Australia And The New US Agenda

Donald Trump was elected as the next President of the United States on November 8, 2016. His Presidency will commence on 20 January 2017 following the traditional Inauguration Ceremony. For the first time since 2010, the party in control of the White House will also have control of the US Congress (made up of the Senate and the House of Representatives).

In this note we explore what this might mean for Australia, interest rates, the AUD and global economic activity.

Election Rhetoric v Pragmatic Policy

Without doubt, the recent US Presidential Election contained very strong rhetoric. The President-elect pledged to:

- construct a wall between the US and Mexico
- deport illegal immigrants
- contemplate of partial US debt default if conditions warranted it
- terminate some existing trade agreements
- refusal to sign the proposed Trans Pacific Partnership trade agreement and
- impose of new tariffs after accusing China of currency manipulation.

The global implications of these policies have many economists, us included, somewhat concerned regarding market uncertainty and the medium term outlook for global economic growth.

The Trump agenda, as highlighted in his acceptance speech, included large spending on public infrastructure. At the same time, a key policy is to reduce business and personal taxation. Both of these have implications for interest rates and the currency.

Also of note during the acceptance speech was a toning down of the previously aggressive rhetoric. Was this the beginning Mr. Trump's path to pragmatism? While President-elect Trump's party has control of the White House and the Congress, Mr. Trump could face opposition to the broad spending program he has outlined. Such programs require funding. Will Congress allow US debt to spiral upwards?

The battle for power in the US looks set to continue with a new set of players and new bouts of uncertainty.

Interest Rates

The judgement of debt markets on the Trump election was swift. Ten year US government bond yields rose from 1.85% to 2.07% as the election results unfolded. At the time of writing US 10 year bonds stood at 2.15%. Why the sharp increase? Because the Trump agenda implies higher debt levels – at least in the short term, as spending is ramped up at the same time as taxes are cut. There may also have been lingering concerns regarding the outside possibility of partial debt default and the prospect of greater inflationary pressures.

Whether or not long bond yields remain elevated has yet to be seen. With low unemployment, rising wages and a possible FOMC rate hike, there had been nascent upward pressure on bond yields even before the US election.

Whilst it has been said before (and proven incorrect), the potential for fixed yields to rise over the next two years is real. Serious consideration needs to be given by borrowers to interest rate risk management.

But what about the FOMC? The FOMC has been signalling its intent to lift its Fed funds rate for almost two years. It acted in December 2015 and until 7th November, looked set to lift them again in December 2016. We believe the case exists to lift the Fed funds rate but we are well aware that the Fed takes serious note of global market volatility. That said, the inflationary impact of Mr. Trump's stimulus package may support the case for further rate hikes.

The FOMC is due to meet on 13-14 December by which time the market volatility witnessed in the aftermath of the result may well have declined – leaving the way open for a Fed rate hike. The Fed fund futures market is currently pricing in an 84% probability of a US rate hike in December.

The AUD

The AUD has been remarkably resilient in the face of market volatility and the prospect of global trade tensions. Sitting behind this resilience has been firmer commodity prices and the decision by the RBA to leave its cash rate on hold since August.

A large public infrastructure spend in the US also has the potential to lift the demand for commodities down the track. Since the election, commodity prices have continued their recent surge upwards.

We expect the AUD to sit around US76 cents by end-2017 but there are upside risks to this forecast if a large Trump stimulus package sustains commodity prices or lifts them still higher.

Global Trade

As a small economy, Australia is reliant upon trade. Both China and the US are major trade partners. Mr. Trump has threatened to impose tariffs, to withdraw from trade agreements and indicated his refusal to sign the Trans Pacific Partnership (TPP) deal. This suggests that global economic growth and global trade (which is already weak) could weaken further.

US relations with Mexico could also complicate matters as both Mexico and the US adjust to the, as yet, undefined new migration and trade environment. The flow-on effects from troubles in Mexico (higher interest rates and a possible recession) could destabilise financial markets and the AUD.

Any slowdown in Chinese activity resulting from new US policies threatens the outlook for the Australian economy and the AUD.

Summary

After bouts of volatility in the aftermath of the election, share markets have been generally positive. Debt markets have sold off and yields have risen. In the short term, talk of infrastructure spending and banking de-regulation has lifted markets. What we have yet to see are solid legislative proposals. These will be important given the fiscally conservative nature of the US Congress.

US interest rates seem likely to maintain their upward trajectory. This is unlikely to impact our cash rate but will be felt at the long end of the yield curve. Stronger commodity prices, if they are maintained, should underpin the AUD but higher bond yields in the US will put downward pressure the AUD.

The short term response of markets has been positive, based on the notion of a US economic stimulus package. From an economic perspective, medium term concerns still exist regarding the implications of US trade and immigration policy.

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