بنك أبوظبي التجاري
ADCB

US equity sector allocation: Favor cyclicals over defensives

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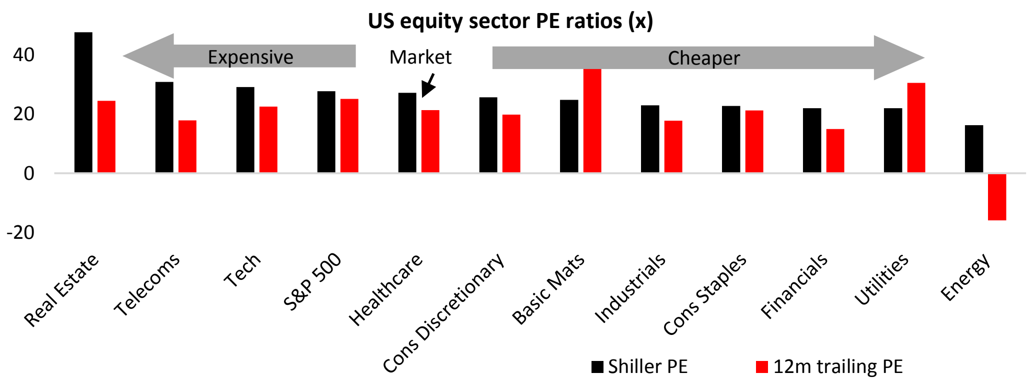
- **Following the outcome of the US election, we make changes to our US sector views. Broadly speaking we now favour cyclicals over defensives**
- **We highlight Industrials, Energy and Banks as the likely sectors to outperform and also retain our overweight (OW) call on the Health Care sector**
- **We cut our recommendation on Utilities and Telecoms to underweight (UW) from OW and downgrade Consumer Staples to neutral from OW**
- **We also remove our positive view on high dividend yielding equities, which lose their appeal in a world where yield curves have shifted higher**
- **In addition to our new, more negative outlook on the Utilities and Telecoms sectors, we also recommend to avoid Tech, which could be more hampered by Mr Trump's policies**

Trump presidency boosts cyclical sectors

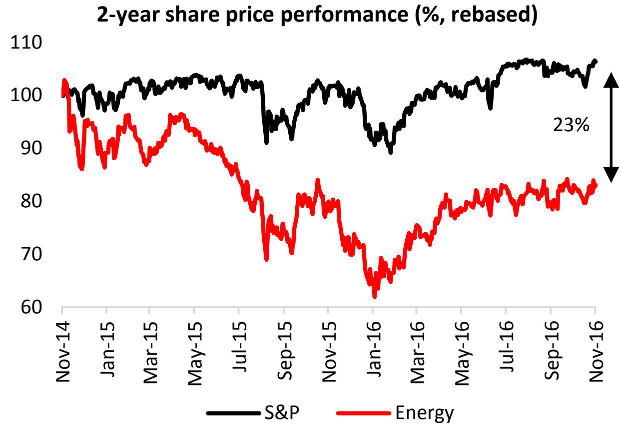
For the greatest part of this year we have held a preference for defensive equity sectors, especially those with elevated dividend yields (**link**). The rationale was simple; central banks in the key economies of the world forced yields down to such an extent, that investors' hunt for yield took them into the equity market and towards sector such as utilities and telecoms with yields in the range of 3-4%. Not only that, but we felt that risks to economic growth, especially in the US remained high, making the stable and predictable income streams of defensive sectors attractive. This has now changed along with Mr Trump's victory. **We therefore shift our sector preferences to those sectors which will benefit from rising growth and inflation expectations as well as higher interest rates. These are industrials, energy, banks and health care.**

Industrials (move to OW): The industrial sector is an extremely diverse one, ranging from construction companies to aerospace & defence and rail freight companies. Mr Trump's proposals of investment led growth will benefit those companies exposed to construction and (potentially) stronger economic growth. It is estimated that there are some 60,000 structurally deficient bridges and airports that are in desperate need of upgrading. So too schools and other infrastructure. The industrials sector is therefore the purest play on Mr Trump's proposed policies. US funds are only neutral the sector (having been UW for the past two years. The scope for rotation into the sector therefore remains plentiful.

Energy (move to OW): The energy sector has underperformed enormously over the past 2 years for reasons that everyone is very familiar with. Since this year's low on February 11, however, the more cyclical nature of the sector has allowed it to outperform the broader market by 9%. This could now continue for a little while longer if Mr Trump successfully rolls back President Obama's policies which have seen the fossil fuel sector in the US increasingly burdened. The flipside would be a much less supportive environment for renewable energy companies, but these comprise a much smaller weight in the overall sector. A more conciliatory tone with Russia could also help large US oil producers, some of which have large project in Russia that have been put on hold. The sector, understandably, is by far the cheapest in market (see below)



Source: Bloomberg



Source: Thomson Reuters, Bloomberg

Banks (move to OW): In our note on September 28 (**link**), focusing on the heavy underperformance of banking stocks (especially European banks), we highlighted the 3 key drivers weighing on the sector's performance;

1. Central bank policy is causing banks pain (by keeping yield curves flatter)
2. Economic slowdown, banks are a proxies for economic activity
3. Regulatory environment has changed for banks

We concluded that *"unless there is a central bank induced change which leads to steeper yield curves or a substantial improvement in economic growth prospects it will be difficult to view a rally in bank share prices as anything other than a dead cat bounce."* In the past week, out of these 3 drivers we have potentially witnessed changes to all 3 in the US (stronger growth, a steeper yield curve and potential for less regulation). Of course whether or not stronger growth and higher inflation will materialize is a big question, for the time being, however, investors will likely give Mr Trump and his policies the benefit of the doubt.

Not only has Mr Trump's victory caused yields to rise, but it also has a good chance to translate into greater Federal Reserve rate hikes than what the market is currently pricing in. This offers banks a big dose of margin relief. Mr Trump is also an ardent critic of Dodd-Frank regulations which came into force post-2008 global financial crisis and which is a major piece of financial legislation. Mr Trump has identified financial deregulation as a top priority for his incoming administration, hoping that this will give banks the incentive to start lending more. **As a result of these changes we move the banking sector to overweight in the US.**

Health care (remain OW): Health care is one of the only defensive winners from the election of Mr Trump. The reason why the sector had struggled in the run-up to the US presidential election had to do with the discussions around drug pricing, with Mrs Clinton taking a particularly strict stance on the topic. We kept the sector on OW regardless because we were sceptical whether the new president would really implement concrete changes in the sector. All the while, Mr Trump's stance is more favourable towards the sector and his victory means future earnings expectations have scope to rebound, given after all but pricing in a Mrs Clinton victory. Health care sector dividend yields are not high, meaning that unlike other defensive sectors (utilities, telecoms and consumer staples) they should be less negatively impacted by rising bond yields. Balance sheets in the sector remain very strong making a resumption of the share buyback and/or M&A trend likely.

Sectors which we now think will perform less well

High dividend yielding sectors lose their lustre in an environment of rising bond yields, meaning that the **utilities and telecoms** sectors' attractive dividend yield is no longer sufficient reason to own them. Mr Trump's reflationary policies also mean that the defensiveness these two sectors provide, becomes less appealing for the time being. By saying *"for the time being"* we mean that it is still very unclear to what extent Mr Trump will succeed in reflating the US economy. Equity investors tend to be a very optimistic bunch, as such they will likely price in a good outcome, i.e. markets will give Mr Trump's policies the benefit of the doubt. Time will tell whether their optimism will be rewarded or turn out to be misplaced. If it is misplaced, and the US economy fails to respond positively to the new government's policies a rotation back towards the higher yielding and defensive sectors is very likely.

Given his background Mr Trump has been portrayed largely as a pro-business president, however, it is worth remembering that much of his campaign rhetoric focussed on US companies taking jobs outside of the US as well as large tech companies exploiting tax loopholes. Avoid technology and sectors overly dependent on foreign revenues.

Conclusion: the Market is likely to go with the flow

Throughout his campaign Mr Trump has been long sound bites and short details, so it remains to be seen whether his proposed, highly reflationary policies will have the desired impact on economic growth. However, if treasury yields are any guide, the market is giving him the benefit of the doubt for now. We too, do not want to stand in the way of what could be a very powerful driver of near-term equity sector performance, and therefore choose to express our US equity overweight via the more cyclical sectors in the market.

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*
5. *Gulfbase*
6. *Zawya*

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