Global Investment Letter

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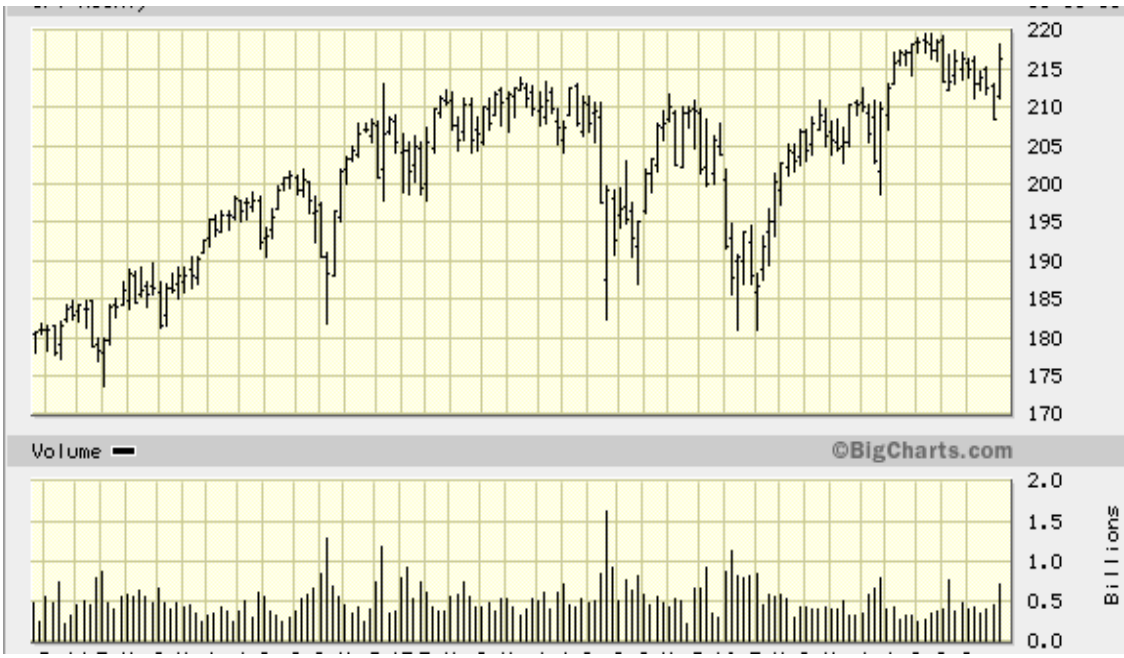
US EQUITIES: ARE POST ELECTION GAINS SUSTAINABLE?

S&P 500



The shocking election of Donald Trump on November 8th has introduced a host of new factors that will influence capital markets for the duration of his presidency. The U.S. election result has added further uncertainty to an already troubling environment for world capital markets. What can be expected of U.S. equities in the months ahead?

Equity indices in the United States retreated sharply the evening of November 8th in premarket activity as the prospects for a Trump presidency rose. The Dow was down as much as 800 points. However, since that time, U.S. equities have performed very strongly. The fact that equities have performed so strongly to what was generally perceived as bad news must be interpreted as being very bullish. Why have U.S. equities responded this way?

I believe one factor is psychological. We have entered into a "phony war" stage in dealing with a Trump presidency. The term "phony war" was coined to describe the period between the time that Britain declared war in 1939 and the commencement of hostilities by Germany in 1940. During this period, day-to-day life went on largely as usual, as the population struggled to keep the coming struggle out of mind. Donald Trump will not become President until January 20, 2017. Since the election, there has been an effort among the media to rationalize the election outcome by suggesting that fears of a Trump presidency have been overblown. We observed another case of the "phony war" phenomenon in the UK in the months following the Brexit vote. After an initial shock, the FTSE and pound sterling performed surprisingly well. The "phony war" ended when Prime Minister Theresa May announced that she would be triggering Article 50 no later than next March, and that she was seeking a "hard" exit. The benign response to President-Elect Trump will last until he invokes a policy that shakes investor confidence.

A basic premise of my analysis of markets is that capital flows can trump (pun intended) valuation and other concerns in the short to medium term. The United States has benefited from international capital flows in a world that contains precious few more attractive alternatives. The relative strength of the US dollar versus the pound, euro, yuan et al makes holding US dollar denominated assets even more compelling. I believe the US dollar will continue to perform strongly.

While U.S. equity markets responded to the election of Donald Trump, U.S. bonds sold off sharply. U.S. bonds have been under pressure for some time, with the probability of the Fed raising interest rates increasing as the year wore on. However, U.S. long bonds fell especially sharply in the days after the election as President-Elect Trump's stated policies of significant tax cuts and deficit spending on infrastructure are seen by many as leading to higher interest rates. U.S. equities have and will continue to benefit from the enormous sums that will flow out of bonds as the bond market continues to weaken.

The chance of a Fed rate increase in December seems very good at this point. The U.S. economy has been surprisingly strong in 2016, especially compared to other large nations. Moreover, the Fed would like to raise rates from current low levels to provide itself with ammunition in the form of rate cuts to combat the next recession. Lastly, President–Elect Trump's policies of tax cuts and infrastructure spending will likely provide at least a short-term stimulus to the U.S. economy, which the Fed will want to anticipate with a rate increase.

A Fed rate increase in December will likely not derail an advance in U.S. stock prices. The early increases in the interest rate cycle are not typically harmful to stock markets as they are viewed as indicative of a robust economy and, hence, stronger corporate earnings.

A final argument for U.S. equities can be made by the long observed bullish seasonal tendency of equities during the winter months.

In conclusion, U.S. equities appear poised to perform strongly for at least the next few months. The only major risk to this bullish view is market-unfriendly policies or behaviour by President-Elect Trump. Most new presidents enjoy a honeymoon period, which should help ensure positive equity performance in the months ahead.

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