Brief consolidation in equities wouldn't be a surprise

The S&P500 closed a further 1.4% higher over the week, at another all-time closing high (2,213.35), although it was eclipsed by the 2.4% rise in the Russell 2000, the US small- and mid-cap index. The Russell's constituents tend to be domestically-driven, hence are not so de-geared by a strong dollar as the multinationals. Overall, though, US equities continue to reflect the higher earnings growth potential expected to result from the economic stimulus and business-friendly policies of the incoming Trump Administration. Eurozone equities closed 0.9% higher over the week, with euro weakness overcoming political considerations coming back into focus with the Italian constitutional referendum due on 4th December. Japanese equities were 2.5% ahead over the week, once again helped by yen weakness vs. the dollar. In US Treasury bonds, the 10- and 30-Year yields were little changed (at 2.3572% and 3.0045% respectively), although the more policy-sensitive 2-Year yield firmed by four basis points (to 1.1168%) to a six-year high as the Bloomberg-calculated probability of a Fed December rate hike reached 100%, with the likelihood of greater certainty of rate increases next year. The US Dollar Index was 0.2% higher over the week, closing off the top, at 101.49, following a 14-year high above the 102 level. The MSCI Emerging Market Currency Index was little changed over the week, and stands 3.2% lower than immediately before the US election results. Emerging market equities were 1.3% higher over the week, although are 5.4% lower for the month-to-date, with both equities and currencies to an extent worried about a 'Trump Tantrum' as US interest rates increase and the possibility of EM capital outflows persists. **The EM world is in better shape than it was during 2013's Taper Tantrum, but we are erring on the cautious side and exercising great selectivity in these asset classes as rising rates in the US can still be expected to cause some pain in emerging and frontier markets.**

"Inflation expectations have moved upwards – but not off the chart"

With a Fed funds rate hike now seen as a foregone conclusion by the markets next month, the US 2-Year yield at just below 1.12% also goes some way to discounting a few more hikes in Fed funds in 2017. The exact wording of the December Fed statement will be very important to dissect, and the FOMC knows it cannot remain behind the curve as 2017 proceeds - indeed the proposed Trump policies of course provide them with ideal arguments to raise rates. However, unless the new Administration is aggressive to the degree of being hugely irresponsible (or some other very adverse factor comes into the equation), rates should not take off. Adjustments in investor expectations have already occurred. For instance, looking at market indicators such as the Fed's own Five-year forward breakeven inflation rate (inflation expectations), this has risen to 1.92%, up from 1.67% a day before the election. So although inflationary expectations have certainly risen, these have not blown through the 'roundaphobic' 2% level above which bond investors might take fright. Unless the incoming Trump Administration's spending moves much above proposed levels (or for instance, the Chinese sell foreign bonds heavily - unlikely, in our opinion) it looks as though the epitaph of the global bond bull market could have been written too early. There has been a large upward move in many bond yields, although in all probability this has run out of steam for the time being. **Last week's US 7-Year Treasury auction went well, and investors may now find these higher yields sufficiently attractive for them to return as net buyers.**

Looking at the performances of the various S&P500 sectors for the month-to-date, the clear winner has been Financials (+13.7%), yet there could still be more to go for. This will depend on the extent to which the banks end up being able to operate in a less regulated environment under Trump, in addition to the advantages to banks of higher interest rates. **On debt, let's not forget the President-elect's core business sector to date and the way it conditions one to the use of debt (and that he and at least one key member of his team have been very direct about the positive role that the use of debt can have in the economic system).**

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

"Information Technology has been left behind – unfairly, we think"

The Information Technology segment of the S&P500, on the other hand, is only up 0.8% for the month-to-date, compared to the S&P500 itself, which is up 4.3%. Investors have seen outperformance for the period up to the election, plus worries about trade protectionism to justify reducing positions. While we accept that in the event of a much more protectionist environment taking hold, the sector could be impacted by rising prices of internationally-sourced components at the margin, this broad sector still has one of the best and most visible growth profiles looking forward, and it is home to many billions of dollars on balance sheets likely to drive M&A activity. We expect its historically above-average beta (responsiveness) to rising equity markets to return. **Looking at**

the broader MSCI All Country World Information Technology sector, its P/E for 2017 is 15.9x, compared to expected earnings growth of 13.34%, for a P/E-to-Growth ratio of just 1.19, below the same metric for the MSCI AC World Index of 1.24. So for a change investors have been offered a chance to buy the technology sector at a discount.

We appreciate there will come a time when US equity upside potential could be slowed by too much dollar strength, yet there are offsetting factors, and not all of these hold equity valuations down. As the dollar strengthens the global demand for many commodities tends to be subdued, as they are more often than not priced in US dollars, so keeping industrial costs lower than they would otherwise be. More in relation to equity valuations, if the dollar is rising on the back of expectations of higher interest rates and rate differentials, it is also likely to be on the basis of higher expected real economic growth after making an allowance for increased inflation. If genuine reflation can be achieved, linked to improved business confidence (which has been lacking for some years in the West) finally taking hold, then earnings per share growth (and even free cashflow) can be expected to rise. It is *this* that enables equities to withstand higher interest rates when they occur. Historically (admittedly during periods of higher underlying growth than we have seen in recent years) it used to be reckoned that only a US 10-Year Treasury yield in excess of about 4.50% would begin to seriously impact equity valuations, via the net present value of future earnings or other metrics. Today's circumstances are different, and we will be doing our own calculations in the weeks and months to follow – but our readers will take the point: higher equity valuations can co-exist with a relatively strong dollar and higher bond yields. **The yield on the S&P500 is once again below the yield on 10-Year Treasuries and this appears justified; in times of growth, equity dividends grow, whereas bond coupons never do.**

Broad-brush negative conclusions regarding, for instance, world trade and protectionism, could well be premature. Investors might consider that (a) it will take many months for any new overall global trade environment to become clear, (b) a series of bi-lateral deals may actually work better even if they take time to negotiate, (c) given the growing importance of the emerging world, the importance of the US in the mix will be diluted over time, and (d) we have seen that the emerging world has in recent years begun to increase trade between themselves, to the relative exclusion of the developed world.

"The US consumer is back – and drives the US economy"

Turning to last week's important US economic statistics, it has been underlined that there has been a significant improvement in consumer sentiment since the election. The final reading for the University of Michigan Consumer Confidence Index for November was 93.8, up from October's 87.2. The report described the post -election improvement in optimism was widespread, with gains across all income and age sub-groups, and across all regions of the country. The preliminary reading for November had been 91.6, and economists had expected the final reading to be unchanged. **Additionally durable goods for October came in above expectations, driven by civilian aircraft orders, and the previous month's number was revised upwards.**

We are expecting some possible dislocation in the event that Mr Renzi loses the Italian constitutional referendum on 4th December, which seems to be the general expectation, preventing him from proceeding with necessary reforms. Elsewhere, it is worrying to hear that the consensus is that populism in France is not expected to go to extremes, i.e. that Mr Fillon should beat Marine Le Pen in next May's presidential election. We are not expert in French politics, but we interested to see Ms le Pen being interviewed on the BBC's 'HardTalk' programme a few weeks ago, and she seemed to come through Stephen Sackur's grilling very well indeed. While we wouldn't advocate what she stands for, we believe many French voters will agree with her rhetoric, and do not under-rate the strength of populism on the ground in many countries globally. **Similarly, we would be quite surprised to see Angela Merkel be confirmed as leader of her Christian Democratic Union party and able to run once again for German chancellor in next year's federal election.**

"Increasing our global equities overweighting"

INVESTMENT SUMMARY: Our Asset Allocation Committee last week voted to move overweight in US equities, from neutral, and to do this by overweighting the Information Technology and Financials sectors. This takes the models further overweight in global equities, and adding to the existing overweight in Eurozone equities. **Also, it was agreed to utilize the weakness in both Indian equities (the Sensex is down 4.6% since the 'demonetization' announcement), and the rupee (down 2.7% vs. the dollar over the same period), to move overweight in Indian equities**; although there has been criticism of how demonetization has been rolled-out, and also with reference to the negatives of wealth destruction and supply chain disruption in the short-term, we are enthusiastic regarding this sub-asset class for the medium-to-long term. We appreciate this is a slightly contrarian call, but one that we believe will pay off handsomely in 2017. The subject was discussed in depth in last week's report. The purchases have been funded out of cash, rather than reducing bond positions.

The Committee remains overweight in Eurozone equities, despite the upcoming Italian constitutional elections due to be held on 4th December, with the currency exposure remaining fully hedged. It has been correct to leave this hedge in place - and similarly for the yen hedge covering the neutral Japanese equity position. **Lastly, the Committee was on-balance rather sceptical that a workable agreement would result from this week's OPEC meeting, although would consider adding to energy-based weightings in the event of a WTI price reaction towards to the low $40s.**

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