



Monthly comment by
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The surprising election

In many ways the US election was one of the biggest surprises in the market in years. First of all, the result was surprising to most observers who had followed the polls, bookmakers' odds, models for the US electoral college's vote distribution, statistical commentators' websites (such as www.fivethirtyeight.com) and the many political analysts and celebrities who spoke out against Trump's chances of winning.

Secondly, the market's reaction to the election was surprising. Before the election there was consensus that the political uncertainty Trump would bring as president would cause a major drop in the stock market. Interest rates and interest rate projections were also expected to fall, and reduced growth and a weaker dollar were expected.

All these expectations were dashed. Perhaps I can boast that I was considerably more optimistic about the market's reaction to the choice of Trump as president, and that I also recommended that readers of the monthly report perceive a decline in the stock market as a buying opportunity. But my expectations also proved emphatically wrong.

Futures on the S&P 500 Index did sell heavily in the early morning hours, after the election results were certain, and with a decline of slightly more than 6%, we actually came close to my own expectation of an 8% fall in the MSCI USA (as described in last month's report). But few had probably imagined that within a matter of mere hours the index would come back and even rise on the same day – and the rest of the month!

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The reaction in the bond market was perhaps even more spectacular. With a significant curve steepening in the 2-to-10-year span for US bonds, the bond market signalled in the clearest possible way that commentators' expectations for the election would be put thoroughly to shame.

What to expect from Trump?

Precisely the bond market's reaction is significant when we are to form our expectations for the Donald Trump presidency. Trump went to the polls promising much greater public spending on the infrastructure and the military, as well as tax cuts. Trump has never presented a coherent plan for financing these election promises, and thus – as the bond market's reaction also indicates – one can expect most of these promises will largely go unfunded.

Trump's electoral program should therefore, among other things, be perceived as major fiscal easing, which may cause inflation. That's why we've seen the large increase in long-term US interest rates (which has also spread to other markets, but not to such a large extent).

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Against this background, it is interesting to note that the bond market probably has pushed expectations for short-term rates higher, but not so high that full neutralisation of the inflationary impact is expected from the Fed. In other words, expectations in the bond market, and both monetary and fiscal policy, will be more expansionary than in many years.

The Federal Reserve Bank of New York has a so-called GDP Now model that, based on the ongoing publication of high-frequency macroeconomic indicators, shows what we most likely can expect of GDP growth in the US in different quarters. For Q4 2016 the most likely, annualized growth in GDP has risen from 1.63% to 2.5% since the election (i.e., within roughly 20 days), which must be considered extremely remarkable.

The big macroeconomic picture across the election must therefore be described as follows: Before the election the macroeconomic indicators were generally still recovering from a bad first half-year. Interest rates and inflation expectations were rising (but still low), and the leading indicators had already bottomed out at year-end and have shown steady improvement since. After the election, these developments have dramatically accelerated, with the greatest curve steepening since mid-2013 and an increase in long-term inflation expectations in the US (5Y5Y) of 30 bps.

Strong US dollar may continue

The trade-weighted value of the US dollar has increased by 3.3% since the election. This roughly corresponds to the development in the six months leading up to the election. My assessment is that this trend may continue due to the expectations for the US economy, which are now built into the bond market.

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Perhaps one can compare the situation with 1980, when Ronald Reagan was elected president of the United States for the first time. Reagan's economic program was highly characterized by "supply-side" stimulus in the form of very large tax cuts and more or less constant public spending (as a share of GDP), which in 1982 led to large deficits in public finances.

As an economist one can say many positive things about the Reagan administration, but it left the United States with a federal debt ratio of almost 50% (compared to about 31% in 1980). In turn, the trade-weighted value of the US dollar also increased by more than 80% in the course of four years. This was due to the combination of very strong nominal GDP growth at 8.5% per year the first four years and a tightening of monetary policy, for which the Fed chairman at that time, Paul Volcker, should be credited.

From a political standpoint, the recent election can be compared to the election of Reagan, whilst the establishment undoubtedly would have liked Jimmy Carter to have remained president.

US market no longer underweight

There are already critics among the corps of analysts who warn that it is too late to buy US stocks. My assessment is that they are correct regarding the returns in local currency

(USD). However it is my judgement (see above) that the dollar has the potential to be further strengthened and that US stocks, because of fiscal and monetary stimulus, will be able to overcome this effect which, seen in isolation, will erode their competitiveness.

I myself have in recent quarters recommended an underweight to the US due to the expensive pricing of US stocks. I do not anymore – the stimulus they receive as a result of Trump's program is a lot stronger than what European equities have been experiencing lately. In turn, US equities remain expensive, which balances out the stimulus.

Big changes for equity strategies

In previous monthly reports I described how the stock market is constantly moving closer to a dark, depression-sized hole characterized by complete macroeconomic stagnation as a result of rather uninspiring macroeconomic developments (lower interest rates, inflation, leading indicators and growth and expectations of it).

However nothing in the economy remains completely unchanged over time, and this long-lasting trend that has characterized the world economy since 2014 has now come to an abrupt end with the election of Donald Trump as the decisive event.

As a result of the low and falling interest rates, large-cap growth stocks with stable cash flow and a significant part of their (expected) earnings far in the future were particularly favoured in the stock market. Other variants of this have been minimum volatility (Min Vol) shares, stable consumption, defensive stocks and stocks with high and stable yields.

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As discussed, long-term yields soared both before but especially after the election of Trump, and this has naturally led to considerably greater returns, especially in the value factor. The reasons that value strategies again are yielding greater returns are undoubtedly many. First and foremost, value stocks are quite inexpensive compared to the mass market – and particularly compared to growth and min vol shares. In addition, both growth and Min Vol shares are more sensitive to interest rates since a greater share of their earnings lies further into the future than is the case for value shares.

A third reason may be the announcement of large corporate tax breaks in the United States, which in the same way will favour value stocks. It would probably also benefit small-cap shares, which have a higher proportion of their income taxed in the United States than large-cap stocks, which also are taxed abroad. Finally, one can argue that the types of shares that are value stocks today will benefit to a greater extent from the stimulus that the Trump administration by all accounts will represent.

Political uncertainty in Europe may weaken the euro

The European economy is doing fine and there is no immediate risk of recession. Most macroeconomic indicators continue to point upwards, although one could wish for more.

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From a currency perspective there may be cause for concern, however, since the election of Donald Trump will not just from an isolated perspective strengthen the dollar as a result of higher interest rates and expectations of inflation, but at the same time will tend to provide impetus for European protest parties that have most in common with Donald Trump. Here we are talking typically about parties that are critical of the EU and its handling of the immigrant crisis in Europe.

A series of elections in the coming year will therefore in all likelihood create a lot of noise and uncertainty in relation to European collaboration:

- The referendum in Italy on the abolition of one chamber in Italy's two-chamber system led to the expected defeat of Matteo Renzi who, as a result, has announced his resignation. In my assessment, the defeat will not have significant economic importance, but it may give further momentum to the Five Star protest movement in Italy.
- The December 4th election in Austria resulted in Norbert Hofer from the Freedom Party of Austria (FPÖ) not being elected, which has spared the EU collaboration from some unrest. Hofer has already accepted defeat, and thus the general election that he had threatened is not being forced. The next ordinary parliamentary elections in Austria are in 2018 at the latest.

- On April 23rd the French presidential election will be held, which in all likelihood will result in Francois Fillon moving on to the second round with Marine Le Pen. Fillon will probably win the second round, but it is not given, and the process presumably will also create a lot of noise.
- In August or probably September, Germany will hold federal elections in which the Alternative for Germany (AfD) party presumably will advance significantly. The party is highly EU-critical, but it may prove difficult for them to achieve more influence over EU policy.

Overall, the picture is muddy and likely characterized by greater political uncertainty about the EU collaboration, and this may (in addition to the strength of the USD) put the euro under pressure in the coming 12 months.

MomVol indicator - back at almost full strength

Our MomVol indicator rose during the month of November from 0.69 to 0.81. The threshold below which the model recommends underweight in shares in the following month is 0.6. I note with satisfaction that – if one followed the model – one has benefited from a significant increase in the stock market following the US presidential election – despite the great uncertainty that was associated with it.

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