November 14th, 2016

# MARKET INSIGHTS

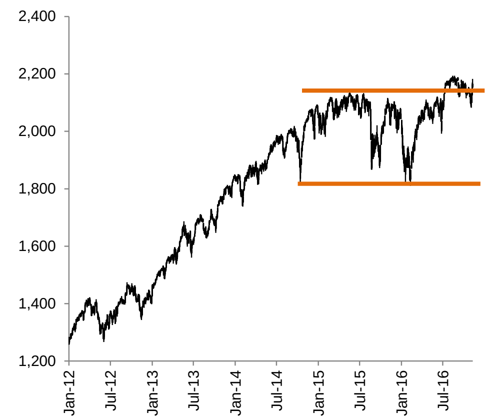
The latest Market Insights
from the Connected Wealth team

# Golden Trump Years?

Craig Basinger, CFA
Derek Benedet, CMT

As we all sat in amazement following the election results, something strange started to happen. Markets started to go up. If you had asked just about everyone ahead of the election results how the markets would react to a Trump surprise victory, just about everyone would have said the market would not be very happy. After all, the market rallied Monday after the email scandal facing Hillary Clinton was once again resolved according to the FBI, increasing the likelihood she would win. So why have global markets reacted so positively to Trump? It surprised us, but we believe there is a rather simple explanation: the election is now over.

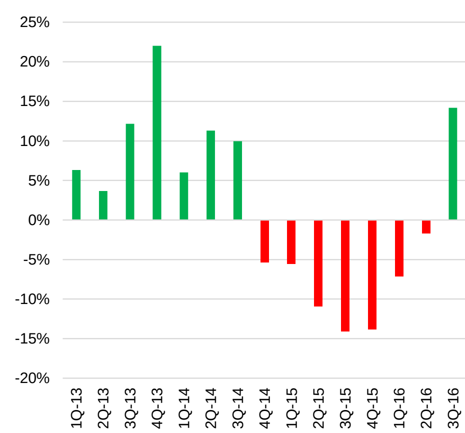
Chart 1 - The S&P Has Been Range Bound For A Few Years




For two and a half years, the S&P 500 has been range-bound, stuck in between 1,900 and 2,200 (Chart 1). It hasn't been dull, with enough rallies and sell-offs to keep everyone entertained. But, there have been some fairly powerful headwinds keeping the market from moving higher. These include:

- Oil
- China
- Earnings
- The Election
- The Fed

Chart 2 - S&P Earnings Growth Is Finally Positive Again




No question, these have been big headwinds. The drop in oil prices caused investors to begin worrying about bank balance sheets. Fortunately, now with oil back in the $45 area, the market is much less concerned.  China, which was at the heart of weakness earlier this year and in the summer of 2015, was endeavoured to rapidly increase credit in Q1. This is now resulting in better economic data. Turning to earnings, growth turned negative for the S&P 500 about two years ago, at roughly the same time the market got stuck in this trading range. Yet, after a few years, we are now seeing positive earnings growth again (Chart 2). So this headwind has dissipated.

That leaves the Election and the Fed. The behaviour of markets is truly interesting as they tend to react more negatively to 'unknowns' than they do to even negative news. Simply put, markets hate uncertainty. And while Trump winning the election may not be the greatest thing for

RICHARDSON GMP

the markets, knowing who the President is and that the election is over, in and of itself, appears to have removed enough uncertainly to let the markets rally. So that leaves the Fed. And with bond yields rising, the likelihood of a rate hike is once again elevated.

Though markets are up following the election results, sector disparity has only grown (Chart 3). The real winners this week have been the Financials, which are up 7.7% in the U.S. and 2.1% in Canada. Industrials are the other big winner up 4.9% in the U.S. and 2.6% in Canada. Cyclical yield, a concept we've discussed quite frequently over the past few months, has certainly profited following Trump's election. Rate sensitive sectors on the other hand have continued to underperform. To the right, we can see how these sectors which include Telcos, Utilities, and REITs, have fared since the midway point of the year. Just this week, Utilities, one of the top performing sectors the first half of the year, have fallen more than 5% in both Canada and the U.S. The moves this week have been quite strong, and while we do not expect the rate of change to continue at this pace, we do believe the ongoing sector rotation presently underway will have some staying power as the latter stages of the aging bull market continue to play out.

While we believe rates will continue to trend higher, the current pace of the change will likely slow. In terms of percentages, this past week, US ten-year yields jumped 21%, this is the largest weekly percentage jump over the past 50 years (Chart 4). Starting from a small denominator certainly helps with this calculation, but closing the holiday shortened trading week for fixed income with a 10-year Treasury at 2.15% is probably a bit of a surprise to even the most ardent bond bears. We're quickly closing in on the high mark for the year, which coincided with the very first trading day. Interestingly, the jump in bond market volatility is coinciding with a VIX that is quickly retreating. Over the past couple of years Move Index (measures bond market volatility) and the VIX Index (measures equity volatility) have been quite highly correlated. This week, we're witnessing a very large divergence between the two (Chart 5).

How much room is there to run in yields and what do we need to see next for rates to continue up their current path? Continued hawkishness from the Fed in coming meetings, along with a rate increase or two, continued strong economic data and inflation numbers which continue to creep higher. There is still a considerable amount of uncertainty surrounding what a Trump government will look like, and even more regarding the specific policies that will eventually be passed by the government. If the recent Canadian experience can provide any example, it is that there is quite a lag between announced infrastructure spending and any tangible shovel-in-the-ground benefits to the overall economy. Time will tell if the initial impulse higher proves to be right. Some obstacles holding markets back have been removed, but if there is anything that investors should be used to, it is that we should not be surprised by surprises.

**Chart 3 - This Is What Rate Sensitivity Looks Like**
Canadian Sector Performance (%)

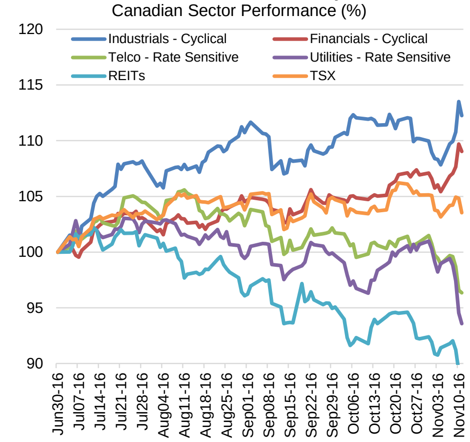



**Chart 4 - Largest % Jump In US Treasury Yields In Past 50 Years**

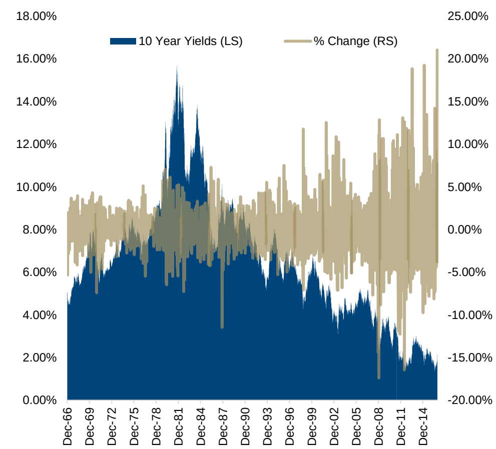
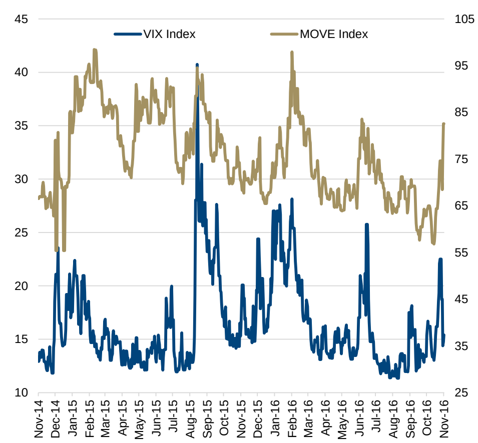



**Chart 5 - Volatility Divergence**



*Charts are sourced to Bloomberg unless otherwise noted.*