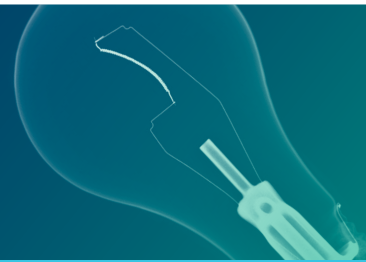
Heartwood Investment Management

25 November 2016

Investment Insight



Weekly Insight

Early messages from Trump

Despite fears that a Trump victory would be a negative risk-event, quite the reverse has happened. The four main benchmark US indices have hit record levels in November. The standout performer has been US small-cap stocks, which have enjoyed their longest consecutive-day winning streak since 1996.

Financial stocks have led the rally on hopes of reduced regulation and as yield curves have steepened, with industrials and cyclical sectors also finding favour as they are perceived as standing to benefit from an incoming Trump administration. Meanwhile, higher dividend paying stocks – labelled 'bond proxies' - have lagged cyclicals.

In an environment dominated by central bank liquidity, equity markets have rallied in lockstep with bond markets in the past couple of years, overturning conventional market correlations. However, over recent weeks, we have seen a return to the more traditional market behaviour as US treasury yields have moved meaningfully higher, especially since the US election result. The ascension of the US dollar has also been reasserted, climbing 3% on a trade-weighted basis in November.

Main US benchmarks	Month-to-date returns (in US dollar as of 23 November 2016)
Russell 2000 (smaller companies)	12.76%
S&P 500	3.92%
Dow Jones Industrial Average	5.53%
Nasdaq	3.87%

Data source: Bloomberg

Investors have voted with their feet

The strong performance of US equities has brought comparisons to the melt-up in 1999. The current rally appears to be technically driven, as investors chase returns into year-end. In recent months, investors have been sitting on large cash piles, reluctant to commit capital in an environment of higher political risk premia and on worries that central bank policies are losing their effectiveness.

According to Barclays[1], Trump's election victory has accelerated flows out of bonds and into equity markets: $27.5 billion into equities in the week ending 16th November, and $18.1 billion out of bonds. This represents a sizeable reversal of the year-to-date trend of money being put into bond markets away from equities (circa $500 billion). It has not been a simple shift into broad-based equities, however.

Unlike the risk-on/risk-off environment seen in the last few years, there now appears to be greater segmentation between asset classes and sectors. Of the total equity inflows, the primary beneficiary has been US equities, specifically smaller companies, financials and industrials. In contrast, total equity fund flows in emerging markets, Japan and bond proxy sectors (utilities, consumers and telecom) all reported outflows. Moreover, active managers have not benefited, with investors preferring to invest in US equity exchange-traded funds (ETFs).

Clear Thinking

1 Performance dispersion and redemptions, Barclays Equity Research, 23 November 2016

Contact

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Can the US equity melt up continue?

Investors are looking for reasons to invest in what have been fairly moribund markets since the summer. The US election result has prompted a revision of future expectations, shifting the narrative of markets to perceptions of reflation and higher growth, fuelled by infrastructure spending and tax cuts.

Of course, any actual policies have yet to be implemented and little is still known about the incoming Trump presidency. Trump has sketched out a policy plan in the first 100 days, which includes, among other things, pulling out of the Trans-Pacific Partnership, promoting production and innovation and loosening environmental restrictions to boost shale and clean coal industries. There has also been some backtracking from the campaign rhetoric on a number of issues, including Climate Change.

Investors are clinging to the belief that pragmatism will prevail and are so far giving Trump the benefit of the doubt. Trump is not a partisan-ideologue and this could position him favourably to broker pro-growth policies in areas like infrastructure spending, where he can find common ground with Democrats. For Republicans, Trump has delivered an unexpected victory. Moreover, Congressional Republicans will be keen to show they can get things done after years of deadlock with the Obama administration. If Donald Trump the President can show his ability to make deals in a manner that is constructive for the economy, then this is likely to be looked upon favourably by investors.

The Thanksgiving Holiday has provided a breather away from the headline noise of recent weeks. Much like the Pilgrims' path to the New World in the early seventeenth century, the journey ahead remains volatile and precarious; but it is one that could potentially reap a decent harvest in certain parts of the economy.

The jury is still out.

David Absolon
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