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November 2016

EQUITY VIEWPOINTS

GLOBAL MARKET COMMENTARY

OCTOBER/NOVEMBER 2016 – TRUMP VOLATILITY BRINGS SPICE TO THE MARKET

To take into account the recent US Election result, we are reporting on the markets as of 15 November, 2016.

Stocks fell in October, as a whole, as concerns over tighter global monetary policy and uncertainty in advance of the US elections outweighed some encouraging earnings reports and economic data. However, stocks rallied as investors reassessed prospects for corporate earnings, economic growth, and inflation in the wake of the surprising victory of Donald Trump in the US presidential election. Gains varied widely depending on how different sectors might fare under the new administration. Financials, industrials, and health care did well, while technology and "bond proxy" stocks such as utilities lost ground. Small-cap equities outperformed large-caps, although all the major indexes recorded solid gains. The blue chip Dow Jones Industrial Average reached a record high.

International markets mirrored the US with sharp falls in the immediate aftermath of the Trump victory, but rallied strongly as a more conciliatory tone was expressed by President-elect Trump after his victory.

GLOBAL EQUITY VIEWPOINTS

UNITED STATES: We generally expect an uncertain investment environment 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. On the other hand, many technology companies have sold off as the new administration may not provide a good environment for the tech sector if Trump's campaign promises are implemented.

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.

Looking forward to next month, the Federal Reserve (Fed) is likely to deliver a 'dovish hike' – a contradiction in terms – in December. Unemployment is below 5%, wages pressures are rising, growth is meaningfully above potential and, importantly, financial markets are stable. The modus operandi for the upcoming meeting is likely to be the same as that employed in December 2015 where the Fed successfully managed to hike interest rates without upsetting financial markets. Admittedly, financial markets took a big tumble in January 2016, but we attribute most of this to the developments at the time in China, and in particular to the Chinese authorities' response to the US interest rate hike.

For 2017, the most important impulse is the prospect of fiscal stimulus from the President-elect. 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 raises the spectre of higher inflation, which will put pressure on interest rates to rise and for the yield curve to steepen.

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 now Republican suggests that we will see some progress on a tax reform that likely comes with some incentive to repatriate 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 against both emerging and developed market currencies.

Overall, investors are still reassessing the prospects for corporate earnings, economic growth, and inflation in the wake of this result. At the same time, we also have to take into account that we are eight years into the second longest bull market in history and in an environment where so many of the pillars of past return are evolving. Importantly, bull markets usually end with recession or due to valuation bubbles – we see no signs of either. 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: European equities have rallied following the US election result, as investors perceive that a Trump administration will favour European banks with significant US exposure. Insurers, military and defence companies, and mining and basic materials firms tied to infrastructure building are also doing well.

Eurozone government bonds have sold off sharply and yield curves have steepened – with longer-term yields increasing more than shorter-term rates – following raised expectations for developed market fiscal stimulus and potentially higher inflation. The German 10-year government bond yield has risen to its highest level in eight months, while the 10-year French government note yield rose above 0.70% for the first time since late January. The 10-year Italian sovereign bond yield rose to its highest level since July 2015 amid concerns about the country's upcoming referendum on constitutional reform.

As the election of Mr. Trump raises the spectre of uncertainty around political events in Europe, we think that this is likely to bring some jitters to Eurozone peripheral credits. Additionally, the outcome of the US presidential elections brings about an environment where the EU must take steps that will make it easier for the Prime Minister of the UK, Theresa May, to strike an acceptable agreement on Brexit. Altogether, this argues in favour of some weakness in the Euro and some strength for Sterling against the Euro.

We also face an abundance of discussions about whether the ECB will announce a tapering of its asset purchases in December. Without great conviction, we expect ECB President Draghi to announce a continuation of the current program with asset purchases of EUR 80Trn per month.

Overall, the outlook for Europe remains uncertain and there is fear that economic growth may lose momentum due to the broader uncertainty of Brexit. The problem with trying to gauge the potential long-term impact is the myriad of potential outcomes, ranging from a hard exit to a more conciliatory end. However, in talking to the management of our cyclical UK company holdings, they have so far felt no discernible impact from the Brexit decision. Similarly, the impact on consumer confidence has been minimal.

With the market trading at around 15-times earnings, which is slightly above average, Europe still remains quite attractive relative to other major markets.

JAPAN: Equity market sentiment has been shifting in 2016. Given renpany 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. This slowing profit growth has been quickly priced into the market, hence Japan's underperformance so far this year.

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: Trump's victory triggered a frenzy of volatility in emerging markets, driving stocks, bonds, and currencies of most developing countries lower. Mexican assets have been especially hard hit, with the peso plunging against the US dollar. However, we believe the peso has actually held up better than expected. We expect Mexico's central bank to raise interest rates to defend the currency.

Brazilian assets also suffered despite the release of government data showing that the country's inflation rate reached a two-year low, which will likely allow Brazil's central bank to keep cutting interest rates. In another longer-term positive for Brazil, a senate committee approved legislation that would impose a spending limit that is a key piece of the country's ongoing fiscal reforms. Russian stocks have outperformed other emerging markets as investors anticipate a thaw in relations between the US and Russia.

Overall, emerging markets continue to hold onto decent gains, even despite concerns over a rate hike in the US. The fear that rising US rates will spell doom for the emerging world is now no longer as valid. Many emerging economies have continued to improve their fiscal and current account deficits, debt positions and inflation levels, leaving them in a much better macroeconomic position and more able to absorb shocks.

As important, economic growth relative to developed markets is now showing signs of stabilising. The Brazilian and Russian economies are still weak, but are expected to start turning around towards the end of the year. India's economic outlook is strong, particularly for the second half of 2016 as they experienced a normal monsoon season. Meanwhile, the Philippines are experiencing healthy growth, while Indonesia and Thailand are showing signs of strengthening. China is the one exception, as its economy continues to slow and leverage remains high. However, emerging markets growth looks brighter versus a lacklustre pace in developed markets. This improved economic growth should provide a healthier environment for corporate earnings, particularly if margins begin to improve, as we expect. Valuations remain attractive.

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