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The Ultimate Trump Card

by Royce Mendes and Avery Shenfeld

Executive Summary

- Trump's infrastructure spending and tax cuts should drive growth of 2.1% in 2018, two ticks faster than previously expected.
- But that will cause the Fed to move faster than previously anticipated. A wider deficit will have Republicans eyeing offsetting spending cuts in 2019. Both would blunt the growth impact of the other stimulative policies.
- Tighter immigration would drive wages higher, while trade barriers would raise import prices. We've raised our 2018 core inflation forecast a tick to 2.5%.
- Trade barriers aimed at Mexico could see Canadian companies regain US market share. But there are still risks that the tide of US protectionism turns against Canada.
- Trump's desire to support domestic fossil fuel production should boost the supply of oil, putting pressure on WTI prices, barring renewed sanctions on Iran. His support for coal could limit future upside in natural gas.
- Some equities are likely to benefit from the infrastructure plan. But the additional spending might be modest and only phased in over an extended period.
- Trump has called for additional defense spending in the US and for other NATO partners to increase their own expenditures, which should support defense related companies.
- Banks are likely to see lower regulatory compliance costs given the Republican sweep, and Trump's plans to repeal the Dodd-Frank Act. A steeper yield curve is also seen as beneficial to banks. However, Mr. Trump has not been completely warm to the sector, having campaigned as a populist with fewer ties to Wall Street than his rival.
- If Republicans prove to be less aggressive on containing drug costs, biotech stocks could benefit. Moreover, health insurers might be relieved by the dampened chances for a "public option" that some Democrats had been pushing for, although the future of a post-Obamacare system still isn't very clear.

The Ultimate Trump Card

Royce Mendes and Avery Shenfeld

Many, including Republicans, believed that Donald Trump was finally going to fold his hand on election night. But once again he defied the odds, and is now set to become the 45th President of the United States.

The overnight reaction in financial markets was ugly. Equities, commodities and the US dollar were all weaker, while bond yields gained on a safe-haven bid. But as the sun rose in the western hemisphere, the tone in markets turned brighter.

The S&P 500 index has now rallied 1 3/4% since the election, in stark contrast to the inverse relationship that existed between Trump's poll numbers and stock prices during the campaign. Markets are judging Trump's policy mix to be friendly for shareholders that would benefit from lower corporate taxes and lighter regulatory costs, supporting a risk-on trade. In addition to the move in equities, the change in sentiment has also seen both Treasury yields and the US dollar climbing in these early days after the election.

Near-Term Boost To Growth, But Then...

Trump's plan to embark on an infrastructure build would be a net positive for growth on its own, particularly given the state of disrepair of some US public assets. His plan for corporate and personal income tax cuts would also be a source of near-term stimulus, although the tilt of the latter to high income earners with higher savings rates would dull the impact on consumption. The plan has a high likelihood of passing ahead of the 2018 tax year, given that Republicans were able to retain power in both the Senate and House of Representatives. The combination of these proposals should see the US economy grow by 2.1% in 2018, a couple of ticks higher than our previous forecast.

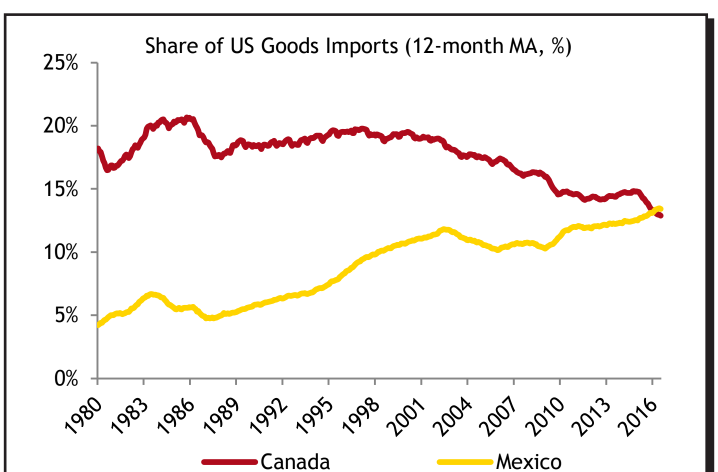
Why such a small lift? Because there are important offsetting factors. The boost to growth prospects, coming as the US is already closing in on full employment, will see the Fed add to its tightening plans. We're now projecting at least 75 bps in hikes in 2018 (or 150 bps from current levels), 25 bps more than we had previously expected. Moreover, with these higher growth rates still not reaching the levels Mr. Trump needs to make his plan budget neutral, the federal deficit is likely to balloon. That could cause many in the Republican held Congress to begin calling for entitlement cuts come 2019, turning the fiscal boost of the first two years of his administration into a drag thereafter. The Republican platform already called for such spending restraint as a part of tackling debts and deficits.

Inflation Getting A Nudge Too

Tighter immigration controls and the prospect of some deportations will reduce already weak growth in the US labour force, which could help drive wages marginally higher than previously expected. That's especially true since the economy is already operating close to full employment.

Chart 1

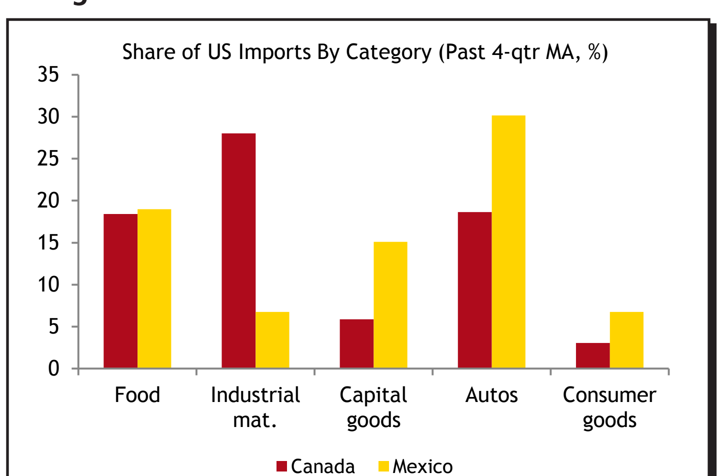
Mexico Has A Greater Market Share of US Imports Than Canada



Source: BEA, CIBC

Chart 2

Mexico Is A Larger Exporter To The US In Many Key Categories



Source: BEA, CIBC

Moreover, the President has the power to unilaterally withdraw from trade deals or slap tariffs on imports, with ready access to at least a 15% tariff for 150 days. Either of those steps could also add to the inflationary pressures in the US economy causing import costs to rise, unless a stronger US dollar fully offsets the tariff.

While Republicans that had historically been free traders will likely attempt to moderate his protectionist platform, Trump is likely to take at least some steps in that direction given the issue's prominence in his campaign. We have revised our 2018 core inflation forecast up a tick to reflect these greater foreign and domestic pressures.

That impact would be greater if not for the counterweight of the Fed. FOMC members are already signaling that they will respond to the additional price pressures from a looser fiscal policy regime. That, combined with a pullback in government spending in 2019, could see the economy look slightly more sluggish again as Trump's term hits the halfway mark. Fiscal stimulus could have been a powerful growth boost if offered up a few years ago, but its scope is now much narrower given that the economy has closed in on full employment.

Shying Away From Trade

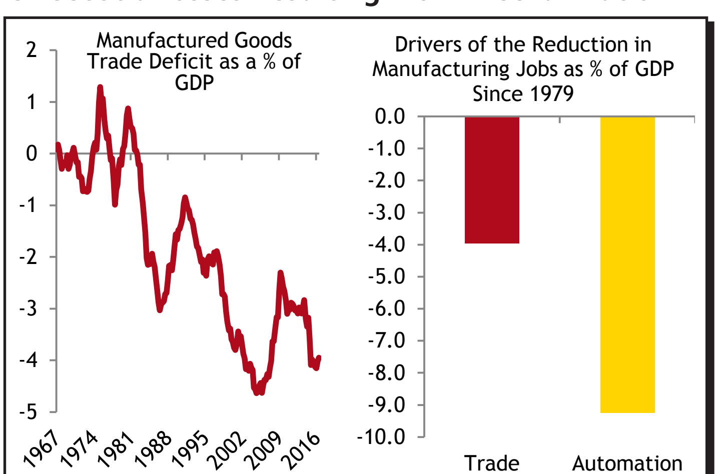
The President-elect's concerns about globalization are mostly focused on low cost producers like China and Mexico, but tearing up NAFTA would leave Canada in a vulnerable position. As of now, the Canada-US Free Trade Agreement is in a state of suspension and would come into force if NAFTA were revoked. In that scenario, the exclusion of Mexico might actually help Canada reap some of the market share we've lost (Chart 1). With regards to US market share, Canada trails Mexico in a number of key categories (Chart 2), with our nation recently falling behind in the auto sector (Chart 3).

But, there are also risks that protectionist sentiments could extend to restrictions on some Canadian shipments to the US, with that uncertainty looming over capital spending decisions in this country. The renegotiation of the softwood lumber agreement could be the first place Trump's protectionist tendencies hurt Canada. So, while Trump hasn't yet taken aim at Canada, the election result clearly raises a lot of uncertainties for Canadian companies reliant on the American market.

While Trump's protectionist plans could bring back some jobs in the goods production sector, they're unlikely to spur a manufacturing renaissance for employment. A proxy for manufacturing trade suggests that there is a deficit with the rest of the world of 4% of GDP (Chart 4, left). Compared with the last time it was in balance, manufacturing jobs as a percentage of total employment have fallen 13% (Chart 4, right). A rough estimate then suggests that more than two-thirds of the reduction in the share of manufacturing jobs has come as a result of technology not trade, meaning that they can't easily be brought back with protectionist policies. Moreover, if companies were forced to move production back onshore, the higher labour costs would likely increase their propensity to mechanize the production process. So, while some jobs could be created in the manufacturing sector as a result of Trump's plans, the aggregate number of positions wouldn't be as large as some might expect, and those employed outside the sector would see higher retail costs for consumer goods.

Chart 3

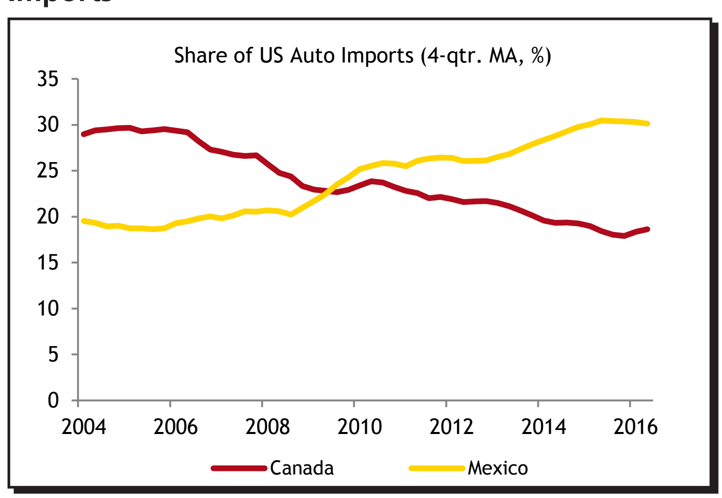
Reducing the Manufacturing Trade Deficit Can't Offset Job Losses Resulting From Mechanization



Source: Census Bureau, BLS, CIBC

Chart 4

Canada Now Trails Mexico Our Share of US Auto Imports



Source: BEA, CIBC

Trump's Effect on Commodities a Mixed Bag

The risk-on tone has seen a some commodities rally in the aftermath of Trump's surprise victory. With inflation expectations moving higher post-election (Chart 5, left), gold has gained ground in recent days. Precious metals have been correlated with the odds of a Trump victory since the campaign, and could be still supported by investors who want a hedge against the unexpected. However, longer-term, a quicker return to target inflation will see rates increase faster than previously expected (Chart 5, right), putting some downward pressure on bullion.

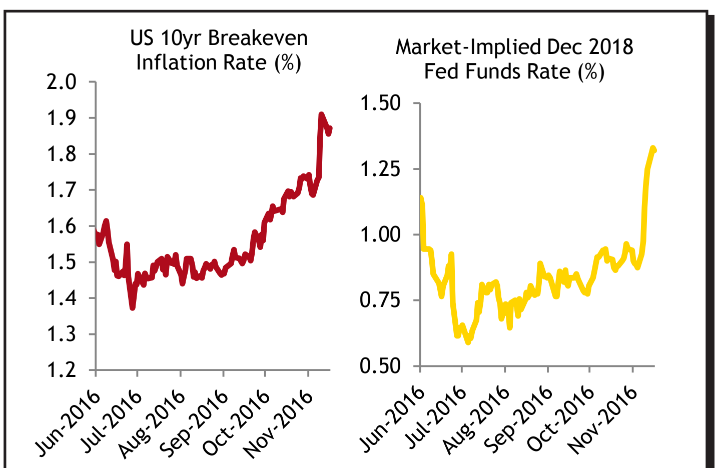
Copper has been a recent winner, although it was already climbing ahead of the vote. Talk of enhanced US infrastructure may have added fuel to what looked in part to be a speculative rally. But, with oversupply still an issue in that market, some of the gains are already being reversed.

The effects of a Trump presidency on oil prices is less clear. His desire to support domestic fossil fuel production and pull out of international agreements on carbon emissions should boost supply, putting pressure on WTI prices. However, his pro-growth agenda and hostility toward Iran could both have the opposite effect on prices.

Natural gas might also struggle to make gains under Trump. His desire to support the coal industry could limit future upside in natural gas, relative to a scenario in which coal was more aggressively phased out.

Chart 5

Inflation Expectations Have Increased (L); So Have Market Expectations For Fed Rate Hikes (R)



Source: Bloomberg, CIBC

A Rallying Cry For US Equities

Overall, US equity indexes have rallied since election night, but after the dust settles there will be a more clear distinction between winners and losers. As President-elect Trump's infrastructure plan takes shape, names in the industrials, materials and technology sectors are likely to benefit. That said, the infrastructure spending might be modest and only phased in over an extended period.

Trump's desire to promote US fossil fuels should also support coal and oil names, while alternative energy and natural gas companies could struggle. Importantly for Canada, Trump has stated that he wants to reopen the discussion surrounding the Keystone XL pipeline.

Companies tied to the country's defense sector are also likely to see gains from Trump's victory. He recently called for an elimination of the sequester on defense spending which his staff claim would add $500 bn over 10 years, with the possibility of additional funds on top of that. Combined with that plan, his pledge to pressure other NATO partners to increase their own expenditures could also support defense stocks.

US banking stocks have surged following the election. Banks are likely to see lower regulatory compliance costs given the Republican sweep, and Trump's plans to repeal the Dodd-Frank Act. A steeper yield curve is also seen as beneficial. However, Mr. Trump has not been completely warm to the sector. He has indicated a willingness to enact something akin to the Glass-Steagall Act, and campaigned as a populist with fewer ties to Wall Street than his rival.

If Republicans prove to be less aggressive on containing drug costs, biotech stocks could benefit. Moreover, health insurers might be relieved by the dampened chances for a "public option" that some Democrats had been pushing for, although the future of a post-Obamacare system still isn't very clear.

Indeed, more broadly, Mr. Trump's post-election comments have had a tendency to soften some of the platform that he ran on. Since markets have now priced in some of his platform as a fait accompli, there are still risks that investors looking for specific measures will be disappointed, and in other cases, the market may not be considering offsets to initial stimulus from either the Fed or subsequent Congressional budget restraint. Greater clarity will await his inauguration in January, the budget process that will play out over 2017, and for Canada, the early readings on the extent to which this country can escape the tide of American protectionism.