The reflation trade is back

- Reflation trade reverberates across asset classes
- KSA upgrade to EM status deferred by FTSE
- Confluence of positive catalysts supporting equities
- Rising odds of US tax reform boost investor sentiment
- US Treasury yields and US dollar have more to go

Stocks in the developed countries outperformed their EM peers, and US yields rose back to their average level for this year as the US tax reform took center stage. The US dollar was boosted by positive economic surprises and higher policy rates following a hawkish speech by Janet Yellen, which saw gold retreat further. Crude oil and industrial metals were up again, against the backdrop of strong global growth and a bullish data release from China.

KSA upgrade to EM status deferred by FTSE
Index provider FTSE Russell refrained from adding Saudi Arabia to its index of emerging market countries amid its September country classification annual review. Kuwait was added to the list. FTSE Russell said that KSA will soon meet criteria and will be assessed in March. Capital markets regulators in the KSA have introduced reforms in the attempt to attract international investors. The improvements are part of a broad program to diversify the country’s economy away from oil, and ahead of the sale of the Saudi Aramco IPO planned for 2018. The Inclusion of Saudi Arabia could lead to $4bn inflows to the equities market, assuming it would represent 2.5% of the Index. Including Saudi Aramco’s IPO, KSA’s weight in the index could reach up to 4.5%. The performance of the Tadawul Index was muted last week, and there was no build up in anticipation of an upgrade.

Reflation trade reverberates across asset classes
Performance across asset classes suggests that investors have recently embraced the so-called reflation trade, which quickly fizzled out earlier this year on disappointment with Mr Trump’s pro-growth agenda. Cyclical stocks are outperforming, crude oil and industrial metals are trading close to their 2017 highs, the US Treasury yield curve started steepening last week, the US dollar turned around while central bankers are reducing stimulus.

Odds of a tax reform shot higher following declarations from the White House and the presentation of a tax package by Republican leaders, which, although scant on details, acted as a powerful trigger to restore the reflation trade to life. We think that this theme has further to run, with more upside in particular for DM equities and the US dollar and further weakness in store for government bonds.

The cyclical boost offered by potentially lower taxes comes on the heels of an already strong business cycle. In the near term, DM equities should outperform EM peers, led in the US by small caps and financials.

A positive quarter for global equities
Global stocks posted record highs for the quarter. The Stoxx Europe 600 is at a 10-week high. Major European indices are ending the quarter 3-4% higher despite a 3% climb in the euro, on the back of receding political risks, strong corporate earnings and a buoyant economy. The German election results boosted the Dax, although Angela Merkel’s Christian Democratic Party won by a reduced majority.

Key indices in the Asia Pacific region finished the quarter higher, with solid earnings and broadly positive risk. Japan led the way regionally in September, with the Nikkei notching its best month of 2017, up 3.6%. The yen’s recent weakness helped the Nikkei reach a two-year high. Strength in Asian equity markets will likely continue through the fourth quarter, amidst strong fundamentals and plentiful liquidity with most of the major global economies in an accommodative phase.

Tax reform back in the limelight
The tax plan released by the White House last week was largely in line with expectations. If enacted, the
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plan would lower the federal statutory corporate tax rate to 20% (from 35% currently) and enable corporations to repatriate overseas cash at a reduced rate. Every 1% cut in corporate taxes leads to circa 1% earnings-per-share growth for the S&P500. Stocks with the highest tax rates, the most likely beneficiaries of a tax cut, have rallied during the past two weeks after underperforming the broader market for most of 2017 as hopes of a tax reform had diminished.

As per analyst estimates, the overseas cash by S&P500 companies totals $2.5tn. It is expected that firms would allocate repatriated cash among buybacks, dividends and capital expenditure. The technology companies’ account for 70% of the total S&P500 taxable cash held overseas.

The S&P 500 made new highs last week as investors began looking forward to 3Q earnings. The stock market breadth seems to be improving with 62% of stocks on the NYSE closing above their 200 day moving average. Volatility is close to all-time lows, with the VIX below 10. US equities rallied sharply into the earnings season in Q1 and Q2 as investors realized earnings estimates were too low. Q3 may follow the same pattern given the low 5.5% year on year EPS growth rate currently estimated for the S&P500.

Global financials – Resurrected

We reiterate our positive view on global financials, driven by strong earnings momentum, an improving business cycle and higher bond yields. Banks will be aided by stronger capital bases and regulatory tailwinds. With earnings, profitability and capital return all forecast to improve financials still have scope to outperform. We think European banks offer the most upside even though the STOXX Europe 600 Banks Index is up 52% since mid-2016. US banks too, continue to record gains on the back of rising yields and talk of corporate tax cuts.

US Treasuries attractive following back-up in yields

With US inflation readings stabilizing and a steady economy, the Fed should be on track to hike rates in December this year and continue in 2018. This view is reinforced by the latest declarations by Fed Chair Yellen, who said in a Cleveland speech that “it would be imprudent to keep monetary policy on hold until inflation is back to 2%”. We continue to hold the view that US 10-year Treasury yields are headed towards the upper end of this year’s range, with upside risks past the 2.5% mark increasing.

At current yields benchmark US Treasuries are starting to look attractive, with a December rate hike almost fully priced in. Our assessment takes into account macroeconomic factors driving long-term valuations of US Treasuries, the shorter term growth outlook, as well as uncertainties related to the debt ceiling and the proposed economic reforms.

Shorter term upside on dollar, crude overbought

Currency returns in the dollar and higher US Treasury yields reflect an improved confidence in the US growth outlook. The EUR/USD reached a seven-year low in the wake of the “Brexit” vote, but has since recovered to a level which it believes is reliable to the best of its knowledge. ENBD makes no further forecasts as this publication is accurate, reliable and complete and Emirates NBD accepts no responsibility whatsoever for any loss or damage caused by and act or omission taken as a result of the information herein.

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