TrendMacro™

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MACROCOSM

Trump and the "Reflation Trade"

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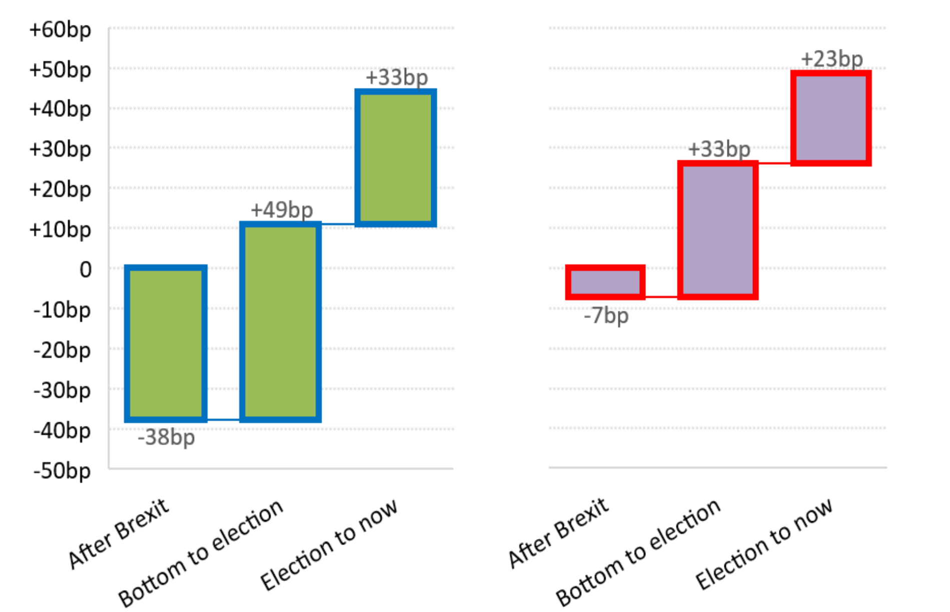
The back-up in yields may signal something much greater – the end of secular stagnation.

The risk-off Brexit-like reaction to Donald Trump's upset presidential win lasted mere hours, exhausting itself over the course of election night (see "Our Hot Take on the Trump Upset" November 9, 2016). *Since the election, the reaction – most conspicuously in rising long-term bond yields and inflation expectations – has been exactly the opposite of the immediate aftermath of the Brexit surprise. It has been a continuation of a reversal that was the "reaction to the reaction" to Brexit, which began on July 6. More than half of this move was already completed by election day* (please see the chart below).

- If this move in yields and inflation expectations is all about Trump, does that mean markets secretly started expecting that he would win the election all the way back on July 6, the all-time lows from

Start at pre-Brexit: 10-year Treasury yield 5-yr 5-yr inflation swaps



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US BONDS, US STOCKS, OIL, FX, GOLD: The reaction in markets to Trump's surprise win is all over the lot and internally contradictory – how are higher inflation expectations consistent with weak gold and a strong dollar? Supposedly the big back-up in yields is about expectations that, magically, Trump will embark on a debt-fueled government spending binge. Trump's seeming mandate – more a symptom of shock and surprise than a true electoral mandate – may not be enough to get that done, if it's even a priority for him. Longer term Trump may signal the end of "secular stagnation" – after eight Bush years of insecurity, and eight Obama years of self-loathing, his brash style evokes a revival of "animal spirits," which is the deepest well-spring of growth. He has the executive power to roll back growth-smothering regulations, and facilitate the ongoing fracking revolution. In this growth environment, higher yields don't have to be lethal to equity valuations.

[Strategy dashboard]

which the present back-up began? That doesn't seem plausible.

- Media narratives claim this "reflation trade" is due to expectations that Trump is going to unleash massive debt-funded government infrastructure-spending. That doesn't seem plausible either.
- Even if Trump could wave a magic wand and bring a huge government spending binge into existence, that doesn't necessarily mean that economic growth or inflation would ensue (neither materialized in response to Obama's spending binge in 2009; and neither is necessarily related to the other anyway, as we learned in the Reagan prosperity of renewed growth and falling inflation).
- And we don't know, really, that Trump would choose to achieve this particular outcome with his magic wand, versus all the many other outcomes he has promised.
- Besides, he doesn't have a magic wand in the first place. No president does. It's not at all clear Trump even has much a mandate.
- It *feels* now like he has a mandate, but only because his win was such a surprise. There is a natural tendency for people to imagine he has magical powers, simply because he achieved something they weren't able to rationally anticipate, and at the moment are too much in shock to understand.
- But in fact, his win by 74 Electoral College votes was quite narrow – the fourth narrowest in the post-war record (normatively, our election model expected 229). He didn't win the popular vote.
- The GOP holding the Senate was a surprise, too, but hardly a mandate. It lost seats in both the Senate and House, when the "coat-tails effect" would have suggested gains. In the Senate, it has far from a filibuster-proof majority.
- And from this far-from-dominant position, Trump will have to work with the Republican party establishment to achieve most of his aims. However surprised and delighted that establishment may feel right now at having survived the election, next year it may insist upon its own long-standing agenda. For small-government conservatives like Paul Ryan (R-WI) and Mitch McConnell (R-KY), that may not necessarily include the debt-fueled infrastructure binge the markets are, seemingly, now taking for granted.

If it sounds like we're trying to be a wet blanket, we don't mean to. We're very positive here, as we'll explain shortly. We're just cautioning against reading too much specificity into the markets' *immediate* reactions to the election. Just because they are, in many ways, the opposite of Brexit doesn't mean that they are correct, or won't undergo many transformations. *The reality is that the world is in shock, and in ignorance. Just like it was after Brexit. Nobody knows what's going to happen here – perhaps least of all Donald Trump himself* (see "Which Trump Will Americans Get?" November 10, 2016).

- Some evidence of the shock and ignorance in which markets find themselves is the flatly contradictory stance that some markets have taken versus other markets.

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[About us]

Recommended Reading

The Shock Heard 'Round the World
Amy Walter
Cook Political Report
November 9, 2016

The Oldest Divide
Victor Davis Hanson
City Journal
Autumn 2015

Trump, Clinton and the Culture of Deference
Shelby Steele
Wall Street Journal
November 8, 2016

[Reading home]

- *With inflation expectations suddenly elevated, why has the US dollar been so strong, and gold so weak?*
- If that's because of a more hawkish Fed – we've heard everything from Yellen accelerating rate hikes in response to "reflation," and Trump wanting to put America back on the gold standard – then why does the curve still assume only one-and-a-half rate hikes per year over the next three years?
- *If there is going to be a surge of stimulus-driven growth, why is oil down?* Greenlighting the Keystone X-L and Dakota Access pipelines, and opening federal lands to fracking, won't have any impact on the short-term supply-squeeze the global oil markets are inevitably heading into (see, among many, "Who Knew? OPEC Actually Matters Again" June 6, 2016).
- *Even if there's going to be a surge of protectionism against the US's biggest trade deficit counterparties, why is Mexico down and China up?*
- *Since Trump's deregulatory agenda can be implemented to a large extent by executive fiat through cabinet departments and regulatory agencies, and is congruent with GOP establishment ideals, it makes sense to us that financials, pharmaceuticals and small-cap have been strong.*
- *But there is much we do not know.*

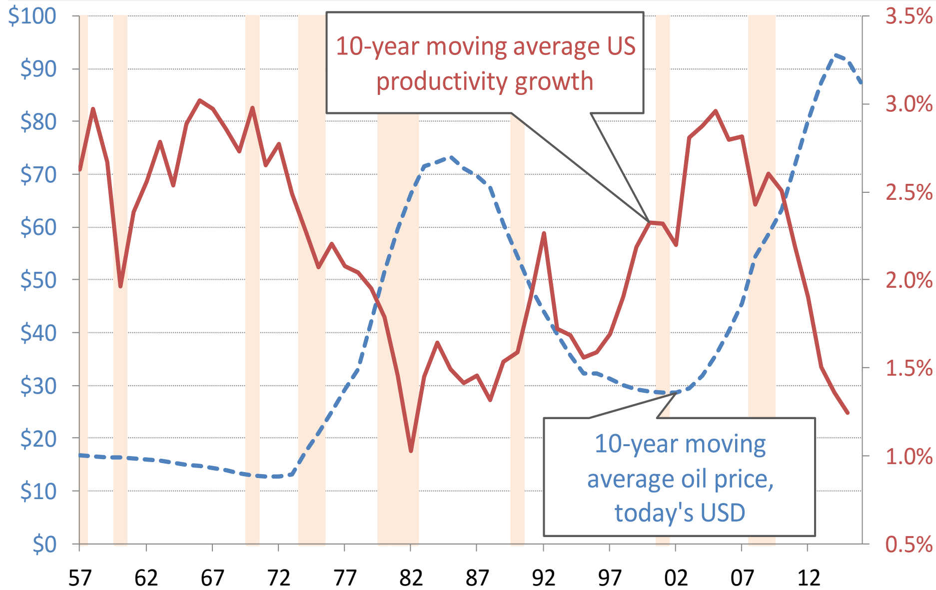
Having warned against too much presumption of *immediate* knowledge, now please indulge us to share a vision of what might be beginning to unfold *longer-term*. Although it is necessarily subjective, we have more confidence about it than most of things we could say about the short term. And as you will see, it turns out to be not at all inconsistent with higher long-term bond yields and more normal inflation expectations. *Specifically, we invite you to consider that the election of Donald J. Trump as president might mean the end of "secular stagnation," an exit from "the new normal," and a return to prior standards for growth.*

- From the very beginning of our recognition that Trump could go all the way (see "Trumped!" December 14, 2015), we argued that his brash persona – for all its faults – encodes a leadership narrative that could liberate the long-dormant "animal spirits" of the economy.
- After the shock of the terrorist attacks of September 2001, George W. Bush presided over a turn of American culture away from growth and toward security. The growth-killing re-regulation of the American economy – after two high-growth decades of liberating de-regulation – began with Sarbanes-Oxley, which it was born in this atmosphere of fear.
- After the trauma of the financial crisis and the war in Iraq, Barack Obama presided over a turn away from pride in American ascendancy and toward a questioning of America's virtue. The growth-strangling re-regulation continued, with Obamacare, Dodd-Frank and Title II control of the Internet.
- Over the same time, starting right after the 2001 attacks, the oil price started relentlessly rising. On a 10-year moving average basis, the oil price has been the highest in history since 2011, and

has only slightly backed off with the crash that ensued from June 2014.

- The inverse relationship of productivity growth and oil prices is quite clear in the historical record (please see the chart below).

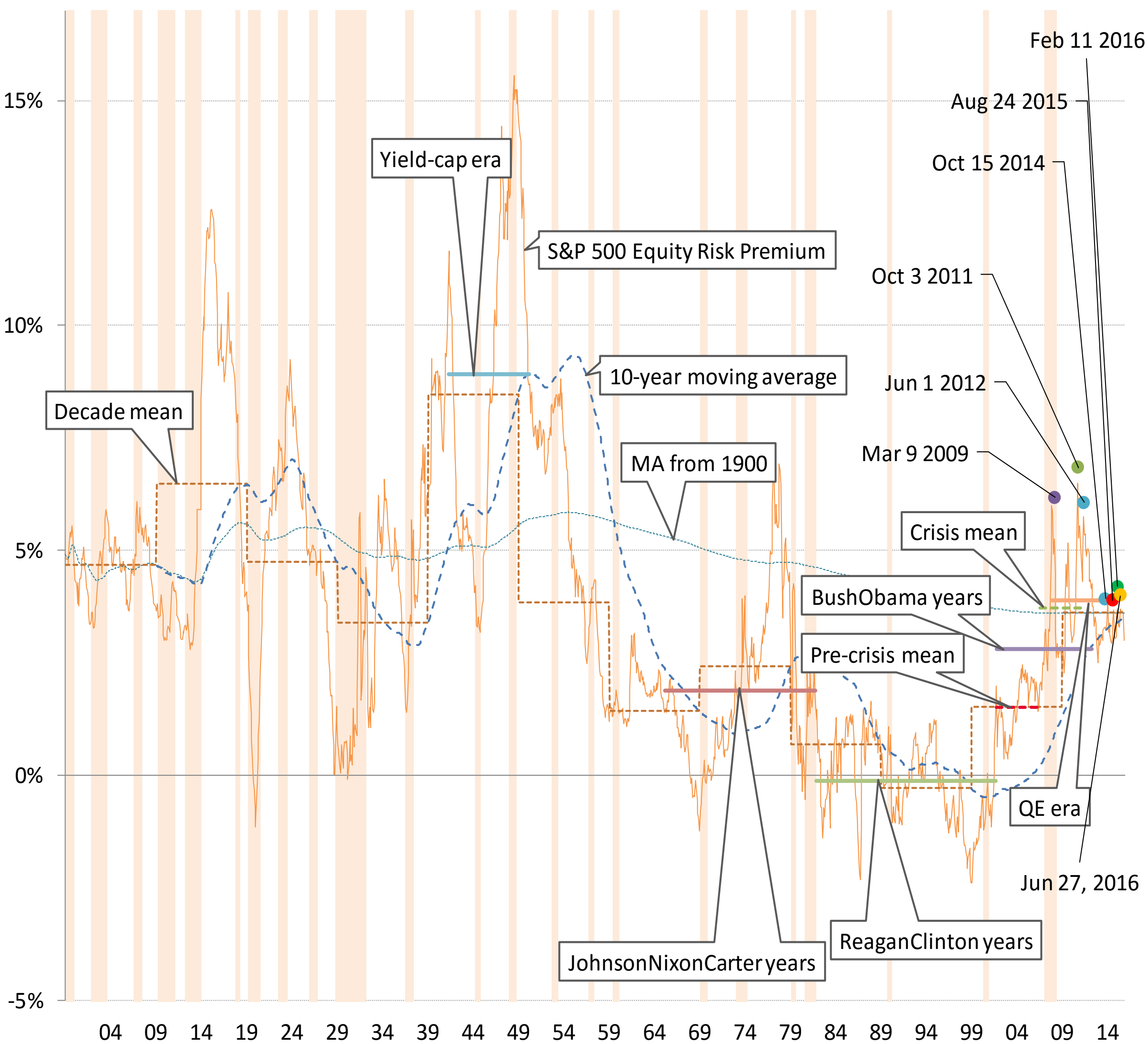
Relation of long-term productivity growth and oil price **Recession**



Source: BLS, Bloomberg, TrendMacro calculations

- Put it all together – a shift in the culture toward insecurity and guilt, a dramatic reregulation of the economy, and a prohibitively high price for the most critical industrial commodity – and you have “secular stagnation” and the “new normal.” You don’t need all the other stuff that Larry Summers cites to explain it.
- Now consider Trump. Forget about characterizing him as a “populist,” whatever that means. *He is a reaction.* Consider only that, in the same sense that it took Nixon and Carter to give us Reagan, it took Bush and Obama to give us Trump.
- With four simplistic words – make America great again – he has encoded a new narrative focused on growth over security, and pride over self-questioning. He has modeled these ideals – to a fault sometimes, and crudely, but we are talking about *animal* spirits after all – throughout his campaign.
- Now, whatever else he may accomplish, he has accomplished *that*.
- *Do not underestimate the power of more positive popular sentiment – the propensity of hundreds of millions of individual workers, consumers, savers, investors, entrepreneurs and retirees who make, in aggregate, billions of little decisions every day that make productivity growth possible* (see “Trump May Be First Since Reagan To Unleash America’s Animal Spirits” March 19, 2016).
- In terms of policy to substantively facilitate this new more growth-favorable collective attitude, Trump is in a position to roll back large parts of the regulations of the last decade-and-a-half. Yes, they

S&P 500 equity risk premium Forward earnings yield minus 30-year **Recession**



Source: Various, TrendMacro calculations

seemed like a good idea at the time. But they proved to be too costly in their growth-smothering side-effects.

- At the same time, by forbearing on regulation of fracking, and the transport of its product, he can facilitate this technology revolution that will return the oil price, durably and profitably, to its long-term growth-sustaining norm of a range from $15 to $35.
- *If that's right – that is, if Trump signals an end to "secular stagnation," then we should expect to see the end of the era of inexplicably low interest rates and long-term yields. We don't buy the simplistic "stimulus" narratives, and we think markets have gotten ahead of themselves for now, but we have no problem believing that the back-up in yields we've seen over the last quarter is just the beginning of a secular shift.*

- *In fact – perhaps this explains why the back-up in yields began, not with Trump's election, but in the aftermath of Brexit. Perhaps that supposedly "populist" election was, like Trump's election, not a matter of populism at all, but rather a decision to turn toward pride and growth.*
- One complication – which many clients have asked us about – is whether a secular reversal of the era of low yields must lead to a collapse of equity valuations.
- We understand the concern, because low long-term yields have sustained very high equity risk premia world-wide, which have made equities relatively attractive (please see the chart on the previous page, and "Data Insights: Global Equity Risk Premia" November 14, 2016).
- We will write much more about this soon, but for the moment, suffice it to say that a renaissance of global growth after a decade-and-a-half of "secular stagnation" has to be very positive for equities. Equity risk premia may indeed decline – but in a new regime like the one we are envisioning, that would be entirely consistent with a rebirth of risk-preference that would support equity valuations despite rising long-term discount rates.
- *Especially if Trump succeeds in cutting the corporate tax rate to 15%.*

Bottom line

The reaction in markets to Trump's surprise win is all over the lot and internally contradictory – how are higher inflation expectations consistent with weak gold and a strong dollar? Supposedly the big back-up in yields is about expectations that, magically, Trump will embark on a debt-fueled government spending binge. Trump's seeming mandate – more a symptom of shock and surprise than a true electoral mandate – may not be enough to get that done, if it's even a priority for him. Longer-term Trump may signal the end of "secular stagnation" – after eight Bush years of insecurity, and eight Obama years of self-loathing, his brash style evokes a revival of "animal spirits," which is the deepest well-spring of growth. He has the executive power to roll back growth-smothering regulations, and facilitate the ongoing fracking revolution. In this growth environment, higher yields don't have to be lethal to equity valuations.