Market Volatility and a New President

SOME HISTORICAL PERSPECTIVES

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With the election decided, the burning question now is, “What next?” And as “unprecedented” as the 2016 US Presidential election may have been, there are at least some precedents to which we can point for insights into what may now lie ahead. Granted, the economic impact of policies introduced by Donald Trump will not be seen for many months or years. Nevertheless, we can look to other market events to get an idea of what we might expect in equity and currency markets over the near term, while the markets are still absorbing the news.

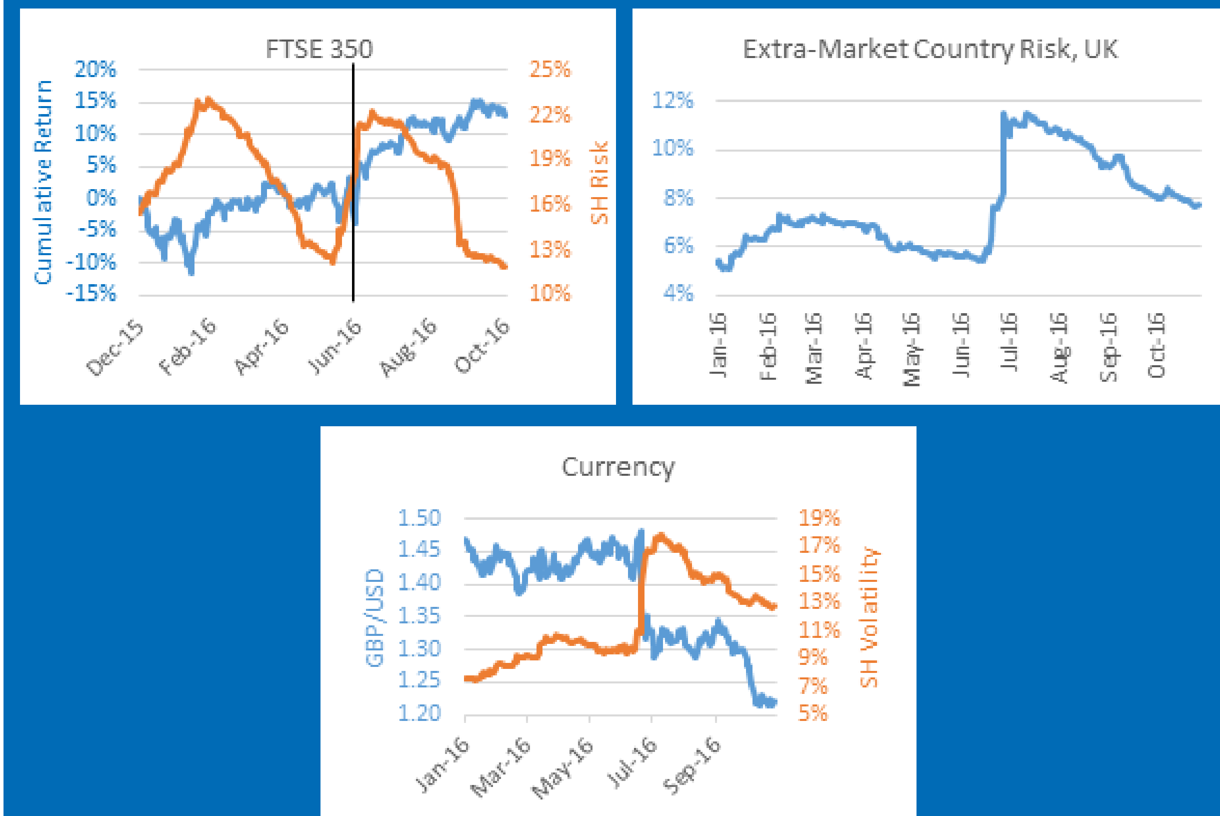
Our first comparison comes from the Brexit vote. While predictions seemed to lean toward “Remain,” British voters surprised the pollsters and pundits by voting to leave the European Union. Parallels between the Brexit surprise and the Trump candidacy were frequently drawn by Trump’s team prior to the vote, and by many others since.

In the US market, the initial overnight reaction to Trump’s victory was a plunge in equity futures prices. However, by the time US markets opened Wednesday morning, the fear seems to have dissipated. As of this writing, the Dow, fueled by the banks, has flirted with new highs. In contrast, the UK market fell for a few days on the heels of the Brexit vote. From a risk perspective, the risk of the FTSE 350 jumped from 16.7% immediately pre-vote to a near-term high of 22.3% 13 days later. As we have observed and written about, risk for the FTSE 350—and for most other markets—started to decline at that point, and by the end of October reached a level lower than it had been for at least a year. At the same time, the UK’s extra-market risk (risk over and above that of the other risk factors, including market risk, based on Axioma’s Worldwide model) also dropped, but has not yet reached the level seen before the vote. In other words, the UK market remained “more different” from the global market than it had been prior to the vote.

As the British pound fell in the immediate aftermath of the Brexit vote, its volatility soared from 9% to more than 17%, its highest level in more than seven years and just below the 17-year peak of the Global Financial Crisis. As we noted for the UK’s extra-market risk, the volatility of the pound has come down from that unusually high level, but it has not fully recovered and remains well above its average level.

From this example, we might conclude that even in advance of Trump taking office we may see heightened volatility in the US market and volatility of the dollar relative to other reserve currencies, as his choices around staffing, priorities and policies come into better focus.

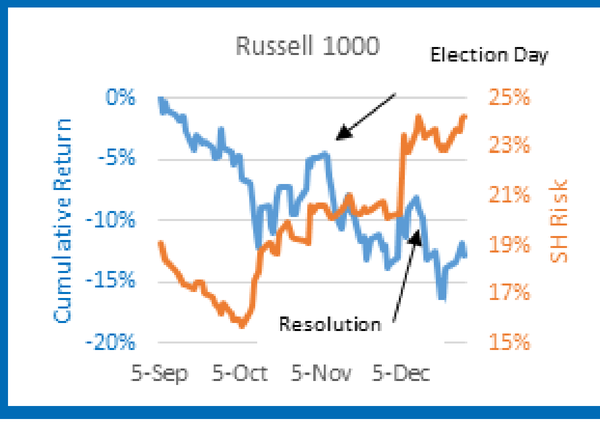
Figure 1. FTSE 350 and GBP Returns and Volatilities in the Period Surrounding the Brexit Vote



Our next example is the 2000 US election, when the outcome remained uncertain for several weeks until the US Supreme Court ruled in Bush's favor. That period of uncertainty parallels at least to some degree the uncertainty surrounding Trump's next steps.

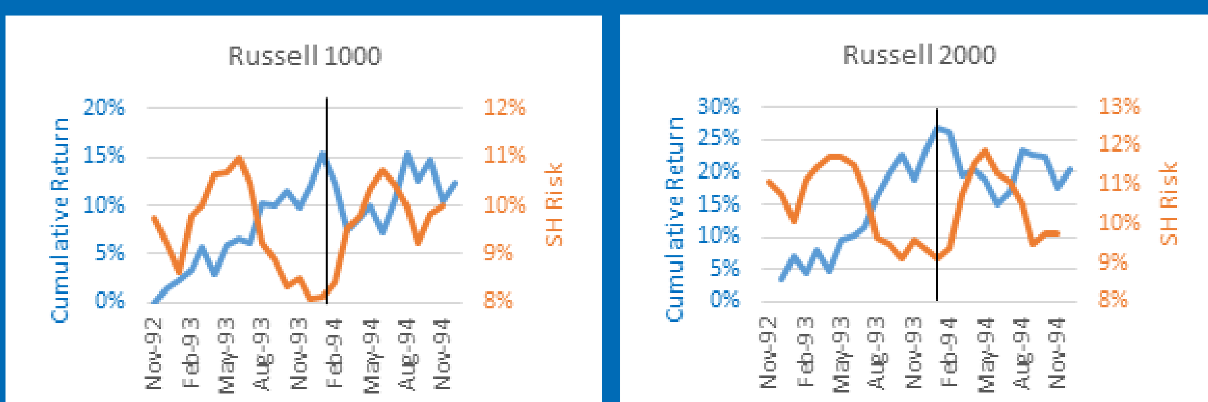
In the period between Election Day and the Supreme Court's decision, the US market (as measured by the Russell 100) fell about 9%, recovered a bit, and then plunged another 7% or so over the next few weeks. Risk for the Russell 1000—which had already been rising as the market fell in the month before the election—jumped, and remained choppy and somewhat elevated for quite a few more months.

Figure 2. US Market Performance and Volatility Around the Bush vs. Gore Election and Recount



Finally, as trade is one of the issues Trump is expected to address early on, our last set of charts looks at US market performance and volatility in the period surrounding the NAFTA agreement in January 1994. The market had been rising fairly steadily for at least a year prior to NAFTA taking effect—presumably it was being discussed and the market's moves reflected its expected impact, along with numerous other things the market was taking into account. The impact was bigger on Russell 2000 stocks than on the Russell 1000, but both indices did well. Risk started to fall in May 1993, and then bottomed out at the point the agreement took effect, when there was also a sharp plunge in equities. Equity prices did not really start to recover until May 1994. This suggests to us that we may see market volatility related to Trump's trade policies, once we see the extent of what he plans to do.

Figure 3. US Market Performance and Volatility in the Period Surrounding the NAFTA agreement in January 1994



The two examples of vote-related surprises and associated market movements and volatilities, along with the example of how the market may view one of Trump's signature issues, are hardly comprehensive indicators of what we might see in markets over the next few months. And, of course, the economic impact of trade and other policies may not be known for months or years. But we believe the uncertainty and associated market volatility we have seen in the past may well come to pass again, and market volatility may become the order of the day, as the US transitions to a substantially different style of administration from the past eight years and new policies are put into place.

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