WHAT MIGHT THE "TRUMP THUMP" TO BONDS AND THE US DOLLAR MEAN FOR GLOBAL ASSETS?

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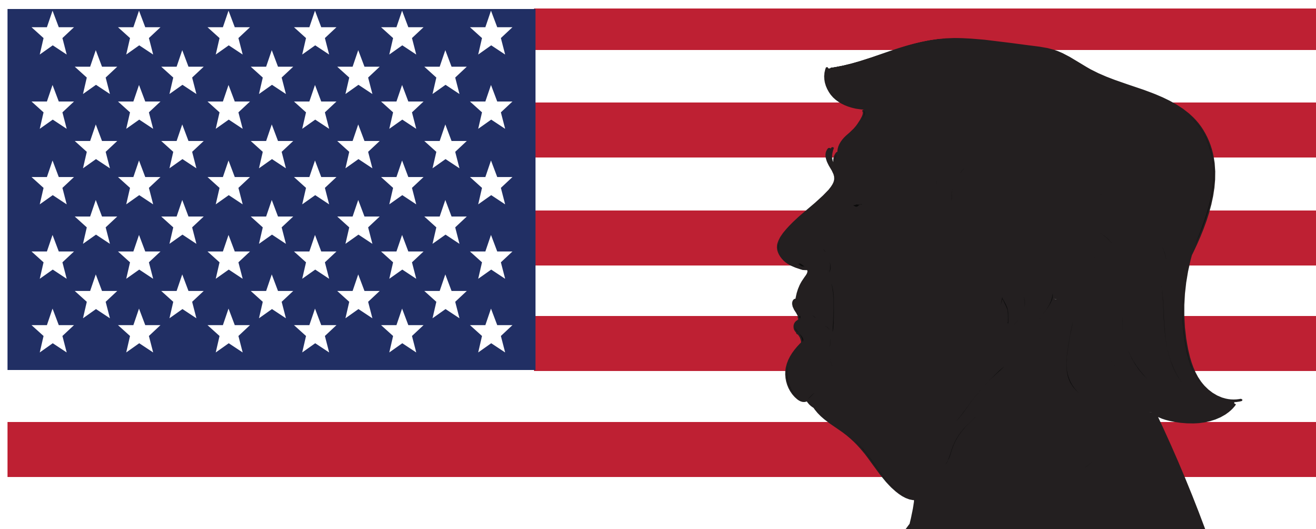

In the fortnight since Donald Trump's election as the next US President (note the "next" – despite the tone in the media, his inauguration is still two months away) there has been a significant surge in both US bond yields and the value of the US dollar. At the same time, developed market equities have generally rallied, which is unusual when bond yields are also sharply on the rise.

Commentators have explained the new mood in markets as an anticipation of Trump's likely policy directions (for an insight into these, see Bevan Graham's piece from 18 November, "Trump the pragmatist?"). I'd add that while recent market developments clearly needed the shock election result to take off with a vengeance, the strength of the moves is partly due to higher yields and a higher US dollar being long overdue.

To understand why, we need to look back at the year so far.

A BRIEF HISTORY OF A PROTRACTED POLICY PAUSE

Until the US Presidential Election, 2016 had been largely a waiting game for investors. The first US Federal Reserve (the Fed) rate increase since the Global Financial Crisis (GFC) last December was expected to kick off a sequence of small, cautious but inevitable upward adjustments in the key global interest rate. Accompanying these progressive tightening moves, many anticipated a steady rise in the US dollar against most other currencies. US Treasury bond yields were likewise widely forecast to rise during the year as the American economy continued to revive after a fairly flat performance over the Northern Hemisphere winter months.

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Divergence between firmer US interest rates and sustained lower rates elsewhere was expected to drive the euro and Japanese yen lower and help other major share markets to rally ahead of the US index.

Then, early in January, the first of 2016's patches of intense but transitory turbulence hit global markets in the wake of weak Chinese economic data, a falling Chinese yuan, and tensions in the Middle East causing gyrations in the oil market. Rate rises went back on hold, pending greater market stability, and this set up a pattern of central bank response to confidence crises and political disruptions that repeated throughout the year. The US dollar weakened rather than strengthened, and interest rates in the high-quality part of the bond market resumed their drift lower. The US and New Zealand share markets continued to beat European and Asian markets. An outlook for low interest rates not only continuing but being pushed ever-lower by each succeeding mini-crisis led investors away from financial stocks (penalising Europe) and exporters with unduly strong currencies (hurting Japan).

A low dollar also helped emerging markets stabilize and recover, after the hit from weak oil and commodities prices. In essence, the Fed became the world's paramedic. Lack of inflation pressure at home made delaying interest rate increases the least-disruptive course for the Fed to follow.

The most marked instance of this 'paramedic pause' was the Brexit referendum period through June and July. Although the US unemployment rate has been at or below 5.0% all year, and despite US growth turning out (after revisions) to have been accelerating, the Fed chose to remain in ultra-cautious mode. World bond yields sunk after the Brexit vote, even in the United Kingdom – perversely, as the country had just incurred a credit rating downgrade on the news. The yield on US ten year Treasury notes fell to a historical record low of 1.36%, German yields slid to -0.21%, Australian yields to 1.81% and New Zealand's to 2.12%. The phrase "lower for longer" became the near-universal forecast for interest rates. Why would rates rise, even now, when there is very little inflation?

The answer comes down to a greater sense of future inflation but also political, budgetary and credit risks emerging in several of the more indebted and sluggish major economies.

US DOMESTIC CONDITIONS CAN BEAR HIGHER RATES, BUT CAN ANYONE ELSE?

The benign outlook for bonds was not to last. Barely four months after they troughed, yields on ten year bonds have surged by almost 1%, to 2.35% in the US, 2.72% in Australia, and 3.08% in New Zealand. Even German yields have risen by almost 0.5% back into positive territory despite the European Central Bank's continuing bond buying programme of 80 billion euro per month. Looking at the increase in US yields since July is revealing: around half a percentage point of the rise mounted gradually before Election night on November 8th and the other half percent has built up quickly since the surprise result.

This suggests that while the Trump effect is substantial, it is not the only influence at play.

Both the US benchmark bond yield and the US trade-weighted dollar have achieved new highs for 2016. The impact on other assets is already marked. Last week saw the largest US equity fund inflows recorded in two years ($28 billion) accompanied by $18 billion of bond fund outflows, a three-and-a-half year high.

Emerging market debt redemptions by foreign investors since the Election are estimated at $7 billion, putting downward pressure on emerging currencies. The Bank of Mexico has raised its target rate to discourage capital outflow, and the Bank of International Settlements has warned that a sharply stronger US dollar may trigger a decline in cross-border lending to emerging economies and put pressure on their domestic banks which have dollar-denominated loans outstanding that have been re-lent in their local currencies.

DXY USD Index

STIMULUS STILL STRONG WORLDWIDE, UNDERPINNING DEVELOPED COUNTRY EQUITIES

Of course, in the developed world, official policy rates such as our OCR remain very low by historical standards, and this seems unlikely to change any time soon. Many central banks, having most recently lowered their target cash rates, either have an easing bias or remain in no rush to tighten conditions. Ample liquidity is usually rewarded by equity markets, even for a period after its growth slows.

What has changed since August is a rising perception of inflation risk and of higher risk generally. Years of exceptionally low interest rates have encouraged a build-up in global indebtedness. This has been manageable in the post-GFC years, mainly because the major central banks have consistently pushed borrowing rates lower. On occasions when market factors provoked traded interest rates to jump meaningfully, authorities tended to respond with complex bond purchasing programmes (QE) and, in some countries, with negative interest rate policy (NIRP) to ensure that any sense of credit restriction was short-lived.

Remember that interest rates are fundamentally about expressing risk (otherwise, loans would be free.) This 'price of risk' could relate to the probability of inflation, of currency weakness, of loan impairment and default, and even of armed conflict. Artificially lowering bond interest rates, as has been central bank policy, numbs the bond investors' risk-assessment antennae.

Monetary authorities' sustained intervention in the bond markets has been likened to economic anaesthetic.

In central banks, government bonds have enjoyed a 'dream buyer' with limitless purchasing power (because the bonds are held on the balance sheet and purchased with newly-created funds).

When sentiment shifts and investors put a higher price on the various risks to their returns from (relatively-safe) government bonds, the key question becomes: how much do less-safe investments need to adjust in price? Credit rating agency Standard & Poor's have expressed a cautious view, noting that global corporate defaults for the year so far are at their highest level since 2009, with an elevated number of companies at risk of credit downgrades.

Chasing yield without regard to risk is going to require much more agility in the next few years. Similarly, borrowing in USD and 'carry-trading' by depositing the funds in a high-yielding foreign currency account will require more nerve, as any unexpected US inflation stress would accelerate the Fed's tightening agenda and the dollar would move up quickly, anticipating higher interest rates ahead.

"SAFETY" DUE FOR A SECOND LOOK IF US FISCAL DISCIPLINE FRAYS

In the years after the financial crisis of 2008, waves of regulation have required large institutions to buy ever-more government bonds, because they are comparatively safe. This, alongside low inflation and many countries keeping strict limits on their budget deficits, has contributed to supressing their yields and generating consistently strong returns from Sovereign bond markets. Other interest-rate sensitive investments have been lifted as well.

The yields available for taking on investment risk have been forced lower by governments encouraging economic activity and savers looking to preserve their investment income level.

Regulators have deemed government bonds to be the best guarantee that financial portfolios (whether individual or institutional) can weather extended periods of economic and market weakness.

A new phase of (presumed) Trump-style domestic reflation through protection, tax cuts and/or infrastructure projects could change the balance of global risks quite notably. It is conceivable that government bonds may begin showing sustained negative real total returns and that recent years' popularity of bond funds will wane. Higher interest rates on riskier debt instruments look tempting but an increase in publicised defaults as credit re-financing accelerates in 2018 would undermine investors' appetite for fixed income.

A phase during which other currencies weaken meaningfully against the resurgent US dollar would support activity (and also lift inflation) in Europe, the UK and Japan. However, the fiscal responsibility that has limited growth-promoting policies globally in the last three decades is already coming under pressure in sluggish developed economies. If the US shifted definitively away from balanced budget priorities, it is hard to believe other major countries would not follow. European governments are already under budgetary pressure from refugee migration, and granting 'fiscal leeway' may be seen as the lesser evil if nationalist political movements continue gaining traction there. On the other hand, emerging market economies (particularly in Latin America) are at risk of debt-servicing pressures and even corporate defaults, and are likely to remain volatile, regardless of announced reform programmes.

NOT AN OVERNIGHT REVERSAL IN RETURNS PROSPECTS, BUT A TURNING POINT

It is important to note that these new market influences will take time to reverse the low-returns investment world that we have become grudgingly accustomed to. If inflation does eventually rise in response to 'Trumponomics' and the Fed reacts pre-emptively, inflation-adjusted US dollar returns may indeed be subdued in the next decade. However, a sustained period of higher nominal returns, initially from equities, may well be logged before inflation emerges to erode them. Positioning for this implies remaining tolerant of expanding equity market valuations, because corporate earnings are more likely to grow to support them.

It is possible that the US Presidential Election and this year's European political pressures will be seen by history as a turning point in the post-financial crisis norms of a soft US dollar, persistently low bond yields and cheap global credit. Once President-elect Trump takes office on January 20, whatever agenda he chooses to implement will likely transform markets' longstanding mindset on what to expect from US economic and trade policy.

> Central Banks around the world, led by the Fed, have pursued monumental stimulus efforts in recent years, in the cause of preventing deflationary slumps developing.

The new information markets need to absorb is that popular impatience with the speed of economic and income recovery is driving ever-more populist re-thinking of how to best remove the debt and deflation legacy of the financial crisis.

Investors should not let concern about the loss of caution in the US polity blind them to the potential for an engineered boom in certain economic sectors, as occurred during the Reagan era of 1980-88. A Trump programme may not leave the US a richer country in 2025, but it could revive considerable activity in the near term, freeing up the enormous corporate cash balance held both domestically and abroad. My own instinct is that investors' 'fear of missing out' is likely to trump the 'fear of government messing up', and that in the new climate from next year onwards we could be treated to market trends in developed countries that have been in the past more characteristic of emerging markets – in other words, waves of enthusiasm greeting new initiatives, political cheerleading for risk-taking, punctuated by bouts of doubt and fragility.

EIGHT ASSET MARKET IMPLICATIONS

From the New Zealand investor's standpoint, a strong US dollar and any sustained increase in US bond interest rates would likely:

1. Reduce the yield advantage enjoyed by New Zealand debt securities over Treasuries, lowering their appeal to international investors and supressing the NZ dollar.
2. Confirm a US-driven 'reflation and income recovery project' which should improve returns to New Zealand investors in international growth assets such as equities and infrastructure.
3. Encourage global portfolio investors to repatriate funds to the core markets from the smaller markets where they have been actively seeking dividend yield advantages in recent years. This would lower returns expected from Australasian assets compared to returns anticipated from other developed markets.
4. Render the capital value of higher-yielding 'income' investments more volatile, without necessarily impacting their running yield.
5. Revive interest in inflation-linked bonds (ILBs) which will come into favour to hedge against CPI effects of Trumponomics.
6. Put global property sector valuations under pressure, as these have benefited from years of falling financing costs. However, commercial property yields remain well above government bond yields and risk-tolerant investors will continue seeking yield. Local price pressure could be offset by acquisitive USD-funded institutions.
7. Keep commodity prices capped and cause difficulties for leveraged producers like miners and shale frackers.
8. Challenge China: a strong USD pressures the Chinese government to allow a weaker yuan. As China is a significant holder of US government bonds, Chinese liquidation of US Treasuries to support CNY is counter-productive and would only increase political and trade tensions if China scaled up its selling substantially.

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