Investing post-Trump: Putting the 'alt' into Alt-Right

Duncan Sankey, partner and head of credit research at Cheyne Capital, highlights a number of portfolio shifts since November's US election

The Art of the Deal, which Trump wrote (or, at least, inspired) in 1987, alluded to the 'concept' of "truthful hyperbole", which it characterises as "a very effective form of promotion." (Indeed, Trump's description of the volume as the "no.1 selling business book of all time" provides a self-referential illustration).

Developments since November 8 attest its efficacy. Since Trump became president-elect, the US index of investment-grade credit has tightened significantly and the S&P 500 and Dow have scaled all-time highs, while consumer sentiment has been jolted out of two-year doldrums.

This bull run is not based on any formal policy statements but more on a Twitterstorm of boosterism; rarely have 140 characters (or frequently fewer) had such a profound impact. But are we justified in pricing in such good news?

Although not directly related to the economy, Trump's recent and very public contre-temps with the courts over his proposed travel ban cast into sharp relief the limitations of his executive power.

No amount of virtual foot-stamping will enable him to circumvent the US constitution, whose guardians are less swayed by 'truthful hyperbole'. Thus, the wholesale deregulation that he has promised might well fall foul of states' rights, where federal pre-emption is not already clearly established.

Fiscal stimulus that is not revenue-neutral is unlikely to find favour with the budgetary hawks among the Republican legislators, whose concurrence he will need to pass it. Even tax reform, which enjoys a degree of bi-partisan support, will require a good deal of horse-trading over the individual provisions. So, for assets to extend their post-Trump rally, we will need the administration to prioritise policy design over populism and collaboration over cavilling. If not, market expectations of what Trump can actually achieve are probably overly optimistic.

Meanwhile, investors seem to have become inured to the storm clouds gathering elsewhere. Some of these have drawn energy from Trump's victory, most notably the resurgence of protectionism and the potential for a trade war with China amongst others, which could trigger a day of reckoning for China's enormous corporate debt burden.

In Europe, Trump's success has given oxygen to populist campaigns. Although consensus suggests that Marine Le Pen will fail at the second round of the French presidential elections, the fall from grace of the mainstream right candidate, François Fillon, has introduced fresh uncertainty.

Moreover, a tie-up between the two candidates of the left, Benoît Hamon and Jean-Luc Mélenchon, could pave the way for a Le Pen victory, which would raise the possibility of a referendum on Frexit from the EU and the Euro. This would precipitate an overnight depreciation of the redenominated currency with asymmetric fallout for bondholders. We have already seen a minor repricing of French credit (with names like EDF, Veolia and Engie widening over the last few weeks).

Buying CDS on such names will likely be seen as a hedge for political risk. Trump's granting an early audience to hard-line Brexiteers, Farage and Gove, has encouraged those wanting the UK government to sunder existing trading relationships with the EU. And Trumps's influence over the IMF (given that the US is the largest shareholder) will probably not bode well for consensus with the Eurozone over the Greek bailout, which could spell more aggro for peripherals. Spreads currently synthesize few of these risks.

As managers of leveraged credit, we know that, as long as we do not suffer defaults or face a forced deleveraging, our returns are pretty much locked in, mark-to-market volatility notwithstanding.

We are also aware that a market-wide disruption offers a great opportunity to add the credits we like at much more favourable – even distressed – levels and significantly boost returns. However, in order to do so, we need to keep our powder dry, which argues for a focus on conservatism and liquidity. The Trump rally has seen a 50bps-plus narrowing in the basis between European IG and crossover spreads, leaving sub-investment grade credit vulnerable to a violent decompression if risk aversion re-emerges.

> "A review by Trump's administration of Dodd-Frank and the Volcker rule could [...] ease bond market illiquidity"

We have therefore dialled down our exposure on this sector of our credit universe in favour of solidly IG names. In the US, these will enjoy a technical benefit from foreign buying as a yield-enhancing alternative to Treasuries, despite financing and hedging costs.

We also maintain very limited exposure to peripherals, with a focus on those names that enjoy multinational, multi-currency earnings streams and we maintain a long-standing underweight in Eurozone banks, in which structural constraints on profitability, politicised regulation and opacity surrounding asset performance do not redound well on the sector.

Liquidity is also a key concern. Paradoxically, a review by Trump's administration of Dodd-Frank and the Volcker rule, could, if it eased risk-weighted capital requirements on holding bonds and allowed more leeway to prop desks, ease bond market illiquidity.

For the time being, however, we are confronted with a bond market that has experienced unprecedented (or is that unpresidented?) primary issuance but has little scope to provide secondary market liquidity. In addition, the growth of foreign investors, bond market mutual funds and ETFs as buyers of credit (over the traditionally sticky life assurers, P&C insurers and pension funds) has added to the fickleness of the investor base. The scene these developments set are that of a very crowded theatre, most of the exits from which have been blocked. Better hope nobody shouts 'fire'.

This situation makes us nervous of cash markets generally and HY bonds in particular. (We had a dry run of what a rout might look like in January/February last year – it wasn't pretty). We prefer to access credit exposure through CDS, which as a standardised instrument (compared to bonds with their different currencies, covenant structures and maturity dates) channels liquidity through a single contract for any given maturity and is thus a much more liquid vehicle for taking exposure to IG credit. This has proven particularly true in cases of idiosyncratic distress (Portugal Telecom, VW, Deutsche Bank), in which liquidity in CDS has far surpassed that in cash.

As for what might trigger a rout in cash bonds, a resurgence in rates is certainly in the cross-hairs. After an initial post-election spike, which wiped trillions off the value of global bond markets, 10-year Treasuries have traded in a 15-20bps range. (Although, if Yellen assumes a hawkish tone in her semi-annual testimony to Congress this week, we could see a break-out).

Yet a confluence of US fiscal stimulus with a diminishing foreign appetite for US government debt could send rates higher. Foreign holdings account for about 43% of the US government debt market. 2016 saw a reduction in foreign holdings of $201.9bn compared to $11.5bn in 2015 and inflows in every other year going back to the turn of the century (peaking at $750.5bn in 2010).

Given the magnitude of total foreign holdings of Uncle Sam's debt (about $6trn), the significance of a $200bn outflow should not be over-egged. Nor is it necessarily all a response to Trump's liverish lashings on trade, currency manipulation and foreign relations; in the case of China, it reflects currency defence combined with capital flight. Moreover, a foreign flight-induced rout would hurt the very foreign investors who would be trying to exit. That said, if foreign investors perceive that the US rate cycle is turning, it would make sense for them to try to reduce holdings or at least not add to their net position.

Should Trump pursue an aggressive fiscal policy (again, we are far from convinced that Congress would acquiesce to proposals that compromised revenue-neutrality), it could fuel further increases in Treasury yields.

Lest we lose sight of historical context, the current bull market is the third-longest in terms of duration and second-most profound in terms of the decline in rates over the last 800 years! There is plenty of room for normalisation, which should be a concern for anybody attempting to eke out some extra return from extending duration. And, yes, Trump's twilight Tweets are only likely to fuel volatility.

> "Investors are better placed leveraging synthetic exposure to investment grade than ploughing cash into HY or more esoteric asset classes"

Again, we advocate use of CDS, which have no direct exposure to rates. These instruments enable investors to disaggregate rate risk, which could prove capital-destructive, while taking exposure to investment-grade corporate credit spreads, which still offer a compelling risk-reward trade-off.

At current spreads, the European index of investment-grade corporate credit is pricing in a five-year cumulative default rate of just under 6% -- over five times the average realised cumulative default rate of any five-year cohort from 1970-2015 and nearly three times the worst.

We do not see the same compelling dislocation in HY valuations despite the fact that the QE-driven tsunami of money that has poured into HY has driven up leverage in the sector and undermined underwriting standards.

In the current environment, we think investors are better placed leveraging synthetic exposure to investment grade than ploughing cash into HY or more esoteric asset classes, where the underlying is neither as safe nor blessed with such a long track record as investment-grade corporate credit. As The Donald himself advocated in The Art of the Deal: "Protect the downside and the upside will take care of itself."