THE
Envestnet Edge
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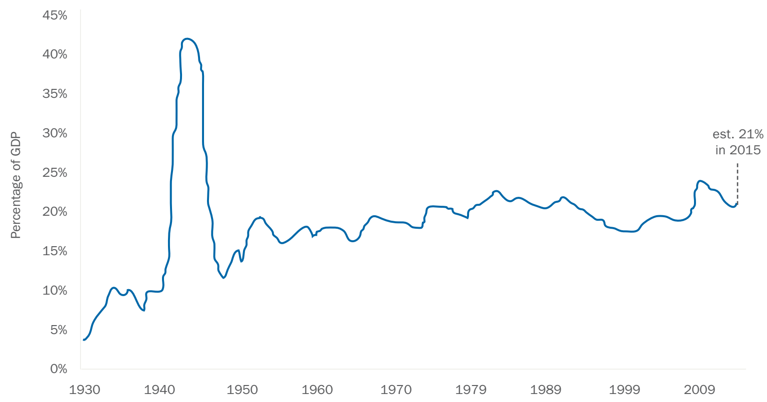
Investing in Trump's Economy? Proceed With Caution

As investors are tempted to invest in response to the new administration's policies, this month, we compare the positive areas that could have strong impacts on the economy with those that could prove more problematic. We caution against making reactive investment decisions based on speculation and momentum in favor of waiting to see what Congress actually passes.

Judging from the past weeks, we are in for a considerable period of time when news of the new Trump administration dominates public commentary. Now that the waiting is over and Trump has actually assumed office, the daily desiderata of news and commentary is likely to revolve around decisions made and actions taken, rather than on speculation about what those actions and decisions might be. Investors, however, would be well advised not to make major decisions in reaction to what emanates from Washington and the White House. That is true at all times, but given the passions roiling around this new regime in the nation's capital, it is especially true now.

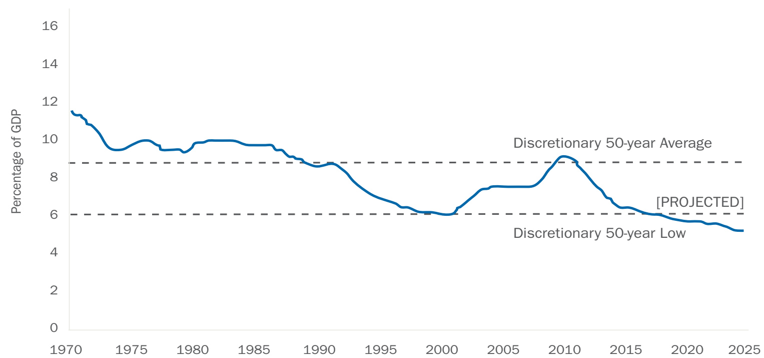
First, it's vital to keep Washington in perspective. What happens in the Beltway matters, but judging from the news and commentary that is saturated with all things Trump, one would think that the fate of the US economy and markets depends entirely on what decisions get made in Washington in the coming months. That is simply false. The federal government is a healthy chunk of the $17 trillion economy, but still represents less than a quarter of it (Figure 1). And of that quarter, much of the money spent by government would be spent by other players if the government did not. If the federal government didn't pay for roads, state taxes would be raised to do so, and much

Figure 1:
Federal Spending % of U.S. GDP



Source: Office of Management and Budget (OMB) via National Priorities Project.

Figure 2:
Discretionary Spending % of U.S. GDP



Source: Congressional Budget Office via FirstBudget.org

of government spending on healthcare would be spent by others. Washington surely matters, but it is hardly the alpha and the omega it is often seen to be.

In addition, much of what is currently debated is simply words and noise, and until actual policy is clear, reacting to the noise is a poor investment strategy. Think of the first orders issued by the Trump administration, to work towards the replacement of Obamacare and the renegotiation of the NAFTA trade accord with Mexico and Canada. It would be easy to extrapolate market consequences of such moves, and buy or sell the stocks of various healthcare and manufacturing companies accordingly, or underweight/ overweight those sectors. Indeed, many traders and algorithms do just that. For the vast bulk of investors, however, such moves are a combination of speculation and momentum, which rarely works as a long-term strategy.

So what to do?

We see at least five areas of emerging policy that investors should monitor. Three of those could be quite good for markets over the longer term, and two are murkier and potentially negative, especially in the near term. The most dramatic impacts are likely to be on domestic equities, but to the degree that they could also impact the value of the dollar, there could be strong effects on both earnings of companies that sell abroad and on global interest rates.

The good (maybe)

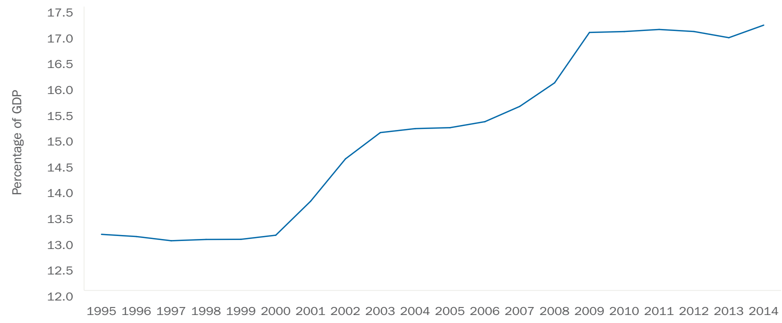
The three areas where initial policy could be seen as a strong positive for markets are deregulation, tax reform, and infrastructure spending.

On the first full Monday of his presidency, Trump let it be known that he was fully committed to a regulatory overhaul of the federal government, suggesting that his administration might review and retire up to 75% of existing rules. It's unlikely to be that extensive, but given that regulation unchecked grows like garden weeds, some pruning could only do the American economy some good. This is especially true in the financial space, where multiple agencies oversee the same businesses, and banks are subject to layers, not just of regulation, but of regulators. Obviously, some regulation is essential, but the goal should be smarter regulation. Regardless of whether the Trump administration moves cautiously or precipitously, it's relatively clear that markets and financial market actors will view some deregulation as a positive that, in turn, could unlock a modest amount of optimism and animal spirits needed to invest and spend for the future.

Tax reform is another area that everyone seems to agree is needed, and yet one on which no one in Washington has been able to agree. The initial focus of the new Congress and White House is on lowering the corporate tax rate from its current 35%, which is far higher than most comparable countries, and which in many cases goes uncollected, as companies keep foreign profits domiciled abroad to avoid paying that tax. The argument is that a government collecting 10%-15% will still garner more revenue than an uncollected 35%, and that a more competitive tax code will not just raise more revenue but encourage companies to re-invest profits in the United States. It's unclear whether that will, in fact, happen, or whether companies will continue to hoard cash. But here as well, markets are likely to respond positively to corporate tax reform, both in terms of rising equity prices and more bond issuance for domestic spending.

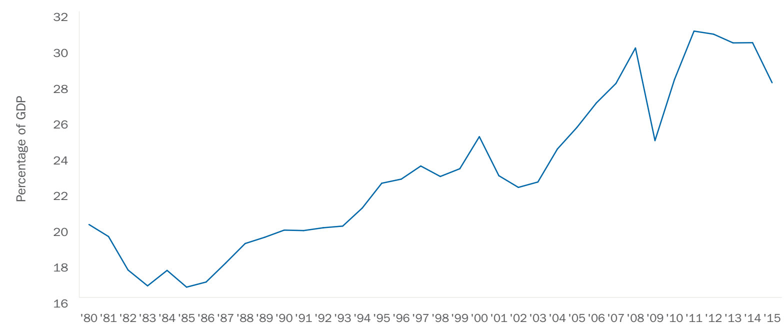
Finally, infrastructure spending is likely to be seen as a market positive. Markets could (and since November already have) interpret such spending as inflationary and hence push interest rates higher. But the prospect of up to $1 trillion in additional spending—whether in the form of direct Congressional appropriations (unlikely) or public-private partnership incentives (more likely)—is clearly a positive both for a variety of companies that would directly benefit and for economic activity in general. The short-term stimulus of better bridge, roads, and airports is dwarfed by the longer-term benefits of the efficiencies that better infrastructure creates. From equities boosted to more municipal bond issuance, such spending will be seen as a clear positive.

Figure 3:
Healthcare Spending % of U.S. GDP



Source: World Bank.

Figure 4:
Trade % of U.S. GDP



Source: World Bank.

The not-so-good

Two other policy areas are likely to generate more negative headlines and more problematic fundamentals: healthcare reform and trade negotiations.

Healthcare is close to 20% of aggregate spending in the United States (Figure 3). The Affordable Care Act (Obamacare), whether you love or hate it, has become the primary legislation governing insurance and disbursement of healthcare, other than Medicare and Medicaid. Any plan to repeal or dramatically change it will create some turmoil as the industry struggles to adjust. Some players will inevitably lose, while others will benefit, and healthcare-related market segments are likely to gyrate wildly, either on rumor or on actual new legislation and regulation. The proverbial dust will eventually settle, but in the interim, healthcare reform is more likely a market negative than a positive.

The Trump team has taken an aggressive stance on trade, pulling out of the Trans-Pacific Partnership, announcing an intention to renegotiate NAFTA, taking a stern line on China and currency valuation, and speaking of protectionism and tariffs as possible policy options. The intent is clearly to align trade agreements with the demands and needs of domestic US companies and job creation, but hard stances can have hard consequences.

Several members of the administration seem willing to launch trade wars, limited perhaps to China and Mexico, if negotiations fail. Even if that doesn't happen, the rhetoric is likely to be heated in the months ahead, and that alone can spook market participants to hold more cash and think more short term. It can also spook companies, leading them to hold more cash until it is clear what the trade and tariff regime will be.

The final negative, of course, is unexpected political crises, whether international or domestic. That can happen in any administration or at any time, but with a less-experienced team with more ambitions, the risk here is perhaps greater than usual. It is also almost impossible to position against, and here especially, there is no simple or even complex investing strategy that effectively protects from that risk.

Keep calm, carry on

If ever there were a time to try to filter out the noise, now is it. Sharp market reactions to news could create some buying opportunities if they are clearly anticipatory rather than reactions to actual policies. The rapid decline in long-term bond prices in November was a response solely to the *expectation* that Trump's policies would be inflationary and lead to more economic growth. Until there are actual policies that then are passed into law by Congress, such moves are speculative. That doesn't mean they are wrong, just that investors thinking of the longer term might wish to use market volatility (when it is volatility triggered solely by expectation rather than fact) to add to existing strategies or adjust.

For the most part, however, it's vital to keep some perspective: Washington is *one* economic actor in a vast and complicated system, and not *the only* economic actor. What happens over the coming months will matter more to some sectors than others, and some changes have the potential to be more positive than others. Wait until the policies are actual rather than rumored, however, to make any substantial decisions.

January Takeaway:

Heated rhetoric in Washington points to the need to maintain perspective, rather than let speculation and momentum drive investment decisions. Some policies will bring positive benefits. Deregulation, making it easier for businesses to operate, tax reform that raises revenue collected and encourages corporate reinvestment, and infrastructure spending to build better bridges, roads, and airports and improve efficiencies, are among them. However, healthcare reform may create initial turmoil, and tough stances from trade negotiations may have hard consequences, as investors and companies hoard cash until clarity unfolds. Investors can take advantage of interim volatility for buying opportunities and making portfolio adjustments, but would do well to wait and see what policies are enacted before making long-term decisions.

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