22 May 2017

Sell in May and go away? Too much uncertainty to let it be.

American politics in turmoil again. What's happening with Trump's tax plan? Increased uncertainty and risk of disappointment. Profit taking is vital. Buy gold!

Key points

- American politics in turmoil again, could trigger a sudden shift in risk perception
- Increasingly unpredictable outlook for Donald Trump's economic programme
- Expecting a less ambitious tax plan
- US companies will not be able to further strengthen their excellent results in Q1 over the rest of the year
- Rather disappointing economic surprises in the US in April
- Selling equities before the summer a profitable strategy since 1985… and in 2017?
- Risks of 'tech mania' bubble bursting
- Sell in May and… buy gold!

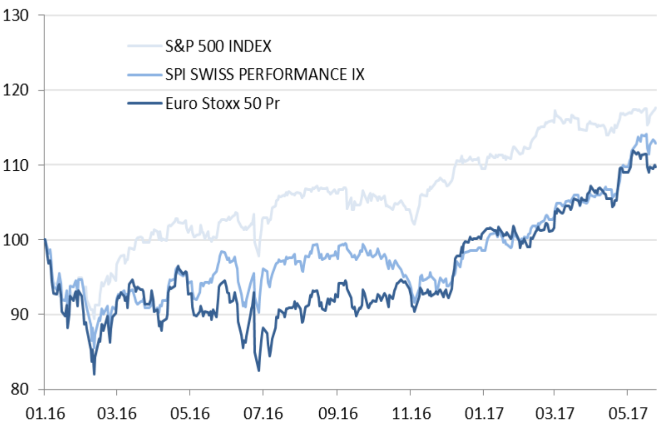
American politics in turmoil again, could trigger a sudden shift in risk perception

We mentioned at the beginning of the year that uncertainties likely to affect the markets' new-found serenity would most probably be triggered in 2017 by the political factor in the US.

We pointed out that economic data would certainly continue to improve in the US as well as in the rest of the world but that this factor, essential in the long term, would not always be sufficient to counterweigh the growing risks to international equilibria resulting from the particularly unpredictable style of management of the White House's new resident.

Recent political developments relating to the sudden and shocking dismissal of the FBI director tend to show the acuity of our analysis. Even if President Trump can momentarily brush aside journalists' questions and avoid a confrontation by setting off on his first diplomatic visits to Saudi Arabia and Israel, we believe it is highly unlikely that he will be able to avoid for long the many issues raised by the exceptional circumstances surrounding the dismissal of the man responsible for investigating the possible links between the president's entourage and representatives of the Russian government. The next few weeks should see more revelations published regularly that are unlikely to remove doubts of possible collusion and Russian interference during the presidential campaign.

Performance of equity markets



Sources: Bloomberg, BBGI Group SA

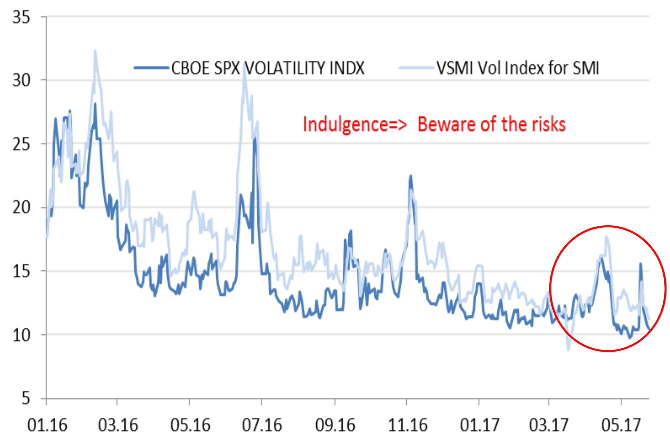
The correction in the equity markets, -1.8% for the S&P500 and -2.51% for the Nasdaq on 17 May, is probably a preview of what could happen if investors started to be genuinely concerned that the President had acted in proven violation of his mandate. Indeed, rumours according to which President Trump asked FBI Director James Comey to shut down the investigation into his former National Security Advisor Michael Flynn surprised observers and likely instilled some doubt as to the integrity of the new US President. Further rumours according to which the latter may have acted inappropriately when he received the Russian Foreign Affairs Minister at the White House by claiming to have successfully relieved some pressure thanks to James

Comey's dismissal have reinforced the general perception of President Trump as incompetent and naive.

Despite the White House's denials, uncertainty has overshadowed the confidence that had prevailed in the last few months.

In line with this emerging shift of perception, the VIX Index, a volatility and risk indicator, has surged from an all-time low of 9.77 to 15.59, posting a 50% increase, which is still nowhere close, however, to the extreme levels that were reached during the 2008 crisis (90) and other crisis periods in 2010, 2011 and 2015, when volatility peaked at close to 50.

VIX and VIX SMI



Sources: Bloomberg, BBGI Group SA

At present, the dollar seems to have reacted more strongly to these possible political upheavals, slipping by -0.54% before continuing its correction without rebounding, while Wall Street recorded its sharpest daily correction in eight months before rebounding in an attempt to ward off the political threat thanks to fortunately encouraging corporate results. The banking sector, expected to be one of the clearest beneficiaries of Trump's expected deregulation measures, was also severely affected (-3.04%).

Increasingly unpredictable outlook for Donald Trump's economic programme

The increase in equity markets in the last few months probably owes much to improved economic conditions and the particularly positive evolution of corporate earnings in Q1, but prospects for tax reforms and their effects on US corporate profits have also supported an increase in prices in the last few months. Indeed, after the election in November 2016, financial markets were quickly reassured by certain aspects of President Trump's programme, which were particularly favourable to US corporate earnings growth. The expected effects of the promised fiscal stimulus and tax measures on US corporate profits have obviously broadly boosted investor optimism to the point that equity markets have grown by +15% since 8 November, comfortably pursuing a trend that began in 2009. Going forward, a shadow has been cast over the actual implementation of Trump's economic and tax programme, or its postponement, or even its reassessment, with the risk of widely disappointing investors and triggering profit taking in the next few weeks. The Justice Department's appointment of a special prosecutor, Robert Mueller—a former FBI Director considered as the most incorruptible man in the US—to investigate the issue of President Trump's possible attempt to influence FBI Director Comey and get him to shut down the investigation into Russia's possible interference in the US presidential campaign, ensures that an inquiry into what is now referred to as 'Russiagate' will indeed be carried out.

We believe that the media and political pressure that will most likely intensify in the next few weeks will dampen any hopes of a coming implementation of Trump's economic and tax programme.

After high expectations relating to the tax reforms, it is now likely that these will not be implemented before 2018 at the earliest.

Beyond the issue of the timing of the programme's implementation, tax cuts, initially estimated at close to 2 trillion over ten years, will likely be reduced by 50% to only 1 trillion dollars.

This eventuality may change the perceptions of investors now probably more inclined to reduce their risks.

Expecting a less ambitious tax plan

However, the argument above may have to be tempered inasmuch as the recent performance of certain assets that should have benefitted from Donald Trump's economic programme have already suffered a few setbacks in the last few weeks, thereby suggesting that investors have actually already incorporated, at least partially, the reduced probability of the presidential programme being implemented. The underperformance of the infrastructure and banking sectors and of highly-taxed shares, and the decrease in expected inflation over five years may indicate that investors have already taken into account the reduced probability of a growth scenario resulting from Trump's programme being implemented.

Companies will not be able to further strengthen their excellent results in Q1

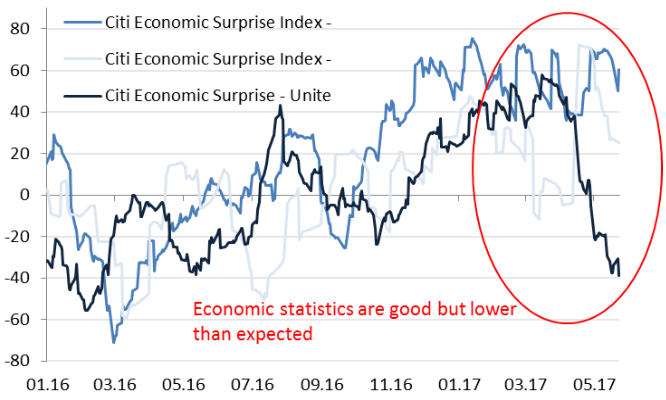
Q1 in 2017 was certainly one of the best quarters in the history of US corporate results. The +14% or so average growth in S&P500 corporate earnings is exceptional, as is the +8% or so growth of revenues. Sales have increased sharply (+8%), but an increase in margins of close to 0.5% (9.5%) also made it possible for three quarters of US companies to beat analysts' earnings estimates. Multinationals with greater international exposure saw their profits grow more quickly than domestic companies'. All sectors seem to have benefitted from the economic recovery except for telecommunications. The spectacular recovery of the energy sector should also be noted, since after losing some 1.5 billion dollars in Q1 2016, the sector brought in some 8.5 billion dollars in the first few months of 2017. Thus, this sector has established itself as the main profit growth driver in the US. The banking sector has also been a significant driver with +20% growth in retained earnings. In Europe too, results have been good with over 50% of companies beating estimates. What seems a little worrying at this stage is that, given such results, earnings revisions for the rest of the year have not been significant. On the contrary, a downward revision of expected earnings for Q4 has been observed, although margins are still expected to increase slightly. Given the potential pressures that may affect the job market, we do not deem it reasonable to expect any new margin growth. Moreover, if tax cuts were to be deferred a little longer, no effect that would negatively impact expectations regarding earnings per share at year-end may be expected in 2017. Without any growth in profits, equity markets will find it hard to continue growing without accepting an increase in valuations through an increase in P/E ratios, which are already relatively high.

Hence, it is possible that the 'profit growth' factor might not contribute positively to continued equity market growth, despite positive macroeconomic conditions.

Rather disappointing economic surprises in the US in April

On an economic level, the statistics published for the US are still positive and will undoubtedly point to stronger economic activity in Q2, but in the meantime, they express investors' relative disappointment with regard to expectations that were probably too high at the beginning of the year. In contrast, surprises seem better in Europe and China, as suggested by Citigroup's economic surprise indices, which still point to a regular improvement in the flow of macroeconomic data.

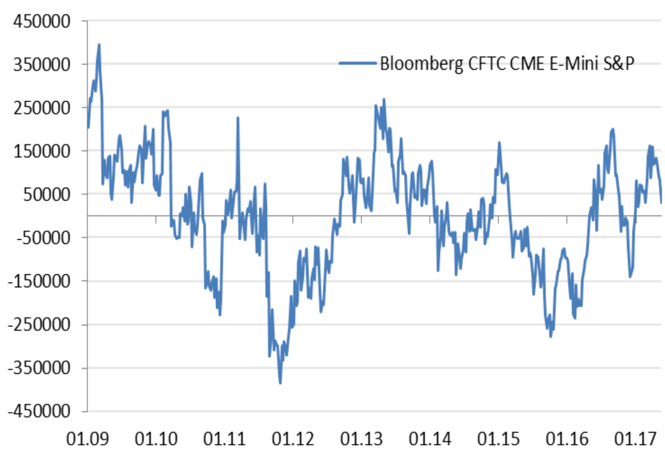
Economic Surprise Index



Sources: Bloomberg, BBGI Group SA

That being said, despite a few disappointments, investor optimism has remained relatively high in the last few weeks, as evidenced by the total Mini S&P500 futures speculative positions, which are close to the peak they reached in late March, and the flow of funds into equity markets, which remains positive.

S&P500 Speculative Positions

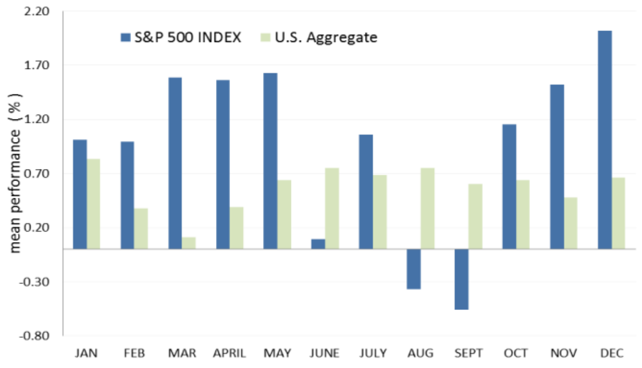


Sources: Bloomberg, BBGI Group SA

Selling equities before the summer a profitable strategy since 1985… and in 2017?

Since 1985, when the OPP2 was created, the S&P500 has performed relatively weakly compared to US Treasuries in the summer months with negative average performances in August and September and a cumulative peak performance in May. Thus, selling equities in May and spending the summer in a 'risk off' position seems to have been an efficient strategy for over 30 years. Will 2017 confirm this analysis?

Distribution of monthly performances of US equities and bonds 1985-2017

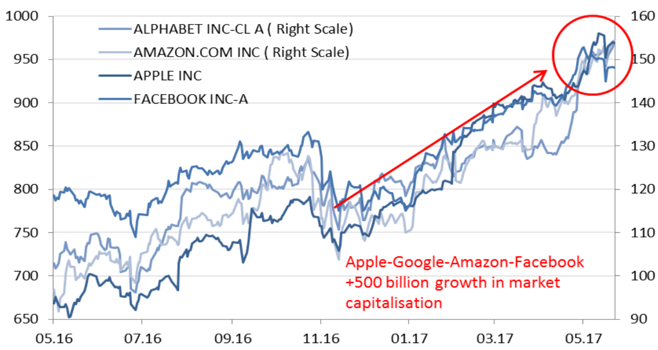


Sources: Bloomberg, BBGI Group SA

Risks of 'tech mania' bubble bursting

The market capitalisation of the four Internet giants (Google, Apple, Facebook, and Amazon) has increased by over 500 billion since the beginning of the year. The four key US-listed companies have contributed to almost one third of the increase in the S&P500 in 2017. Although Apple's P/E is still acceptable at 17x expected earnings for 2017, Google's has soared to 29x, just short of Facebooks' multiple (31x), while the valuation of Amazon at 145x earnings defies gravity. The Nasdaq will not be outdone and also shows a generous valuation at 27x 2017 expected earnings. So, is a tech bubble growing around these web giants?

GAFA: 500 billion in market capitalisation



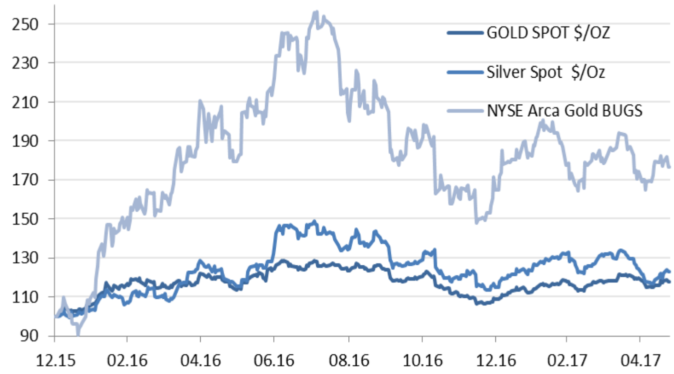
Sources: Bloomberg, BBGI Group SA

The significant growth in the share price of these four leaders of the digital revolution has pushed the multiples of some of them to extreme levels. A real frenzy has developed around these key values, driving enthusiasm for future developments to rarely-seen levels. The next iPhone 8, priced at almost 1,000 euros, will likely boost sales but could also alienate some consumers. Risks of a correction in that segment should be considered.

Sell in May and… buy gold!

We believe that uncertainty has grown sharply in the last few weeks. Our risk indicators point to a reduced exposure to risky assets. This may be a good time to diversify investments by investing in physical gold.

Evolution of gold, silver and gold mines



Sources: Bloomberg, BBGI Group SA

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