After two long years, the 2016 U.S. election cycle is over and the focus now shifts to how effectively surprise winner Donald Trump can transition from campaigning to governing. While he has the advantage of a Republican-controlled Congress with which to work, in the event, many Republicans kept their distance from their party's presidential nominee. The Standish view is that the need to succeed will motivate more cooperative behavior from the President than he delivered as candidate. Otherwise, under government by grudge, financial markets would punish poor performance, supporters would squawk, and rivals would become emboldened to criticize. In addition, there are too many positions in a new administration (about 3,000 in total, of which 1,200 to 1,400 require Senate confirmation) to fill on the fly without the help of the Republican establishment.\(^1\)

This view, part prediction and part hope, is not evidently priced into financial markets. Instructive in this regard is the daily association between two financial predictions from May to late October. The plotted points at the right compare the probability of a Trump victory (gotten from the Iowa Electronic Market and measured along the horizontal axis) with the probability that the Federal Reserve raises its policy rate at its December meeting (inferred from futures trading on the Chicago Mercantile Exchange and measured along the vertical axis). Fairly reliably, an improvement in Trump's electoral fortune was accompanied by a trimming of the expectation of Fed tightening. Presumably, market participants anticipated that a Trump victory would trigger a tightening in financial conditions through a decline

\(^1\) Maeve P. Carey, “Presidential Appointments, the Senate’s Confirmation Process, and Changes Made in the 112th Congress,” Congressional Research Service, October 9, 2012.
in equity prices, a widening in risk spreads, and appreciation of the foreign exchange value
of the dollar vis-à-vis those economies likely targeted for trade sanctions. Faced with such a
tightening in market-driven financial conditions, the Fed would be less likely to add a higher
federal funds rate to the mix.

In light of this track record, the initial surprise of Trump’s victory and uncertainty around how
he might govern may initially produce a sell-off in risk assets. Unlike the short-lived market
pull-back following the UK’s vote to leave the European Union, though, uncertainty and
volatility may persist for a time. On the one hand, if Trump’s administration is slow to take
shape or if he appears more interested in settling scores with his erstwhile antagonists than
in governing, investors could roil markets by fleeing to quality. On the other hand, volatility
could diminish if Trump takes a conciliatory and pragmatic approach toward Congress, fills
his new administration with familiar faces from the George W. Bush administration and
pursues market-friendly policies.

For fixed-income investors, a crucial question is what the new administration augurs for
monetary policy and for the Federal Reserve that sets it. During the campaign, Trump
complained that the Fed had helped create a “big, fat, ugly bubble” and some reports
indicated that Fed Chair Janet Yellen would resign if a president was elected who lacked
confidence in her. Despite that talk, Standish expects Yellen to stay in office at least through
the end of her current four year term. Yellen cares about her institution and her place
in history. By resigning early, she would strip away important political insulation for her
institution and earn herself the dubious distinction of becoming only the second Fed head to
not serve a full term in the past sixty years, two things she appears loath to do. Still, the Fed
will drift in the hawkish direction over time as new governors are appointed to its board that
are more to the liking of the Republican White House and Congress.

The speed and direction other policy initiatives take will be determined by the relationship
between the new administration and the 115th congress. In 2009, the last time the same
party controlled the White House and Congress, President Obama signed the American
Recovery and Reinvestment Act stimulus program just one month after his inauguration.
This time, however, while the Republicans will control the White House and Congress, the
President, Speaker, and Majority Leader are not really on the same page about policy. If they
all recognize a need to show progress, they will make compromises to pick the low-hanging
fruit common to all involved. Fiscal stimulus will kick in quickly, with more spending on
defense and infrastructure and a restructuring of corporate taxes. The increased spending
could push inflation slightly higher. After that, expect tax reform designed by the Speaker to
be acceptable to the President to crawl forward.

Trade relationships are more problematic as there is a yawning gap between the positions
of the new President and his party’s establishment. The White House could use executive
authority to abandon ongoing global trade negotiations and backpedal on some existing
agreements. But while denunciations of NAFTA and Chinese “currency manipulation” were
some of Trump’s most powerful weapons during the campaign and he is unlikely to abandon
at least the rhetoric of opposition to many trade deals, Standish does not see these initiatives
undermining the expansion currently in place in emerging markets.

While we think that there will be more bark than bite on trade, the noise will likely prove
unsettling to those listening abroad. Some perspective on those most keenly attentive
comes from the table below, which lists the bilateral international trade exposures to the U.S.
of sixty of our trading partners. Until the new Administration settles the ship of state, market
participants will probably make sharp distinctions between the economies listed in the first
relative to the third columns.

2. As explained in the source note, these data come from the Bank for International Settlements and are based
on the sum of bilateral exports and imports with the U.S. 2011 to 2013.
In the scarred post-election political landscape, the new administration will face the challenge of governing in a polarized environment. Do not expect the passions stirred up by a lengthy and divisive campaign to settle down soon. But the direction of their actions can be gleaned from the conversation during the election, although specifics were few and far between. The table at the right gives a short summary of what we at Standish expect. On many of these items, we do not anticipate quick action, as economic policy takes a long time to change, especially regarding taxation. For now, the working assumption is that elevated uncertainty in U.S. politics or an uptick in financial market volatility should not derail continued modest global growth and relatively low levels of inflation. The advantage of pessimism is that there is less room for disappointment.

TWO LAST OBSERVATIONS.

First, Donald Trump was unconventional in his pursuit of the presidency beyond his temperament. His campaign raised less money and invested less in the infrastructure of modern politicking, including polling, focus groups, and other types of research. His victory calls into question the marginal value of all the “science” such advisors bring to the game. And that someone so far afield of the conventional herd could succeed makes it likely that future campaigns will follow his improvisations, not the scripts of the ones before.

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**Exposure to US trade (%), based on bilateral trade weights, 2011-2013**

<table>
<thead>
<tr>
<th>rank</th>
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<th>rank</th>
<th>country</th>
<th>share</th>
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<td>Russia</td>
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<tr>
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<td>Colombia</td>
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<td>45</td>
<td>Hungary</td>
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<td>46</td>
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<td>Finland</td>
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<td>Slovakia</td>
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</tr>
</tbody>
</table>


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**The likely direction of policy in a Trump Administration**

| Infrastructure spending | ▲ |
| Defense spending        | ▲ |
| Corporate taxes         | ▼ |
| Personal taxes          | ▼ |
| Financial regulation    | ▼ |
| Trade relations          | ▼ |
| Federal Reserve slant   | ► |
Second, if Tuesday’s results, piling on top of the surprise from the UK referendum on membership in the European Union, leave you suspicious of “expert” opinion and the “wisdom” of the crowd, then you are probably right. As shown below, the probability of a Trump victory inferred from the winner-take-all contract on the Iowa Electronic Market consistent traded below 40 percent for most of this year. As of this weekend, Nate Silver’s much-followed website placed the probability of the election outcome at 36 percent.3

### Probability of Presidential victory inferred from winner-take-all contracts

![Graph showing probability of presidential victory](http://tippie.biz.uiowa.edu/iem/)

Source: Iowa Electronic Markets (at http://tippie.biz.uiowa.edu/iem/)

In the event, time and chance happen to us all. Besides ratcheting up our doubts of traditional polling about divisive issues, the Brexit and Trump victories underscore the importance of incorporating nonlinearities in thinking about asset prices and putting in place plans for all contingencies.

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All investments involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing.

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