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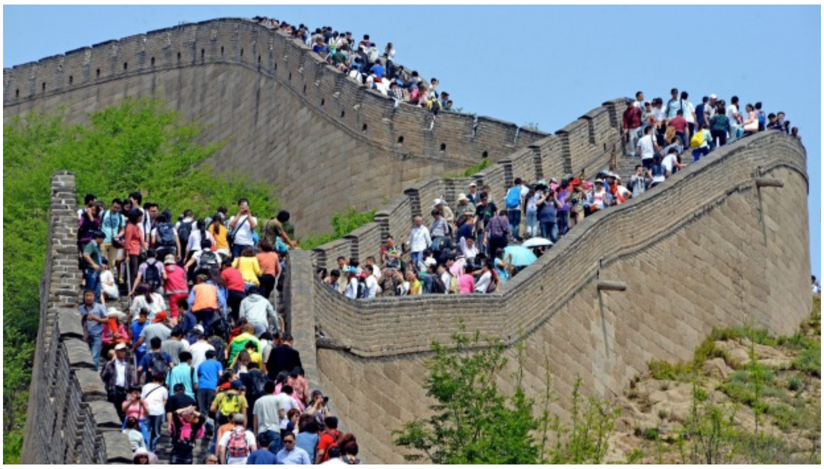
Investors need to change gear as Trump settles in to the presidency



China looks set to wear the brunt of trade policy shifts by President Trump. **Alamy**

by **James Soutter**

There are several adages often used in the investment world and since the election of President Trump, a number of these have rung true, including "buy the rumour, sell the fact" and "travelling and arriving". Both sayings are underpinned by the same principle: we hold high expectations of future events, which then turn out to be somewhat underwhelming.

Markets have rallied strongly since Donald Trump won the US election. The S&P 500 index has risen more than 9 per cent, while the Russell 2000, a widely used US small capitalisation index, is up nearly 19 per cent.

But with the inauguration comes the tipping point: tweets and off-the-cuff rhetoric need to be substantiated and policy needs to be legislated. Election promises will probably be broken. At K2 Asset Management we have analysed closely the impacts of policy changes, forecasting which sectors will most likely be the winners and losers from the shake-up in social, foreign and fiscal policies.

Protection of capital and avoiding or shorting sectors and stocks that can contribute to significant downside risk is just as important as owning the right stocks.

The Trump effect should see a shift in 2017 onwards away from monetary stimulus and quantitative easing, which has been the tide that has floated all boats, towards fiscal policy that will target certain sectors of the economy. This change should create a greater dispersion in stock returns and allow active fund managers with wider remits to create significant value.

Cyclical sectors

The rise of fiscal stimulus through increased spending and lower taxation will benefit domestically orientated cyclical sectors in the US. The largest number of companies that fall into this bracket will be in the mid and small capitalisation areas.

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Increased fiscal stimulus and lower tax rates should lead to higher interest rates and stronger economic growth. Higher interest rates, whether a direct result of Mr Trump's stimulus program or the continued winding back of quantitative easing and the "zero interest rate" policy, will have a significant negative connotation for many sectors. Although rising interest rates are positive for banks as it allows them to expand their "net interest margin", they are negative for many sectors. As per our own forecasts, the long end of the US yield curve has risen sharply, by more than 60 basis points since the election alone. The main losers from this shift are so-called long duration assets, including bonds, infrastructure, property, high-yielding stocks and companies that have been priced as proxies of this clique, including consumer staples.

Rising interest rates lead to substitution effects, with long-duration assets becoming less attractive relative to less interest-rate-sensitive areas. Meanwhile, the cost of debt will slowly increase (a major source of funding for assets such as infrastructure).

Mr Trump's shift from a free-trade agenda towards protectionist trade policies could deliver some of the largest upheavals in global stock markets.

Unintended consequences

At first glance, China looks set to wear the brunt of trade policy shifts and it has been interesting to watch Chinese President Xi Jinping at Davos warning that there are no winners from a trade war. This area of policy is probably the greatest cause of uncertainty in terms of unintended consequences. However, areas that could suffer would be those sectors of the Chinese economy that produce commodity products through cheap labour or government subsidies, with steel exporters being a prime example. That said, we are only at a point of political rhetoric and it is generally expected that the Trump protectionism policies may well be diluted.

Equity markets buoyed by fiscal stimulus and underlying growth should continue to advance. However, the world will look considerably different in four years' time under President Trump.

So investors beware.

Sectors and stocks that historically drove returns under previous governments and near zero interest rate regimes with quantitative easing are unlikely to work in the new fiscal and monetary environment that we are now entering.

James Soutter is head of global equities at K2 Asset Management

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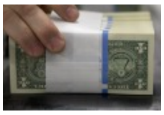

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