UBS House View Briefcases

Top 10 questions answered 17 July 2017

Chief Investment Office Americas, WM

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Are central banks withdrawing easing?

Key message

Over recent weeks, a number of central banks have delivered hawkish signals: Canada, New Zealand, the UK, and Norway. Meanwhile, the European Central Bank hinted the scale of stimulus may soon be reduced, and the Federal Reserve raised rates in June. But we think that the overall stance of the world's central banks remains accommodative. We don't expect tighter policy to provide a headwind for global stocks, and look for pockets of opportunity in currency markets where rates might soon rise.

House view

01 Policymakers from Canada to Norway have sent hawkish signals in recent weeks.

- The Fed raised rates at its June meeting and outlined a plan to trim its balance sheet more rapidly than expected.
- The ECB has said that a further reduction in interest rates from the current –0.4% is no longer on the agenda.
- Canada's central bank raised rates on 12 July. Growth and employment have also been heating up in Norway, while the weaker pound has driven up UK inflation.

02 But the world's top central banks remain accommodative.

- Balance sheets are still growing: the last year has seen BoJ and ECB assets grow by some USD 1.5trn. As a result, global central bank liquidity increased at the fastest pace since the financial crisis.
- The latest ECB staff forecasts project inflation remaining muted, at 1.5% this year and 1.3% next. The medium-term target is just below 2%.
- The Fed remains committed to a gradual path of tightening, with low inflation giving no reason to rush to higher rates.

03 Only steady normalization of monetary policy should allow stocks to continue rallying.

- Continued loose monetary policy provides support for our overweight position in global stocks.
- The gradual reduction in stimulus in the US is backed by synchronized global economic growth, along with rising profits.
- And the pockets of hawkish policy that exist can be seen as opportunities for investors, such as our favorable view on the Canadian dollar versus the Australian dollar.

New this week

On 12 July, Fed Chair Janet Yellen delivered her semiannual testimony before the House Committee on Financial Services. Markets interpreted her comments to indicate an increasing risk that low inflation could slow the Fed rate hiking cycle. The Beige Book, also released 12 July, reported a further strengthening of labor market conditions and rising wage pressures.

One liner

Having staked so much on stimulating recovery, policymakers will not want to jeopardize it if they do not have to.

Did you know?

- The ECB has pledged to maintain its current government bond purchases – EUR 60bn a month – at least until the end of the year.
- The US economy expanded by just 1.4% in the first quarter, its weakest pace in a year, but above analyst expectations.
- US PCE inflation dropped for the third straight month for the year to 1.4% in May, down from a recent February peak of 1.8%.
- Fed rate rises are not necessarily damaging to stocks. On average, since 1971, stocks have risen 11.2% in the 12 months following a rate increase. That compares closely with an average of 11.8% in all other 12-month periods.
- In May, the US unemployment rate dropped to 4.3%, a 16-year low.

Investment view

We forecast 10-year Treasury yields at 2.5% in six months, from 2.35% currently. Within the global tactical asset allocation, CIO recommends an overweight to global equities. We expect the Canadian dollar to strengthen versus the Australian dollar, and the euro to strengthen versus the US dollar.

Is the ECB looking to the exit?

Key message

Market volatility is on the rise as European Central Bank signals on monetary policy skip between hawkish and dovish by turn. After a sharp bond market reaction to Mario Draghi's comments on reflation, a steady drip of policymaker comments has dampened expectations. And yet ECB minutes for June reveal a more hawkish debate inside the ECB than the market expected. We believe Draghi is preparing the market for a gradual reduction in the size of the stimulus, and remain positive that the euro's recent rally will continue.

House view

01 The ECB has downplayed the idea that it will swiftly withdraw monetary stimulus.

- Hawkish signals from the ECB chief on 27 June led to speculation that the central bank was preparing to scale back monetary stimulus.
- But on June 28, the ECB said that the market had "misjudged" Draghi's speech.
- The ECB said Draghi's speech had intended to emphasize current EU economic strength while stressing that "monetary support is still needed."

02 But Draghi does appear to be preparing the market for gradual normalization of policy.

- Draghi showed confidence in the Eurozone recovery by noting "deflationary forces have been replaced by reflationary ones."
- The Eurozone manufacturing PMI for June rose to a six-year high of 57.4, and unemployment is at its lowest since the 2008 crisis.
- Against this backdrop, ECB June minutes show a debate beginning on an eventual tapering of bond purchases later this year.

03 So this should support the euro's recent rally.

- Draghi's comment on reflationary risks helped lift EURUSD to its highest point of 2017 above 1.14, and contributed to a 33bps rise in German yields as of 14 July.
- The euro has also been supported by European stock funds, which have hit USD 49bn so far this year, compared to just USD 33bn flowing into US-focused mutual funds.
- Draghi's mention of reflation risks stood in contrast to Fed Chair Janet Yellen's comments on "below objective" inflation.

New this week

The European Central Bank's asset purchase program could continue for at least "a couple of years" given the weakness of inflation, according to Governing Council member Ilmars Rimsevics. His dovish remarks reinforces our view that the ECB will scale back quantitative easing only gradually.

One liner

The European Central Bank does show signs of preparing the market for less stimulus. But it will not want to take away the punchbowl too quickly.

Did you know?

- The ECB has pledged to maintain its current government bond purchases – EUR 60bn a month – at least until the end of the year.
- German inflation forecasts were beaten by the news that prices had increased 1.5% on the year in June. But annual inflation in June for the Eurozone slowed to 1.3%. This erased some of the euro gains.
- French, German, and UK 10-year bond yields have all risen by over 20bps since 26 June.
- The 10-year Treasury/Bund spread narrowed to 175bps as of 14 July, close to its tightest level since Donald Trump's surprise victory last November.
- The Eurozone economy grew at its fastest rate in two years in the first quarter, at an annualized pace of 2.3%. This outpaced the 1.4% rate of expansion in the US.

Investment view

CIO expects the euro to appreciate against the dollar, with EURUSD reaching 1.18 in six months and 1.20 in 12 months. We estimate the long-term purchasing power parity of the euro at USD 1.26. In our tactical asset allocation, within Europe we remain overweight Eurozone stocks over UK stocks.

Will the bond sell-off spoil the equity rally?

Key message

Signs of tighter policy from the European Central Bank and Bank of England have sparked a sharp sell-off in bonds around the world. But while the pendulum is swinging slowly toward higher yields over the long term, we don't expect the pace of the bond sell-off to be sustained. This is partly because central bankers at the Fed, ECB and Bank of Japan remain cautious about shifting policy. So we don't expect a sharp rise in borrowing costs to threaten the equity rally.

House view

01 Hints at a reduction of stimulus, notably from the ECB, led to a sharp sell-off in government bonds.

- ECB President Mario Draghi said that "deflationary forces have been replaced by reflationary ones."
- Bank of England Governor Mark Carney said a rise in rates was likely needed as the economy came closer to running at full capacity.
- 10-year Bunds and gilts rose 20 and 24 basis points respectively in the three days to 30 June, a magnitude of movement only seen twice more in the last two years.

02 But while the pendulum is swinging toward tighter policy, we don't expect yields to continue rising swiftly.

- Market positioning contributed to the speed of the recent moves. Despite an improving economy, German Bund yields were just 0.25% on 26 June, versus a 5-year average of 0.9%.
- Subdued inflation, with core figures at 1.4% for the US in May and 1.2% for the Eurozone in June, gives central banks no reason to rush.
- Draghi has said the Eurozone still requires "persistently" easy monetary policy, while Fed Chair Janet Yellen has expressed caution that low unemployment has not yet produced inflation.

03 So we are unlikely to see a rapid rise in borrowing costs that could stop the equity rally.

- We expect the yield on the 10-year German Bund to move only slightly higher over the next 12 months to 60 basis points, from 55 at present.
- Continued cheap borrowing is positive for corporate profits, and we forecast 10–15% earnings per share growth globally for 2017.
- A synchronized global improvement in growth supports our overweight in global equities.

New this week

Bonds have stabilized in the three trading sessions to 11 July, following a sharp two-week move higher for 10-year bond yields (Germany 31bps, France 32bps, UK 27bps, US 23bps).

The sell-off was sparked by higher inflation expectations in Europe and investor fears over abrupt normalization of monetary policy.

One liner

Supported by strong fundamentals, equities should continue to rally, while the path of yields is more likely up than down.

Did you know?

- The 10-year Treasury/Bund yield spread has narrowed to 182bps, close to its tightest level since President Trump’s surprise victory last November, which is positive for EURUSD.
- EURUSD reached a 14-month high above USD 1.14 on 30 June.
- Trailing 12-month EPS has been improving in all major regions over the past six months, on IBES data, and we expect double-digit earnings growth in both the US and Eurozone in 2017.
- Retail investors poured USD 426 billion into bond funds in the first half of the year, on track to exceed the previous record inflow of USD 849 billion seen in 2012, based on data from JP Morgan.

Investment view

We are overweight global equities, and within Europe we overweight Eurozone equities relative to UK stocks, in our tactical asset allocation. We forecast the US 10-year yield to be 2.5% in 12 months, versus 2.37% at present.

UBS

Could political tail risks upend markets?

Key message

A UBS client survey showed that over 80% of respondents believe now is the "most unpredictable" time in history. Worries include lingering tail risks like an impeachment of the US president, or escalating tensions on the Korean peninsula or between Saudi Arabia and Iran. However, investors who remain overweight cash risk missing out on strong equity markets at a time of synchronized global growth. Investors can reduce their exposure to low-probability tail risks through diversification.

House view

01 Political tail risks have become a worry for more investors.

- An FBI investigation over obstruction of justice has raised the possibility that President Trump could face impeachment.
- North Korea tested an intercontinental ballistic missile, increasing the security threat posed by the nation.
- An escalation of tensions between Saudi Arabia and Iran could interrupt oil supplies, leading to sharply higher prices.

02 However, tail risks remain unlikely and shouldn't guide investment strategy.

- Republican lawmakers, a majority in Congress, will probably resist impeaching a president from their own party.
- North Korean tensions have been rumbling for years, and the US and China have strong incentives to reach a diplomatic solution.
- Saudi Arabia is seeking to liberalize markets while Iran wants to lift international sanctions, making an escalation damaging for both.

03 Investors who retreat from markets risk missing out on strong returns at a time of improving global earnings and growth.

- Leaving the market directly after a tail risk plays out could result in missing future potential gains.
- South Korea is Asia's best-performing index so far in 2017 despite political risks, with the KOSPI up 18.2% year-to-date as of 11 July. The S&P 500 is up 8.4% year-to-date, as Trump administration reform hopes diminish.
- The global economy has been enjoying a synchronized upswing and we expect global earnings per share to rise by between 10% and 15% in 2017.

New this week

It was revealed this week that President Trump's eldest son, Donald Jr., met with a Kremlin-related lawyer who promised damaging information on Hillary Clinton prior to last year's election.

The ongoing FBI investigation into links to Russia has raised concerns over the Trump administration's ability to implement its pro-growth economic agenda and raised the possibility of impeachment.

One liner

Global political concerns will always remain, however markets may overreact before normalizing.

Did you know?

- Impeaching a US president requires a two-thirds majority in Congress. No US president has ever been removed from office through impeachment. Nixon resigned and Clinton's impeachment did not pass the Senate. Neither impeachment effort had a lasting effect on markets.
- The past five nuclear tests by North Korea led to South Korean equities falling by an average of 2.5% – a limited impact.
- North Korea said its Hwasong-14 missile climbed to a height of 2,802 kilometers in the 4 July test, and warned it was "capable of carrying a large-sized heavy nuclear warhead."
- Saudi Arabia and Iran combined account for 18% of global oil supplies.

Investment view

While political risks haven't gone away, they are contained for now. Economic and earnings growth are likely to push stocks higher, and we recommend a tactical overweight to global equities.

UBS

Should investors fear a US slowdown?

Key message

US economic releases have been generally disappointing expectations, with slower growth, weaker retail sales, and lower inflation. We believe there is no cause for investor alarm, and expect the soft patch to pass soon. But with a synchronized pick-up in global growth and European central bankers contemplating a step back from ultra-accommodative policy, the US is no longer the international leader. That calls for greater global diversification.

House view

01 US economic data has been undershooting expectations, with slower growth and retail sales.

- The Citi surprise index fell to –54 as of 13 July, with readings below zero indicating that data releases are undershooting expectations. This is close the lowest readings since 2011.
- Revised figures show GDP grew by 1.4% annualized in the first quarter, an improvement from the second revision estimate of 1.2%, but still far slower than the 2.3% pace of Eurozone expansion.
- US consumers have been holding back. Retail sales dropped 0.2% in June, falling further from 0.1% in May.

02 This period of weakness is likely to prove fleeting, especially given the strength of the labor market.

- The jobless rate rose to 4.4% in June, but remains below the Fed's definition of full employment. This should put upward pressure on wage growth and support consumer spending.
- There are already some signs of a growth rebound. The Atlanta Fed's latest model update shows 2Q GDP tracking at 2.6%, while the New York Fed's has growth at 2%.

03 But the US no longer looks exceptional, strengthening the case for global diversification.

- The global surprise index is running at –2, down from a recent peak of over +45 in March but still more balanced than in the US.
- Purchasing managers' indices are now above 50 in most major economies, indicating expansion. The JPMorgan Global Composite PMI stands at 53.7 for June.
- US stocks currently trade at a roughly 10% premium to the average trailing P/E over the past 30 years, while global equities are at a 2% discount.

New this week

Comments from Fed Chair Janet Yellen on 12 July were interpreted to indicate an increasing risk that low inflation could slow the Fed rate hiking cycle. And CPI data for the year in June reinforced this view, coming in at 1.6% from 1.9% in May. The core CPI remained stable, rising by 1.7% year-on-year as in May. Furthermore, retail sales dropped by 0.2% in June in the second consecutive month of declines.

One liner

At a time of synchronized global growth, the US is no longer the star performer.

Did you know?

- Despite the recent soft patch, CIO expects the US economy to expand by 2.2% for 2017, an improvement on the 1.6% expansion last year.
- The manufacturing purchasing managers' index for June came in at 57.8, the highest level since August 2014. A value over 50 indicates expanding activity.
- In 2014, the US economy's 2.4% growth rate was twice as fast as that of the Eurozone. But in the first quarter of 2017 the Eurozone outpaced the US, growing by an annualized 2.3% versus 1.2%.

Investment view

Although US growth and equity valuations no longer justify a separate overweight position, CIO believes that US equities can continue to climb. Within our tactical asset allocation, we recommend an overweight to global equities.

Can equities continue to hit record highs?

Key message

Equities have delivered very good returns in recent months and years, with price appreciation outstripping earnings growth. But valuations are a poor predictor of market returns on a six-month investment horizon. And markets are currently well supported by secular, as well as cyclical earnings and economic, trends.

House view

01 Equities have performed well in recent years, and valuations have risen.

- In the past five years, the MSCI All-Country World Index has returned 70%, and the S&P 500 is about 100% higher. In both cases, markets have run ahead of EPS growth.
- P/E valuations are now above long-run averages in most major markets. The US is trading at 20x vs. a 20-year average of 18.8x, the Eurozone at 16.8x vs. 16.6x, and emerging markets at 14x vs. 13.7x.
- The US P/E ratio is now in line with the average of previous bull market peak valuations: 19.7x.

02 But there is more to markets than valuations.

- Valuations have low explanatory power over short-term returns. Earnings growth, earnings momentum, and economic momentum are all more important factors.
- Earnings and economic momentum are strong. The US is experiencing its best EPS growth in six years (+11%), and we expect 12% growth in the Eurozone.
- Despite the Fed increasing interest rates, central bank policy remains generally accommodative, and real interest rates are negative in most major currencies, supporting inflows into equities.

03 And there is reason to believe current valuations could persist.

- Relative to bonds, stocks are cheap. The risk premium on the S&P 500 is just below 5%, compared to a long-run average of around 3%.
- Innovations in robotics and automation, and increasingly knowledge-centric companies, provide scope for higher returns.
- And it took a flat yield curve to upset the past two bull markets, but the US 2y–10y spread is still 96 basis points.

New this week

It was a record-setting week for equities. The MSCI All-Country World Index and the FTSE All-World Index, two gauges of global equities, reached record highs on 13 July. Joining them were the Dow and the KOSPI.

One liner

Global economic growth, low real rates, and improving earnings suggest that global stocks are well supported.

Did you know?

- History suggests a Fed rate hike need not knock US equity performance. Since 1971, the S&P 500 has returned 11.2% on average in the 12 months after a rate rise compared to the all-period mean of 11.8%.
- The US unemployment rate of 4.4% is close to its 16-year low of 4.3%.
- The US and Eurozone are set for the best earnings growth in more than six years.
- The JPMorgan global manufacturing PMI is at 52.6 for June, close to a six-year high.

Investment view

While valuations are now fair in the US, they remain below average internationally. In both US and international markets, equities are well supported by fundamentals. CIO is overweight global equities in its global tactical asset allocation.

Should we worry about China's slowdown?

Key message

The threat of an abrupt economic slowdown in China has been a concern for investors. Anxiety has focused around rising debt and climbing interbank rates. However, we believe the Chinese government will maintain economic and financial stability. As a result, it looks unlikely that China's gradual slowdown poses an imminent threat to investors.

House view

01 Investors have been worried by climbing Chinese debt, rising interbank rates, and capital outflows.

- IIF estimates show China's total outstanding debt at 304% of GDP as of May, compared to 160% in 2008.
- Policymakers tightened interbank liquidity to curb excess leverage, sending three-month Shibor up nearly 2 percentage points in just seven months to a 13 June peak of 4.78%.
- Chinese FX reserves have fallen by nearly 25% from their 2014 peak, leading to stricter capital control measures in March.

02 But none of these issues look likely to derail China's economy or markets.

- Alongside new capital controls, a rise in non-US dollar currencies has helped lift Chinese FX reserves, which have risen for five straight months, to USD 3.057 trillion in June.
- PBoC liquidity injections have helped loosen financial conditions, with three-month Shibor moderating to 4.36% as of 7 July, signaling a more flexible approach to deleveraging efforts.
- Bets against the yuan have faded following the introduction of a new FX pricing mechanism, with the yuan up 1.3% against the dollar since the system was first detailed on 25 May.

03 China's orderly slowdown is unlikely to disrupt global markets.

- The government has recently shifted away from strict regulatory tightening toward policies that promote economic and financial stability.
- Robust PMI and industrial output data suggest solid second-quarter GDP growth, following a targeted 6.9% expansion in the first quarter.
- We are overweight global equities, and overweight Chinese equities in our Asia tactical asset allocation.

New this week

China's Producer Price Index (PPI) rose 5.5% in the year to June, providing further evidence that the nation is working through its industrial overcapacity. Producer prices were declining between early 2012 and September last year. The recovery in factory gate prices is positive for industrial profits, reducing the risk that firms will default on their debt.

One liner

Threats to the Chinese economic and financial system remain contained at present, and look unlikely to interrupt the rally in global equities.

Did you know?

- China imported 7.5% more iron ore last year than in 2015. The 1.024 billion metric tons translates, writes Bloomberg, to about 32 tons – per second.
- In 2014, the country's fixed asset spending of USD 4.6 trillion totaled nearly one-quarter of all global investment, and more than double India's GDP.
- Consumption contributed 77.2% to first-quarter Chinese growth, up from 64.6% for all of last year, according to National Bureau of Statistics data.

Investment view

CIO expects USDCNY to reach 7.1 by year-end. With ample policy flexibility, we believe authorities will be able to manage the country's gradual economic deceleration. Against this backdrop, we remain overweight global equities in our tactical asset allocation.

Can Eurozone assets strengthen further?

Key message

The Eurozone is enjoying a renaissance. The single currency is the best performer among its G10 peers this year, and the Euro Stoxx 50 Index is up almost 8%. The Eurozone has occasioned bursts of high optimism before that have been cut short by political angst, slow growth, and weak earnings. But this time looks different. Economic and earnings data have both turned positive. While the market has begun to catch up with our expectations, we believe both the euro and Eurozone stocks can rise further.

House view

01 We've seen false dawns in Europe before.

- Every year since 2007, earnings per share (EPS) forecasts have ended lower than where they started.
- Political risks from France, Spain, Italy, and Greece have tended to resurface when all appeared calm.
- And Eurozone economic growth has been slow: below 2% year-over-year each year since 2010.

02 But this time genuinely looks different, with rising earnings and improving economic growth.

- For the first time in more than six years, EPS forecasts are rising convincingly.
- Eurozone growth at 2.3% annualized in the first quarter outpaced the US figure by a wide margin. Business confidence reached a record high in France.
- Consumer confidence is at the highest level since 2001.

03 Despite optimistic sentiment, we see scope for the euro and Eurozone equities to rise further.

- Investors have been pouring money back into Eurozone stocks in recent weeks. The region has seen inflows in 14 of the past 15 weeks, as of 6 July.
- The euro is still around 10% undervalued versus the US dollar on a purchasing power basis. We estimate the long-term purchasing power parity of the euro at USD 1.26.
- Eurozone stocks now look appealing, especially versus UK equities, whose earnings momentum is slowing.

New this week

The euro reached a 14-month high on 12 July. Eurozone industrial production rose by 1.3% in May. This surpassed analyst expectations and was the best month since November 2016.

One liner

Europhiles have been let down many times in recent years. This time their optimism looks justified.

Did you know?

- The Citi economic surprise index for the Eurozone was 37 as of 13 July. That compares to an average of 3 over the past five years. Any reading over zero means economic data is exceeding the consensus forecast.
- The Eurozone June manufacturing PMI came in at 57.4, the highest since April 2011. The average reading over this quarter was also the best outcome in six years. Any reading above 50 points to expanding activity.
- Eurozone unemployment has fallen from a peak of 12.1% in 2013 to 9.3% in May.

Investment view

CIO expects the euro to appreciate versus the expensive US dollar, with EURUSD reaching 1.18 in six months and 1.20 in 12 months. In our tactical asset allocation, we recommend an overweight to global equities, and an overweight to Eurozone stocks versus UK equities.

UBS

Is the worst over for the oil price?

Key message

A June bear market run in oil, which spent 10 days below USD 45/bbl for WTI, was a cause for concern for some producers, triggering falls in US high yield and energy stocks. But it does not appear likely to bubble over into the broader market, and a tentative bounce in oil is defusing some of that pressure. We remain overweight global equities and US high yield credit. Both could receive a further boost if the oil price rallies in the months ahead, as we expect.

House view

01 **Softening oil prices have threatened to adversely affect other markets.**

- Weak WTI prices, which are down some 14% since the start of the year, have fallen to levels that make some high yield debt issuers unprofitable and at greater risk of missing debt payments.
- Since the 25 May OPEC meeting, US high yield energy spreads have widened by around 90bps.
- Year-to-date, the US and European energy equity sectors have fallen roughly 13% and 9%, respectively.

02 **But the harmful impact on equities and high yield bonds should prove short-lived.**

- First, we believe the oil price will rebound in the coming months, as OPEC production cuts help reduce unusually high US inventories.
- In any case, the weighting of the energy sector in the S&P 500 is now less than half its early 2009 weight – going from 14.1% to 5.9%.
- US shale oil firms have become more efficient. A short period of oil at USD 45/bbl or below is unlikely to drive another wave of defaults.

03 **So we remain confident in our overweight to global equities and US high yield.**

- We still expect to see around 10% global earnings growth for 2017, and stocks continue to be supported by a synchronized upswing in the global economy.
- Overall high yield defaults are 2.2%, the lowest since 2015, and ex-energy defaults are 1.5%, vs. a long-term average of 4%.
- And if the oil price rebounds due to a second-half supply deficit, as we expect, this could provide a further boost to stocks and US high yield.

New this week

US crude inventories dropped by 7.6m barrels per day over the last week, easing fears of a global supply glut and boosting oil prices. The reduction in stocks exceeded analyst expectations of 2.9mbpd, and is the largest one-week drop since last September. The news took WTI prices 1.5% higher to slightly above USD 46 a barrel.

One liner

We expect the next big move in oil to be up, not down.

Did you know?

- US oil demand rose above 19 million barrels per day this April, a high for that month since 2008.
- Brent endured its worst half of the year in almost two decades. Prices fell by 15.5% since the start of the year, compared to a 19% fall in 1998.
- OECD oil inventories declined by 6m barrels to 3,047m barrels in May. Over the past five years, May has seen an average of a 28m-barrel build in inventories.
- Compliance among OPEC members with the deal has been estimated at 92% over six months, compared to previous deal rates of 75% to 80%.
- Media reports indicate Saudi Arabia plans to reduce its August crude exports by 600,000 to 6.6mbpd.

Investment view

CIO forecasts Brent crude oil prices to reach USD 60/bbl in six months and USD 57/bbl in 12 months. Higher oil prices will support our overweight to energy stocks in the US and Eurozone country equity sector strategies.

UBS

Will US politics help or harm markets?

Key message

President Trump's pro-growth policies, including tax cuts and a boost to infrastructure spending, have the potential to help markets. But recent political dysfunction has threatened that agenda. We believe US political developments are unlikely to harm global stocks. Markets' lowered expectations leave little risk of disappointment. Instead, investors should focus on solid economic and earnings growth.

House view

01 **President Trump's recent political woes have cast doubt on his ability to enact pro-growth reforms.**

- In the months after Trump's election, markets appeared to get a lift from hopes of tax cuts, higher infrastructure spending, and a lightening of business regulation.
- The White House has proposed cutting the corporate income tax rate from 35% to 15%. We are more likely to see a smaller cut, to 25–28%, but even this would boost earnings per share.
- Progress has been slow and healthcare reform difficulties have been an obstacle, but we believe Congress will make progress on pro-growth reforms.

02 **But the scope for further disappointment is now limited.**

- Firms that enjoyed a boost after Trump's election have largely given up these gains.
- Construction and engineering firms, which initially beat the index by 20%, have given up all the relative gains amid fading hopes.
- High-tax firms, which outperformed the index by over 3 percentage points in the month after the election, have lost this edge.

03 **So investors can focus on solid economic and earnings growth, which should push stocks higher.**

- Ebbing hope of significant stimulus has not derailed equity markets. We expect global equities to remain supported by the global upturn in economic growth and profits. We expect 2017 S&P 500 profit growth of 11%.
- The S&P 500 index is up 8.5% year-to-date, as of 11 July, and is just 1% below a record high hit on 19 June.
- While US inflation and retail sales have been weak, the jobless rate is the lowest since 2011. That bodes well for consumer spending in the coming months.

New this week

On 10 July, the US Consumer Financial Protection Bureau outlined new restrictions on the ability of financial firms to settle customer lawsuits out of court – a move that appeared in conflict with the Trump administration's pledge to trim regulation on businesses.

After the proposed change, customers would find it easier to sue banks. Financial services firms have said this could increase costs.

One liner

Donald Trump hasn't yet delivered the pro-growth policies markets expected. But equity investors have plenty of other reasons for optimism.

Did you know?

- The White House has ordered government agencies to propose eliminating two regulations for each new one they issue.
- A trade war with China and Mexico would be risky for the US – the Peterson Institute estimates it could cost up to 4.8m US jobs, or 4% of the total labor force, by 2019.
- The US dollar, which initially gained 20% against the Mexican peso on expectations of greater US protectionism, is now back to pre-election levels.

Investment view

Fundamentals matter more than politics. CIO is overweight global equities its global tactical asset allocation. We also expect the euro to strengthen versus the US dollar.

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