Trumpenomics: winners and losers

We change our asset allocation, downgrading bonds and upgrading equities

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Wietse Nijenhuis
Equity Strategist
Tel: +971 (0)2 205 4923
wietse.nijenhuis@adcb.com

Rahmatullah Khan
Economist
Tel: +971 (0)2 696 2843
ramatullah.khan@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Economically, Trump is the opposite of Brexit, and China will for the moment continue to devalue its currency

Over the coming 3 – 6 months we expect that:

- *The incoming US administration will likely be successful in boosting fiscal spending allowing the Federal Reserve to hike rates (in any case, what will matter over the next months is that markets will give Mr. Trump the benefit of the doubt).*
- *Unlike Brexit, where the weaker pound sterling favors the wealthy over the disenfranchised working class, the stronger greenback coupled with deficit-financing will go a long way in accommodating Mr. Trump's discontented electorate, thereby allowing the incoming administration to refrain from implementing its most disruptive populist election slogans.*
- *China will continue to allow for a moderate devaluation of its currency. This will go hand in hand with a gradual and modest decline of its foreign reserves, in fact showing to the world that its intervention is preventing a massive depreciation of the renminbi. It will not be possible for the new US administration to raise any complaint. A weaker renminbi buys time for China in that it allows the authorities to continue to stimulate the domestic economy, albeit in an inefficient and ultimately damaging way.*
- *Nonetheless, even if China is for the moment unlikely to cause global jitters, the stronger US dollar combined with the lingering threat of protectionist measures is a sufficient condition for continuing damage to emerging markets assets.*
- *Deteriorating domestic US financial conditions, specifically a stronger US dollar and higher yields, will put a cap on how high US equities can go.*
- *Far more important, we believe, is the selection of those US equity sectors, and those global equity markets, that will benefit from the new US policy framework of deficit-spending, a stronger US dollar, and increased protectionism.*
- *At the level of the US equity market, we see a healthy sector rotation that, amidst more volatility, should provide a floor, and thus prevent a massive correction.*
- *The case for bonds becomes less positive, since higher deficits, stronger growth and inflation lifts the yield outlook, as long as a recession can be avoided.*
- *US yields are likely to stabilize in the short-term, then move sideways with an upward bias.*
- *Hard currency bonds of large commodity importing emerging markets, like India, continue to make sense.*
- *Once yields stabilize it will make sense to move into higher yielding US corporate bonds that, barring a recession, might well outperform the US equities.*
- *In the alternatives space, market-neutral strategies and gold continue to make sense as an insurance policy against increased geopolitical and macro-economic risks.*

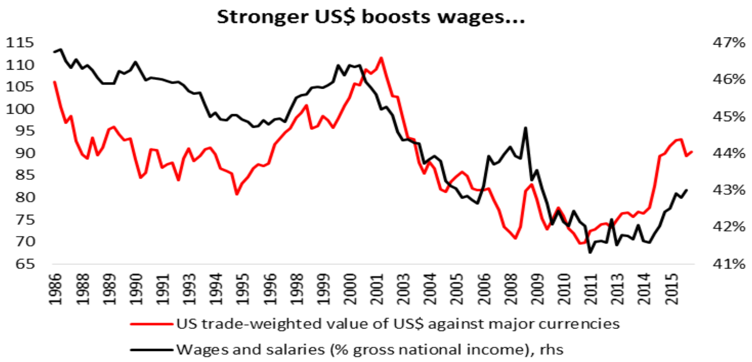
Our asset allocation - key views

- **Equities:**
  - ***We move neutral on global equities after having been underweight since February 2015.***
  - ***We stick to the US equity overweight and the European equity underweight that we have held since** January 2016.*
  - ***We introduce a** JPY-hedged call on Japanese equities **and retain our existing** GBP-hedged call on UK equities.*
  - ***We have downgraded emerging markets equities further from** neutral **to** underweight. **We are looking for an optimal moment to exit our** Mexico call. **At the same time, however, we stick to our** overweight Indian equity call. **We will shortly send out an update on India.***
  - ***We are updating our sector calls. This update – generally speaking – will reflect a shift from defensives to cyclicals.***
  - ***Within the US market, we reiterate our call** on inward oriented companies over exporters. **In the same spirit, we will shortly introduce a note on small caps that likewise tend to benefit from a strong US dollar and more protectionist trade (and tax) policies.***
- **Bonds:**
  - ***We move neutral on global bonds after having been overweight since May 2014.***
  - ***In the medium term, we expect 10-year Treasury yields to stabilize in a range between 2.0-2.5%. We would wait for yields to reach the lower bound of that range before reducing duration. At that point, we will also recommend a switch from traditional Treasuries into TIPS.***
  - ***We stick to selective hard-currency emerging markets bonds. Here too, over time it makes sense to reduce duration.***
  - ***We are exploring ways to increase holdings of higher yielding US corporate bonds since – barring a recession – they could outperform equities.***
- **Alternatives:**
  - ***We stick to our neutral allocation on alternatives.***
  - ***We overweight market-neutral over directional strategies.***
  - ***We stick to a significant gold holding.***

US policy turnaround is concrete game-changer, positive policy momentum is sustainable over the next months

Persistent deflationary pressures and the increasing ineffectiveness of advanced economies' monetary policies had been the main drivers behind our February 2015 choice to go underweight global equities. In the United States we are now observing an attempt for fiscal policy to pick up the baton from central bankers. Specifically fiscal policy will become more expansionary in the world's largest economy, whilst monetary policy is likely to tighten more. This should, barring a recession, keep yields at higher levels.

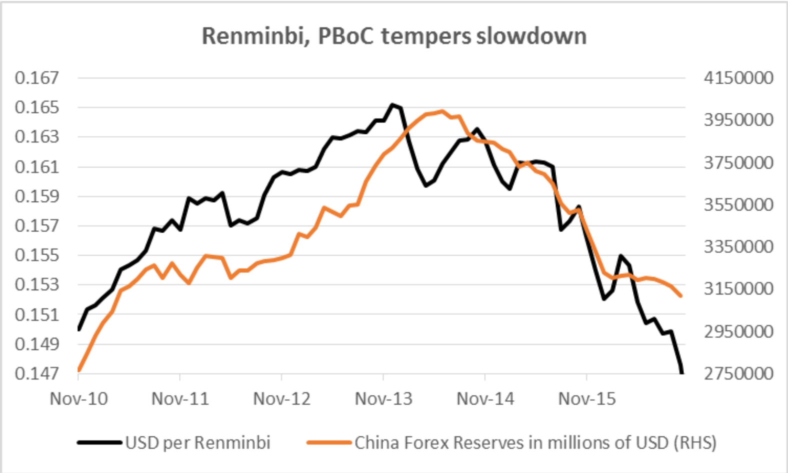
It is important to stress that over the next months the incoming administration will be highlighting only the positive narrative of less regulation, corporate and personal tax cuts and, importantly, infrastructure spending. This narrative – together with the stronger US dollar – will in fact be sufficient to placate the anger of the disenfranchised and impoverished (former) middle class that voted Mr. Trump into power. Herein lies the big difference with Brexit. Brexit has determined a massive devaluation of the pound sterling, and consequently a revaluation of British assets, which benefits the wealthy at the expense of the poor. In the US exactly the opposite is happening: there is no political need for the new populist administration to engage immediately in populist measures!



Source: BCA, Thomson Reuters, US BEA

Risk are here to stay, but the can is will be kicked down the road, again

China will be allowed to further devalue its currency. It will not gain significant benefits from this since most currencies, and in particular Asian currencies, will fall also fall against the US dollar. Importantly, however, moderate devaluation implicates relatively stable foreign exchange reserves, which means that the authorities can keep on stimulating the economy. They will do so again in the wrong way, increasing investments in the inefficient state companies and real estate, thereby further growing the country's debt burden. It remains to be seen if this will be sustainable until November 2017, when the Chinese Communist Party will renew its leadership and President Xi Jinping intends to strengthen his hold on power. Over the next months, however, it will be sustainable and we expect both Beijing and Washington to strike a conciliatory tone.

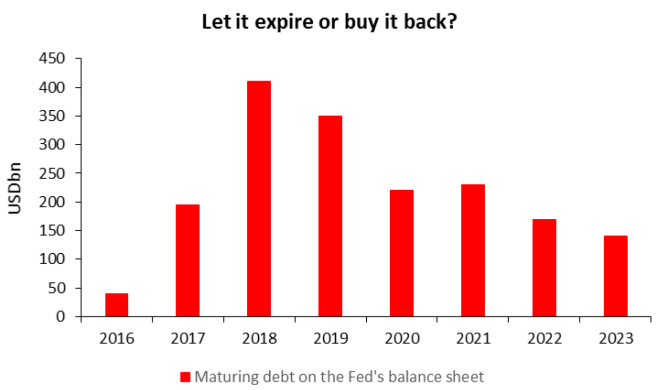


Source: Bloomberg

During the election campaign, Mr. Trump often complained about a Federal Reserve that has been too accommodating with the Obama administration. Now, he'd better hope for an accommodating central bank since he will start a massive fiscal reflation program at a time that the unemployment rate is at 4.9%, inflation is picking up and the federal debt over GDP ratio is 74%. Here, arguably lies the key difference with Reaganomics. When Ronald Reagan came to power and started his reflation policies, unemployment was above 7% and had been rising for more than a year, whilst the federal debt over GDP ratio stood at 26%.

We think that Mr. Trump might, come February 2018, replace Yellen not with a hawk, but with a dove. This, as we see it, reflects the true nature of a real populist who would not want a nascent fiscally-driven recovery to be derailed by central bankers' concerns about inflation. In our view it is a major risk, if not the major risk. An independent Federal Reserve may be forced to hike overly quickly as inflation climbs too fast, thereby compromising any US recovery and making life harder for emerging markets. The alternative, i.e. a Federal Reserve that is cajoled by the administration into a submissive attitude would be very disruptive as well.

And it is not only about interest rates. Trump's aides have been indicating that they would like the Federal Reserve to reduce its balance sheet, by no longer using the proceeds of expiring Treasuries to buy new paper on the open market (something the Federal Reserve so far has kept doing). As an increasing amount of paper is now expiring, we expect the Trump camp to change its mind here too.



Source: Bloomberg

Equity, upside potential capped, but ample opportunities within the asset class

Higher global yields and a stronger US dollar will keep emerging markets under pressure. US equity markets are already expensively priced, yet the positive momentum from fiscal policy taking over the baton from monetary policy (finally!) might persist over the next coming months. Moreover, the overall market might be further sustained since the narrative of reflationary fiscal policy might, in fact, induce a healthy rotation into the hitherto depressed value and cyclical sectors.

So, whilst we remain prudent as to the effective upside potential of global equities, we do see less downside over the next months. As we have been doing through 2016 when we were underweight equities, we continue to implement our overall equity positioning by taking marked regional calls. We stick to our US equity overweight and Europe underweight because we believe that the former is more defensive in case a global risk-off phase re-emerges, whilst the latter would act exactly in the opposite manner. Also, the euro stands to be the most resilient to US dollar strengthening, which is not good for European blue chips.

Within the US equity market, 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. 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 small caps will meaningfully outperform large caps in the US. In fact in general the fiscal reflation trade is allowing for a healthy rotation from defensives to cyclicals; we will shortly send out a note on small caps, and soon also on the general optimal equity sector positioning.

We have added to our GBP-hedged call on UK blue chips, a JPY-hedged call on Japanese equities. The rationale behind the UK call has not changed: a hard Brexit remains the most likely outcome, which means more expansionary fiscal and monetary policies, thus a weakening pound sterling which is favourable for UK blue chips. The rationale behind the Japan call is similar in that, here also, for economic policy reasons the yen will remain weak against the US dollar. On the monetary side, the BoJ has now capped 10-year government bond yields at zero, giving the government more freedom to stimulate on the fiscal side. Lower yields imply lower required returns for Japan equities, and – through the exchange channel – higher corporate earnings.

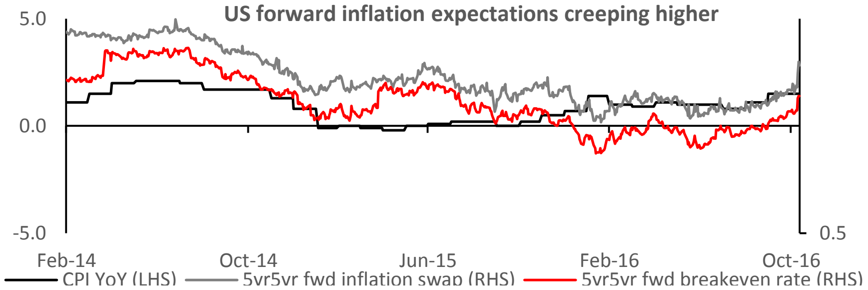
We have further reduced our emerging markets stance to underweight. Financial conditions were already bound to deteriorate with the imminent rate hike in the United States, which is why we moved in September from overweight to neutral. Now this process is being exacerbated by higher global yields, a stronger US dollar, as well as the threat of unfriendly US trade policies.

We still see potential for large, and therefore relatively insulated, emerging markets to do relatively well, especially if they are net commodity importers. That is why we stick to our India call. We will shortly circulate an update on India.

Yields to stabilize at higher levels

Our bond overweight, which we have held since May 2014, was essentially based on the persistence of deflationary pressures and the inability of central bankers to normalize yields, without precipitating a recession. The prospect of an expansionary fiscal policy is now facilitating this “normalization”. The process will take time and will be volatile. Also, yields are still likely to remain capped at historically low levels. It will be a volatile and time consuming process because the other two major central banks, the ECB and the BoJ, are still working in a different direction. True, the ECB is likely to taper sooner rather than later, but fiscal policy is still austere. More importantly, the BoJ has capped 10 year yields at 0%. This should also exercise some downward pressure on global yields. As to the levels beyond this process, we would caution to see a return to the levels prior to the Global Financial Crisis. Debt levels remain at historically high levels and the populations in most advanced economies are ageing. These are structural impediments to growth and inflation. Fiscal policy is not the right instrument for addressing them.

As a risk hedge it makes sense to keep an underweight holding in US Treasuries. We now favour 5 to 7 year TIPS, however, as they are the better hedge to the increasing risk of inflation. We will wait for yields to stabilize before implementing that trade.



Source:Bloomberg

We still see value in hard currency emerging market bonds. As before, however, we stick to large emerging markets that are more insulated from the global economy and that are not commodity exporters. In addition, however, we recommend to over-time reduce duration of such holdings. Finally, we are exploring the opportunity to invest in higher yielding corporate bonds. To the extent that the new reflationary policy will reduce the risk of a recession, they might provide more upside than equities.

Alternatives: stick to gold and market-neutral strategies

Whilst the weighting of our alternative investments also remains neutral in our portfolios, we maintain a substantial overweight in non-directional market neutral strategies as well as gold. The former addresses the issue that, in the current environment, an increasing number of active managers no longer deliver significant absolute returns. The latter remains a necessary hedge against persistent geopolitical, and now also inflationary risks.

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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