# Is the “Reflation Trade” in Trouble?


Is the “Reflation Trade” in trouble? Many have lost steam recently, argues Geoff Lewis, Senior Asia Strategist, as initial assumptions made by investors regarding passage of key legislation have been re-rated. Global growth prospects, however, continue to remain strong and drive markets. As a result, US and Emerging Market (EM) equity markets remain buoyant. In years when the US stock market opens strongly, it also tends to finish strongly; hence investors could consider buying on the dips and remain vigilant along this potentially bumpy political and economic journey.

## First quarter markets overview[1]

March was yet another successive month of positive returns for global equity markets, with all major regions showing solid returns in US dollars.

### Europe outperformed developed markets in the first quarter

Amongst the developed markets, Europe (+7.6%) outperformed the US (+6.2%). In fact, the US slightly disappointed investors in March. The S&P 500 fell 1.3% after the Republican House failed to repeal and replace Obamacare. By sector, IT was the best performing global sector in the first quarter (Q1) with energy the main loser, the only sector with a negative return.

### Asia, Latin America, EMEA (Europe Middle East & Africa) are clear winners in Q1

Emerging markets continued to post positive returns in March, with the MSCI EM index up 2.6% and the MSCI Asia ex-Japan index up 3.3%.  Emerging markets were indeed the clear winners in the first quarter of 2017 with double-digit returns in each of the three main regions – Asia, Latam (Latin America) and EM (merging Markets) – and an overall return for the asset class of 12% to 13%.

### Three favourable trends helped the EM markets in the first quarter

The EM markets were helped by three favourable trends in the first quarter:

(i) Broad stability in the US dollar. The dollar did not continue to appreciate as many had assumed in January;

(ii) Strength in commodities, with oil in particular holding up despite high US inventories and rising Shale production, and;

[1] FactSet, Manulife Asset Management, as of 31 March 2017. All returns are represented by MSCI indices, in US dollar and total return.

(iii) Lower long term rates in the US, where yield on the 10-year US Treasury rolled over and never came close to challenging 3.0%.

## The Trump Administration will likely recover from recent policy setbacks

In February we advised that the potential stock market beneficiaries of Trump's agenda had already run quite hard and that this theme was no longer worth pursuing.

We saw several important developments in March. Trump and the Republican leadership sought (and failed) to repeal Obamacare, intending to replace it with a much less generous scheme that would significantly reduce public health spending in future years. That would have created room for some of Trump's deep tax cuts.

The American Health Care Act's failure now pushes back the timing of Trump's entire economic policy agenda. It has also cast doubt on whether the expected fiscal stimulus can be delivered in 2018. This is because some Republican groups are willing and able to block tax legislation that adds to the budget deficit.

So what happens next?

### The central focus for investors remains taxes, not healthcare

Donald Trump's draft 2017 fiscal year budget and the composition of public spending is not the central focus for either the public or investors. The central focus remains taxes, and especially corporate taxes. It is Trump's planned tax cuts that have led business sentiment to soar to stratospheric levels, especially among smaller companies. Nobody will care too much if Trump only gets half of what he has asked for in his budget on the expenditure side.

We believe most US businessmen and households are ready to be fairly patient on this occasion and they know that major policy changes take time, but are coming eventually. In this respect, economic policy uncertainty in the US is surely much lower now than it was prior to the November election.

## Our View: Stay positive on equities, but stay alert

Our friends at independent research firm TIS recently reminded us of a point we made earlier in January: in years when the US stock market opens strongly, it also tends to finish strongly. In similar vein, TIS report that a study of US stocks since the 1950s shows that "when the first 50 days of trading exceed a 5% gain in the S&P 500, then in 95% of subsequent observations, stocks continued to rise showing an average gain of 12% by year-end."[2]

[2] TIS Market Intelligence Report," 21 March 2017.

This statistic would suggest continuing to buy the dips in 2017, rather than taking a bearish stance at this point.

Indeed, equities do not want to retreat and give up ground. Even if the final Trump tax reform package does not pass Congress until the first quarter of 2018, dragging out the timeframe may not be too bearish for US equities – even if Trump's economic policy intentions have shifted market attention away from dwelling only on Fed monetary policy and expected rate hikes.

Our position at this point is to stay positive on equities, but to stay alert. “Sell in May and go away” is most likely to apply in 2017 if an inflection point in Purchasing Manager Indices (PMIs) and Leading Economic Indicators lies just ahead. That is perhaps the most likely potential trigger for a more substantial near-term setback to equities.