Investment Strategy Note

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Trump – Making US small caps great again!

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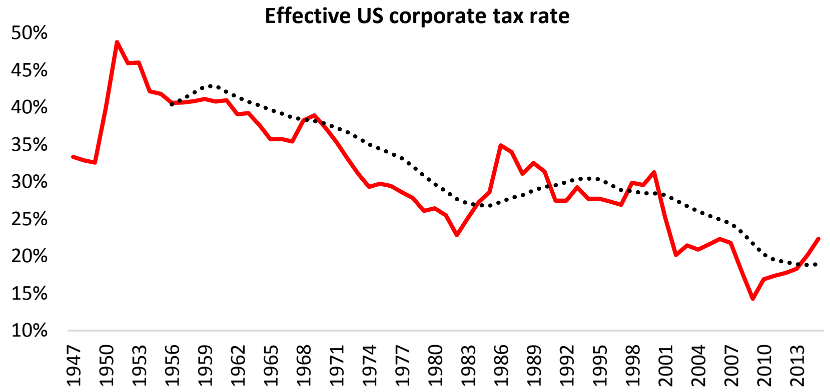
- **Mr Trump's proposed policies, such as cutting corporate taxes are great for small cap companies at the expense of large caps**
- **In addition, a stronger US dollar on the back of more reflationary policies will also support smaller businesses**

Trump presidency benefits US small caps at expense of large caps

There is a lot of speculation in the markets about what Mr Trump's victory, and what the Republican "clean sweep" means for financials markets. The knee-jerk reaction has been clear, investors expect Mr Trump's policies to drive up bond yields. While there are likely to be profound implications for asset allocation and equity market and sector selection from this change, one segment of the US market which could benefit disproportionally from Mr Trump's proposed policies is small cap equities. We initiate an overweight recommendation.

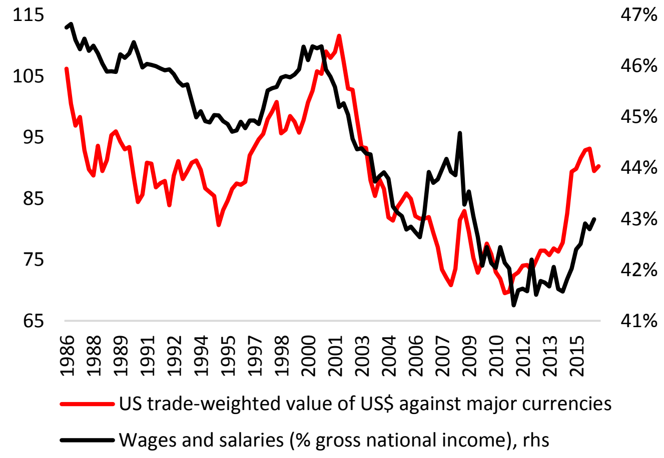
Given his background Mr Trump has been portrayed largely as a pro-business President-elect. However, it is worth remembering that much of his campaign rhetoric focused on US companies taking jobs outside of the US as well as large tech companies exploiting tax loopholes. It is therefore not so clear how beneficial for business he will really be. On the surface, his plan reduce the 35% corporate tax rate to 15% may sound very favourable for business. The reality is, however, that most large US domiciled multi-nationals don't pay anywhere near the 35% tax rate, instead they take advantage of write-downs and loopholes which means that their effective tax rate is already much closer to the 15% level which Mr Trump proposes (see chart below). Mr Trump finding a way to lower corporate taxes would therefore provide hardly any benefit to large multi-nationals (and may even hurt those who pay below the 15% threshold). Instead, the major beneficiaries would be smaller companies who don't have the financial firepower or know-how to hire expensive tax consultants able to help them lower their effective tax rate. **Bottom line: Mr Trump is good for small business but bad for big business.**



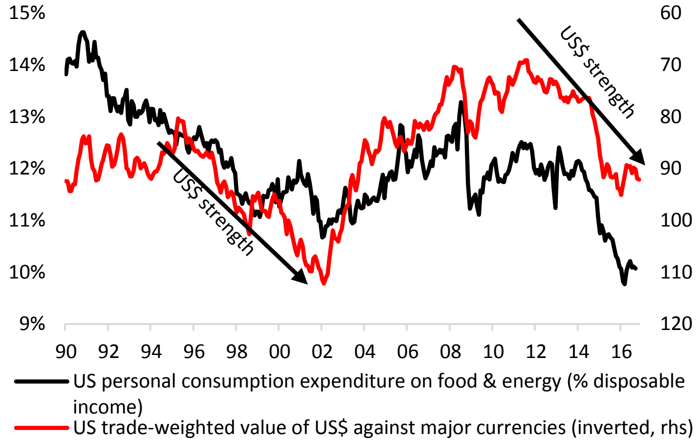
Source: Bureau of Economic Analysis, St Louis Fed

What's more, to the extent Mr. Trump's policies lead to a stronger dollar via reflationary policies, this will impact large multi-nationals which export all over the world much more than smaller companies which derive a greater share of their revenues from inside the US. It could be argued that Mr Trump will push-back against a stronger dollar, however, given the platform that he was elected on, supported particularly strongly by blue-collar workers who feel that their standard of living has deteriorated, it seems unlikely that Mr Trump will crave a weaker dollar given that this predominantly benefits the larger multi-national corporations. In fact, a stronger dollar tends to lead to a boost in wages and salaries while simultaneously supporting growth in household disposable income (see charts below). **Bottom line: A stronger dollar tends to help smaller companies.**

Stronger US$ boosts wages...



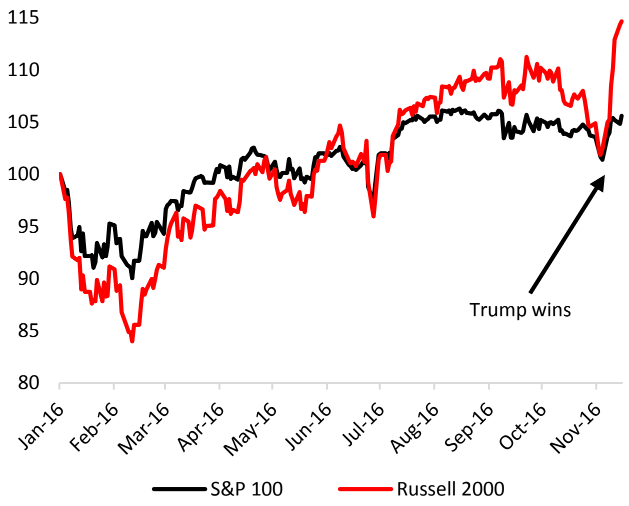
Stronger US$ supports disposable income



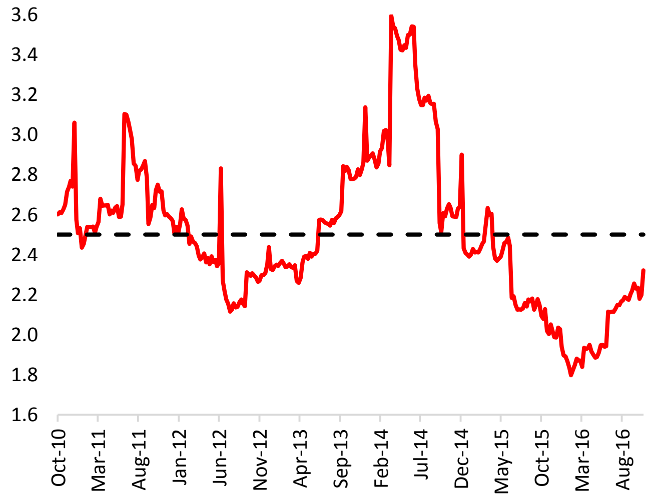
Source: BCA Research, Thomson Reuters, US Bureau of Economic Analysis

This is not really a new view, we have already written in June about a preference for domestic revenues earners in the US over those with higher overseas exposure (**see link**). Our main reasoning back then was that the protectionist/de-globalization trend was accelerating, which would favour companies less dependent on trade. This will now be super-charged by a Trump presidency. In the week since the US elections, the Russell 2000 index has outperformed the S&P 100 by 7.4% (chart below). Of course, small caps tend to be much more expensive than large caps, this is because the growth potential of these companies is far greater. Looking at valuation data since 2010 (chart below) shows us that the Russell 2000 trailing PE ratio currently stands at around 45x vs. 20x for the S&P100, meaning that small caps are 2.3 times more expensive than mega caps in the US. However, this remains below the average relative valuation of 2.5 times. Indeed, significant overshoots are possible, in 2014 small caps were 3.5 times as expensive as mega caps.

US small caps vs. Mega caps y-t-d (rebased)



Russell 2000 PER rel. to S&P100 PER (both trailing)



Source: Thomson Reuters, Bloomberg

In conclusion, we believe small caps have the potential to benefit disproportionally from Mr Trump's policies which are likely to favour the little guy over the large corporations. This, after all, would be consistent with the platform that he was elected on. The fact that Mr Trump owes little to the political establishment adds to the belief that he will not deviate significantly from his domestic plans (it is more likely that if anything changes it will be his foreign policy proposals). If he is able to deliver the cuts in corporate tax which he has touted, and his policies lead to a stronger dollar, there is a very good chance that the outperformance over the past week of small caps is only just beginning.

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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