Now what for markets?

We may have a rocky road ahead as markets react to the unexpected election results and uncertainty.

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Market Volatility Stocks

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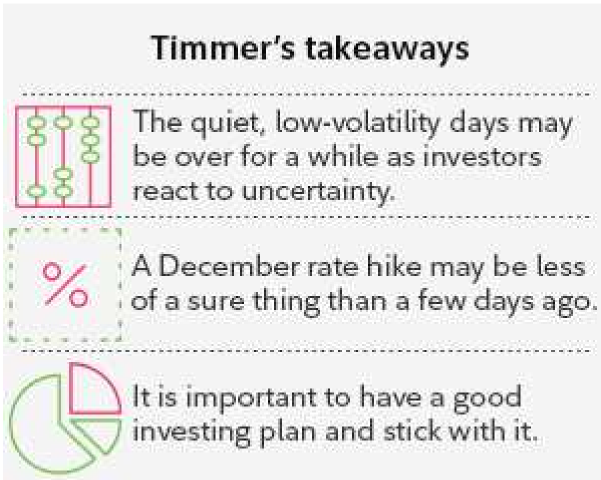
Looking at the election strictly through the lens of the financial markets, I have always viewed the presidential race as a choice between a “low-vol” candidate—one who would maintain the status quo—and a “high-vol” candidate—one who promises massive change and would upset the status quo more than the other candidate would aim to preserve it.



Now after a stunning upset, we have the high-vol candidate as our president-elect. And with that outcome comes Republican control of the House and Senate, which suggests that many of the claims and promises that were made could actually be implemented.

What does it mean for investors? With change comes uncertainty, and if we know one thing about the markets, it’s that investors don’t like uncertainty. And that’s what we have for now, as we wait for the president-elect to take office and announce his cabinet and policy specifics. So, it is not a surprise to me to see the market futures sell off on election night, but reverse those overnight losses the day after the election.

Markets pricing in uncertainty

Greater uncertainty by definition reflects a wider range of outcomes, and that requires a higher risk premium for stocks. A higher risk premium means a lower price-to-earnings (P/E) ratio. So, when I see the market trade lower, I view that more as a manifestation of investors repricing the uncertainty premium rather than as commentary on President-Elect Donald Trump’s economic policies and their impact on the markets.

And there is considerably uncertainty, of course. Will the new administration cut taxes, move towards greater fiscal stimulus, cut regulations, and repatriate the $2 trillion in corporate cash idling abroad? Is it sort of a Reaganomics 2.0? If so, this could jump-start the economy out of secular stagnation, and that would be bullish for growth. If nominal growth starts to accelerate, that should be bullish for earnings and stock prices (even if it comes at a lower P/E multiple). But if the above comes with increased protectionism through tariffs on goods imported from China and Mexico, then what the market stands to gain on the one hand might be given back on the other.

At this point, the answer is unclear, which is why the market is likely to demand a higher uncertainty premium. But to me, this election outcome does not have to be seen as a one-way ticket lower for stocks. It could just as easily be the opposite. But one thing is certain in my mind—there will be twists and turns along the way. The quiet low-volatility days are probably over for a while.

Shift to fiscal policy

The other implication to me is that we will likely see the policy baton being passed from monetary policy to fiscal policy. As we have so clearly seen since the financial crisis, monetary policy has its limits when interest rates are this low. This is, in part, because the stimulus stays trapped in the financial system (the excess reserves that are generated through quantitative easing (QE) remain trapped on bank balance sheets and therefore don't make it into the real economy). But it is also because the benefits of zero rates and QE—via the so-called wealth effect—have not accrued evenly across the population. After all, not everyone owns investments.

A greater emphasis on fiscal stimulus could very well lead to more growth (if done in such a way that it creates a multiplier effect), and it could also lead to more inflation. But for now, in my personal view, a December rate hike is once again far from a done deal. Beyond December, it will be important to determine to what degree the Federal Reserve will aim to "sterilize" fiscal stimulus with offsetting rate hikes.

Stick with a good plan

So what should investors do with this renewed uncertainty and greater volatility? My answer is always the same: Have a good investing plan and stick with it. If your plan makes sense, stick with it and don't be that person who sells at the bottom. If your plan isn't where it should be, take advantage of the market's likely gyration to rebalance.

We will probably have a rocky road ahead, but I am not in the camp that thinks this election outcome is a one-way ticket to a bear market.

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