Preparing your portfolio for the Fiscal Push

January 2017

Lyxor ETF

Latest insights

Executive Summary

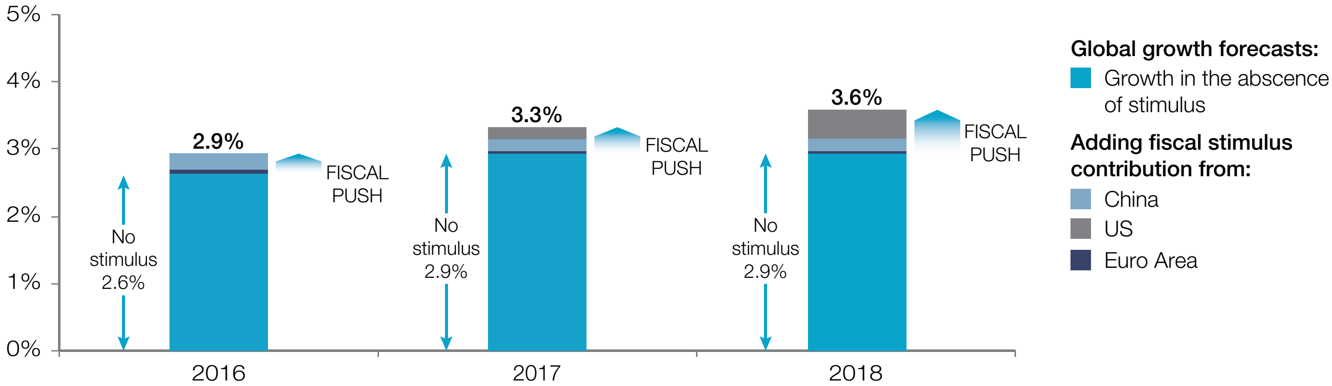
- Trump's New Year revolution could finally stir the global economy from its post crisis lethargy of low growth, low inflation and low rates
- The new US administration could move faster-than-expected on reforms including trade restrictions, a growth-friendly tax overhaul and an extensive infrastructure programme
- Direct effects on growth may not kick-in before H2 but reflation could be felt sooner. The Fed could hike rates three times in 2017, and we expect the Fed Funds Rate to reach 1.4% by year end
- We expect the US to export its growth pulse as major developed market currencies depreciate vs. the dollar
- Broad equity valuations across the world are already rich, so you may need to dig deeper for new opportunities. We advocate going beyond broader indices and taking the key thematic calls
- The reflation baton could be passed on to the eurozone later this year as Draghi pressurises eurozone governments to increase their spending

When politics trumps economics

President Trump seems to have pulled off the trick of kickstarting a global fiscal push without actually having been in charge. The UK has already presented the biggest government investment programme for over a decade in an effort to tackle poor productivity and low growth. China announced a $503bn rail expansion plan in December, as well as a colossal infrastructure spending plan to support growth and drastically improve connectivity to most of its major cities.

Germany has broken the mould, embarking on its first major government spending boost since the financial crisis. Other eurozone governments could follow suit as ECB support starts to fade.

World real GDP growth forecasts



Source: OECD projections, IMF, Lyxor International AM calculations. December 2016

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Expect Trump to move quickly

We believe the new administration will get more done, and do it sooner, than many expect.
Core campaign promises on trade, tax reform, infrastructure spending, and health care are first on the agenda.

Trump could revoke or obstruct trade agreements such as NAFTA and the Trans-Pacific Partnership. The latter was conceived as a way for the US to counter China in the Asia-Pacific region, but the new President seems likely to take a more direct approach. Of course, it could just be posturing designed to create a better position from which to negotiate new deals.

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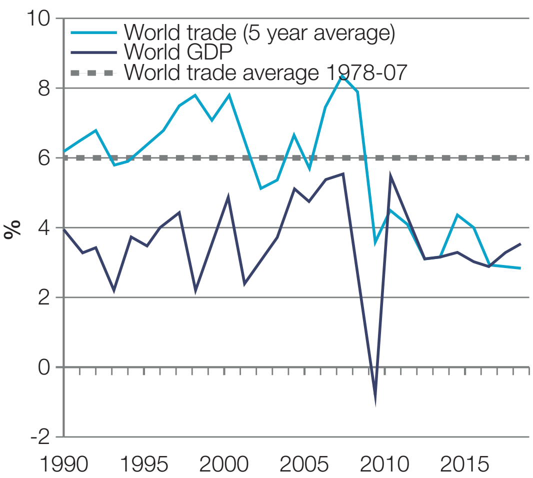
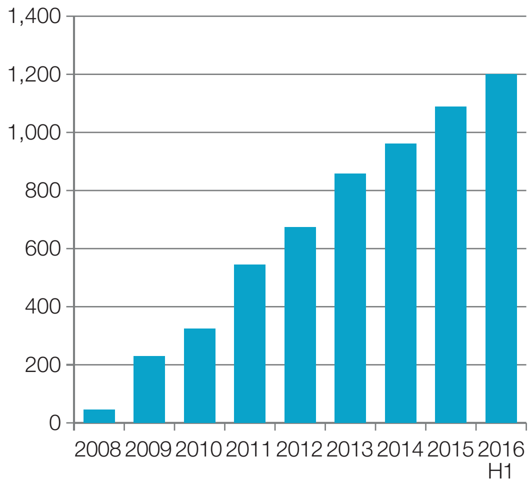
Trade in trouble?

World trade and GDP growth



Trade restrictions rising in G20 countries

Number of trade restrictive measures in-force since the crisis



Note: World GDP volumes measured at PPP exchange rates. World trade volumes measured at market exchange rates in USD dollars. For 2014, world trade average growth for four years to remove the rebound following the crisis.
Source: OECD November 2016 Economic Outlook database; and WTO-OECD-UNCTAD 2016 G20 Trade Policy Monitoring Report.

Fully-fledged protectionism is unlikely in our view. Roughly 37% of Chinese exports to the US are made up of imported parts from other countries, including the US itself. A trade war would hurt the entire supply chain. Any retaliation from China would affect US exports and erode its market share in sectors such as aerospace, technology, and foods & beverages.

Tax reforms to focus on corporations

Trump's plans should mean lower taxes for most American households, especially the highest earners. Corporate tax proposals are where the administration plans wider reform however. Proposals include a tax cut from 35% to 15%, lower taxes on repatriated profits and a taxation rate of just 10% on earnings of foreign subsidiaries held abroad.

Even though the effective corporate tax rate is already quite low, we believe this tax overhaul will have a positive impact on US earnings overall.

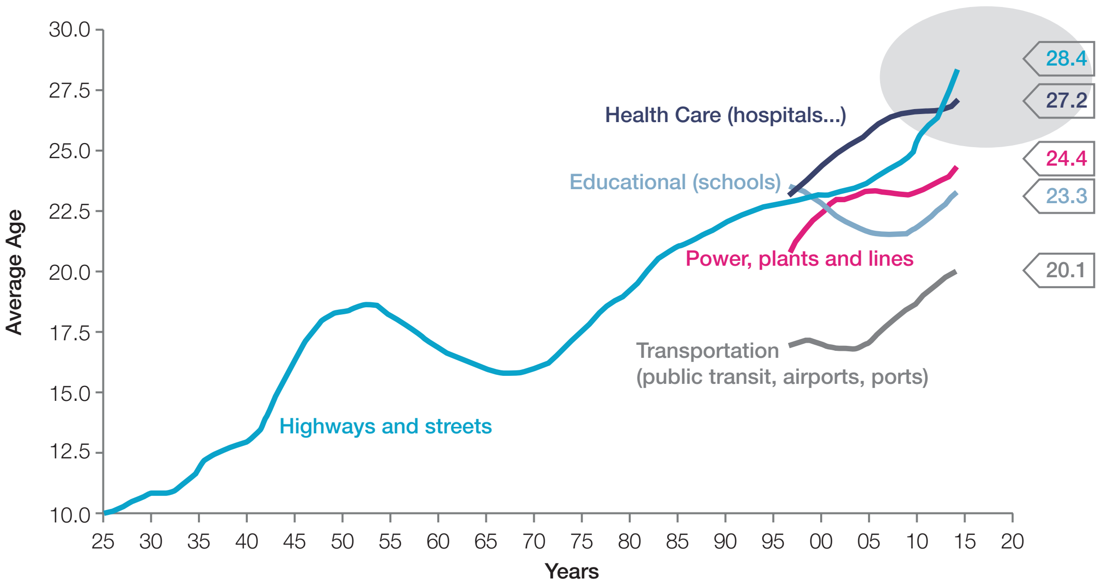
Infrastructure spending plans lack substance for now

On the stump, and in the debates, Trump pledged to double Clinton's five-year infrastructure plan without adding to the deficit but gave no specifics about how he'd do it. Additional spending of $100bn per year would represent 0.5% of GDP, which would be compounded by the multiplier effect. Whether it's enough is another question.

Public assets have aged dramatically. Infrastructure needs over the next decade amount to $3.3tn, but 43% of the necessary work is still unfunded. Several solutions have been proposed, including a private/public levered scheme. As always, the devil will be in the details.

Fixed assets are ageing

US Government fixed assets average age since 1925



Source: Macrobond, Lyxor AM. December 2016.

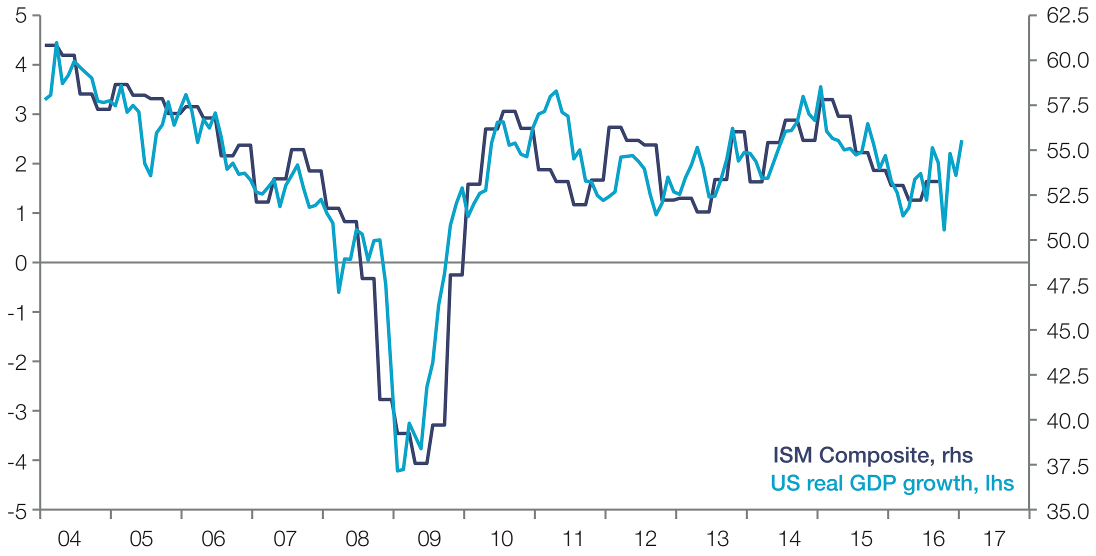
Could Congress derail his plans? We doubt it. Previous Republican administrations have not shown any great fiscal discipline, and the move away from globalisation, tax cuts and higher fiscal spending all have important GOP allies. The repeal of "Obamacare" may however intervene to delay the passage of the economic package until the summer.

Rejuvenating an ageing cycle

Consensus suggests real GDP growth in the US could return to around 2.2% in 2017. We think that's a little low, and expect something closer to 2.5% because the effects of the new administration's economic package have been underestimated.

Positive effects on the real economy will take some time to materialise, but indirect effects are already being felt in the financial markets: investors expect higher confidence levels to breed more consumption and capital expenditure.

US growth reaches 2.5% in 2017



Source: Macrobond, Lyxor AM. December 2016.

We assume government spending will accelerate in the second half of the year. The fiscal push will encourage business expansion as sentiment improves, which in turn should spur non-residential private investment. Residential investment is likely to be hampered by rising interest rates, which makes a lengthy housing recovery unlikely.

The pickup in consumption should help imports grow by around 2%, but exports could stall as world trade stagnates and the dollar strengthens. The US won't be able to rely on external contributions to boost growth.

All in all, economic momentum is already building, albeit slowly. PMI surveys are encouraging and conditions in the labour market look tight: lay-offs and jobless claims are nearing historical lows, while unemployment and underemployment are receding. Hiring difficulties are apparent, which suggests wage pressures will keep building.

A great reflation…

We expect US inflation to rise higher than the 2% consensus (via Bloomberg) currently suggests. Cyclical pressures are building and investors are smart to monitor for the first signs of wage growth acceleration. March 2017 CPI inflation prints could reach 2.7%. We expect it to fall back slightly thereafter unless oil prices creep higher.

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…begets faster Fed normalisation

A series of headwinds forced the Fed to wait until December last year to tighten policy, but the macro pulse is now much stronger. Full employment, mounting wage pressures and growing inflation expectations all point to action.

The Fed has already prepared the ground for three more hikes in 2017, and we believe the effective Fed Funds Rate will reach 1.4% by year end. Expect Trump to fill the two empty FOMC seats with more hawkish profiles.

US earnings face a reality check

US equity valuations were already rich, but the post-Trump rally has complicated the picture further. Most valuation metrics are already at or above pre-crisis levels, so tread carefully if rates do rise. We don't expect a collapse, but tighter financial conditions may prevent broader indices from rising further.

Our base case calls are for Brent prices to hover around $55 per barrel ($50 target for WTI prices), for US real GDP growth to reach 2.5%+ next year and for further dollar appreciation; all of which should be good news for sales and consumption. According to Lyxor Research, S&P 500 companies are expected to grow their top-line by 3.5% in 2017.

Robust sales prospects support earnings, but wage pressures and the nature of the changes to taxation will be the decisive factors. The market is waiting with baited breath on whether the forthcoming tax measures will be applied retroactively to all 2017 corporate profits. If so, it could add 11% to 2017 earnings, adding real impetus to profit growth. Without it, profits could fall. SG Equity Research tells us the S&P 500 could reach around 2,400 by year end.

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Know the risks

Such uncertainty is a major risk, so we retain a neutral stance on broader US equity indices given the fullness of valuations and the potential for policy surprises or disappointments. We favour tactical and thematic plays.

Questions include how much upside is left, where to look for the next layer of opportunity and whether apprentice policymakers can keep their promises. The market is priced for perfection, but great expectations are often dashed. If the fiscal push is delayed, or watered down, the reaction could be severe.

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Look to domestic over global, and sectors over broad indices

We expect those companies most closely tied to the domestic economy to outperform global companies as the fiscal push is priced in and tax reforms are enacted. However, large multi-nationals will see little easing of their tax burden. As exporters, they will also be affected by the renegotiation of trade deals and dollar appreciation.

The fiscal push could boost demand for REITs if taxes on investment income are lowered significantly. Valuations still look extended, but we are cautiously optimistic on the sector's outlook.

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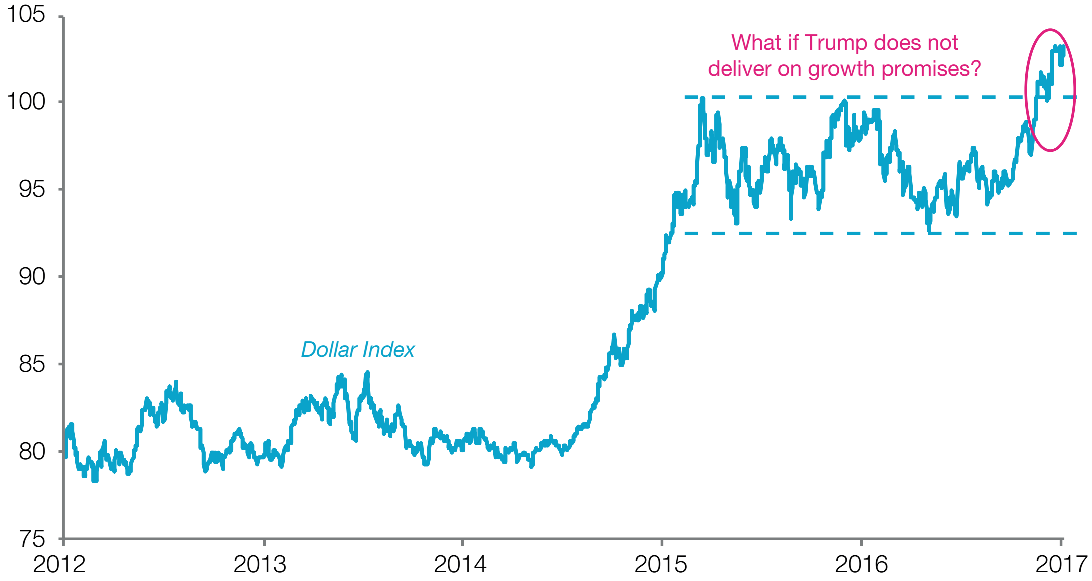
FX moves are increasingly hard to predict

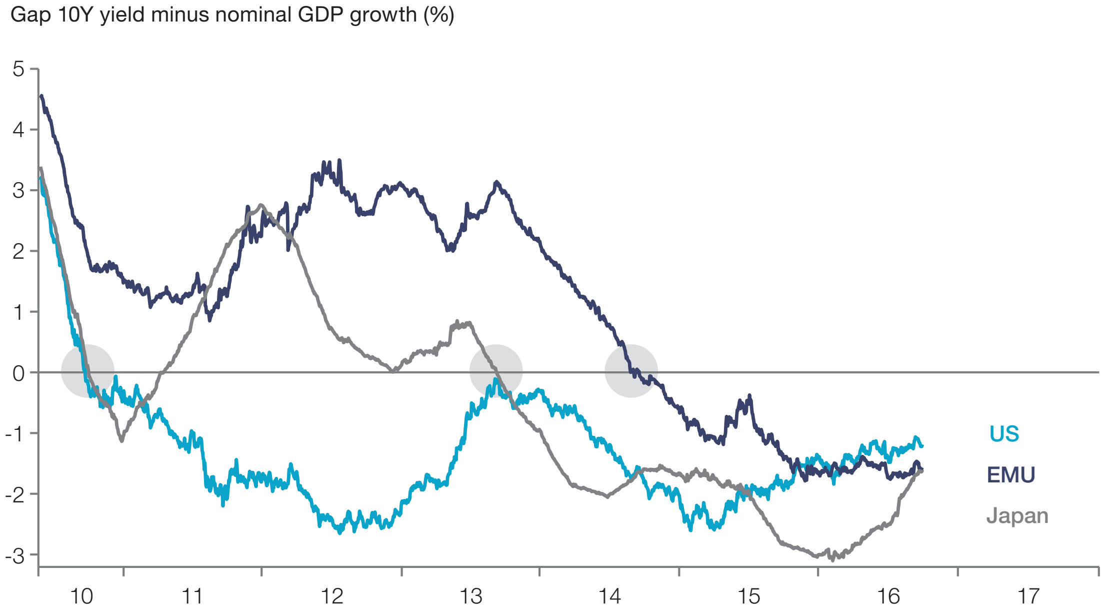


Source: Bloomberg, Lyxor International AM. December 2016.

Fiscal Push: Material effects elsewhere

While US rates climb, the two major developed markets still working to reflate their economies (the eurozone and Japan) will need to keep their domestic rates low. If they can, the widening of the policy gap should help devalue the euro and the yen. This should in turn allow demand from the US to be “exported” elsewhere in the form of lower prices in dollar terms.

Monetary policies diverge (finally!)



Source: Macrobond, Lyxor AM. December 2016.

The ones to watch

North American equities	We've talked at length about the US already, but Canada's TSX Index should not be forgotten. It was one of the best-performing indices last year (+17%) and it could sustain its momentum this year. The Bank of Canada could lower rates again in 2017 to bolster economic recovery. External support will come from higher oil prices and rising inflation, and rates, in the US. TSX could be a major beneficiary given its weightings of 35% in financials, 21% in energy and 12% in basic materials.
Eurozone equities	The US cycle is ageing, while the eurozone's is still in its infancy. Investment is increasing, profit margins are being repaired and buybacks are on the up. High dividends and relatively attractive valuations could tempt risk seekers. The pass-through of euro weakness and a long-awaited acceleration in credit markets will be key to an upswing in inflation. ECB support (via QE) is assured for the rest of the year at least. Fiscal expansion also remains a possibility at a later date despite recent pronouncements. We expect the US to finally pass the reflation baton on to the eurozone later this year on the back of a weaker Euro and improving activity, which is why we favour a slight overweight to European equities. Some caution is however prudent, especially given the potential for political upheaval.
Asian equities	Japan: All about the yen The case for Japanese equities is less clear cut, given the mixed record of Abenomics so far. Economic growth is likely to be anaemic at best. We expect the Bank of Japan's unconventional decision to control the yield curve by targeting long duration bond yields to weigh on the yen. Further devaluation is possible, and could be the main driver of returns for local equities as exports strengthen. A tight labour market with rising wages is driving a soft acceleration in domestic consumption, suggesting government spending may finally be supporting the recovery. Nonetheless, corporate profits remain quite vulnerable to external shocks.
	China: Looking positive…for now In China, we're relieved the state-fuelled bubble in the property sector is finally starting to deflate in the wake of coordinated and progressive tightening by the authorities. Economic activity has proven resilient, largely because the yuan has weakened. Recent rule changes make it easier for foreign firms to invest in China and tougher for Chinese companies to buy assets overseas - all in an effort to limit capital outflows and maintain domestic growth. Trump's protectionist policies, if enacted, could have dire consequences. However, recent developments suggest his new administration will be less aggressive than their campaign rhetoric suggested.
Equity Sectors	A rotation into equities on the back of further government spending favours some sectors over others. Look to Basic Materials, Information Technology and Energy. Meanwhile, Trump's crusade to slash regulation should support industries like healthcare and financials.
Inflation-linked bonds	Cyclical pressures are building in the US as the economy moves closer to its peak growth rate. Headline inflation rates may well exceed current expectations. US breakeven valuations have started to reflect the spike already, but there could still be room for upside. We are still positive on US breakevens. We've also seen some above consensus CPI prints in the eurozone this month, which has pointed us towards a more favourable view on the region's breakevens as well.

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