Chaos, confusion, and why we must stay the course

Thoughts on the first 100 days of President Trump

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KEY POINTS

- Elections in Europe are a vote for centrists, calming fears that a populist wave would sweep the continent
- We remain wary of the administration’s ability to achieve legislation that is meaningful enough to boost near-term growth
- Relative political risks point to better financial market performance overseas, although we remain vigilant
As we stressed in our Capital Markets Forecast at the start of the year, we expected 2017 to be a year when political events would hold great sway over market performance, and so far that has proven to be true.

We began the year fresh-faced and optimistic that the incoming Trump administration would be able to push through pro-growth policies to benefit both the economy and risk assets. At the same time, the clouds hanging over a series of elections in Europe left us cautious about those markets and, by extension, the international developed equity asset class.

By the time we neared the end of the first quarter in late March, we had adjusted our views based on shifting political risks as well as relative valuations. Domestic equities had appreciated through the first quarter, pushing valuations above long-term norms, while the pricing and valuations of equities in developed markets remained attractive. Of even greater import was the painful House effort to repeal and replace the Affordable Care Act (“Obamacare”), which heightened our concerns about the effectiveness of the Trump administration and the Republican Congress. And while domestic policy was becoming increasingly suspect, politics in developed international markets were increasingly encouraging, as several critical elections seemed to break in the right direction from a markets perspective. Accordingly, we adjusted portfolios by reducing our allocations of domestic equities to a neutral weighting and put those funds to work in developed international equities, increasing our overweight to the latter. We also maintained our overweight to emerging markets equities, and our underweight to core fixed income.

A series of fortunate (international) events

On Sunday, May 7, France held the second round of its presidential election, in which Independent pro-European Union (EU) centrist Emmanuel Macron faced anti-EU anti-immigrant nationalist Marine Le Pen. Macron emerged victorious with the vote breaking down at 66%–34%, exceeding 60%–40% projections.

European equity markets registered strong relative returns between April 21, the last trading day before the first election round, and May 8, the day after the second round (Figure 1). There was a slight retreat on May 8, as investors turned their attention from the French presidential election to the somewhat increased likelihood that the European Central Bank, looking at improving economic indicators, would now feel free to withdraw monetary stimulus.

France will now focus on the campaigns for National Assembly elections to be held in June. We expect Le Pen’s party will pick up some seats, but that a solid majority will be split between the center-right Republicans and candidates of Macron’s newly established party. The principal European issue to watch during the rest of the year is the Brexit negotiation. U.K. Prime Minister Theresa May has scheduled general elections for July 8, which her Conservative Party should win by a landslide. Her purpose is to shore up support for her tough negotiating positions vis-a-vis the EU. For their part, EU members are formulating their own positions. Expect a lot of public rhetoric while real negotiations take place behind closed doors.

Through an overweight to developed-country equities, we had positioned our clients for a reduction in 2017 of the European risk premium. In addition to Le Pen’s defeat, Dutch extremists failed to win first place in March general elections. Of course, there are additional European elections over the course of the next 12 months. We expect German elections in September to produce another moderate coalition, likely under the current chancellor, Angela Merkel. Italian elections are not due
until early 2018, and at this point we see little chance that the eclectic Five Star Movement will be willing or even able to produce a governing coalition. While we are encouraged by recent events—especially that the feared wave of populism does not appear to be sweeping across the continent—we maintain a 9- to 12-month investment horizon for tactical trades, and hence continually reassess our positioning.

In the emerging markets space, we maintain our overweight. Even though oil and commodity prices are softer this year than last year, emerging markets equities are performing strongly, due to e-commerce and consumer-oriented financials. We are closely watching developments in China, where it appears that a coordinated effort is under way to curb “financial excesses.” Whether this will have a meaningful impact on Chinese equities remains to be seen.

On our own shores…

We see very little reason to change our view about the organic economic growth picture of 2.5% in 2017. First-quarter GDP came in at only 0.7%, but is not in our view indicative of a deterioration of the economy. Instead, it was severely weighed down by a warm winter, particularly in the Northeast, which resulted in very weak consumer spending on utility bills. The most encouraging part of the GDP report was business capital expenditures (capex), which showed its strongest quarter since 2013. That stronger capex, combined with positive incoming results for first-quarter earnings, paints the most positive picture for firms that we have seen for several years. Importantly, the April jobs report—reflecting over 200,000 new private payrolls—reversed the weakness reflected in the March report and, in our view, solidifies the case for a June rate hike by the Federal Reserve.

We remain wary of the Trump administration’s ability to achieve meaningful legislation that would boost growth at any point in the near term. Even though “repeal and replace” ultimately did find a path through the House, we are not optimistic that either the initiative or the tax reform effort (which is still in the infancy stage of the legislative process) will yield meaningful economic benefits for 2017.

Indeed, the tax reform proposal was so light on detail and substance that it was hard to gauge potential impacts on the government’s budget or the economy. The administration had promised that a detailed package will be developed over the course of May,

**FIGURE 1**

Emmanuel Macron’s victory in French elections has boosted European equity returns
(April 21, 2017 through May 8, 2017)

![Bar chart showing European equity returns](chart)

Sources: Bloomberg, WTIA
though legislative days continue to tick by. We still expect the administration to achieve legislative victories bringing meaningful impacts, but we have now significantly discounted the chances of that happening this year. We also expect the administration to make headway on deregulation, but keep in mind that the largest reforms require legislation and are subject to a lengthy review process, as pointed out in a recent client call by our guest Tim Pawlenty, CEO of Financial Services Roundtable and former governor of Minnesota:

“You have to give formal notice that you’re gonna change the rule. You have to then allow a significant comment period for the rule to be changed … once you receive those comments, you have to publish the change in the rule [then] there’s typically further opportunities for comments and revisions. And then, once you finally get to the point of issuing the changes or the rule in its new form, there’s a period of time that elapses between that being published and when it actually takes effect… most of these rule changes and regulatory relief in their final form aren’t gonna be available … until at the very earliest at the end of this year and perhaps well into 2018.”

Summing up, we are heartened by developments and market performance over the past month, and our view of the economic and political landscape is unchanged. We continue to expect stronger economic growth in the U.S. than in other large developed markets, but the relative political risks point to better financial market performance overseas. We also believe the Federal Reserve is on track to continue raising interest rates, most likely at the upcoming meeting in June. Accordingly, we made no changes to our portfolios in May. We remain vigilant in watching for other external risks, especially geopolitical events in the Middle East and North Korea. As always, we will keep you apprised of important developments and portfolio shifts.

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Tony plays a key role in developing and delivering investment services for our wealth, institutional, and brokerage clients. He provides strategic direction for the firm’s asset management investment activities including asset allocation, manager research, and portfolio construction. Tony leads the firm’s Investment Committee. He earned his law degree from Harvard Law School. He holds a Master’s degree in French and international tax law from Université Panthéon Sorbonne, and graduated magna cum laude from Brown University with a degree in philosophy.