Taking profits on our US small caps and US banks calls

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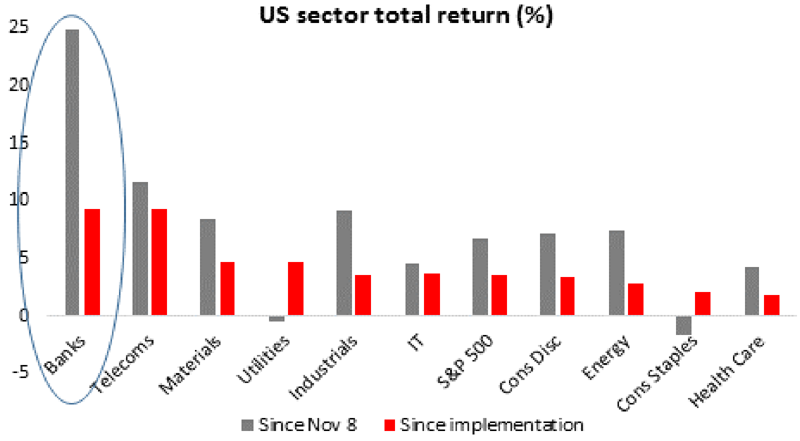
In the weeks following Mr. Trump's election we made some key changes to both our asset allocation as well as our US sector and style preferences. Although we were always skeptical as to what could realistically be delivered in terms of fiscal, especially infrastructure spending in the US, we felt that there was sufficient momentum in the Trump reflation trade to warrant a shift in our own defensive stance. **On the back of a more cyclical outlook we recommended US banks and US small caps which we felt could outperform. Following strong performance in both, we now neutralize these calls.**

The main reason is that we believe markets have run ahead of themselves and that a pull-back is likely in the near-term. This means that the areas of the market which have done especially well are likely to correct more. **In particular we are concerned about banks and small caps. While they are still likely to outperform over the course of 12 months, they now appear to be priced for perfection.**



Source: Thomson Reuters

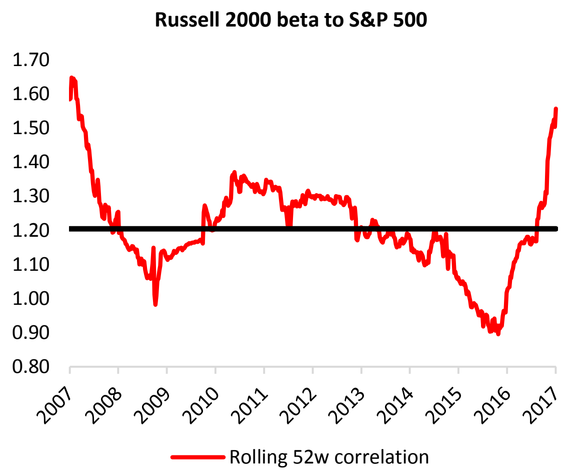
__Banks__ have been the biggest winners since November 8th, returning an impressive c25% relative to c7% of the S&P as a whole. Since we implemented our call the sector has risen 9.4% vs. 3.6% in the S&P 500 (total return). Q4 2016 earnings season kicked off in the US last week and so far all five of the financial institutions to have reported have beaten expectations. This is good news for banks, but it is likely already reflected in share prices. The S&P 500 banks sector returned only 0.4% last week despite the strong earnings numbers.

At the same time, the steepening of the yields has been sharp, and while higher rates are generally positive for banks net interest margins, this is only true up to a certain point. At some stage higher rates will dampen demand for credit. On the regulation front, there are high hopes. The partial reversal of the Dodd-Frank reforms are among the reasons we recommended the sector two months ago. However, given the run up in share prices it is likely investors will be disappointed by the pace of financial deregulation. Indeed there are good reasons to believe that Mr. Trump will not want to be perceived to be helping Wall Street given that he was elected on the back of an anti-elite message.

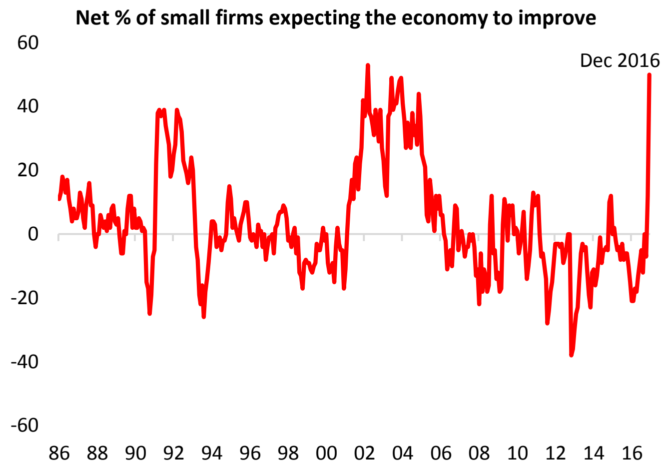
We have not become negative on US banks, we just believe that the good news is now in the price. Mr. Trump is a businessman and understands the importance of credit, and so getting credit to flow to the parts of the economy that need it most can benefit both consumers and banks. And although financial deregulation is unlikely to happen immediately, it is fairly safe to assume that the point of maximum regulations is behind us, in and itself a reason for banks to perform reasonably well. These are reasons to not be negative on the outlook for banks. For now, however, we take profit of c9.4% on our US banks call.

US small caps is another part of the market which has benefitted from the election of Mr. Trump. When we recommended them the main arguments were that they would benefit disproportionally from lower corporate tax rates and were more insulated from the side-effects of the stronger dollar. We continue to believe this is the case, meaning that over the medium-term they will likely do quite well. However, they are also high beta and we believe a pull-back in equities is now warranted. If US large caps now come down, small caps will come down more. The beta of the Russell 2000 index has risen to 1.56 relative to the S&P 500, well above its 10-year average (see chart below).

At the same time sentiment among smaller businesses about the outlook for the US economy has skyrocketed in December (right-hand chart below). The National Federation of Independent Businesses described the 38 point jump witnessed in December as "stratospheric" as the index surged to its highest level since 2004. Although this is macro survey of small business owners, we believe this exuberance is to an extent also embedded in small cap share prices.

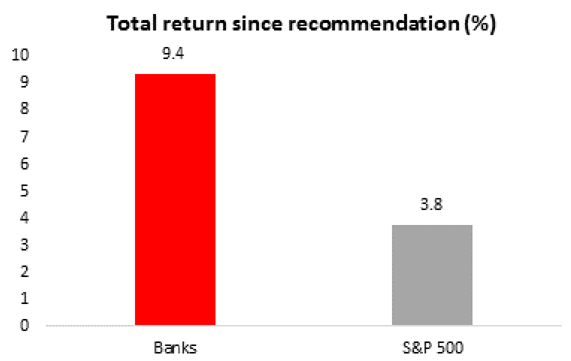


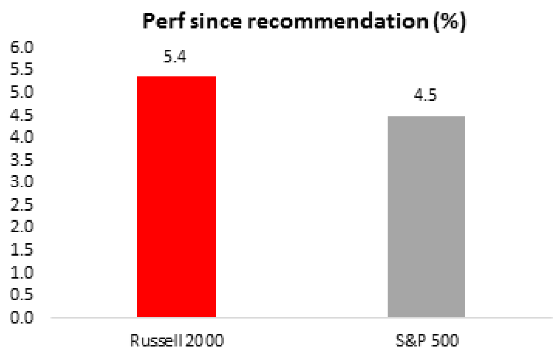
Source: Thomson Reuters



Source: National Federation of Independent Businesses, Thomson Reuters

We book profit on both recommendations, 9.4% on US banks and 5.4% on small caps, both having outperformed the S&P 500 index. We believe that these parts of the US market are vulnerable to a near-term pull-back, even if their longer-term prospects continue to look good.





Source: ADCB, Thomson Reuters

We maintain our US sector recommendations on industrials, energy and health care. Industrials have performed in-line with the broader market, while the energy and health care sectors have slightly underperformed since we recommended them, however, both are positive in absolute terms (2.9% and 2.7% respectively).

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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