 1990’s. Most commentators however, continue to discuss nominal yields in the context of inflation expectations. Importantly, a combination of slower growth and aggressive non-traditional monetary policies (forward guidance, QE and negative rates) has lowered and flattened real yields curves, taking nominal curves along with them. Admittedly, inflation expectations have fallen, but nowhere near the level of real yields.

Figure 1: US & Canada Long Term Real Yields & Inflation Expectations



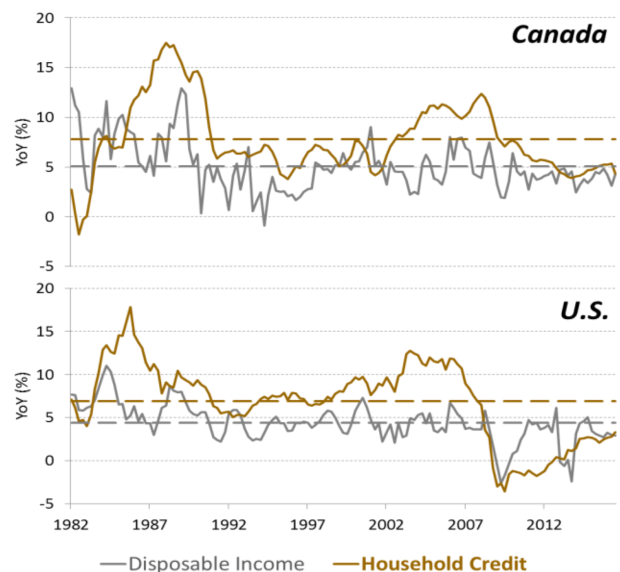
Source: Bloomberg & Lorica Investment Counsel Inc., December 16, 2016.

Despite the focus on the prospects for rising inflation following the election, we have seen a comparable rise in both real yields and inflation expectations. Yes, long-term real yields are still at rock bottom levels: 0.474% in Canada and 0.931% in the US, but the rise since the beginning of the fourth quarter of last year has been 30 and 36 basis points respectively, compared to 66 and 69 bps for respective nominal bonds. We would attribute most of the rise of real yields to the waning confidence that Central Banks will continue their aggressive policies designed to keep long-term yields artificially low – their collective body language indicates “easy money fatigue”; and more symmetry around potential growth, given the probability of some level of fiscal policy renewal.

Secular Growth & Inflation

We are optimistic that we will see slightly higher growth ahead in the US, but are less so for inflation, though we are not overly concerned with either. In an era of high debt levels (Figure 2), population aging, dislocating technological change and globalization, we are not surprised that growth is running lower than several decades ago when none was as significant. This is true for most developed countries that are facing similar environments. (Those that have temporarily avoided slower growth have done so largely because of resource advantages and partially because of immigration.) Just like monetary policy, we think fiscal policy can give a boost to growth, but we do not think it can overwhelm secular trends. Nor do we think other government policies specifically designed to redress secular trends will be successful.

Figure 2: US & Canada Household Debt & Income (YoY, Quarterly)



Note: Dashed lines indicate long-term average.
Source: StatsCan, Bloomberg & Lorica Investment Counsel Inc., December 16, 2016.

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We feel inflation is more difficult to predict. Some of Trump's policies are intended to redistribute wealth to the working class by increasing the number of better paying blue-collar jobs while reducing the size of the workforce beyond what is already anticipated – this would result in some element of wage growth. On the goods side, trade policies should result in some price increases. Combined, Trumponomics could very well result in higher inflation – but difficult to predict if this is beyond what the market is currently expecting.

Longer term, technology and demographics will continue to make it difficult to stir wage inflation. The shift towards services in developed countries, with an imbalance towards lower paying jobs has meant that wage growth has been stagnant. We foresee further scenarios of unfilled jobs for those highly trained, while those with skills not in demand reliant upon insufficient government created opportunities. Aging populations will only exacerbate this job imbalance with the number of lower-paid caregivers outweighing higher cost doctors and other support personnel who will be compelled to ration their services.

The US Bond Market

2016 was a year in two parts for the bond market. The first three quarters reflected relentless demand on the back of global QE, disappointing data and a reluctant Fed. The fourth quarter was a touch of sobriety, as central bank exhaustion and the US election prompted investors to reprice the market risk they had been ignoring. Excessively flat yield curves re-steepened and market returns reversed. The best place to be in the bond market was short corporate bonds (our choice) where the combination of yield pick-up and short duration proved unbeatable.

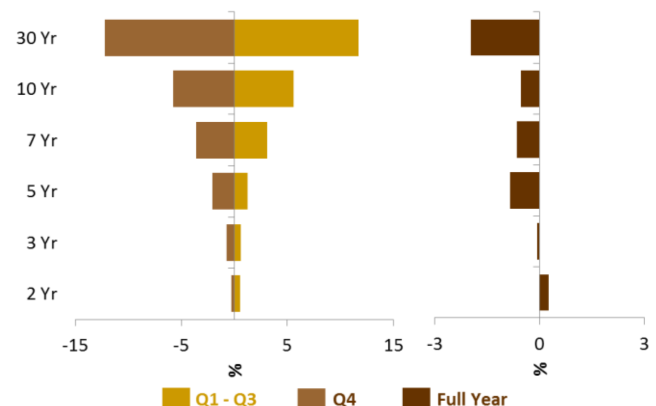
Going forward, our preference for short duration and corporate overweight has not changed. Although yields have risen quickly and substantially from their lows, in our estimation they are pricing-in mostly the possibility of better growth, a touch higher inflation, and tighter monetary policy. Given so much uncertainty in government policy, we find it difficult to believe that investors have priced-in the best-case scenario. Should supportive "Trump" policies unfold and the Fed deliver on more than half of their interest rate projections, we expect US bond yields to rise.

The Canadian Bond Market

The Canadian bond market experience in 2016 was much the same as the US's – three quarters of lower yields, followed by a one-quarter correction (Figure 3). The biggest difference was the more significant steepening of the Canadian yield curve due to the divergence of monetary policies. While the Fed has raised the path of expected yields, the Bank of Canada continues to wax about the potential need for lower rates. We expect this divergence to persist in 2017, which implies more steepening for the Canadian yield curve.

Although Government of Canada yields are off their lows, break-evens remain relatively unattractive. We still see the best risk-reward relationship in short-term corporates given their yield spreads make up over 50% of overall yields, the short part of the yield curve is at its steepest, and the BoC is likely to stay on the sidelines. In addition, despite challenges facing the Canadian economy, we are comfortable with overall credit quality and viability of the corporate sector.

Figure 3: 2016 Canada Benchmark Returns



Source: Morningstar & Lorica Investment Counsel Inc., December 2016.