OBSERVATION

TD Economics

November 9, 2016

AMERICA HAS SPOKEN: TRUMP WILL BE PRESIDENT.... NOW WHAT?

Highlights

- Americans voted for change last night. Republican nominee Donald Trump secured 48% of the popular vote, which translated into an expected 289 of 538 Electoral College votes. Counts are ongoing. For the first time in over ten years, both Congress and the White House will be under the Republican wing.
- Markets reflected a negative knee-jerk response to a President-elect who is very much the unknown when it comes to governing. Trump has never held elected office or a high ranking public position, and campaigned on a number of hot-button issues.
- While Trump's tougher stance on trade is at odds with Congressional Republican policies, a greater degree of protectionism is on the table. Areas of common ground with Congress will likely be found on lowering taxes, replacing the Affordable Care Act and reducing government regulation.

Americans voted for change last night. On January 20th, Republican nominee Donald Trump will step into the Oval office. Trump secured 288 of 538 Electoral College votes. Republicans also retained their majority in the House of Representatives and the Senate. This is the first time in over ten years that both Congress and the White House will be under the Republican wing. That said, the popular vote in America was evenly split between Clinton and Trump, indicating that it wasn't a full sweep in sentiment and it remains to be seen how Republicans choose to bridge that divide. Early comments from President-Elect Trump appeared to extend an olive branch noting, "Now it's time for America to bind the wounds of division....I pledge to every citizen of our land that I will be president for all Americans".

A President-elect who has never held elected office or a high ranking public position, and has campaigned on a number of hot-button issues has injected uncertainty into financial markets overnight. This was telegraphed last week when market volatility spiked as the polls showed Trump gaining ground on Clinton. Before markets opened, futures on the S&P 500 had weakened significantly, but have since calmed down. With Mexico directly in the line of fire of President-elect Trump's negative trade rhetoric, the Mexican peso has fallen almost 8%, marking the largest one-day decline in two decades and a record low for the currency. The Canadian dollar held more stable, shedding roughly 1% in early morning trading. The Japanese Yen saw safety inflows from international investors.

What we witnessed in market reaction overnight was in a small way "Brexit-redux". The fear of the unknown created an initial negative knee-jerk market reaction, but ultimately no policies have been enacted. Just like with Brexit, based on Trump's policy platform and rhetoric ahead of the vote, numerous third-party economic institutions estimated that the economy would suffer both near and longer-term damage. Bleak ramifications of immigration and trade policies would overwhelm positive

2016 U.S. Election Results

Presidency	Democrats		Republicans	
Electoral College votes	218		289	
Popular vote share (%)	47.6		47.5	
Congress	**2016**	**prior**	**2016**	**prior**
Senate	47	44	51	54
House of Representatives*	191	188	236	246

Source: Office of the Clerk, U.S. House of Representatives, CNN.com, results as of 8 am EST Nov. 9th. Some races still undecided at time of writing
*Prior does not sum to 435 due to 3 vacancies

Beata Caranci, Vice President and Chief Economist, 416-982-8067
Leslie Preston, Senior Economist, 416-983-7053

economic contributors from lower marginal income and business tax rates, as well as potentially reduced regulation. But, a crucial distinction with today's market reaction relative to the Brexit referendum is that this voter outcome has occurred on domestic soil and will directly influence the path of the world's largest economy.

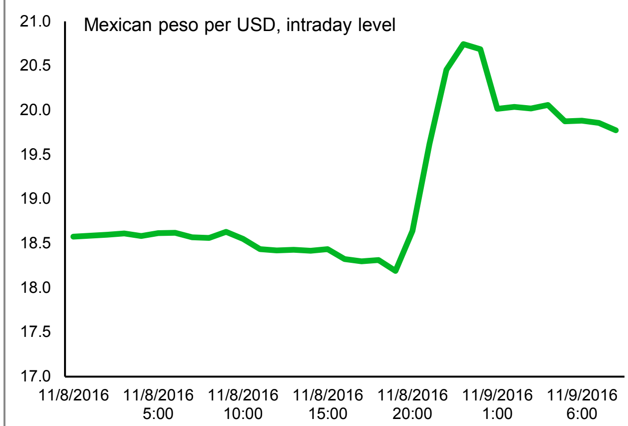
Importantly, although there will be a Republican controlled Congress, there is a difference of opinion between President-elect Trump and many Congressional Republicans on those hot-button issues. The U.S. system of checks and balances between the legislative (Congress) and executive (the President) branches of government significantly limits the power of the presidency. It is likely that Trump's agenda will be modified or toned down by Congress. But, these pieces of the puzzle are outstanding at the moment, and financial markets (and businesses) simply don't like uncertainty.

At the forefront of international concern is that President-elect Trump follows through on punitive tariffs or his threat to "immediately renegotiate" NAFTA or "withdraw from the deal". The fear of a less global America puts multinational corporations and those with significant cross-border value chains directly in the line of fire. However, President-elect Trump's campaign rhetoric is not in perfect alignment with the GOP, and the checks-and-balances of Congress will likely be hard at work. The Republican agenda (link) offers a softer tone that is quite supportive of promoting free trade, reducing the regulatory and tax burdens, and employing trade deals to level the playing field among competitors. At face-value, these policies would be pro-growth if implemented to encourage trade flows. However, these differences are ultimately at the root of financial market angst. International investors are not sure what to expect.

Negative market sentiment also reflects Trump's election rhetoric for a preference to replace Fed Chair Janet Yellen when her term expires in early 2018. This layers into the equation monetary policy uncertainty on top of economic policy uncertainty.

If the President-elect and GOP move quickly to speak in a more unified voice to reassure markets of a measured approach, clarify policy priorities, and/or appoint an experienced and more moderate cabinet, markets would likely be calmed. Should there be a persistence of market volatility and tightening of financial conditions, it would certainly sideline a rate hike in December where the odds were sitting at 80% prior to the election results. The Federal Reserve won't pass judgment on government policies that have yet to be known, but they will evaluate financial market conditions and business sentiment for what they are. We have seen this before. In the summer of 2015, market odds of a Fed rate hike fell from 73% to 46% when financial market confidence was shaken by the unexpected revaluation of the Chinese Yuan. Likewise, sentiment towards a rate hike over this past summer was reduced when market turmoil followed the UK referendum results. So, there is every expectation that the Fed will be responsive to the evolution of market conditions ahead of their December 14th meeting.

CHART 1: MEXICAN PESO PLUNGES ON TRUMP WIN



Source: Bloomberg, TD Economics. As of November 9 at 8:30.

Common ground – lower taxes, repeal Obamacare

Looking past the near-term, what might policy look like once the new government sits? On paper it would seem that the new Republican President should have minimal trouble implementing his agenda with a Republican Congress, but as we noted earlier, many of Trump's policy plans do not square with traditional Republican stances, most notably being pro free trade. However, given that anti-trade sentiment was a key pillar to winning the election, some common ground will likely be struck. Areas of greater alignment between Congressional Republicans and a Trump White House are to be found on repealing the Affordable Care Act, restructuring the tax code and reducing federal regulations.

On taxes, during the campaign, Trump revised his tax cut plan to be more in line with that put forward by House Republicans, therefore a compromise is likely to be reached on lower taxes on a variety of fronts. Both plans by President-elect Trump and House Republicans reduce the number of personal income tax rates to three from seven, sport lower marginal rates and eliminate the alternative minimum tax. Although the level of income tax brackets varies, this is relatively low hanging fruit for compromise. Common ground could also be found on lowering corporate tax rates (Trump's plan is to lower from 35% to 15%, while House GOP's plan lowers to 20%) and some kind of elimination of the estate tax.

Details on policies to lower taxes and expenditures are known from the Republican platforms, but far less is provided on how these initiatives would be funded to ensure a balanced budget under the resulting reduced revenue profile. This adds yet another unknown variable into the equation and is likely why 10-year Treasuries sold off strongly this morning. Yields have risen by about 10 basis points, as international investors brace for the possibility of higher debt levels and potentially higher inflation.

Two of the biggest policy priorities in the campaign were trade and immigration. It is likely Trump could put his anti-trade stance into action, pursuing a renegotiation of NAFTA. It is unclear how a new trade agreement would differ from the current one, but given the asymmetric nature of the relationship between the U.S. and its smaller North American neighbors, Canada and Mexico would likely be placed into a position to renegotiate. Hence, the decline of their currencies this morning via market reaction. On immigration, even if Trump is not able to achieve the deportations promised, there would likely be a tougher stance on border security and immigration screening, along with increased deportations. These actions would risk crimping labor force growth, and hence growth in the economy over the medium term.

Canada caught in protectionist cross-fire

Canada was not the focus of Trump's anti-trade rhetoric during the campaign, but as a member of NAFTA, if the President-Elect pursues renegotiation, it will cause a great deal of uncertainty for the $51 billion in goods that cross the border every month. Moreover, a potential trade war with another country, like China, would increase uncertainty and reduce global and U.S. growth and this would have negative knock-on effects for Canada.

One small positive for Canada is that Trump has indicated he would approve the Keystone XL pipeline, enabling Canada to export more crude oil into the U.S. market. Trump has also talked about how "American energy dominance will be declared a strategic economic and foreign policy goal", which may worry some Canadian producers that imports would be disadvantaged versus domestic production. However, while the U.S. has made significant strides in reducing its dependence on foreign oil in recent years, domestic production could not be ramped up fast enough to fill the gap, and imports from Canada would likely be viewed as the most acceptable foreign source. Between the positives and negatives on trade, if NAFTA was negated, it could hamper many oil-services related exports from Canada to the U.S., potentially swamping any benefits from approving Keystone XL.

The Bottom line

What will be important from here to maintain market calm is that President-elect Trump clarifies the early priorities and his transition team. If the focus is on tax cuts and pr-growth policies, this should lead to a reassuring, positive market response. However, in the event of a persistence of market uncertainty, the Fed will likely have to take a pass at raising interest rates in December. Any adjustments to our near-term economic growth in our upcoming December forecast will solely reflect observed embedded risk premium in the market and estimations of feed through effects to business and foreign confidence. Adjustments to the forecast on policy initiatives would be incorporated as information is solidified on this front.

Beata Caranci, Chief Economist
416-982-8067

Leslie Preston, Senior Economist
416-983-7053