NBAD

From West to East

Weekly Investment View

13th November, 2016

Populism wins again

The winning of the US Presidential Election by Donald Trump is the latest win for so-called 'Populism' in the Free World. The consensus view beforehand was that in the event of a (largely discounted) Hillary Clinton win, the markets would breathe a sigh of relief and rally. If on the other hand Donald Trump won, investors expected an immediate fall in equity prices of about 5%, and that hedges - principally gold - would click-in to help offset losses made elsewhere. As it became clear that Mr Trump was actually going to win, anxiety in the markets rose substantially - the dollar weakened, gold rose beyond $1,300/oz, bond yields rose, and stock futures began to head downwards by the prescribed 5% or so. But that didn't last, and despite the probability of some market volatility to come, investors with maintained net-long positions in equities will be grateful.

"A remarkable change in market mood greeted Trump last week"

So what changed the mood? Many have said that the conciliatory nature of the President-Elect's acceptance speech was an initial factor, and we would agree. Thereafter, the markets began to (a) be relieved that they at least had the result and knew which analysis path to take, and (b) then question the extent of its own negativity about Trump in the first place. Investors bought stocks, and many once again wanted to 'travel hopefully'. So what is the essence of the bullish view on the one hand, and the bearish view on the other - and what should investors do?

The bullish view: Led by an emphasis on infrastructure spending (Clinton had this, too), this will be an effective way of making a switch to a greater reliance on fiscal policy, and the multiplier effect of this (thought to be in the region of 1.6) can be expected to boost growth. Trump's corporate tax cuts (down to a proposed 15%) will boost free cashflow and encourage investment, in turn boosting growth. A larger fiscal deficit will in time be reduced by money flowing back to the US Treasury in taxes as the result of higher economic growth and a higher labour participation rate. Mr Trump's advisors appear to have already borrowed some good Democrat ideas, such as a levy on repatriated corporate profits stashed abroad, designed to partly pay for such fiscal largesse, along with the intended use of Public Private Partnerships to help with its financing. At the same time, the fact that the Republicans managed to (again, against the odds) retain control of the Senate means that the Trump Administration will be able to get legislation passed much more easily. Also, it is likely that the substantial position of power that Donald Trump finds himself with will in reality have come as a shock to him, prompting him to rely on the extensive experience from the likes of Mike Pence and Paul Ryan (despite being at loggerheads with the latter during the election campaign). Of course it is not as simple as this.

"All of a sudden, Donald Trump isn't so bad for markets"

The bearish view: Trump has limited political experience, and some aspects of his personality and temperament have been known to get the better of him. Despite the body of political talent around him he may choose to proceed doggedly along his own path, alienating more members of his own party. Trump's admittedly considerable experience in business, centred on real estate, is not automatically transferable to or necessarily helpful in the corridors of power. From the opening months of

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

his tenure he could be hampered by legal cases relating to Trump University, although we doubt such things will seriously distract him from carrying out his program. Elsewhere, many commentators are concerned, for instance, that his apparent willingness to take on China and others regarding unfair trade practices could lead to growing protectionism, in turn triggering lower global growth. Some commentators' greatest concerns relate to the President-Elect's conduct of foreign policy, an area in which he has much to learn. He has arguably shaken the US political establishment to the core, in terms of his own party and Washington generally. The effectiveness of the Democrats in providing worthwhile opposition has been severely reduced. Again, the above is an over-simplification.

So what should investors do now? Firstly, let's briefly review some aspects of the investment background. It is worth noting that the average length of the historic US business cycle expansion (at 59 months) has already been very much exceeded. However, investors know that QE and near-zero interest rates have elongated the cycle, and made it abnormal. Fortunately, US corporate balance sheets are generally in good shape. They also know that if business confidence and capital expenditures can be induced to recover, the outlook for corporate earnings growth could improve, and in a leveraged manner. In the weeks and months to come analysts will be reviewing their forecasts in the light of what they expect from 'Trumpanomics', and as more detail is made available. In the meantime, bond yields have jumped, largely reflecting concern about the possibility of unfunded fiscal expenditure as infrastructure plans become reality - as they now must.

Investors have some very basic conundrums to resolve. Suppose we accept that - given alone that Trump is unhappy with the way the Federal Reserve has failed to 'normalize' rates during the last few years - the term structure of interest rates is shifting higher, meaning that the net present value of future equity earnings falls, ordinarily resulting in lower P/E ratios. This, however, is almost certain to be countered by the fact that a more relaxed regulatory background - in effect, less government - is consistent with *higher* P/E multiples. Central bankers have spent recent years trying to engineer inflation (as a response to deflation), and have been asking for more help from their fiscal planning colleagues. At least in the case of the US, that help looks as though it is about to arrive. What investors want is effective reflation that provides some pricing power, without debasing currencies. More pricing power boosts profit margins.

"US bank stocks will benefit from higher rates, and less regulation"

Healthcare, Financials, and Basic Materials stocks saw moves higher during the last few trading days, the latter especially helped by a sharp upward move in copper (to $2.50/lb), which accelerated once it was confirmed that Trump had won the election and had underlined the importance of his infrastructure agenda. We have been bullish on US Financials, especially banks, in recent months as we have been expecting rising rates. The latter has now come more clearly into focus, and the incoming Trump Administration can also be expected to reduce the regulatory load on the banks. The President-Elect has decided that Janet Yellen's current tenure at the Federal Reserve will not be extended beyond its expiry in 2018. Trump has been very critical of her.

In Healthcare stocks, particularly Pharmaceuticals and Biotechnology, the prospect of Hillary Clinton limiting the sector's pricing power had depressed valuations for many months. Despite a positive reaction after the election result there is almost certainly more to go for. The President-Elect has demonstrated some pragmatism by indicating that he won't necessarily scrap Obamacare after all, but rather adjust it, retaining its positive aspects.

"The extent of the fall in safe-haven asset prices underlined a new 'risk-on' tone in markets"

In bond markets, prices fell heavily last week after the election results as part of the overall market reversal in favour of the 'risk-on' mode, and greater pessimism on US rates related to the deficit logic mentioned earlier. At the end of the week Treasuries and German bunds saw large outflows as their safe-haven status was impacted. Similarly, other safe-haven assets such as the yen and the Swiss franc also suffered.

A special 'US Election' meeting of our Asset Allocation Committee took place a few hours after the confirmation of the results, and made the following decisions: (1) In the light of the encouraging recovery off the lows in US equities and the dollar, and a definite shift to a 'risk-on' mode, to close the overweight in gold established as a hedge against Trump-inspired market turbulence, (2) To close the underweight position in Investment Grade Corporate Bonds to take advantage of weakness in that sector, and (3) To give active consideration to how the models should move overweight in US Equities, i.e. which sectors should be emphasized. The gold price subsequently fell heavily the following day (to a close of $1,227) as investors closed their hedge positions, while the S&P500 only gave back 0.2% of its recovery.

In summary, we expect the new risk-on market tone to be reflected in asset allocation decisions taken by many money managers in the weeks to come. We expect money to come off the sidelines, and to mainly move into developed market equities. There will inevitably be some bumps along the way, for instance relating to upcoming discussions on the US debt ceiling, and other factors such as the upcoming Italian constitutional referendum (leading to weakness in the Euro, adding to dollar strength). Too much strength in the dollar would impede export earnings, and adversely impact foreign earnings upon translation, limiting US equity upside. Elsewhere, although proponents of emerging markets will argue otherwise, they will probably continue to suffer (as they did last week) from a strong dollar, and expectations that US interest rates are now more likely to firm.

Alain.Marckus@nbad.com
Clint.Dove@nbad.com

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