Investment Strategy Note

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A pull-back in equities will likely precede the next move higher, but the Trump reflation trade has momentum

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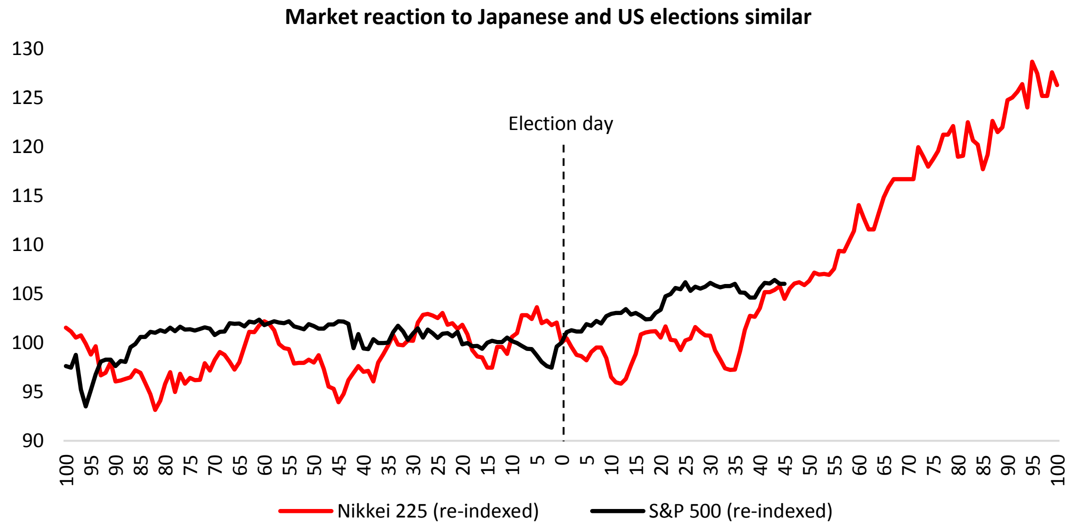
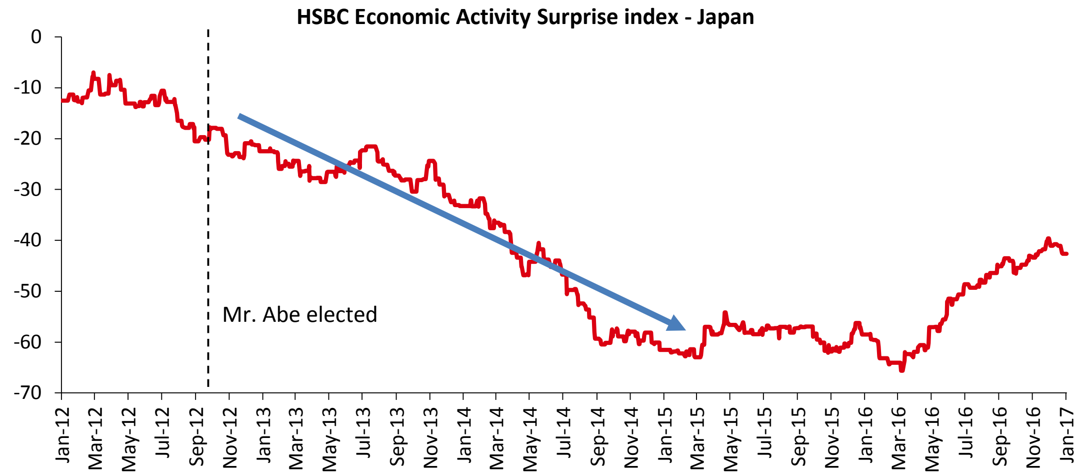
Equities have rallied significantly since the US Presidential elections on November 8. Markets have risen to such an extent that it is now plausible, if not likely, that we will see a pull-back in the coming weeks. We do not expect this to amount to more than a pull-back given the Trump-reflation trade still has momentum. As we have argued during our Q1 2017 roadshow, **global financial markets, which had until last year been driven by central banks and expectations of monetary easing, are now being driven by politics. This is visible across the globe, Brexit, Trump, Italian referendum, Mr. Modi in India, the political scandal in Brazil, events in Turkey, etc. etc.** This means that the policies that Mr. Trump proposes will also determine the near-term direction of markets.

And there is a precedent for this kind of politically-sourced market optimism, Japan. Prime Minister Shinzo Abe rode to office in September 2012 on the back of a huge stimulus plan focusing on the so called 'three arrows'. These were monetary policy, fiscal policy and structural reform. Investors bought into the hype and pushed equities up, and the currency down. Within 3 months of the election Japanese equities were up 26% and continued to rally thereafter. Of course US equities were already around record highs when Mr. Trump was elected, as such the extent of the performance in the US is unlikely to match that in Japan (even though for now it has, see chart below). The chart below shows the performance of the Nikkei 225 and S&P 500 in the 100 days before, and 100 days after the respective elections of Mr. Abe and Mr. Trump.



Source: Thomson Reuters, HSBC

The chart above should be viewed in conjunction with the chart below. This is the HSBC Japan economic activity surprise index. The red line shows how economic data came in relative to expectations. A downward trend indicates that the data released disappointed, indeed it is clear that for years post Mr. Abe's election that economic data disappointed. **This did not matter, investors continued to give Mr. Abe's 'three arrows' policy the benefit of the doubt. The point being that Mr. Trump with his reflation package can continue to generate enough enthusiasm to push markets higher, even if in the next few months there are no tangible results.**



Source: HSBC, Bloomberg

So we think that the global reflation trade which kicked off on the day of the US Presidential election can continue for some time, but first some consolidation is likely. Global equities are currently in the over-bought territory with most sentiment indicators suggesting investors are overly-optimistic. At the same time, expectations of both global as well as US earnings growth for 2017 are hovering around 12%. This seems quite unrealistic given earnings have hardly grown at all in recent years.

Overall, however, provided the expected pull-back does indeed materialize, it should create an attractive entry point for another leg higher in global equities. Higher beta markets, such as Japan and Europe will outperform in this scenario. Albeit it should also be noted that Japan in particular will likely underperform during a risk-off phase given that the yen, the predominant driver of Japanese earnings expectations will likely strengthen. Nevertheless, our overweight on Japanese equities (hedged) is structural rather than tactical, meaning that a short period of underperformance following a c15% surge over the past 3 months is quite normal. The same can be said for our currency-hedged UK equity call; the FTSE 100 has for the first time ever closed at a record high for nine consecutive days, **so we can expect a period of consolidation before equity markets resume their upward trajectory.**

We are neutral global equities in our asset allocation.

بنك أبوظبي التجاري
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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*
5. *Gulfbase*
6. *Zawya*

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