EQUITY

America Decides: A Vote for Change

November 9, 2016

Edward D. Perks, CFA
Executive Vice President,
Chief Investment Officer
Franklin Templeton Equity

Christopher J. Molumphy, CFA
Executive Vice President
Chief Investment Officer
Franklin Templeton Fixed Income Group®

With Donald Trump emerging victorious in the US presidential race, many investors may be thinking: Now what? Here, Ed Perks, CIO of Franklin Templeton Equity, and Christopher Molumphy, CIO of Franklin Templeton Fixed Income Group, offer their initial take. One thing they agree on: there could be continued market volatility ahead.

The outcome of the US election likely contributes to continued equity market volatility, in our view. President-elect Donald Trump's campaign clearly struck a nerve with many Americans, reflecting what some might characterize as a disenfranchisement with the current state of the US government. His appeal as an outsider, a person who could bring a different voice to Washington, implies change, and with change comes uncertainty. The previously maintained balance of power between the executive and legislative branches now rests with the Republican Party. This may result in more significant policy shifts over the coming years.

Though US equity markets have demonstrated resiliency since the global financial crisis, political challenges in the United States (e.g., sequestration, tax reform, general gridlock) and abroad (e.g., eurozone crisis, the United Kingdom's referendum to leave the European Union) have contributed to bouts of market volatility, and we believe this event will likely have the same effect. During the past eight years, we've found that the underlying strength of the US economy supported by positive corporate and consumer fundamentals has been a key driver for value creation. We believe the health of the US economy, in concert with corporate earnings and dividend growth and consumer employment and spending trends, should be a significant factor for future market returns. However, it's important to recognize that Trump's trade agenda could alter the path to growth for multi-national corporations, casting doubt into many investors' minds about the sustainability of market resiliency. What remains to be seen is where the new administration will focus their efforts and how the policies will take shape. Our role as active managers is to discern where these potential impacts might create risks and opportunities for our clients.

In the months and weeks leading up to the US election, our teams had been evaluating the potential policy implications of both candidates to inform our views about where different sectors of the market may be impacted. Sectors potentially facing regulatory changes or systematic government policy changes may be most subject to impacts by the new administration. One of the foremost examples is health care. At a higher level, it remains to be seen whether the Republican Party's call for a repeal of the Affordable Care Act will gain traction. As well, many drug companies within the health care sector have been under pressure in recent months on market concerns that a new administration could enact sweeping legislative efforts to rationalize drug pricing, which could negatively affect pharmaceutical and biotechnology companies. Our analysts believe these risks, in large part, are reflected in valuations and that regulatory and legislative actions likely won't live up to the negative expectations that currently exist.

Financials are another sector subject to impacts from a change in administration. Since the global financial crisis, the regulatory environment for financial services firms has changed dramatically; thus we don't expect major changes to policies under the new administration. Trump's campaign rhetoric was more supportive of financials; we would expect him to generally make more business-friendly political appointments, for example. In our view, a bigger risk to the sector stems from the broader economic destabilization that could result from his proposed trade policies.

A key question on many investors' minds is whether and how the Federal Reserve (Fed) reacts to the election. The market had appeared to be pricing in higher volatility in the latter days of the election as polls indicated a tighter race. In our view, with the election behind us, though one element of uncertainty (i.e., who will win) has been removed, more elements have been introduced. The Fed has been operating under a data-driven framework in its assessment of the timing and magnitude of future rate hikes. It appears the Fed is also highly focused on economic and financial market conditions outside the United States, as bouts of economic weakness or volatility around the world have become factors that are included in Fed commentaries with increasing frequency. Developed economies—not just the United States—have been struggling to produce robust growth in what continues to be a mild inflationary environment. Ultimately, our longstanding view has been that rising rates typically signal the Fed's belief that the US economy is no longer in a vulnerable state, which we view positively. With less clarity regarding the future of US economic growth going forward, we expect that the Fed may tread cautiously and continue to defer rate increases.

Proposals which likely foster economic growth relate to infrastructure spending and repatriation. Ahead of the election, both parties emphasized the importance of increasing infrastructure spending on major projects, including bridges, roadways and airports. In addition to job growth, which can facilitate a consumer-driven multiplier effect on the economy, these projects may benefit companies across the materials, industrials, and technology sectors. Repatriation, which may allow US corporations to bring back offshore cash, could offer companies greater flexibility in investing for growth or returning capital to shareholders. Either of these proposals may impact individual companies to varying degrees; the potential benefits may be included in an assessment of upside and downside risk as part of our analysts' bottom-up, fundamental research approach.

Following January's inauguration, as the rhetoric of the past several months takes shape into actual policy, our investment teams will continue to evaluate the ramifications of changes to relevant segments of the market. Importantly, we believe the underpinnings of the US economy remain in place to support a modest level of growth. We have seen a high degree of stability in corporate and consumer balance sheets, as companies and individuals have taken advantage of low rates and positive credit fundamentals to access capital and put it to work. As we look ahead to 2017, we at Franklin Templeton Equity focus most on understanding economic conditions and the financial health and fundamentals of the individual companies in the various sectors and industries in which we are investing. As unexpected events play out, they may create dislocations, but they also may create opportunities for longer-term investors. We aim to potentially take advantage of some of those short-term dislocations. With the uncertainty of the election now past, we believe markets can once again focus on fundamentals.

The market is undoubtedly happy to have this election behind it and can now begin the process of moving forward. Given the unexpected nature of this win, we will have to wait and see what the longer-term response will be in the markets. Clearly, the initial reaction has been volatility, which we would largely expect given the future uncertainty around a Trump presidency and White House.

Now that we have clarity on the White House and Congress, the focus will shift to policy and the way forward. We believe actual policy actions vs the rhetoric we have seen from President-elect Trump throughout the campaign will most likely differ by a large margin. Many of the policy items discussed on the campaign trail cannot be implemented without bi-partisan support. Unfortunately, that means we most likely will see elevated levels of volatility in the markets including a "flight to quality." These conditions may continue until the market gains comfort in the way forward under a Trump presidency.

As we have highlighted before, fundamentals ultimately drive the longer-term performance in the fixed income markets. Despite the presidential outcome, we continue to see recent fundamentals as constructive; economic growth and the labor market continue to improve at a gradual rate. We believe these fundamentals, along with the passage of this election, should give the Fed confidence to continue the tightening process and raise rates in December, albeit at a very measured pace. This unexpected outcome may delay that hike due to market volatility, but we don't see this outcome as materially altering the course of the US economy in the near term. While we continue to watch for short-term dislocations, we remain anchored in our investment discipline of focusing on the fundamentals and investing through the cycle.

As we look forward, there are some potential headwinds that we will have to navigate. As we have seen throughout this election, there still are fairly strong divisions within the parties. We think the next 100 days are critical for the newly elected officials in the United States, and we will continue to gain clarity on many policy items over that timeframe. There is no doubt that this election, and outcome has challenged the status quo and we could see even small issues become larger should impasses persist. We have seen these periods before and in some cases they have led to volatility. Although the election is now behind us, the current political landscape will remain as a point of importance when investing within the fixed income markets.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

The comments, opinions and analyses expressed herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.