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UPDATE

The Stock Market and the Implications of Trump's Election

The March edition of *SFI's Practitioner Roundups* revealed how the election of Donald Trump affected the US stock market until year-end 2016. Now that Trump reached the 100 day-mark it's time to reflect on the past and take a look ahead.

The election of Donald J. Trump as the 45th President of the United States of America on 8 November 2016 surprised most observers. On the morning of Election Day, Trump's chances were 17 percent with Betfair and 28 percent with 538Silver. Such low odds on a Trump victory, combined with the significant policy differences between the two candidates, led to substantial reactions from financial markets. Such reactions can be used to infer markets' assessment of relative winners and losers, both immediately after the result and as details of the new administration's policies emerge. Specifically, if the market responds optimally to a surprise, the change in the market price of any asset will reflect both the difference in its expected discounted future payoff between the two possible outcomes and the pre-event probability of the outcome.

> "How stock prices reacted to the result says a great deal about shifts in investor expectations regarding growth, taxes, and trade policy."

Capitalizing on this insight, three authors including SFI's Alexander Wagner investigate the differential performance of Russell 3000 stocks from the day after the election through year-end 2016 and on to mid-March 2017. The reaction of company stock prices to the election result reflects shifts in investor expectations with regard to economic growth, taxes, and trade policy. This information is useful for investors as well as for corporate decision-makers who are grappling with how they should prepare for the new administration's upcoming policies.

Three of the main findings of the paper are as follows: First, even after controlling for the rally in the broad market, until year-end several low-beta industries (beer, tobacco, food products, and utilities) were among the losers, while cyclical industries tended to be winners. Presumably, expectations of higher growth initially induced investors to rotate from low-risk to high-beta industries. However, the cumulative abnormal returns for several high-beta industries have reversed since the end of the year. For example, printing, steel, transportation, textiles, and precious metals, which did well through year-end, underperformed the market since then. Thus, expectations regarding economic growth appear to have softened somewhat.

Second, while the details of any future tax plan remain hazy, it is clear that President Trump wants to cut corporate taxes to significantly below their current 35 percent level. Had Hillary Clinton won the election, corporate taxes might well have been trimmed, but not cut to nearly the level that Trump has proposed, (and reiterated on April 26), namely 15 percent. The paper's analysis reveals that expectations of signifi-

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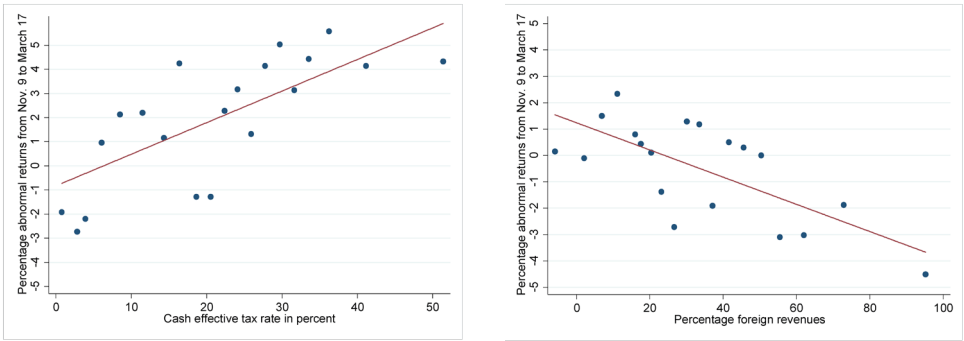
cant corporate tax cuts boosted high-tax firms, but hurt firms with significant net operating loss carryforward balances. Interestingly, a substantial portion of the overall tax-related reaction was already reflected in stock prices from day one after the election

Third, how did the market vote on predominantly domestic stocks versus those substantially oriented to the world economy? There are several expectations with regard to policy that suggest that stocks with a domestic focus should have fared better. First, market participants may simply have higher expectations for US growth versus foreign growth. Second, such stocks are less at risk from trade wars that involve retaliation by other countries. Third, Trump's infrastructure plan would naturally benefit domestically focused firms. Fourth, Trump's expansionist fiscal policies, particularly severe cuts in taxes, should foster inflation. Domestic profits would increase; exports would be hurt. On the other hand, some have argued that the VAT flavor of the House Republicans' tax plan will help make US companies more competitive abroad. If so, that would relatively favor internationally oriented stocks. These stocks might also benefit from new lower tax rates on repatriation of earnings currently stashed away abroad. Overall, the stock market's reaction until mid-March 2017 implies clearly negative expectations regarding the anticipated policies' impact on internationally oriented US firms.

> "The stock market can tell us something about the future for internationally facing US enterprises."

The figure below illustrates these findings. Here, all stocks are sorted into 20 equal-sized bins by their cash effective tax rate (left panel) and foreign revenues (right panel). The effects are sizable. For example, comparing two otherwise similar firms, the one that had a one standard deviation higher cash effective tax rate than the other had a 1.8 percentage point higher cumulative abnormal return through mid-March 2017. A one standard deviation higher fraction of foreign revenues implied 1.9 percentage points lower abnormal returns.



Binned scatter plot of cash effective tax rate (left panel) and percentage foreign revenues (right panel) against abnormal returns (that is, returns adjusted for exposure to the overall market) of Russell 3000 firms from November 9, 2016 to March 17, 2017 (Source: Wagner, Zeckhauser, and Ziegler (2017)).

> "Significant policy surprises, and significant changes in company stock prices, lurk in the near- and not-so-near-term future."

It is important to stress that all of these responses were based on investor conjectures at a given point in time. Substantial new information will unfold as Trump's presidency progresses, and expectations regarding policies and their effects on company fortunes may well reverse themselves. As the example of high- and low-beta stocks illustrates, investors can revise their assessment of a firm's or industry's prospects swiftly. A substantial portion of the market's rally to date seems to have been driven by expectations of higher after-tax earnings. Looking ahead, should investors become skeptical of the tax plan's prospects, the market may quickly react negatively.

Whatever one's politics, the 100 days of Trump's presidency mean that at least one prediction can be made with some confidence: significant policy surprises, and significant changes in company stock prices, lurk in the near- and not-so-near-term future.

The full paper can be found at http://bit.ly/2mhBFbF.

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