GONET MARKET OUTLOOK
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WINNING STREAK

IN A NUTSHELL

Restored confidence following the election of Donald Trump has galvanised equity markets, but also sparked further problems, as bonds tumbled and the dollar surged. As both factors could weigh on growth, we are betting on a pause in the rise in yields, while monitoring the risk of a correction among equities. Against this backdrop, our core scenario remains bullish, provided that dollar strength does not trigger another episode of risk aversion.

OUR STRATEGY

During the autumn, we adopted a cautious allocation profile, slightly underweight both in equities and bonds. Our intention was nevertheless to redeploy our cash positions opportunistically. Although we switched a number of positions, the main changes were triggered by the election of Donald Trump.

By 9 November, we had already resumed neutral equity exposure and we then went overweight a week later. This two-step increase mobilised our cash position.

We are currently riding the wave, although as we explain in this review, we are closely watching several indicators which may signal a turnaround.

Our allocation risk is mitigated within each main segment. Our equity positions are limited to core markets, while our bond weightings are dominated by sovereign issuers.

DOLDRUMS OR BOOM?

Market turnarounds rarely coincide with key landmarks in the calendar. However, a quick glance at 2016 reveals an interesting scenario, demonstrating a remarkable symmetry either side of the mid-year Brexit crisis. On the one hand, there was the panic over China in January-February and on the other, the euphoria following the election of Donald Trump in November-December.

Despite their differences, all three were political events. This was clearly the case for the pro-Brexit vote and the US presidential election, but it is also true for the shift in the currency regime applied to the renminbi, which revealed Beijing's hesitation between two strategies, namely stimulus or deleveraging. This episode fuelled uncertainty and had the most negative impact on investors. Conversely, the pro-Brexit vote and the election of Donald Trump were followed by a roller-coaster reaction characterised by a brief spell of uncertainty, which soon gave way to optimism and even euphoria.

The turnaround was increasingly rapid each time. It took six weeks for the S&P 500 index futures to return to their level recorded on 11 January, five days to recoup the losses triggered by the pro-Brexit vote, 16 hours following the election of Donald Trump and just nine hours following the failed referendum instigated by Matteo Renzi.

These rapid market turnarounds were hardly surprising however. As we had highlighted in the previous issue of *Market Outlook*, intervention by the central banks has muted market volatility, which is perhaps even one of the aims of their programmes. Any black swan event, unforeseen at least by those who ignored the wave of political discontent in the UK, the US and elsewhere, was bound to disrupt this artificial sense of tranquillity. This explains the surge in pessimism, but what accounts for the euphoric turnaround? We believe that this reaction is not particularly surprising, as both the Brexit and Donald Trump's programme give hope that the current doldrums will come to an end.

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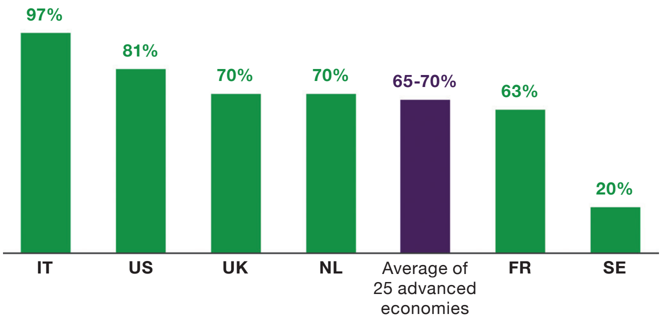
Is the term doldrums not an exaggeration? Let us clarify what we mean. Economic growth is sluggish throughout all of the developed economies and its impact is unevenly distributed, leading to living standards among the middle classes stagnating or even deteriorating. Aside from the insecurity caused by technological changes and geopolitical developments, the surge in public debt has led to a persistent increase in the tax burden, even in the US. Heavier public debt has also driven most retirement pension systems further into crisis. Of course, although the central banks have no say in budgetary policies and even less power in terms of structural reforms, their bond purchase programmes, now totalling several trillion, have facilitated government over-borrowing and weighed heavily on savers.

We have frequently highlighted the decreasing efficiency of quantitative easing and the counterproductive effects of negative interest rates. However, as no one is ready to give up the anaesthetising comfort that the central banks have accustomed us to, another form of stimulus is required as a relay. While investors were hoping to see spending-power increased through the distribution of helicopter money, UK voters decided to regain control of their economic policies and the Americans elected the candidate promising tax cuts and protectionism. On reflexion, all three cases reflect the same policy, involving deeper budget deficits in the name of stimulus. While investors only dreamed of this, the citizens actually brought it about. ■

Share of households with flat or falling income, 2004-2014



Incomes are inflation-adjusted, include wagesband income from capital and are before taxes and transfert.
Sources: BlackRock and McKinsey, October 2016

DRAWING HASTY CONCLUSIONS

At first unbelieving, market consensus rapidly regained confidence, abandoned the formerly prevailing scenario, based on infinite liquidity creation, jumped on the reflation bandwagon. Investors started selling defensive bonds, while shunning growth stocks and buying into cyclicals and financials. The dollar rally weighed on the price of gold and breathed fresh life into European and Japanese stock markets. Although there are several subtleties to be clarified, which we shall cover later, the most striking feature is the apparent conviction that all of the promises made by candidate Trump during his campaign will be fully carried out, without any negative secondary effects or hitches.

It is true that euphoria among financial markets often causes a lengthening of the investment horizon. Forecasts for 2018 or 2019, which are now being taken as fact, have immediately been priced into the market, whereas any potential hitches on the road to a glorious future are quite simply being ignored.

We do not intend to cover the measures of the Trump programme in detail, nor explore the potential opposition from Congress despite the Republican majority. We shall also leave out any analysis of international relations, at least for the time being, focusing instead on factors which will influence market trends over the next few months, namely growth potential, interest rates, forex and risk appetite dynamics. ■

GROWTH WILL LIVE LONGER, BUT WITHOUT GETTING ANY YOUNGER

The US economy has recorded its eighth consecutive year of growth and has been experiencing a number of typical late-cycle tensions for some time now, including full employment, falling productivity and an increase in wages. Among the measures planned by Donald Trump, we consider the proposed tax cuts for mid-range incomes to be the most important on a 6-18 month horizon. In the US, such measures have always stimulated consumer spending. The net impact of corporate tax cuts will be more difficult to assess however. Despite the fact that the corporate tax rate is currently very heavy, the regime provides optimisation loopholes which considerably reduce the overall charge. Meanwhile, protectionist measures and plans to encourage the repatriation of delocalised production, will undoubtedly help support the manufacturing sector, although charges will be increased by as much. Despite the planned measures, businesses are unlikely to invest massively during such a late phase in the cycle. Ultimately, although *Trumponomics* should ward off the risk of an imminent recession and extend the current cycle, its policies are not expected to spark a new, dynamic fresh cycle. Growth should accelerate slightly but without exceeding historical norms. Even if capital investment ceases deteriorating, household spending will nonetheless remain the main growth driver, which should also deepen the trade deficit, in spite of protectionist measures. Inflation is also expected to accelerate, even though the main conditions were already in place long before the elections, i.e. higher wages, rising rents and surging healthcare costs.

The Federal budget deficit is bound to increase, but without reaching 2008-2009 crisis levels. Meanwhile, any of the proposed measures could meet with opposition in Congress, while above all, a plunging deficit risks destabilising the bond market over the longer term, which would have heavy repercussions. Although the theme of a resurgence of bond-market vigilantes, like in the 90s, has not yet been widely reported on, few commentators doubt that interest rates effectively represent the primary constraint that will curb the most ambitious projects. ■

BOND MARKET CRASH?

The prospect of *Trumponomics* heartened the equity markets, but triggered a sharp correction among bonds. Although the global yield trend had begun to inverse before the election, the result nonetheless caused an earthquake. The current correction has equalled the 2013 taper tantrum in terms of its amplitude, but over an even shorter period. The shockwaves have been felt across all sectors and markets, even though optimistic earnings outlook has mitigated the effect on corporate bonds, while Japanese, German and Swiss sovereign bonds were impacted less than US T-notes. Japanese and German 10-year yields have nonetheless reentered positive territory. Longer-dated Treasuries were hit the hardest. The total global capital loss since 8 November is estimated to be greater than 6%.

If rates continue to steepen, the trend could have a considerably negative impact on heavily-geared companies and also on leverage-based market strategies. Although it is impossible at this stage to identify the source of potential defaults, insolvencies are the inevitable consequence of higher interest rates. The first critical threshold is around 2¾ or 3% for 10-year T-notes but we doubt that this level will be reached within the next few weeks. Any disappointing macroeconomic indicators or resurgent financial tensions should rekindle investor appetite for defensive bonds, albeit temporarily.

At this stage, yields have risen sufficiently to curb growth, as much as, or even more than the progressive climb in Fed Funds, i.e. the decision to raise rates on 14 December and the three hikes planned by the Fed during 2017. Combined with the dollar rally, the increase in short-term and long-term rates should curb GDP growth by approximately 1% on the year. In other terms, we believe that the current optimism regarding growth is exaggerated, both in terms of macroeconomics and corporate earnings capacity. *Trumponomics* will have a complex impact on many sectors, on foreign trade, on taxes for US companies and tariffs for their foreign competitors. But overall, the expected boost to growth will not suffice to justify current valuations among equities and corporate bond markets which were already highly-demanding before 8 November. We believe the markets are still overvalued. ■

[1] Approximately 8.5% since August according to Holger Zschäpitz, Die Welt estimates. However, the global bond market capitalisation of USD 44,000 billion is still higher than the average 2013-2015 level.

DONALD TRUMP IS NOT RONALD REAGAN…

Before the elections, the dollar had already gained ground against emerging currencies, but only marginally vs the euro or the yen. The post-electoral euphoria drove the dollar sharply higher. Although the dollar appears to be set in a resolutely bullish trend, we believe that it could soon lose momentum. But is the euphoria not being fuelled by optimism regarding growth? Perhaps, but we consider the markets overoptimistic, particularly as the dollar will weigh increasingly on growth as it appreciates.

A different approach brings us to the same conclusion. If we accept that interest rate divergence is fuelling the dollar rally, its effect will run out of steam. Although the 10-year spread between the dollar and euro has hit an all-time high, US yields could now lose momentum, as the Bank of Japan intends to maintain its 10-year rates at zero, and the ECB has recently decided to taper its asset purchase programme. ■

…BECAUSE JANET YELLEN IS NOT PAUL VOLCKER

The same is true of short-term rates. Although the majority of the Fed Open Market Committee is advocating three base rate hikes rather than two this year, this will have very little impact on real rates, which will remain deep in negative territory. The euphoria caused by the election of Donald Trump has been compared to the Ronald Reagan victory, which triggered a surge in the dollar. The current context is completely different however. In 1981, the US economy was gripped by inflation with Paul Volcker implementing drastic measures, increasing Fed Funds to 19.5%, i.e. 9.9% in real terms, which tipped the economy back into recession. On the contrary, the Fed has remained extremely cautious. It undoubtedly has good reasons for doing so, particularly given the high level of public and corporate debt, without forgetting the extraordinarily rapid expansion among derivative markets, which probably reflects far heavier financial leverage than during the 1980s.

A parallel cannot be drawn between the 1981-1985 dollar rally and the current trend. Although it is too early to establish whether Donald Trump will be another Reagan, it already appears clear that Janet Yellen is no Paul Volcker. ■

IS THE STRONG DOLLAR GOOD NEWS?

Euphoria currently reigns among US equities and is reflected in the dollar exchange rates. Although chartists are generally betting on the current rally continuing, a trend by definition only lasts as long as no event occurs to invalidate it. We prefer to analyse quantitative indicators by observing the open positions in the market, such as the ratio between put and call options on the S&P 500 index. Most of these indicators have reached extremes that would suggest a pullback, albeit temporary. We are also adopting a cautious approach based on another factor. We believe that the strong dollar will increase risk aversion, rather than have the opposite effect.

Firstly, as we referred to above, the rise in the dollar will curb US growth, whereas the latter is the sole justification for the current optimism among equity markets.

Secondly, the US dollar is not being driven by any fundamental improvements. On the contrary, both the trade deficit and the Federal deficit should widen. Steeper bond yields are driving the dollar higher. However, an increase in long rates will not only impact growth as much or even more than dollar strength, it will also cause financial deleveraging and more generally weigh on investor risk appetite.

The third reason is associated with capital flow dynamics in financial markets. The US dollar is the reference currency for the majority of global derivative contracts[2]. As a result, there is generally outflow from the dollar when bullish strategies on riskier assets are set up and inflow when these trades are unwound. Throughout recent history, strong dollar phases have put pressure on riskier assets, whether bond yields are steepening or not.

The impact on emerging markets is well known, whereas the inverse is presumed for European and Japanese equities. Although it is true to say that these markets ostensibly benefit from any weakness in the euro or the yen, this claim is illusory, as most blue-chip stocks in the Dow Jones, Eurostoxx 50 or SMI indices are multinationals which are equally exposed to the major monetary regions, to such an extent that their earnings capacity is affected only marginally by forex trends. If the dollar rallies, securities listed in euros will appear cheaper and will therefore be in greater demand, until they reach fair value. However, beyond this short-term technical factor, an analysis of preceding cycles demonstrates that European equities have come under as much pressure as other markets during strong dollar phases.

For all of these reasons, a prolonged dollar rally, instead of fuelling optimism, could lead to risk aversion among investors. There is therefore a potential contradiction between the equity rally and the surge in the dollar. The way in which this contradiction will be resolved is crucial for our investment policy. ■

[2] According to the BIS Triennial Survey, in June 2016, 50.7% of the total transaction volume in interest rate derivatives was denominated in dollars, representing a notional value of 1,357 billions per day.

Comparative performances in %

$/€ exchange rate (inverted), S&P 500 index, EuroStoxx 50 index

Source: StockCharts.com

INVESTMENT CONCLUSIONS

Our core scenario is based on the dollar falling back once the effects of *Trumponomics* are fully understood. Despite appearances, this is nonetheless a positive medium-term view, which is bullish on riskier assets, even though temporary corrections are probable. Any such downturns will be beneficial as they will correct the current market overvaluation.

We believe that a long-term dollar rally from current levels is unlikely. However, if the dollar continues to appreciate, it could have a negative impact on all investors, as it will undermine growth outlook and weigh on risk appetite.

What if the dollar and Wall Street both continue to rise? Investors may of course be delighted in the very short term, but we believe that this scenario will become problematic. The longer it lasts, the greater the tensions in the financial system. We stress that this is not our core scenario, although this risk must be borne in mind. ■

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