



Is the so-called 'reflation trade' over?

Confidence in President Trump's ability to execute his pro-growth agenda has further evaporated as more allegations have come to light around the Trump campaign's possible collusion with the Kremlin in November's election. Risk aversion took hold mid-week, with investors growing less optimistic that tax cuts, infrastructure spending and deregulation will be executed. The dollar has fallen by 6% on a trade-weighted basis from its post-election high set in December 2016.

Against the rising tide of political headlines, investors are determining whether the reaction to political events is just a temporary setback or if this unwind signals something more sinister. Headlines are fluid and it remains too early to draw any concrete conclusions about Trump's political troubles. However, we would caution that the so-called 'reflation trade' was not solely premised on Trump's ability to deliver significant fiscal easing, but also reflected the overall improvement in global economic conditions and fading disinflationary effects that began in the summer of 2016.

So far, our key takeaways are:

- **The magnitude of the market moves seen is relatively modest:** The S&P 500 remains at near record highs and has risen 14% since November's US election (in US dollar terms). US equities have given back just over 1% of those gains. Furthermore, the implied measure of volatility of the S&P 500 Index has spiked but remains low on a historic basis.
- **The fundamental backdrop has not shifted:** As stated above, the global economy was on a recovery path before Donald Trump's election victory which was supported by the recovery in commodity prices, a stable US dollar and the impact of policy easing in China. US economic fundamentals remain firm. The economy is at full employment, further highlighted by this week's jobless claims report showing claims at a multi-decade low. We expect tight labour market conditions to underpin wage growth and consumption. Importantly, the corporate sector is recovering, which is evidenced by rising business spending and improving corporate profitability. US companies had their best quarterly earnings season in the first quarter since 2011. According to FactSet, blended earnings growth for S&P 500 companies was 13.6% (based on 91% of companies reporting). The largest contributor to the profits recovery was the energy sector, due to the oil price rebound. However, even excluding energy, blended earnings growth still rose by 9.4% and suggests that the improvements were broad based. Elsewhere, the eurozone economic recovery appears to be well supported as credit growth recovers and business and consumer confidence remains high. China's growth remains stable and Japan's economy is benefiting from stronger external demand.
- **Liquidity continues to drive financial markets** as global central bank policies remain accommodative. We believe the US Federal Reserve remains on course to lift interest rates in June as it seeks to gradually normalise monetary policy from historically low levels.

We recognise that we are in the latter part of the market cycle and sentiment is likely to remain vulnerable to pressure points as we move through the year. However, we are maintaining our modest overweight exposure to global equity markets, believing that the fundamental backdrop remains constructive for financial markets in the shorter term.

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