NBAD

From West to East
Weekly Investment View
30th April, 2017

US events dominated last week

The S&P500 closed up 1.5% over the week, just 0.5% short of its all-time closing high of 2,395.96 of 1st March. Markets had to digest a diverse mix of fundamental news, including: confirmation of the broad details of Trump's tax reform proposals, news that the financing for the proposed wall along the US-Mexico border would be delayed (but with this helping to avoid a US government shutdown late in the week), it becoming clear that the Trump Administration will renegotiate NAFTA, central bank meetings, US first quarter GDP data, and a slew of US corporate earnings results. Early this weekend North Korea had another failed missile launch, and this cauldron of potential risk continues to boil, with discussions taking place at the UN and elsewhere. China says it doesn't have any commanding influence over this situation, however on the face of it they appear to be doing all they can. Perhaps traders thousands of miles away are a little too relaxed, as they seem to be focusing more on an impressive group of (especially technology) earnings reports, results which drove the NASDAQ Composite to a new all-time high of 6,048.937 on Thursday, with that index closing only fractionally below that level on Friday. The STOXX Euro 600 index had a very good week, up 2.5%, following the win by Mr Macron in the first round of the French presidential election the previous weekend, the general market assumption being that he is now a shoe-in to win the second round. We have read various market reports suggesting all is now set-fair for the euro, and we don't agree. The euro rose vs. the dollar by a fraction under 2% over the week, a period when the dollar was in any case on the back foot, partly due to commentators (unreasonably, we believe) having expected more detail on Trump's tax reform, as well as some slightly lack-lustre US economic data.

Regarding tax reform, it is a massive task and will take some months until it is ready to go before Congress; on the first quarter GDP (discussed below), there are good reasons why this should be treated as temporary, even if the numbers posted were below expectations. **In terms of its index, the dollar closed 0.9% lower over the week, also a function of stronger sterling, which rose just over 1% to a seven-month high of $1.2951 as the advantages of holding the June UK general election gradually become more fully appreciated, also as the Conservatives' lead in the polls increases.**

"We expect US equities and other risk assets to continue to climb a wall of worry"

Elsewhere in the markets, the US 10-year Treasury yield edged up by about three basis points, probably a continued reaction to it reaching an oversold position of sub-2.18% a few weeks ago. The yield on the 10-year German Bund ended just over six basis points higher on the week, restrained by a cautious ECB policy statement. Both the ECB and the Bank of Japan decided to keep monetary policy (QE) constant, in the case of the former the ECB is still worried about downside risks to economic growth (despite higher than expected eurozone inflation), and with the BoJ saying that reaching their inflation target will likely take even longer than planned, although their economy was described as 'expanding'. So the ECB and the BoJ are continuing with loose monetary policy via continued asset purchases. Oil prices in the US were slightly lower over the week (WTI closed at $49.33, vs. the previous week's $49.62 close), despite the third week of US crude inventory drawdowns, participants more concerned that US gasoline inventories have risen for the last few weeks. Gold closed 1.3% lower over the week, off $16 to $1,268.28, despite a lower dollar and still-simmering geopolitics. **Assuming no serious escalation of the situation on the Korean peninsula, we expect US equities and many other risk assets to continue to climb the proverbial 'wall of worry', to the great annoyance of the bears, and in accordance with our views stated in our Global Investment Outlook 2017.**

Claude-Henri Chavanon

Head of Products & Services
Wealth & Private Banking

"Underlying US consumer confidence is still very good – and bolstered by firm housing markets"

In other US economic news, the all-important housing sectors continue to be in very good shape, an important pre-requisite to the elongation of the economic cycle. Firstly, existing home sales posted a very good 4.4% year-on-year increase in March (to an annualized 5.71 million), in a recovery from a downwardly revised 5.47 million rate in

February, and vs. expectations of a 2.2% increase. Similarly, new home sales increased 5.8% year-on-year (to an annualized rate of 621,000 in March, and vs. market expectations of a fall to a rate of 585,000). Meanwhile commentators bemoaning the fact that the Conference Board consumer confidence index came in at 120.3 for April, vs. expectations of 123.1, are probably missing the point: this respected consumer confidence index is close to a 16-year high, and at a very health absolute level. As we have seen from recent statistics, wage growth – while not moving ahead rapidly – has been gradually improving (the best in almost nine years, according to Bloomberg) and against the background of a better labour market. It seems reasonable that the average US consumer (especially middle-income Americans) is pausing on major purchases until they know what their 'Trump-and-Congress'-determined tax code will be. **Also, we understand that many tax refunds have been delayed.** Meanwhile, though, the 'net worth' effect from rising average house prices (at a recent 5-6% annual rate – not too much, not too little) is still improving. In similar economic news, the University of Michigan Consumer Sentiment index came in at 97.0 for April, almost unchanged from March, maintained by good 'current conditions' (this sub-index was at its second-highest since 2005). Staying with Conference Board statistics, their Leading Index rose by 0.4% in March, month-on-month, vs. expectations for a 0.2% increase, which we take as another positive indicator for economic growth in the months ahead. So we are not very concerned that US first quarter GDP growth came in at an annualized 0.7%, compared to expectations closer to 1.0%. Consumption rose by 0.3%, held down by a slowdown in auto sales (as seen from other data in recent weeks). Business inventories are now believed to be at low levels, and at some point these will have to be re-built; decision takers in business are expecting an improved regulatory backdrop, and we would imagine they need some further clues regarding exactly what this will look like. Many of these statistics are of course linked, so for instance it is also not surprising to see that US durable goods orders increased by 0.7% in March, below expectations of +1.3%; a pick-up in defence capital goods and commercial aircraft more than offset a fall in the 'ex-transportation' component. **So we are confident that the US consumer will bounce back, and that this could be sustained for some time in what we still believe is likely to be an elongated US (and global) economic cycle – and also that business investment will recover.**

"European equities are closing a relative valuation gap, but are limited by political, debt, and reform concerns"

In European economic statistics, the Eurozone IHS/Markit 'flash' Composite (manufacturing plus services) PMI index rose to 56.7 in April (vs. 56.4 in March), its highest level since April, 2011, and vs. expectations for no change. It wasn't the small 'beat' that is important, but rather the healthy absolute number, with a reading of 50.0 being the boundary between expansion and contraction. There was a further acceleration in both manufacturing and services activity, with manufacturing benefiting from a relatively weak euro. Another important European statistic is Germany's 'Ifo' Business Climate index, an assessment of current conditions, which improved to 112.9 in April, from 112.4 in March, and vs. expectations of unchanged. The German economy is "growing strongly," although companies are "somewhat less optimistic" about their six-month outlooks, according to the Ifo Institute. This is interesting in that while we remain bullish of European equities, based on relative valuation vs. the US, for instance, we can understand more of a cautious view on the part of - in this case, German – business looking out six months. While Mr Macron might be leading Ms Le Pen by about 60% to 40% in the polls, the path to French structural reforms won't be easy, and neither will further Greece debt talks, to say nothing of Italian and German elections due later this year. **In conclusion, our overweight in European equities has more of a genuinely 'tactical' feel about it, and while the Asset Allocation Committee (which meets again later this week) will always seek to sell any market it believes to be expensive, the background to the US equity market is very likely to see important – and bullish – structural change.**

"Of course they can't provide all the Trump policy detail yet – we like the look of the basics, though"

As foreshadowed previously, it was confirmed last week (it was rushed out, to make the newswires before the '100 Day' mark) that the Trump Administration is planning to reduce corporation tax to 15% (from a standard 35%), and this would clearly be the initially expensive part, prior to the projected pay-back of this and the overall tax reform package. Also mentioned earlier was a 10% (this actual rate is still under discussion) 'one-time' tax on offshore cash holdings, a low rate to induce companies to repatriate trillions of dollars of profits held overseas. For individuals, there are intended to be simplifications, with a reduction in the top rate of tax from 39%, to 35%, combined with fewer tax brackets (three, down from seven). Those with incomes of less than $24,000 would pay nothing under the proposals, which would double the standard deductions. This whole discussion with different groups in Congress is at a very early stage, although at least Republican House Speaker, Paul Ryan, says that he and the Administration are "on the same page", which is a good start.

It is expected that the Administration will not shrink from increasing the budget deficit for a period of years until the anticipated growth kicks-in, boosting tax revenues. Fiscal conservatives in Congress will fight this, however, and say the assumptions are unrealistic. Steve Mnuchin, Treasury Secretary, has emphasized that the tax reductions would pay for themselves via higher growth and hence government revenues, and has called the payback with growth above 3% “staggering”, based on the models and assumptions being used. Congress will have to discuss whether the reforms are to be at least ‘revenue-neutral’ (hopefully they will be better than that). President Trump really wants to accelerate the rollout of these plans, although it is likely to take until June for full disclosure of the proposals to be provided to Congress. To get through the Senate without Democrat support, the package cannot add to the budget deficit over a 10-year period; House speaker Paul Ryan’s plan (based on a 20% rate) is itself intended to be revenue-neutral over 10 years. The controversial Border-Adjusted Tax has been de-emphasized (it would have increased inflation in the US), as had been hinted at subtlety by Mnuchin a month or so ago. Trump is clearly listening to his senior economic advisors, although he is pressuring them to deliver far more rapidly than the size of the job might suggest. Trump now seems not to want the passage of a revised healthcare act to get in the way of tax reform, which makes sense as boosting growth is his priority. Meanwhile, Congress will have to revisit increasing the federal debt limit later this year. We return to the typical response of “How will it all be paid for?”. Having said this, it does sound as though Congress is basically agreed that tax reform is very necessary, and most serving there want it. The exact shape of it will have to be argued out in the weeks to come.

As we learned in economics at school, provided a capitalist/mixed economy basically works and that state spending is under control, lowering tax rates maximizes the ability and willingness to work and invest, and is more likely to drive growth.

“As US equity estimate revision improves further, this will likely drive equities even higher”

INVESTMENT SUMMARY: The Asset Allocation Committee remains happy to maintain its overweight position in European equities. Mr Macron had a difficult start to last week, following his victory in the first round of the Presidential election, but should nonetheless win comfortably as ex-Republican and Socialist votes go to him to keep Le Pen out. Macron’s political inexperience is naturally showing. Our technical analysis of the euro/dollar rate suggests investors should remain resolutely bearish on the euro, contrary to the views of some in the market that the euro is now ‘set fair’.

Regarding the US, it’s possible that the jewel in Trump’s crown is Steve Mnuchin (as well as senior economic advisor, Gary Cohn), as he keeps saying and proposing the right things (e.g. he highlighted early on that the Border Adjustment Tax was far from perfect, needed ‘re-assessment’, etc. – and he has successfully argued the ‘gentle bullish case’ for the dollar (i.e. our own view) very well, after his boss mentioned the dollar a few weeks ago to its cost. Subject to seeing more detail, we like the basics of US tax reform proposed, even if many commentators took the opportunity to shrug their shoulders and say “not good enough”. It’s taken a few months for the new Administration to find its feet and learn how to compromise with Congress, but from this point and certainly looking out six months the Trump team could even be seen to be doing a good job. Much of Congress want lower taxes, even if Ryan and some others wouldn’t have chosen the ‘15%’ number for corporate tax.

We regularly see perceptions that US equity valuations are expensive, although: the dollar (although still in a ‘big’ bull trend in our view) has corrected a bit, estimate revisions are now moving UP for this year and next, and we expect the so-called ‘Trump trade’ to return (albeit a bit slimmed-down), and the 10-year yield will only be a problem for equities above 3.00-3.50%.

Although not the cheapest on a relative basis, we remain overweight in US equities, which are trading on a 2018 P/E of only 16.5x; in reality it’s all been sectorally led by technology, which we continue to have as a preferred sector. European equities are trading on a P/E of only 14.4x for 2018, and lower if the euro does what we expect it to (consistent with our bullish dollar thesis). The Asset Allocation Committee meets later this week.

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

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