

A turning point

Investors should keep an eye on politics but invest based on fundamental drivers

BY TAN MIN LAN

THE US and the European Union (EU) controlled almost half of the global economy at the turn of the century – some 44.5 per cent, according to the International Monetary Fund. But that figure is expected to slide to 32.1 per cent in 2017 and to 30.5 per cent by 2020 as these old world superpowers cede market share to up-and-coming economic giants such as China and India.

This erosion of economic might has had huge consequences for both the US and the EU. Once a champion of capitalism's virtues, the US has elected a president who has promised to bring back the good old days of American preeminence through a protectionist trade agenda. And in Europe, the bubbling populist movements in traditionally pro-free-market economies reveal a clear push back against the merits of globalisation.

This revolt against the march of global capitalism is increasingly clouding the long-term economic outlook for the US and Europe, and therefore the world. So, what should investors expect in the coming years from these developed markets?

Europe's 'stronger together' mantra

For the first time in its history, the EU experiment is quivering under the weight of doubt – doubt that a common currency is the best solution for all of its members, doubt that the European Central Bank has everyone's best interest in mind, and doubt that unrestricted immigration within the EU is a good thing. But the biggest long-term threat to the current European order stems from another worry – the rise of populism.

The fiscal straitjacket imposed by creditor nations on many member states and the deflationary forces it unleashes have fuelled a populist surge across the continent, both on the far left and the far right of the political spectrum. The culmination of voters' disenfranchisement has caused a near Grexit and an actual Brexit, as well as calls for a Nexit, Frexit, Italexit and so on.

As anxiety persists over diminished economic opportunities and cultural identities, the political polarisation of late is unlikely to fade from the scene anytime soon. And the breakthrough of a populist party in a major country could shake up the entire continent.

Still, popular support for the euro and the EU is high, in particular among the young. Importantly, 69 per cent of eurozone respondents are in favour of the economic and monetary union, close to the all-time high of 70 per cent. And the recent threat to the union's stability has a silver lining: The calls to disband may ultimately galvanise the push for even deeper integration. We believe that the EU will survive the challenges to its unity, and become stronger as a result.

The eurozone's economy has continued to firm lately. The latest PMIs (purchasing managers' index) are at six-year highs, and the eurozone's jobless rate now stands at 9.6 per cent, not far from its estimated natural rate of unemployment. We are forecasting eurozone GDP (gross domestic product) growth of 1.5 per cent for this year.

The region's equities should build upon their 10 per cent total returns this year thanks mainly to rising earnings. The seven-year stagnation in eurozone profits looks set to end, and revision ratios (the balance of earnings upgrades versus downgrades) have turned positive for the first time since 2010.



RISE OF POPULISM

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Better growth and inflation data favours pro-cyclical equities in the eurozone, in particular stocks in the energy, financial and materials sectors. And a decline in the political risk premium in France will likely support the euro against the US dollar and growth-sensitive assets in general, including US and global equities.

Trump's economic panaceas

First as a candidate and now as the president, Donald Trump has made bold promises: a US\$1 trillion investment in rebuilding US infrastructure and a US\$54 billion increase in defence spending. Fulfilling these spending promises will be difficult. Large deficits and stretched budgets, potentially exacerbated by tax cuts, plus Republican opposition to new government spending, are high hurdles to overcome.

Likewise, Mr Trump's recently unveiled tax plan looks set to be either diluted or rejected in Congress. Although there is a chance of garnering some support from Democrats, Congress is unlikely to pass any plan that greatly expands the budget deficit. The corporate tax rate will likely be lowered, but not to the 15 per cent proposed by the administration; a rate of around 25 per cent is more likely. Meanwhile, personal income taxes are more complex and a major reform is so controversial that it may be difficult to pass legislation this year.

One common theme of Mr Trump's presidency so far has been bitter partisan politics. It is difficult currently to imagine cooperation even in areas where there is some common ground, such as tax breaks on the repatriation of corporate profits being held overseas. Political infighting could continue to cause many headaches for the presi-

dent, not just over healthcare but also on the fiscal front.

Historically, policy uncertainty has had a negative impact on economic growth in the US. A recent reading on consumer sentiment, which had jumped after the election, showed a noticeable dip in expectations following the mounting discord in Washington. Still, coming to the rescue of the US markets will likely be the true hero of this story: the American corporation.

By the end of reporting season in mid-May, corporate results are expected to confirm that S&P 500 earnings growth accelerated to 12 per cent – the fastest rate in six years. The first quarter of 2017 should also be the fourth consecutive quarter of accelerating S&P 500 EPS (earnings per share) growth. This should offer some of the clearest evidence that improving fundamentals have been the key driver of the equity market rally over the last several months.

Even without a boost from stimulus measures and tax reform, 2017 S&P 500 EPS should jump to US\$130, a 9 per cent increase from 2016, and 2018 S&P 500 EPS should rise to US\$140, an 8 per cent growth. This expected rebound in earnings bodes well for equity prices, and the overall capital investment outlook and economic trajectory of the US.

In short, keep an eye on politics, but invest based on fundamental macro and micro drivers which remain solid globally. Populism is deeply troubling for societies at large. But its impact on our investment portfolios will likely be limited, especially in the short to medium-term tactical horizon. **W**

Tan Min Lan is Head, Chief Investment Office APAC, UBS Wealth Management