بنك أبوظبي التجاري ADCB

Is the Trump rally running out of steam?

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On November 16 last year we upgraded equities. This recommendation was based on the recognition that the global macro- and markets outlook had materially changed, following the Trump election combined with the Republican party gaining the majority in the US Congress.

Precisely because this decision has handsomely paid off, and after Mr. Trump's defeat on healthcare, it is only natural to ask oneself if the market has not moved ahead too much, and valuations – specifically of US equities – are by now not overstretched.

At a summary level we would argue as follows:

- **Some pull-back would be natural, if only because of profit-taking. Increasing volatility seems inevitable.**
- **The overall policy framework remains conducive to continuing economic growth in the US, and globally.**
- **Political risk in Europe is coming down.**
- **China will tighten only gradually through the year, at least until the National Party Congress in fall 2017.**
- **Critically, we are unlikely going to have a massive US dollar rally (although we still see a relatively strong US dollar).**
- **US valuations are stretched, but not flashing red: this has happened before, without reverting therefore a major market trend**
- **The above circumstances still favour equities and other risk assets.**

A pull-back is now more likely, but the reflation theme should endure over the months to come

Animal spirits still roaring on the right assumptions

When we decided to upgrade equities, we did so not because we were convinced that expansionary fiscal policy in the US was finally going to lift the country's growth rate. That growth rate, like elsewhere in the developed growth, will continue to be subdued when compared to what we were used to until the 2008 Global Financial Crisis. Rather, our call was mainly based on the fact that markets would give the new administration the benefit of the doubt, i.e. markets would anticipate "policy success", also in consideration of the fact that the new administration would get the support of the new Republican-dominated Congress. On the other hand, whilst we have serious doubts that fiscal policy can sustainably lift growth above the 3% YoY level, we do think that it can – and will – provide a meaningful boost in 2018.

The track-record tells us that US fiscal policy will provide stimulus to growth in 2018

Ronald Reagan and George Bush Jr. were both republican presidents who, with the support of republican legislators managed to make the deficit "great again". They did so through tax cuts and increases in spending. It makes sense to assume that Donald Trump will likewise be successful. The healthcare reform defeat has increased fears that Mr. Trump is unable to unify the party and that no breakthrough in repealing "Obamacare" means too little savings to allow for meaningful tax cuts. Clearly, the situation needs to be monitored, yet progress on healthcare reform was always going to be a bigger challenge than progress on tax reform (as is also amply demonstrated by the last four decades of US politics). As for the lack of savings, it is precisely the creation of larger deficits that will stimulate growth, similarly as with Reagan and Bush Jr.

Full-blown global trade war is not on the horizon

Selective protectionist trade measures – i.e. measures that target specific trading partners - will also, at the margin, be supportive of growth in the US. Two aspects are important here. First, the US dollar needs to remain on a strong footing so that consumers do not excessively suffer from potentially higher prices. Second, a full-blown trade war is not likely. This is so because the US is the global buyer of last resort. Now whilst it is true that everybody stands to lose in a global trade war, in a world of excess capacity (and we still are in such a world), the buyer loses less than the supplier. Thus, just as Mr. Reagan managed to convince the Japanese to adopt "voluntary" export restraints, the Chinese will be pragmatic too, and accommodate Mr. Trump with some "voluntary" concessions.

Fed for the moment helpful, long-term yields to remain contained

Just as the Federal Reserve did not live up to its own interest rate hike forecasts (the so-called "dot plot") in 2015 and 2016, we think it will be similarly reluctant to derail markets in 2017. Inflation should stabilize and, as the sole dissenting (against the recent rate hike) FOMC member has pointed out, wage pressures are still subdued. At any rate, two more rate hikes in 2017 should be bearable provided the US dollar remains relatively stable. If the greenback would significantly appreciate the Fed would definitely back off from its hiking intentions (this is so because a massive US dollar rally would be bad for the US economy, severely impact financial conditions in many emerging markets and put renewed downward pressure on energy and commodity prices). In sum, we seriously doubt that the Fed reference rate will be around 3% by the end of 2018. Critically, the long end of the US yield curve will remain stable such that the housing market will remain supported, as we have pointed out previously.

Europe risk diminishing, China to tighten gradually, "Russia affair" might grow as a risk factor

We continue to believe that political risk in Europe is overstated, at least as far as the 2017 horizon is concerned, and have somewhat already been confirmed in this by the Dutch election result. China tightening might become a real concern globally, but here too, it is occurring only gradually. Therefore we don't see a meaningful impact before the fall. If there is one risk factor that is decisively on the rise in the sense also that markets have so far ignored it, it is the so-called "Russia affair". If the FBI and the NSA uncover substantial evidence that the Trump campaign did collude with the Russian government, Mr. Trump – who has consistently denied this – would most likely be impeached, i.e. removed from office. This is something we will definitely have to monitor closely over the next days and weeks.

Advanced economies' equity-tilt, selectively emerging market hard currency bonds, US Treasuries and gold remain important additions to a well-diversified portfolio

To the extent that we will have recurring bouts of volatility, we continue to believe that it makes more sense to overweight US equities and take currency-hedged positions in UK and Japanese equities, rather than overweight emerging equities. However, we stick to our long-term core call on Indian equities. Selectively, we still like emerging market hard currencies bonds and recently added Russia. US Treasuries and gold remain important hedges in any well diversified portfolio.

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Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
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