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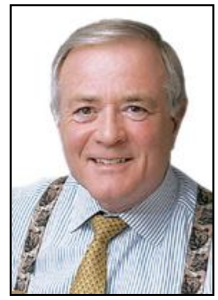

William Rutherford

Presidential election, rate increases upset markets

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November began with the impending U.S. election pitting Hillary Clinton against Donald Trump. Clinton was the odds-on favorite and the favorite of the market too. Investors had largely made their bets on a Clinton win. When Trump pulled the upset of the century, investors had to quickly redirect their investments. Equity investors switched from a risk-off scenario to a risk-on scenario.

As President-elect Trump gave a speech outlining his plans, the bond market had a heart attack. Two trillion dollars were wiped out within days. The Financial Times called it the worst bond rout since 1990. Interest rates jumped over 50 basis points within days – an astonishing move for a bond market, culminating in a move of almost 100 basis points since Sept. 1.

Additionally, the Federal Reserve had been signaling a rate hike of 25 basis points, with the futures market suggesting that the increase was more probable than not. Immediately after the Trump talk, the futures market's certainty of a rate hike rose to 100 percent. The market did the Fed's work for the Fed. Indeed, with the increase in interest rates of nearly 100 basis points, the Fed could easily raise rates 50 basis points, and probably will in the near term.

Investors picked winners and losers from a Trump presidency that sometime brought surprises. For instance, a conservative stock like Constellation Brands, a purveyor of Mexican beer, dropped nearly 20 percent in a flash because of Trump's threatened tariffs on Mexican imports. Tech share values dropped and have continued to decline, because Trump is a perceived threat to international trade. What was conservative became risky and what was growth (tech is 21 percent of the market) was taken to the woodshed.

Among the winners were bank stocks, because of expected higher interest rates. Most of the gains since the election have come from three stocks: Goldman Sachs, United Health and Caterpillar.

What sparked this upheaval? Keep in mind that Trump has a history of borrowing a lot of money against real estate and then defaulting, resulting in serial bankruptcies. During the campaign he even suggested that the U.S. default on its debt. In his post-election speech he promised a trillion-dollar infrastructure program with no way to pay for it, meaning he would have to borrow. His economic program was perceived as inflationary. With that amount of new debt and expectations of inflation, interest rates soared and bonds plummeted.

Higher interest rates also meant a stronger dollar. That was good news for foreign firms selling to the U.S., a move contrary to Trump's resolve to stop importing products and bad news for U.S. exporters, contrary to Trump's plan for U.S. companies to increase exports. All in all, the election outcome was disturbing to the markets, and portfolios had to be changed. Even so, the equity markets surged, even as the fixed-income markets plunged.

Why did the equity markets surge? For the first time in years, the House of Representatives, Senate and White House were all held by Republicans, who are perceived as being better for business. Therefore, it is expected that businesses will be more willing to invest in their own companies, and subsequently create more jobs. More jobs can bring a higher standard of living, which in turn will create even more jobs. Furthermore, higher interest rates will benefit banks, which comprise 13 percent of the S&P 500. Higher inflation should spur current investment. Additionally, Trump promised tax and regulatory reform that would spur investment. Finally, all that money coming out of bonds has to go somewhere, and the better market appears to be equities (Remember: money goes where it is treated best – an immutable law).

The question now becomes: Can Trump make good on his promises? With respect to his grand spending plan, he may well encounter resistance from his own party. Republicans are notoriously tight-fisted and hate deficit spending. They may rebel at an additional trillion dollars in debt.

The president-elect can do better on lowering regulations, since in many cases; the executive branch can act on its own. However, Obamacare will present a special case. Many of the people who voted for Trump are beneficiaries of Obamacare and are unlikely to respond favorably to efforts to repeal or even modify it.

Some of the president-elect's policies on trade can be expected to encounter problems not only at home but abroad. He frequently threatens tariffs, which of course led to the Great Depression in 1929 with the Smoot-Hawley Tariff. Too imperious of a stance could touch off trade wars, which would have serious political and economic implications domestically and abroad.

More uncertainty lies ahead in the elections in Europe. The same populist, nationalist movement that propelled Trump to the White House is sweeping Europe. In Austria, the election threatened to install the first far-right government since World War II. However, supporters of the European Union (EU) successfully beat back this populist nationalist movement.

In Italy, a ragtag political group calling itself the Five Stars Movement, started by a comedian and blogger, toppled the government even though they won only 100 of 600 seats in the Italian Parliament. They were able to do this because the voters rejected a reform measure that the prime minister supported with a pledge to resign if it failed.

Elections in France and Germany, linchpins for the EU, follow. Angela Merkel, the steadfast supporter of the EU, is up for re-election and being challenged from the right as well. What will happen to the European Union and the euro if some or all of these countries turn away?

Expect more market volatility as traders sort through these tea leaves.

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