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EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

NOVEMBER 2016 – US EQUITY MARKETS LEAD THE WAY IN A NEW ENVIRONMENT

In the US, stocks moved sharply higher in November as a post-election rally brought all of the major indexes to new record highs. Small cap markets with their domestic focus in particular performed strongly, but the S&P 500 also continued to set new highs during the month. The technology-heavy Nasdaq Composite Index lagged as a surge in long-term interest rates appeared to cause investors to place a lower value on the future earnings of the many fast-growing and higher P/E stocks included in the benchmark. Rising bond yields also took a toll on utilities shares—whose high dividend yields became less appealing in comparison—making it the worst-performing sector in the Standard & Poor's 500 Index. Conversely, higher rates and improved lending margins, along with the prospect of less regulation under the Trump administration, helped financial shares.

International markets were more mixed. Europe gained slightly, but Japan and emerging markets, in particular, suffered falls. Expectations for stronger US growth have pushed US inflation expectations higher and the yield curve has steepened. Higher US interest rates are resurrecting some of the concerns for emerging markets about lower capital flows (FDI) and weaker currencies.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: Equity markets have rallied as investors have reassessed prospects for corporate earnings, economic growth, and inflation in the wake of the election of Donald Trump to the White House. However, we expect a period of uncertainty in the coming months as market participants try to determine the details of how campaign promises will translate into legislative programs. In the short term, investors are still trying to determine how the incoming administration's favoured policies, such as increased fiscal stimulus, reduced regulations, and changed trade agreements, will affect the market. Financial stocks are benefiting from the possibility of rising interest rates and reduced regulation. Industrials have risen on expectations of higher government spending, and pharmaceuticals and biotech companies have also rallied as the possibility of price controls fade.

Our Chief U.S. Economist Alan Levenson said that some of Trump's campaign proposals—particularly big tax cuts, less regulation, and increased federal outlays for defence and infrastructure—could provide a marginal fiscal stimulus for the US economy in the short term. However, the measures could lead to bigger budget deficits and potentially higher interest rates if they lead to longer-term strength. The new administration could also pursue trade policies that have the potential to hurt the US economy.

At its December meeting, the Federal Reserve (Fed) delivered a 'dovish hike' of 25bps. Fed Chair Yellen remains cautious and does not want to jump the gun on fiscal stimulus, the size, composition and timing of which remains highly uncertain. But **we think that her more dovish comments represent an effort to prevent too abrupt a swing in expectations and stagger the policy transition rather than a directional signal on policy.**

The Fed super tanker is turning in a more hawkish direction, gradually at first but with far-reaching consequences. This has as much or more to do with the current data (unemployment at 4.6%, 2H 2016 economic growth near 3%, real interest rates below -100 bp) as it has to do with potential fiscal stimulus. But the two interact in our view, with the looming shadow of fiscal stimulus altering the prism through which FOMC participants view the current data and associated balance of risks.

Looking into 2017, the prospect of fiscal stimulus will be one of the key drivers. Once the fiscal expansion is approved by congress, the government will push resources into an economy where the output gap is closing and where growth is already running above potential. Undoubtedly, this will raise the spectre of higher inflation, which will put pressure on interest rates to rise and for the yield curve to steepen further.

In addition, in keeping with Republican tradition, President Elect Trump is likely to reduce taxes on dividends and capital gains, and has promised to reduce corporation tax. The prospect of higher after tax earnings and reduced tax payments related to gains on equity investments is likely to support equities.

Meanwhile, the fact that both the House and the Senate are both now Republican suggests that we will see some progress on tax reform, with possible incentives for repatriating earnings held overseas by US corporates. The combination of rising interest rates and capital flows related to repatriation of earnings creates an environment that is very conducive for the US dollar to strengthen further.

With the economy continuing to grow and a fiscal stimulus on the way, we remain reasonably constructive on the US as a whole, but the outlook going forward is inherently more stock-specific.

EUROPE: Politics are once again dominating proceedings. Italian Prime Minister, Renzi, resigned after losing the referendum on constitutional reforms, with almost 60% voting 'NO' at the referendum, showing that the majority of population indirectly did not wish Renzi to remain Prime Minister. We now have a caretaker government in Italy, with no elections until at least mid-2017. Italy is of course used to these episodes of political instability, having had more than 60 governments since the end of World War II, and has ways of dealing with them. Any major reforms, however, are unlikely under this latest caretaker government.

On a positive note, the referendum result does reduce the chances of a Eurosceptic government in Italy in the medium term. One part of the constitutional reform was to fully legitimise electoral premium for a party, who wins elections, potentially opening a way to a single-party populist Five Star Movement (M5S) government. With the rejection of the reform, the electoral law will now likely change back to a proportional system, which favours coalitions and makes M5S government very unlikely. The main focus now is on the Italian banks.

JAPAN: We maintain a positive view on Japan. Central to this has been the real recovery in corporate profits. While Abenomics has stolen the headlines, the recovery in profits has been the fundamental fuel that has driven Japan's equity rally since 2012. However, with the global outlook weakening in 2016, the momentum in corporate profit growth has waned, at least for now. On a market-wide basis, profit growth is likely to be broadly flat over the next fiscal year, with downside risk to this view if the yen remains strong.

We continue to anticipate further volatility and increasing dispersion of stock returns. However, while Japan's place as a cyclical equity market implies a greater level of volatility than peers, it is not the only market that is transitioning through a period clouded by heightened uncertainty. Given attractive valuation levels, and the many pockets of growth and improvement still present, we remain constructive.

EMERGING MARKETS: Emerging markets have continued to hold onto decent gains, despite the Trump tantrum. Improving economic growth and a revival in corporate earnings should bode well for the year ahead. Economic growth relative to developed markets has now stabilised. In fact, the growth premium is once again expanding as the larger economies of Brazil and Russia, which have been suffering tough recessions, now show signs of a turnaround.

China's economy, however, continues to slow. But a growth slowdown should not be confused with a growth crisis, in our view. China ultimately has the ability and willingness to apply policy actions that should prevent its economic and debt dynamics from becoming disorderly.

Improving economic growth is providing a healthier environment for corporate earnings. 2016 marked a turnaround in earnings for emerging markets after a number of years in the doldrums. Some of this improvement was helped by the revival in commodities, but we have also increasingly seen more examples of self-help within companies, with a growing number of companies focusing more intensely on cost control, efficient capital expenditure, and improving shareholder returns.

Profit margins in most emerging countries remain below historic averages, but better growth and more disciplined cost management can help improve them. We are already seeing tentative signs of margin expansion among non-financial companies. Importantly, for the first time in five years, productivity is increasing at a faster pace than real wages in some key markets. This can only help lift margins, although some countries have more scope for improvement than others.

One possible headwind facing investors is the impact of President-elect Trump's policies. The election of Mr. Trump caused some volatility in the immediate aftermath following his victory. If he follows through on his protectionist rhetoric, trade could be damaged for a number of emerging countries.

It is early days in terms of being able to assess the full impact. Most likely the administration will pursue a pro-growth agenda that includes lower taxes, reduced regulation, and infrastructure spending. If so, these measures could pull global economic growth higher, and this historically has helped emerging markets. The question is whether or not developing markets will be allowed to participate in this based on President Trump's pre-election trade and tariff threats.

While still uncertain, our current view is that President-elect Trump will be more pragmatic in the priorities and policies he pursues. We expect him to ultimately embrace a more practical, business-friendly stance, particularly related to trade.

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