NBAD بنك أبوظبي الوطني

From West to East

Weekly Investment View

30th October, 2016

It will be good to move on

The re-opening of the FBI's investigation into Hillary Clinton's emails late last week led to the S&P500 selling-off, with the index closing 0.7% lower over a week which had already seen mixed-to-bad earnings results (for instance from Amazon and Apple, the latter of which saw its first revenue fall in 15 years). It was a similar tone for most other major equity markets, with the exception of Japan, whose investors liked the look of a weaker yen boosting export earnings. Many sovereign bond markets were weak earlier in the week, especially in the Eurozone and the UK, as positive economic releases - in the form of a string of good Purchasing Managers Indices (PMI) and good German IFO business confidence data – led to the markets suspecting that less QE would be required going forward. The Eurozone services PMI was also positive. Also added to the equation at the end of the week was a better - than - expected US third quarter GDP, coming in at an annualized 2.9%, vs. expectations of 2.6%. Bloomberg's interest rate probability analysis at week end suggested a 69.2% chance of the Fed hiking by 25 basis points in December, a reaffirmation that the markets do expect the Fed to hike. A particularly sharp move during the week was a 17 basis point firming in the UK 10-year gilt yield, to 1.26%, after UK third quarter growth came in at a better-than-expected 0.5%, quarter-on-quarter. The UK Treasury had itself forecast a fall of 0.1%. Sterling, however, was seen to take a more pragmatic, medium-term view, as it still fell by 0.7% over the week, to $1.2185, and during a week when the dollar ended 0.3% lower on its index.

"We wouldn't underestimate Populism"

In our reading, we keep on coming across the views that, 'Stocks should do better if Hillary Clinton rather than Donald Trump is elected', and that 'Investors should want Republicans to hold onto control of the House and Senate'. Firstly, although the market is assuming the continuity of Democrat government, we still don't have a view regarding who will win, mainly as we have respect for populism. Some of the conspiracy theories about systematic 'Democratic over-sampling' in polls may have some truth in them. Secondly, the presumption that 'gridlock in Washington is good' isn't something we necessarily accept, either, as it may actually be constructive to get new legislation passed, provided of course that it's the right kind of legislation. What we are all witnessing is probably one of the most exceptional political periods in the US (and much of the world) that many seasoned investors have ever seen. Also, in market and economic terms the various quantitative easing programs of recent years have changed the lengths of business cycles, and altered the ways in which they work. **We stand by our view that for the time being portfolio hedges need to be in place - principally via gold - and that it is premature to position portfolios for one US election result or the other.**

Having said the above, of course related political and market studies keep coming. For example, University of Michigan economist, Justin Wolfers, and Dartmouth College economist, Eric Zitzewitz, recently published an analysis of a collection of market reactions to indications that Clinton's electoral outlook had improved. They concluded that the S&P 500 index would rise 12% if she wins, and that market volatility would be 15-30% lower than if Donald Trump wins. They also said that US Treasury yields could be 25 basis points higher, and that the oil price could be $4/ barrel higher if Clinton wins. They also suggested that a Clinton victory would boost other world equity markets. **While this is all the stuff of which markets are made, the underlying presumptions continue, with the reality of populism being swept under the carpet.**

"The Democrats could win the Senate"

Looking at the contests for House of Representatives and Senate seats, many of these are quite tight. In the House, the Democrats would need a net gain of 30 seats

Claude-Henri Chavanon

Managing Director
Head of Global Asset Management

to get a small majority, with common sense alone suggesting this would be difficult for them to achieve. The Democrats' chances are said to be better in the Senate, in which a net gain of four seats would hand them control (assuming Clinton were to win and that her running-mate Tim Kaine was able to break any 'tie' votes). So the Democrats winning the Senate looks very possible, and a substantial winning margin at the national level would almost certainly deliver this. Once again, our job is not to speculate on whether Clinton or Trump wins, but rather to make changes to recommended weightings immediately afterwards if our Asset Allocation Committee believes that sectors in the various markets haven't done their job of adequately discounting prospects, and in any case to be looking past the election into 2017 and beyond. **If Donald Trump wins, then the 'Street' and a majority of investors would be shocked and a degree of market turbulence could be expected to follow.**

The Republican Party is in major disarray, even if Trump wins, with many of its members still shell-shocked at what has happened. Those already resigned to Trump losing are looking towards the re-building of the Party for four years' time.

Paul Ryan (the Speaker of the House) has damaged his own brand by not solidly backing Trump from the start and wavering thereafter. A Bloomberg Politics poll last week asking Republicans who should be the figurehead of the party in the event of a Clinton win put Mike Pence, Ted Cruz and Donald Trump ahead of Paul Ryan. After the election, the GOP will have to accommodate the populist factor that Trump has drawn upon. If Trump were to lose in a landslide - and again we aren't suggesting that will happen - commentators think the Republicans' 30-seat majority in the House could be reduced by up to 15 seats, or even more. **A reduction in the Republican majority in the House may lead to more genuine compromise in getter legislation passed.**

"Either way, US infrastructure spending will be boosted"

At least both Democrats and Republicans broadly agree about the importance of boosting infrastructure spending, although this is about the only subject they do appear to agree on. Hillary Clinton's mooted $275 billion infrastructure plan would be paid for by 'corporate tax-law changes', according to Bloomberg, by way of a one-off levy on overseas profits brought home. We are unsure as to how Donald Trump would fund his version of any infrastructure program. Either way, there is no doubt that the US's infrastructure is crumbling and needs very urgent attention, with an underlying beauty of this being that John Maynard Keynes would have wholeheartedly approved. Also, as the weeks and months go by it is becoming clear that global policymakers want to have to rely less on monetary policy. **Fiscal policy can be far more targeted, and almost certainly leads to better multiplier effects.**

There has been widespread discussion about the differences between Clinton and Trump on subjects such as trade policy and immigration, so we won't reference them here. Irrespective of who wins, Obamacare needs to be improved or replaced, as does the Affordable Care Act. Also looming for whoever comes into power is the fact that the government's borrowing limit is set to run out in mid-March, leading to a potential stand-off between Congress and the White House. The parties made a deal to suspend the debt limit ($20.1 trillion) until President Obama left office, but the current outstanding debt of $19.8 trillion has only a few months to go before the law is due to be reinstated on 16th March next year. **The US Treasury can take temporary 'extraordinary' measures to avoid default, but a permanent solution will have to be found.**

"Historically, investors usually prefer Democrats"

Bloomberg quotes the Committee for a Responsible Federal Budget, writing that neither Clinton nor Trump are putting forward plans that in overall terms would boost economic growth or reduce debt or deficits significantly. Trump's planned aggressive tax cuts could be stimulative in the short-term, but would likely be offset by resulting larger debt and fiscal deficits thereafter. In terms of US equities, recent analysis by Credit Suisse found that since 1928, these performed best under Democrat presidents, and with Republicans in control of both the House and the Senate. The worst performances on average came with a Republican president, a Republican Senate, and the Democrats in charge of the House. Credit Suisse also noted that equities have done well (probably unsurprisingly) when there is no change in political leadership; for two-year periods starting in January after elections, median S&P 500 returns were 18.9% when leadership in the White House and both chambers of Congress remained unchanged, vs. 11.0% when they changed. **So history would be on the side of investors in the event of a Clinton victory, as markets in many ways would be getting more of the same.**

In the immediate days ahead we expect most markets to trade quite narrowly until the US Presidential result due on the 8th November is out of the way. For the moment investors should plumb in as much certainty as possible into portfolios, especially via guaranteed income, and only be exposed to higher-quality assets. Significant investment views should not be implemented before we know the election result, as upsets can happen, as we have seen in the UK. Client portfolios should be fully diversified, and with 'uncertainty' hedges in place, primarily via gold. If the resulting US political landscape is deemed to be favourable for markets, there will be time to make some 'risk-on' adjustments to portfolios, and it will be safer to make those when one can feel more confident of market trends. Additionally, provided there is leadership from US equities there is the chance for an element of seasonality to kick-in – and a decent year-end rally. Bond yields may have risen moderately last week, but as yet this doesn't look like anything to be worried about, mainly because inflation expectations still appear to be under control. Slightly higher rates should serve to attract investors who need some income, rather than cause concern. **We will be watching events very closely indeed next week as probably the most unpleasant and divisive US General Election campaign draws to a close.**

For any inquiries related to this article, please contact Alain.Marckus@nbad.com or Clint.Dove@nbad.com