

The “New Normal” Becomes the “Old Normal” With Election Surprise

In the eight years since the Lehman Brothers failure induced financial crisis, markets have been operating on an economic outlook of low growth, low inflation, and low interest rates in perpetuity. The surprise victory by Donald Trump has forced a shift in the economic paradigm to a higher growth, higher inflation view based on Trump’s anticipated policy initiatives. Since the Trump election victory, the yield on the 10 year US Treasury note has increased from 1.86% to 2.35%. In the domestic equity markets, most indices are bumping around all-time highs, with the most economically sensitive sectors leading the pack.

So what are the policy assumptions driving this shift in outlook?

- First, Trump’s plan for fiscal stimulus will occur as the US economy is close to full employment, it should have a faster spillover on monetary policy. Increased fiscal spending should be supportive of higher yields.
- Second, Trump has expressed the desire to “get rid of Dodd-Frank” and more generally expressed the need to relax excessively tight regulation. While the total abolition concept has been walked back post-election, easier regulation would also be supportive of higher rates from both a macro perspective and flow perspective (less regulatory driven demand for safe assets).
- Third, a reworking of Obamacare, with an eye to make it less onerous on small business and job creation would contribute to higher GDP growth.
- Lastly, Trump has stated his intention to change the Fed’s leadership. Yellen’s current term ends early 2018. The thinking is that the new leadership would be less dovish, although that could change over time. While the repricing of monetary policy may be latest driver of higher rates to take hold, the risks are tilted towards a less dovish Fed beyond 2017.

It appears the markets are betting a release of pent-up “animal spirits,” driven by a more pro-business federal government. The extent to which that view is validated or comes up short, will determine the staying power of these moves.