Investment Strategy Note

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2 Weeks on – Winners & Losers from Trump in equity markets

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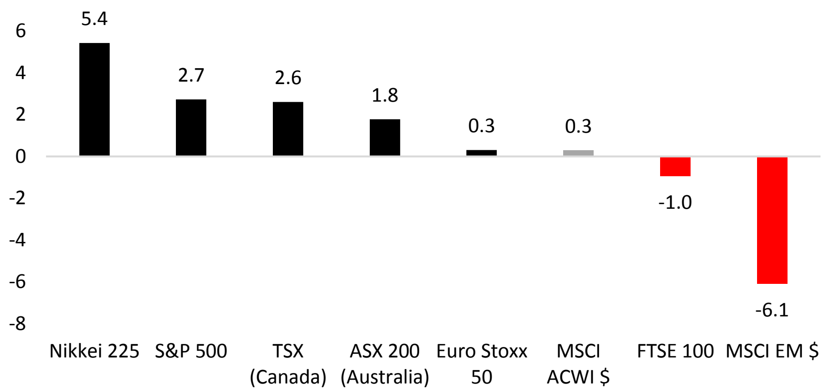
- **By country/region Japan and US are the winners, EM the big losers**
- **Style-wise value is strongly favoured to growth as well as higher dividend yielding strategies**
- **In terms of size, small caps are the clear beneficiaries**
- **Sector winners are cyclicals at the expensive of defensives**
- **In EM Russia is the main winner and Mexico the big loser**

Equity investors are clear about the implications of the US election

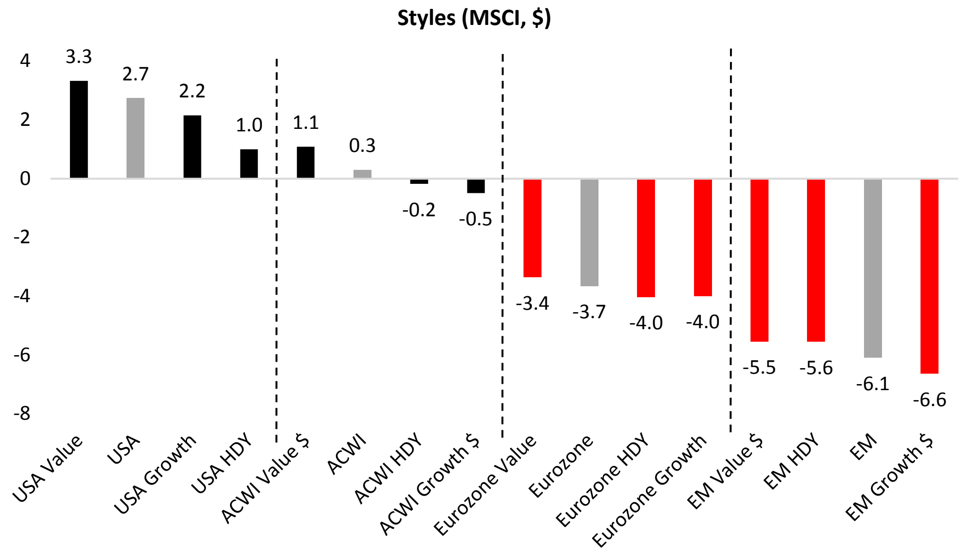
Yesterday all three major US stock indices made new all-time highs which has been attributed to the Trump-effect. Two weeks ago today Americans were at the polls voting for who they want to become the next President. Markets had priced in a Mrs Clinton victory, they were wrong and the rest is history. There have been profound moves in financial markets, bonds have sold off and the US dollar has appreciated. Below in chart format we take stock of the moves in equity markets since their close on Nov 8. We show which countries, regions, sectors and styles have outperformed and underperformed during this time.

Region/Country performance (%)



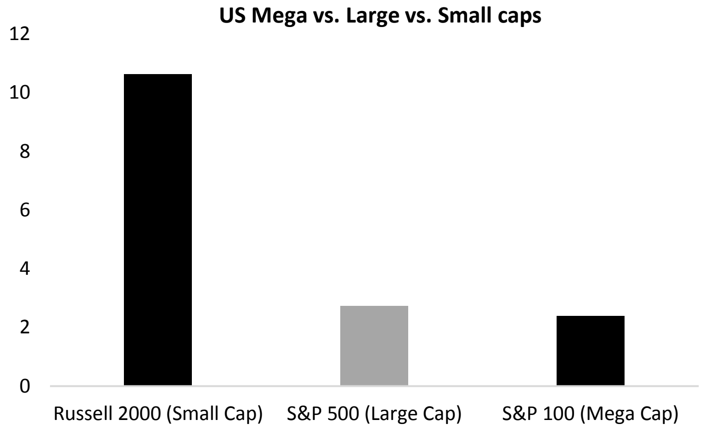
Source: Thomson Reuters, MSCI

The S&P 500 reached a new all-time high on November 21, just shy of 2,199 and in futures trading has risen above the 2,200 threshold. Investors are making their feelings clear, Mr Trump's reflationary policy agenda is good for equities and bad for bonds. Two other very significant moves on the above chart also stand out, the outperformance of Japanese equities and the sharp underperformance of Emerging Market (EM) equities. Japanese equities benefit from a stronger US dollar, the flipside of which is a weaker yen which is already feeding through into stronger earnings growth expectations. The other driver is the yield differential between US Treasuries and Japanese Government Bonds. The BoJ has vowed to prevent 10-year JGBs from rising above 0%, whereas US 10-year yields have risen c50bps since the election. This benefits Japanese equities and of course also keeps the yen weak. Whereas US and Japanese equity investors have chosen to focus on the fiscal policy and infrastructure spending part of Mr Trump's message, Emerging Markets have focused on the trade policy part of the message. This, in addition to the strong US dollar and rising Treasury yields have weighed heavily on EM equities. On November 14 we issued a note **upgrading Japanese equities to overweight (OW) and downgrading EM equities to underweight (UW), see link.** We had already downgraded EM equities once before to neutral in September. **BOTTOM LINE: Mr Trump is good for US equities and good for Japanese equities (via a weaker yen and growing bond yield differential) and very bad for EM equities.**



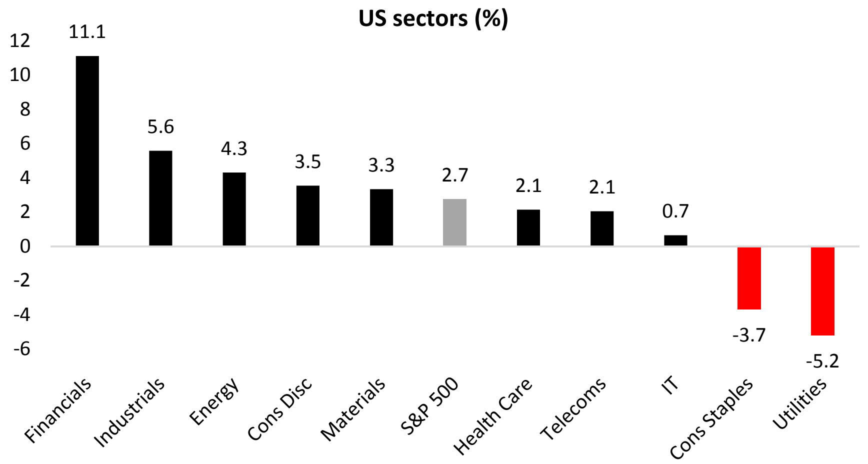
Source: Thomson Reuters, MSCI

In terms of styles, the outcome is also clear, value is expected to outperform growth. Regionally in the US, Eurozone and EM, as well as Globally (ACWI) value is the strongest performer. Whereas growth is the weakest performer in the Eurozone, EM and in the global index (ACWI), in the US it is the high dividend yield index (USA HDY) which is the worst performer. This makes sense given the US is at the epicentre of the paradigm shift we are witnessing. Rising US yields severely diminishes the attraction of higher yielding equities. In EM, however, HDY is only the second worst performer, suggesting that investors are less aggressively selling off higher yielding equities, given these can behave more defensively. **BOTTOM LINE: In a reflationary world value tends to outperform growth, while high dividend yielding equities lose their shine in a world of rising bond yields.**



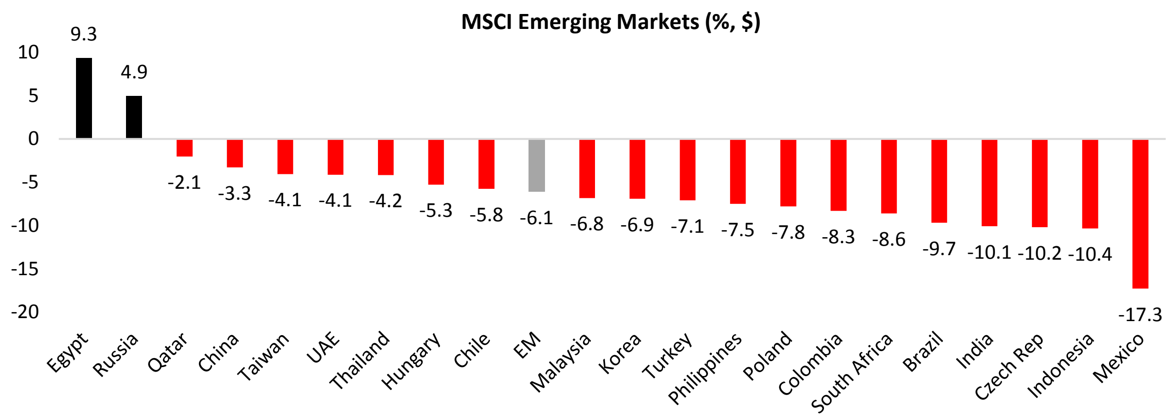
Source: Thomson Reuters, MSCI

Within the US, investors have an overwhelming preference for small caps (Russell 2000) over large caps (S&P 500) and mega caps (S&P 100). The rationale, we think, is as follows; Mr Trump's proposed policies benefit smaller companies much more than larger ones. Lowering the corporate tax from 35% to 15% will not greatly benefit (and indeed could hurt) larger companies given they already 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. Smaller companies on the other hand which are unable to exploit these loopholes in the same way will benefit from a lower corporate tax rate. In addition, smaller companies derive a smaller share of their revenues from overseas, i.e. the domestic market is more important for them than for larger companies which export their goods and services all over the world. The stronger US dollar therefore hurts large companies more than smaller ones. We have written about our preference for US small caps over large caps, **see note Trump – Making US small caps great again!, see link**. **BOTTOM LINE: Trump's policies are likely to benefit smaller companies much more than the larger multi-nationals.**



Source: Thomson Reuters, MSCI

Sector wise in the US there is a shift toward the cyclical sectors. These sectors are more highly geared to a pick-up in economic activity than defensive sectors such as utilities for example. Financials have outperformed the most, this is unsurprising given it is their business model to borrow short and lend long. When long-term yields are depressed (as they have been in the QE era), margins for banks are impacted. Rising bonds yields are therefore helpful for banks net interest margins. Industrials are the second best performers. The sector is essentially a proxy of the overall economy, comprising companies ranging from construction companies to aerospace & defense and rail freight companies. Mr Trump's proposals of investment-led growth will benefit those companies exposed to construction and (potentially) stronger economic growth. Energy is another sector which has cheered Mr Trump's victory, given that he is expected to roll back some of President Obama's policies which have hurt fossil fuel producers in particular. Not only that, but the potential for a more conciliatory tone with Russia would create the prospect of large US energy companies with projects in Russia, currently on hold or frozen to resume those. On the flipside, the defensive sectors have underperformed, these sectors in many cases have higher dividend yields (these are less attractive when bond yields are rising) and are less geared to stronger economic growth. We have made **changes to our US sector allocation, choosing to focus on the industrials, banks and energy sectors, see link**. **BOTTOM LINE: Cyclical sectors will benefit from infrastructure-led reflation.**



Source: Thomson Reuters, MSCI

In the Emerging Markets space (all performance in US dollars) Egypt leads the way in terms of performance, it has recently come through a major currency devaluation (50%) at the start of November. Russia is the only other market in positive territory. The mutual admiration between President-elect Trump and Russian President Putin has been well documented throughout the election campaign. US sanctions on Russia which have contributed a great deal to the economic difficulties in Russia could now be watered down or removed all-together. The Russian rouble and equity market have therefore bucked the trend witnessed in other emerging markets. GCC equities, represented by UAE and Qatar in the EM benchmark have been resilient. Underperforming the EM average (to the right side of the grey bar) are mostly markets with large current account deficits or twin deficits. These markets will find it increasingly difficult to finance their deficits given the surge in the US dollar and Treasury yields. One surprising underperformer (surprising to us) is India, which traditionally acts as a much more defensive market in an EM context. The reason for its underperformance is because on the day of the US elections (Nov 8), the government announced a 500 and 1,000 rupee note demonetization. This has severely impacted the consumer sectors in the market, which had been the engine of economic growth and equity performance. Banks' business has also been impacted. Performance-wise it is no surprise that Mexico brings up the rear as the perceived most negatively impacted by Mr Trump's likely trade policies. The market was hammered in the 3 days post the election result, but has since been among the top performing EM equity markets, rising 1.8% in US dollars since 11 Nov (vs. -0.2% for EM). **BOTTOM LINE: A stronger US dollar, higher Treasury yields and potentially more difficult trade relations with the US are negative for EM equities.**

Conclusion

Major paradigm shifts in financial markets are not always as easy to spot in real-time. Brexit is an example of such event, which had the potential to be a game-changer, but ultimately, so far at least has proven not to be. Judging by reactions across major asset classes, Mr Trump's victory IS a real game-changer. Moves in the major asset classes have been more profound than in the wake of Brexit. Of course there are inherent risks in adjusting one's allocation in response to a single event. Very often initial market moves are a poor indicator of eventual direction. In this instance, however, we believe that the market is for the most part repositioning correctly. The world has been crying out for fiscal stimulus to take over from monetary stimulus for many years, this now has scope to happen. The biggest risk lies in the composition of Mr Trump's fiscal policy. If it is tax-cut heavy and infrastructure spending light, we will likely see a reversal in the moves discussed above. However, just like the markets, we give him the benefit of the doubt for now. Given his election campaign was run on very few policy details, the shifts towards US & Japanese equities, from growth to value, from defensive to cyclical and from large to small caps can continue for a little while longer in our view.

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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