Asset Allocation Weekly

By Asset Allocation Committee

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We publish asset allocation thoughts on a weekly basis in a special section within our Daily Comment report, updating the piece every Friday.

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As promised, this week we will discuss how President Trump's policies would likely affect the financial markets. It should be noted that Mr. Trump has not published any clear policy papers, so our descriptions are based on his public comments. Next week, we will discuss the expected policies and financial market effects from President Clinton.

Trump is a right-wing populist. This means we would expect him to support the following list of policies:

Immigration: Immigration is perhaps the most ancestrally common experience of most Americans. The acceptance of people from other places makes the U.S. unique. In the U.S., if you pass the citizenship exam and take the oath, you are an American. However, in most European nations, becoming a citizen does not make one "French" or "Italian." Despite this commonality of experience, immigrants have not always been welcomed. The "Know-Nothings" in the 1850s opposed the influx of Irish and German Catholics to America, fearing they would undermine American values. Often, lower skilled workers face competition from immigrants which drives down wages in certain parts of the job market. Compounding the problem is that approximately 10 to 12 million foreigners are in the U.S. illegally, signaling a lack of border control. The political establishment tends to turn a "blind eye" to illegal immigration; for the right-wing establishment, this form of immigration provides a steady supply of low wage workers. For the left-wing establishment, a "path to citizenship" would be expected to create new left-wing voters. Trump has appealed to right-wing populists who likely face, or perceive that they face, wage competition from illegal immigration. Thus, Mr. Trump's "build the wall" message raises the hopes of lower income workers that wages could rise.

Defense: Although Mr. Trump has campaigned on making a strong military, his positions are actually more nuanced than they first appear. Specifically, he has adopted positions similar to Sen. McCain (R-AZ) on many spending programs, which is to hold a skeptical eye toward spending programs. For example, Trump appears to oppose the F-35 and suggests that spending more on existing platforms makes better sense because of the inadequacies of the newer aircraft. This will infuriate the establishment on both wings who tend to support newer systems that bring money to their states and districts. Trump has promised to let the military choose what weapons it wants and threatens the infamous "military-industrial complex."

Foreign Policy: As noted last week, Trump is a classic Jacksonian based on the Meade archetypes. This characterization means he will run an isolationist foreign policy, although he will tend to overreact to perceived slights. In other words, he may allow Iraq to crumble and not oppose Japanese remilitarization. He has made it abundantly clear that he won't act as the "world's policeman." On the other hand, we would expect him to react strongly to Russian "buzzing" of U.S. Navy vessels or hostage-taking by terrorist groups. Postwar treaty organizations, like NATO, or other bodies like the U.N., will probably be ignored or allowed to deteriorate.

Trade Policy: Trump sees himself as a deal maker. He wants to renegotiate existing agreements and get better deals on pending ones. He has strongly opposed outsourcing and has threatened trade retaliation against China.

Fiscal Policy: Trump promises to maintain middle class entitlements, namely, Social Security and Medicare. He has promised to replace Obamacare but the details on its replacement are not clear. His tax policy would lead to significantly higher deficits, even when using "dynamic scoring," which accounts for the revenue impact of higher economic growth. His comments on Treasury debt have been interesting—he has suggested that Treasury debt could be restructured, but reversed himself when he apparently discovered that restructuring would not be necessary since the U.S. prints the money required to service the debt. Although it is difficult to determine with certainty, Trump could prove to be more amenable to heterodox economic policies, e.g., "helicopter money," if a recession were to develop. In any case, there is nothing to suggest that Trump is a deficit hawk.

The market impact of a Trump presidency could be significant; at the same time, it is always important to remember that the structure of the American government tends to restrain aggressive policy changes. Rahm Emanuel's famous quote of "you never let a serious crisis go to waste" reflects the structure of American government in that major changes usually only occur when conditions are bad enough to force the change. Newly elected, first-term presidents are at the peak of their political capital early in their terms; we expect President Trump's first priority will be immigration. Beyond that, he may find some support for his anti-trade policies and Congress can't force the president to intervene abroad.

There are two key changes that we see from a Trump presidency. Domestically, Trump's policies are essentially reflationist. His opposition to globalization by interfering with trade and immigration will likely make the economy less efficient and lift price levels. For Trump's constituents, it's a mixed bag. Although higher prices will undermine their buying power, the likelihood of them getting jobs, at least at first, will rise. Eventually, those jobs may face automation pressures, but that will take some time. For the establishment, the outcome is unequivocally negative; rising inflation will raise interest rates, narrow profit margins and compress price/earnings multiples.

The second major change from a Trump presidency is the end of *Pax Americana*. As noted above, Trump has made it clear that he wants to end the U.S. role of world policeman. Without American leadership, the world will devolve into regional power centers with competing hegemonic powers; in other words, China will square off against Japan and India, Russia and

Germany could be at odds again and Saudi Arabia and Turkey could line up against Iran. These policies will certainly lead to deglobalization and cut global supply chains, leading to less efficiency and exacerbating the already inflationist tendencies of Trump's immigration and trade policies.

In our asset allocation views, we have consistently held that inflation would remain low; we have tended to favor longer duration in fixed income and generally supported equities. A Trump presidency would likely be a harbinger of inflation which would lead us to adjust these positions. Rising inflation coupled with deregulated financial markets will almost certainly lead to higher long-term interest rates. Equity markets will face pressures as well. On the other hand, commodity prices will tend to rally if real interest rates turn negative. The impact on the dollar is more mixed. We really have no historical instance where the primary reserve currency is running protectionist trade policies. Because there is built-in demand for the reserve currency and protectionism blocks the traditional path for other countries to acquire the reserve currency, the dollar would become scarce. Paradoxically, Trump's policies could lead to a significantly stronger dollar as other nations take steps to reduce costs and the prices of their exports to offset tariffs and other trade barriers. Although it would seem that Trump's policies would spell the end of the dollar's reign as the primary reserve currency, there is no obvious replacement to the dollar. In addition, we would expect the Federal Reserve, assuming it remains independent, to raise rates to contain rising price levels, giving a further boost to the dollar. Although Congress will act as a restraint on Trump, as the current president has shown, some of these constraints can be evaded through regulatory policy and executive orders. ***Bottom line: a Trump presidency will likely bring higher inflation, reversing 36 years of disinflationary policies***.