Illumination: Equity strategy and market outlook

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Global perspectives: Fiscal forward guidance

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- **Trump has surprised markets twice over, first with a Presidential victory and second a rally in risk assets.** We believe this rally was due to bearish investor positioning prior to the election result as we can discern little that is new news from the Trump camp since the election.
- **We believe investors should continue to focus on valuations and the direction of monetary policy.** Investors should resist the temptation to become fixated by rapidly changing market-implied expectations towards higher growth and inflation. Expectations are volatile and it was only earlier this year that investors feared a worldwide deflationary bust emanating from China.
- **We have asked the question whether "Make America Great Again" could be compared to ECB President Draghi's "whatever it takes" OMT announcement.** A key difference is that in 2012 many asset markets in Europe were trading at distressed levels and this is not the case in the US in 2016. While we can see the parallel, it does not change our cautious positioning on developed market equities.
- **Rising inflation expectations and Trump's fiscal policies provide further reasons for the Fed to step back from ultra-loose monetary policy.** In line with our earlier views, such a transition may benefit Main Street more than Wall Street. We view the US stock market as overvalued at current levels and are not convinced that fiscal policy initiatives will be as beneficial for investors as the trillions of dollars of central bank intervention in financial markets in recent years.
- **From a medium-term perspective, we also note that on a price/book basis US equities are now close to peak levels compared to continental European peers.** Notwithstanding the current political difficulties, relative value at least is starting to emerge in Europe.

Trump's double surprise

It is quite clear that in the days leading up to the US Presidential election, both markets and surveys got it wrong. Traditional polling once again failed to spot the depth of support for radical political change. This was after all the US, which has delivered the strongest post-crisis economic performance of any developed nation.

The gyrations in global markets following Trump's surprise win once again highlight the risk of trying to map political events onto market outcomes. In our view, the remarkable turnaround in markets following the Trump victory tells us more about investor positioning than anything else. It appears that rather more investors were fearful of investing prior to the election than anticipated, leading to something of a short-squeeze in global markets following the overnight rout during the count. As everyone who wanted to sell had done so, there was little stock left for buyers.

Trump's early mention of repairing US infrastructure also ignited a 10% rally in the basic resources sector. While increased infrastructure investment is clearly beneficial at the margin for this global sector, the size of any programme remains uncertain and any positive impact on profits will be a number of years away. Again, the speed and size of the rally appears to us to be more to do with investor positioning than the fundamental outlook.

The key parallel with Brexit is an increase in political uncertainty under Trump. A grand vision has been presented but it is unclear how much of this can be delivered within the constraints of the US political system. However, in our view there is already a clear indication of policy transitioning away from monetary policy as the primary economic stimulus, in favour of fiscal policy. We believe increased political uncertainty and the move away from monetary policy are likely to result in heightened volatility, increased government bond yields and higher risk premia in global financial markets over the medium term, notwithstanding the recent rally.

Looking further out, the key lesson of the campaign is that the growing seam of discontent during this uneven period of economic expansion needs to be addressed. Lessons will need to be learned to avoid further political shocks in Europe. If it was the mantra of "the economy, stupid" which supported the Clinton campaign in the 1990s, it is the perception of inequality and unfairness which is now attracting the popular vote.

Forward guidance – Trump style

Trump's election, previously feared as a universal negative for global markets, has been accompanied by remarkable strength in risk assets. While highlighting investor positioning as a factor we also question if there is more to this rally. Could Trump's fiscal policies actually represent a "whatever it takes" moment?

In recent years, central banks are no strangers to jawboning markets with policy intentions to achieve policy objectives. Forward guidance for monetary policy has become part of policy makers' toolkits. The idea is to maintain a set of financial conditions conducive to supporting the real economy by guiding market expectations for monetary policy.

However, ECB President Mario Draghi raised jawboning to an art form when he declared he would do "whatever it takes" to save the euro through "outright monetary transactions" (OMT). The policy was very controversial and a high degree of uncertainty existed as to whether such action would even be legal. But Draghi's statement of intent was enough to calm markets, stop capital flight out of the eurozone periphery and extinguish the flames of the eurozone crisis. Four years on, OMT remains unused. It would appear that when a bazooka is large enough it does not need to be fired to get the necessary result. In this respect, there may be a parallel with Trump's controversial fiscal policies.

It is very early days and we do not know what action Congress might ultimately support in terms of US tax cuts or spending plans. A full implementation of Trump's campaign promises seems highly unlikely to pass through the US Congress, although in this respect he is not unique.

However, if OMT is a guide, policy efficacy may have a stronger link to intention, rather than action. Instead of "whatever it takes", this time it is "Make America Great Again". A positive feedback loop was created in Europe following the announcement of OMT, drawing the region away from crisis. At the time we were surprised just how far an effectively notional policy could carry markets. For global bond markets, we therefore believe the notable rise in yields is justified by recent events and may have further to run.

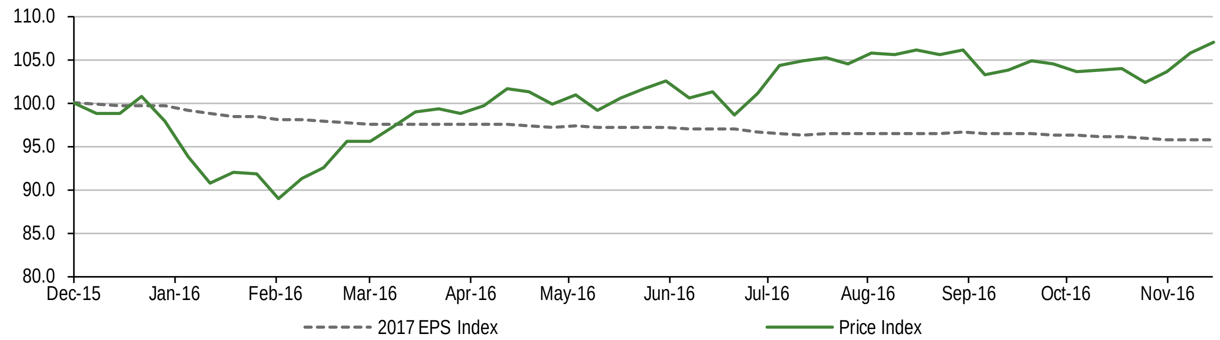
As with Draghi's OMT, owing to the way markets have reacted, the boost to market confidence is real and immediate and the re-pricing of global markets could in theory become self-validating as a race develops to invest ahead of an anticipated upturn in US GDP growth.

Central banks do not have a monopoly on forward guidance. The success or otherwise of "signalling" policies is also dependent on the prevailing mood of the crowd. As investors ask themselves the question "Could 'Make America Great' be as powerful as 'whatever it takes'", markets are likely to remain buoyant. However, we remain cautious and on reflection given current market valuations we would be looking to use this period of optimism - ahead of the details of actual policy implementation - to continue to take profits in US equities.

Earnings revisions – mind the US earnings gap

While the Trump victory may have continued to drive the market higher, US earnings forecasts for 2017 have moved modestly lower since the election. Exhibit 1 shows a growing gap between a declining earnings trend and a higher market, which is likely to act as a brake on the market from current levels, unless closed with upgrades in relatively short order. In addition, we believe the rise in the trade-weighted value of the dollar, consistent with Trump's policies of increased government spending and higher US interest rates and bond yields, is likely to prove a further headwind for US earnings prospects.

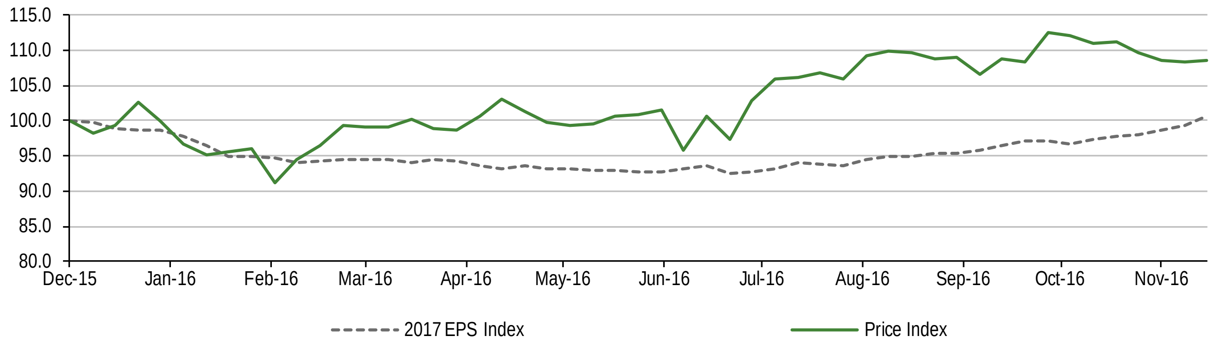
Exhibit 1: US equities and earnings –can the market continue to rally in the absence of 2017 upgrades?



Source: Thomson Reuters Datastream, Edison calculations

In the UK however, market indices appear better supported as earnings forecasts are still increasing, even as the stock market has lagged. Despite the enormous uncertainties in respect of the Brexit process (including the recent High Court ruling on Article 50), UK earnings estimates are still moving upwards and at an accelerating pace. This is being driven by the mining, pharmaceuticals and industrial sectors, and is clearly linked to the continued weakness in sterling. There were few downgrades over the last month but the worst performing sector was retail, where the currency may instead be contributing to margin pressure.

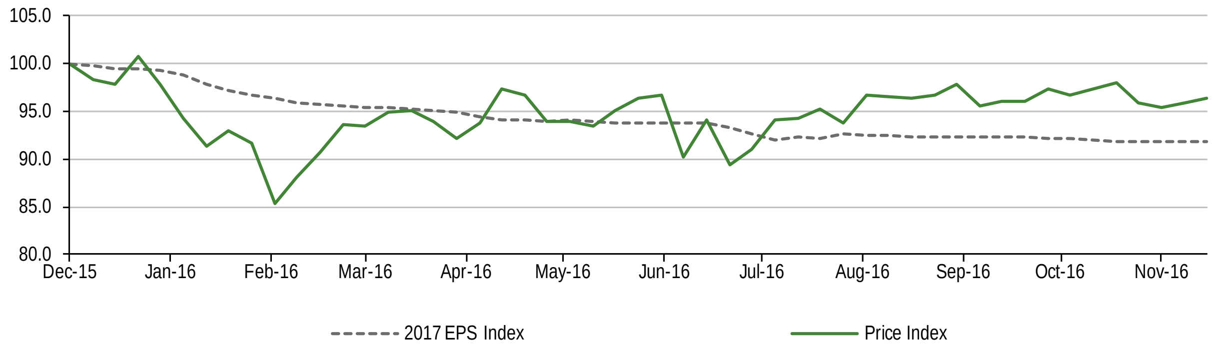
Exhibit 2: UK equities supported by rising 2017 EPS estimates



Source: Thomson Reuters Datastream, Edison calculations

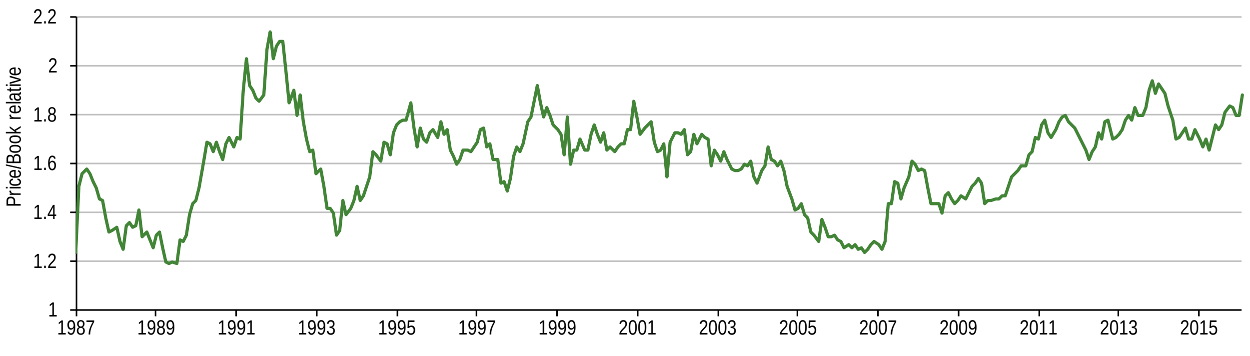
In continental Europe, both earnings forecasts and the equity market have been stable over the past three months. Although it is early days, we also note that following this period of underperformance European non-financials are now moving towards relative valuation levels against the US which have been associated with European outperformance in the past, Exhibit 4.

Exhibit 3: Europe ex-UK – market and 2017 EPS estimates tracking sideways



Source: Thomson Reuters Datastream, Edison calculations

Exhibit 4: Europe ex-UK and US non-financials P/book relative – value now in Europe's favour



Source: Thomson Reuters Datastream

Conclusion

Trump has surprised markets twice over, first with a Presidential victory and second a rally in risk assets. We believe this rally was due to investor positioning as we can discern little from the Trump camp since the election that was not already known, especially in terms of intentions in regard to fiscal policy.

We believe investors should continue to focus on valuations and the direction of monetary policy rather than becoming fixated by rapidly changing market-implied expectations towards higher growth and inflation. Expectations are volatile and it was only earlier this year that investors feared a deflationary bust emanating from China.

We have asked the question whether the Trump campaign slogan "Make America Great Again" could be compared to Draghi's "whatever it takes" OMT announcement. A key difference is that in 2012 many asset markets in Europe were trading at distressed levels and this is not the case in the US in 2016. While we can see the parallel, it does not change our cautious positioning on equities, which is primarily driven by valuation concerns and the reduction of emphasis on monetary policy to drive the economy.

Rising inflation expectations and Trump's fiscal policies provide further reasons for the Fed to step back from ultra-loose monetary policy. In line with our earlier views, such a transition may benefit Main Street more than Wall Street. We view the US stock market as overvalued at current levels and we are not convinced that fiscal policy initiatives will be as beneficial for investors as the trillions of dollars of central bank intervention in financial markets in recent years.

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