CIO Note

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CIO WM Research

President Donald J. Trump. Implications.

This year's US election campaign was one of superlatives. Two of the most unpopular candidates competed in one of the most divisive contests ever. Record numbers of key demographic groups turned up to vote. And we have perhaps the most unorthodox winner of a US presidential race in history.

Volatile trading today has yet again demonstrated the importance of a long-term focus for investors. Trading equities at the wrong time today could have permanently impaired wealth. In our tactical asset allocation, we continue to believe that fundamentals should outweigh political risk. We remain overweight US equities and emerging market (EM) equities and underweight government bonds. And we continue to favor an EM currency basket against a selection of developed market (DM) currencies.

We also expect the euro to appreciate versus the US dollar. Signs that the Federal Reserve (Fed) may be falling behind the curve on inflation could mount if general prices rise under Mr. Trump's presidency. Meanwhile, we continue to expect the European Central Bank (ECB) to taper quantitative easing in 2017, favoring a stronger single currency.

For investors seeking additional opportunities, we also highlight a series of potential winners and losers from this election result. US financial services and health care equities, cyber security stocks, US senior loans, and infrastructure-linked investments are all potential beneficiaries.

Volatility is likely to remain relatively high as the market adjusts to a new equilibrium. Investors should therefore keep a long-term focus, but also remain alert to opportunities.

Three things that caught my eye today:

- **The about-face in markets.** Although equities opened sharply lower in Asia and safe-haven investments rallied, the initial flight to quality moderated after Mr. Trump delivered his victory speech. The President-elect's more conciliatory tone and pledge to work together with his opponents came as a positive surprise to market participants, many of whom had expected more of the aggressive rhetoric that marked his campaign. Some of the rebound for risk assets could be attributed to markets having 'learned their lesson' from the Brexit fall-out (in which risk assets first fell, then regained their poise). But we believe that positive fundamentals will ultimately prevail. *We remain overweight US stocks in global tactical asset allocations.*

- **The run up in 10-year yields.** The rise in US Treasury bond yields is one of the more significant moves in response to the election. It is important to note that this doesn't reflect a change in expectations around Fed policy – real rates are close to unchanged, and market pricing for a December rate hike has rebounded to about 80% (close to the pre-election probability). Instead the sell-off in bonds looks to be driven by higher inflation expectations, presumably in anticipation of looser US fiscal policy from a Trump administration. *We continue to like US Treasury Inflation Protected Securities (TIPS).*

- **The decline in Mexican asset prices.** Given that 80% of Mexican exports are US bound, and 98% of remittances come from Mexican workers in the US, the nation's assets were among the few that failed to retrace their steps meaningfully through the day. Given Trump's proposed curbs on immigration and trade, we think these declines are justified, and *we do not see any immediate opportunities in Mexican assets at present.*

What to watch in the months ahead

While Trump's speech has calmed some investors' nerves, the coming 120 days should be more revealing. We expect the President-elect to give us an insight into how he plans to govern, and whether campaign rhetoric will (or won't) translate into policy.

In the months ahead investors will need to pay attention to:

- **The President-elect's nominees.** Trump's campaign was orchestrated by a close circle of advisors, and there is a risk that the presidential victory could reinforce his convictions in a 'closed' leadership style. This strategy would likely produce greater uncertainty for markets.

- **Whether Mr. Trump imposes tariffs, and if so how quickly.** Much of the campaign rhetoric was directed against the US' trading partners, most particularly Mexico and China. We need to see how this translates into action, if, or when, he looks to renegotiate NAFTA, and whether he labels China as a currency manipulator.

- **The results of the Italian referendum.** Although not directly linked to the US, the Italian referendum represents the next litmus test of the rise in voter popularity for anti-establishment candidates or causes. While we do not expect the outcome of the Italian referendum to have a major impact on markets, another setback for the political mainstream could cause jitters ahead of Dutch, French, and German elections next year.

Tactical asset allocation

- We continue to **overweight US equities relative to government bonds**. Fundamentals should outweigh political uncertainty, as private consumption remains solid and companies continue to benefit from easy financial conditions. We forecast corporate earnings per share growth to rise from 1% this year to 8% next.

- We also maintain our **overweight in emerging market equities, our underweight to international developed market equities via an underweight in Swiss stocks,** and our **preference for an emerging market currency basket.** Key drivers include overall accommodative monetary policy and low yields in advanced economies, undemanding valuations in EM currencies, and some improvement of fundamentals in the developing world. Should global financial market volatility rise further from here, we think a declining chance of a Fed December rate hike would help to limit the downside for EM currencies. Meanwhile, we will closely monitor policy announcements of the new US administration, for indications of measures that could weigh on global trade and growth. We will also look for signs of shifting geopolitical relations between the US and Russia.

- We'd expect our **overweight in US TIPS relative to government bonds** to benefit from the election result. Donald Trump's platform has an inflationary bias: his fiscal policy is likely to be expansionary, and he leans toward protectionism, which is inflationary due to the effects of tariffs and curtailed immigration. Both trends should support inflation-linked bonds, therefore making them even more attractive than they would otherwise be.

- Finally, we **now prefer the euro relative to the US dollar.** The euro is around 12% undervalued relative to purchasing power parity based on our estimates. We believe there are indications that the Fed may be falling behind the curve in raising interest rates – wages are growing at the fastest pace in more than five years, and inflation stands at a two-year high. These trends will potentially be exacerbated if the Fed allows for a more "high pressure" economy over an extended period. Meanwhile, economic fundamentals in the Eurozone continue to improve, and the European Central Bank remains likely to taper its quantitative easing program in 2017.

Additional investment ideas

- **Buy US financials and health care.** With the Republican party in control of both the White House and Congress these sectors stand to benefit from lower regulatory risks. Financials could also get a boost if interest rates continue to move higher as the markets focus on the reflationary aspects of Trump's likely policies. Within health care, pharmaceuticals stand to benefit from a lower risk of drug price controls, and from the repatriation of overseas cash. *We are overweight both sectors in our US equity sector strategy*.

- **Buy US senior loans.** Expected fiscal stimulus from a Trump presidency should be positive for US economic growth, and boost US inflation. Both factors may lead to a steepening in US sovereign yield curves, which is a favorable development for floating-rate senior loans. The asset class has held its ground even through recent market turbulence, losing just 0.2% in the last bout of volatility. And specific loan issuers, especially in the energy and financial services sectors, may benefit from less stringent regulation. *US senior loans* is one of our top themes.

- **Buy cyber security stocks.** We expect the industry to get a further boost under Trump's presidency as he has repeatedly vowed to strengthen the cyber security infrastructure of both the US government and corporates. The cyber security allocation in the US federal budget has already increased from USD 12.6bn in fiscal year (FY) 2015 to USD 19bn in FY 2017. But we expect the broad-based momentum to continue, as we envisage tighter security regulations in the future. See *US equities: Update: Beneficiaries of transformational technologies*, 20 July 2016.

- **Buy platinum and palladium.** Gold acted as a hedge in the immediate aftermath of a Trump victory, rallying 4.7%. We like platinum and palladium which stand to gain from safe-haven flows related to any future concerns around US policy or the Italian referendum, but are also supported by rising auto sales and industrial production.

As usual, please email any comments or questions to ubs-cio-wm@ubs.com.

Best,

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