Market Outlook

A monthly commentary by Gabriel V. Safdié
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TRUMPONOMICS

Generalities (1-5)

1. To everybody's surprise, the election of Donald Trump generated quite a lot of optimism in the US with a rise of 5.4 % for the Dow Jones Industrial index and 2.6 % for the Nasdaq Composite.

2. However, the other markets did not follow the move : +5.1 % for the Nikkei in yen but -3.3 % in usd; -0.20 % for both the Dax Index and the Euro Stoxx50; -4.4 % for the MSCI Emerging Markets index in usd.

3. However this new optimism regarding an acceleration of US growth heavily weighted on bonds with the yield on the 10-year US sovereign bond rising from 1.82 % to 2.38 %, while its German equivalent increased only from 0.16 % to 0.27 %. The yield difference between them is the widest in over 25 years.

4. The dollar also benefited from this environment, with the greenback rising versus the euro from 1.10 to 1.06 and against the yen from 105 to 116.50.

5. And if the CRB Commodity Index was almost unchanged, large divergences happened inside the index : +18.9 % for copper and 7.40 % for nickel, but -8 % for gold and -12.7 % for cocoa.

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Equities (6-15)

6. Contrary to appearances, it is not only the election of Donald Trump that is revolutionary, but also the fact that since 1928 it is the first time that Republicans simultaneously control the White House, the Senate and the House of Representatives.

7. Republicans now have a free hand to do everything they have been dreaming for a long time and quick changes regarding taxes, federal government spending, free trade agreements, immigration, regulation of economic activities and health policy are expected. Moreover, through the appointment of one or more members to the Supreme Court, the influence of this administration could be felt far beyond its own existence.

8. Thus a new world is really starting to emerge and this despite the fact that Hillary Clinton obtained more than 2'000'000 votes than the elected president and that, probably since the civil war, never has the country been so much divided with the large population centers being quite progressive while the rest of the country became more conservative.

9. One must therefore be aware that if politically gridlock is over, from a societal point of view things have become much more tense which could lead to new forms of conflict over the next four years.

10. While waiting to see how opposition to the Republicans will materialize, investors have rightly focused on the expected first economic measures, which, if they occur with the foreseeable magnitude, are likely to boost growth. The market's hope is that with the end of gridlock, the measures taken will be much more aggressive than if they resulted from a compromise between the two parties.

11. Furthermore, Donald Trump is lucky. In our previous months' comments we indicated that the slowdown of US growth in late 2015 and early 2016 was behind us and that naturally it would now return towards 3 %.

12. Thus, not much is needed for growth to reach a level that, not only will push aside the notion of secular stagnation, but also bring a significant improvement in the standard of living of the voters who have enabled Mr. Trump's victory, making him appear as a hero in their eyes.

13. And this even as Mrs. Clinton would have also taken measures favorable to growth, since one of the few agreements between Democrats and Republicans is the need to increase public spending on the country's infrastructure.

14. But obviously, in the new political context, spending should be much larger than what could have been expected before the elections and even more so as Mr. Trump is very sensitive to anything related to construction. And this was reflected in the sectorial indices with a rise in November of 11.5 % for the Dow Jones Transport and 11 % for the Russell 2000 (the small capitalization index).

15. A word of caution nevertheless. There is a risk, which is presently difficult to ascertain, that measures in favor of infrastructure may not be done by increasing public spending, but through tax credits, thus removing much of its effectiveness; a fact that investors would not fail to sanction.

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Equities (16-26)

16. The other markets' great hope is related to taxation where large tax cuts both for individuals and companies are expected. And here again, if they happen at the expected level, this will be strongly stimulative for both household consumption and investment spending. Besides, if it were simultaneously accompanied by a simplification of the tax code and a reduction of tax loopholes, then the positive long-term effects would be far superior to the disadvantages.

17. The adoption of all the expected measures would increase the public deficit to 5 % of GDP in 2017 against 3 % currently. But as they are likely to gradually allow real growth to increase between 0.5 % and 1 %, the higher deficit should not be cause for concern.

18. The conclusion - so far - is that contrary to some who find the market's reaction incomprehensible, we consider that since the above scenario is plausible the US stock market's rise is logical.

19. But it was perhaps a little too exuberant, as nothing is done yet and the measures that will be taken may not reach the current expected level. And skeptics mention the fact that Mr. Trump is a novice in politics, without government experience, and that Republicans in Congress are too fiscally intransigent to accept such a large increase of the deficit.

20. Time will tell; but one must be aware that for better or worse it will be very difficult for Congress to oppose Donald Trump. In addition to his negotiating skills, evidenced by the number of times he has been able as a businessman to extricate himself from very delicate financial situations, he has a communication team who brilliantly knows how to use new media channels such as Facebook. And many were expecting, if he was not elected, that he would start a business in the communication's area. Thus, any Republican in Congress who would stand too strongly against him would undergo media attacks even stronger than those suffered by politicians who confront the NRA, the powerful arms' lobby.

21. Nevertheless if stock market corrections were to occur, one should always keep in mind that even if the measures are lightened, they remain favorable to US growth at a time when growth is already at a decent level.

22. More unfortunate are the protectionist measures that could be taken. The refusal to ratify the transpacific treaty is politically very favorable to China as it reduces US influence in Asia. However, it has few economic consequences.

23. But what will be most interesting is to see how far Mr. Trump will go in his reassessment of the free trade treaty with Canada and Mexico and whether he is really ready to start a trade war with China. Here, as in many other fields, uncertainty reigns and there is not much point in speculating at the moment. Potentially it is THE subject that could weigh the most negatively on the economy.

24. Finally there is another matter - banking reform - which could also be a positive vector for growth if the reductions of the constraints imposed by the Dodd-Frank act following the financial crisis of 2008 are intelligently made.

25. This is the hope reflected by the Nasdaq index, which rose 18.1 % in November.

26. But it is also true that the bull move was also favored by the expectation of faster rises in interest rates, which would allow an increase in the banks' profit margins.

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Bonds (27-32)

27. And it is not surprising that the possibility of the accelerating rise in interest rates heavily weighed on bonds.

28. Indeed, not only are the expected economic measures likely to accelerate growth, but moreover - as we are already close to full employment - there is a fear that the decisions Mr. Trump could take in the immigration sector would accentuate upwards wage pressures, thus leading to higher inflation.

29. Anyway one must be aware that the bond yields' rise in November is only the beginning of the move. If the expected measures become reality thus allowing the US to grow between 3 and 4 % next year, then the three interest increases - of 0.25 % each - expected in 2017 would be quite insufficient, since these would raise the FED's fund rate to 1.5 %, i.e. still well below the inflation level which should be between 2 % and 3 %.

30. Furthermore, paradoxically, the election of Mr. Trump has liberated the FED. Indeed, following the criticisms of Mr. Trump during the campaign, Janet Yellen and her colleagues will be much less reluctant to raise interest rates than before.

31. We therefore continue to recommend caution in this area with only tactical trades and we continue to focus on equities. And in this area, we believe that one should now underweight defensive stocks.

32. Furthermore - and even if they have disappointed in November - non-US equities remain attractive, as they are less expensive than US ones and not subject to the pressure of rising interest rates. Finally, the acceleration of US growth will impact positively the global economy, even more so as other governments will take similar measures against tight budgets and in favor of growth.

Currencies (33-37)

33. Obviously most of what has been mentioned so far is favorable to the dollar, thus justifying its rise in November.

34. But some caution is necessary.

35. Historically when US interest rates started to rise the dollar depreciated because the real yield was falling due to the fact that US inflation was accelerating. And it was only in a second phase that the dollar moved up once the increases in interest rates allowed a higher real yield.

36. But we live in an atypical period, with a return close to 0 % for other currencies. Competition is therefore quite weak.

37. It is therefore likely that in coming months the dollar will be more correlated with the evolution of the stock market than previously, since as long as equities are rising, the normalization of interest rates - which should carry the short-term rate above inflation - can continue.

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Commodities (38-41)

38. Here also, the trend in November was logical, notably with the sharp increase of industrial commodities.

39. The unexpected event was the gold's fall. Mr. Trump's election being a source of uncertainties, gold did indeed increase in the hours that followed the result. But the move was short-lived since, unable to forecast what Mr. Trump's foreign policy will actually be, it was impossible for investors to establish whether it will or will not increase geopolitical tensions, which is one of the reasons that could be favorable to gold.

40. Thus it was only financial moves which influenced the price of gold, starting with the dollar's rise which partially explains the decline of the yellow metal. But the main factor was the rise in yields. Indeed, as long as they move up at the same rhythm that growth expectations it will be difficult for inflation to reach even the 3 % level.

41. Therefore November was the perfect illustration of what we wrote last month : future gold's move will largely be influenced by the evolution of interest rates. The more they will rise and the more gold will suffer and vice versa.

Conclusion (42-47)

42. While for years pundits expected an imminent return to recession, there is a path - of course quite narrow, but no more so than the one that led Mr. Trump to the White House - that sometime in 2017 the market begins to worry about an overheating of the American economy.

43. Indeed, if a good infrastructure investment program is voted, if tax cuts are well targeted and if regulations are intelligently pruned, then an economic boom can occur. Of course the big uncertainty comes with the if.

44. Anyway the main danger for the stock market comes from a too fast rise of bond yields, all the more so as they are still too low. And there remains the risk that investors - who have massively positioned themselves in bond funds - panic and try to disengage en masse, thus leading to a bond crash that will also strongly pull down the stock market.

45. But for now the trend is our friend and one must hope that, if concerns outside the US regarding Mr. Trump decreases, the US equity bull move could then spread to other stock markets.

46. In short, the surprising conclusion is that, at least in relation to the economy, Mr. Trump could quickly appear as a hero in the eyes of the average American, particularly if he remains reasonable on the issue of protectionism.

47. Of course, as many, we are put off by the vulgarity of the elected president and his entourage, especially in comparison with Michelle, Barack Obama and their family. But aren't we in a world where vulgarity reigns ?

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