FINANCIAL TIMES
FRIDAY 2 DECEMBER 2016

MARKETS INSIGHT

Investing under Trump

What the options market tells you about Donald Trump

Sector anticipates a president-elect who understands the value of global trade

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It's time to get back to normal.

Years of ultra-low interest-rate policies by the US Federal Reserve have led to some head-scratching distortions, with US utilities commanding higher price-to-earnings ratios than high-growth Chinese tech companies and investors finding themselves in the bizarre position of paying governments to lend to them after yields on more than $11.7tn of sovereign debt dropped below zero.

Before the US election, the options market had signalled a greater probability of a return to higher nominal interest rates in the US, led by inflation. While expected nominal rates have increased by staggering amounts since the election, the options market continues to signal a greater probability of rate increases in coming months due to higher than expected inflation.

Since the summer, inflation has shown signs of returning in the US, giving the Fed a window to step away from years of monetary accommodation. Ten-year, breakeven inflation in the US has surged 60 basis points since July and by a stunning 20 basis points since Donald Trump confounded pollsters and pundits by winning the presidential election.

Despite these moves, the options market continues to signal a greater probability of more inflation to come, making the chance of a rate rise in December more certain. Indeed, perhaps the most significant risk that the capital markets are underestimating is not just the need, but the desire of the Fed to raise rates faster than anticipated. Failure to do so leaves the Fed limited in its ability to combat the next, inevitable, correction.

By assigning limited downside to equities, the options market is indicating that the market stress that followed the Fed's first rate rise in almost 10 years last December is unlikely to be repeated. It is likely fiscal stimulus will come with the new administration and steady the economy, reducing the risk of a sharp contraction. Fiscal policies will take over, in part, the role played by monetary policy since 2008.

Before the US election, the low expected tail loss that the options market assigned to US equities implied that fiscal stimulus would serve as a backstop to protect the economy from tipping over. The options market, however, wasn't convinced such deficit spending could spur growth in the US and assigned a low probability to large equity gains.

Now the options market has taken on a different view. Since the election, it has begun to signal more growth ahead and more upside to equities.

Not only is the downside to equities limited, the upside has improved steadily, leading to rising attractiveness to holding the S&P 500 — the options market's anticipated tail gains exceed tail losses.

Maybe the new information the market is digesting includes the effects on equities of tax cuts and deregulation in addition to fiscal spending, ushering in an era of faster sustained growth. Industries the options market views as key beneficiaries to these changes are financials, industrials, technology and consumer discretionary — the US consumer is likely back.

So, the risk for investors has swung dramatically in recent weeks from protecting against the "bear" to the possibility of missing riding the "bull". The options market is signalling that the distribution of possible future outcomes has changed considerably since the election, with the upside now more prominent.

Using options market prices to garner information about the distribution of future outcomes is similar to using crowd-sourcing to gather information, such as the traffic app Waze. Market prices do convey important information about changing risks. For example, option prices suggest that Mexican assets are expected to deliver larger gains than losses, implying Trump won't seek to impose headline-grabbing sanctions on the country. Although less pronounced, options market indicators are similar for China, Japan and emerging markets.

In short, the options market does not appear to view Trump as a protectionist but rather as someone who understands the value and importance of global trade.

Low interest rates have long had a pernicious effect on investors, who have struggled to earn the returns needed to meet obligations. By raising rates — and by doing so faster than expected — in an environment of rising inflation, lower taxes, deregulation and deficit spending, the Fed and Treasury can together send a message that normal investment conditions are finally coming back into view.

And from the change in the distributions of possible outcomes since the election, it appears the most important ingredients for the return to normal are deregulation and rational international trade, which ironically is a return to the old normal.

According to the options market, this is the perfect recipe to foster faster sustainable growth.

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C-1216-6046 06-15-17