



Fundamentals coming into focus investment strategy

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The investment environment has become more positive for stocks, as the market's focus returns to fundamentals.

It has been an unusual year in financial markets. There have been large swings driven by market sentiment, as, in the background, the world economy progressed at a very slow pace.

Fears over China at the very beginning of the year and, later, the Brexit vote induced short-term equity market corrections. These adverse periods, however, later reversed, and stock markets recovered. Many investors increased their cash positions through the year. We did too, taking profits in July, when we reduced our equity exposure to neutral.

Improving environment for stocks

World growth has nonetheless proven to be resilient, with central banks successfully providing financial liquidity when necessary. As we wait for the result of the US elections on 8 November, the major world economies are progressing. Equity earnings are expected to recover, and market conditions are stabilising. Our conviction is that the US election is less relevant for financial markets than the improvement in fundamentals and the continued attractiveness of equities.

Stocks are offering appealing medium-term returns at a time when risk has increased in bond markets and cash is yielding only marginal returns. These considerations led us to increase our equity allocation back to overweight at the expense of cash this week.

Return to more normal market conditions

We became more positive on stocks as a number of the factors that appeared to put equity markets in jeopardy during the year have gradually resolved. Global economic growth is modestly positive and resilient, emerging markets are improving and China has been effective in managing its growth and transition to a more domestic-focused economy.

What had been considered major events, such as the US elections and the consequences of the Brexit vote, appear to be slowly moving to the background. For example, we do not expect that the US elections will have a big effect on financial markets. (For more information, see the side bar on page 2.) And the Brexit issue is on a slow trajectory. We now expect a return to more normal market circumstances in the fourth quarter and for investors to again focus on fundamentals.

Earnings are recovering

The decision to suggest that clients increase the equity portions of their portfolios is supported by gently rebounding earnings, which we expect to continue. The effect on the overall economy of the earnings recession observed in the energy and materials sectors is now behind us, as oil and commodities have rebounded substantially. The negative effect of a strong US dollar on the foreign earnings of US companies has also abated.

The earnings turnaround that is unfolding can also create momentum that will support equity markets in the coming quarters.

Valuations are attractive, especially in emerging markets

Equity valuations are attractive, although there are differences in terms of regions. In particular, emerging markets and European stocks appear undervalued. Increasing political risk may be a factor behind lower European valuations, although they are also traditionally lower than US valuations.

In terms of regions, we prefer emerging-markets stocks, particularly emerging-markets Asia, over developed markets. There are a number of positive factors supporting this stance, including interest rates in the US remaining low for longer, recovering commodity prices and the stability of the exchange rate between the euro and the US dollar. In terms of fundamentals, the earnings cycle in emerging markets has reached a low point and is now expected to improve.

US election not a threat to markets

Much attention has been focused on the US election, and it was discussed in depth by the Investment Committee on 20 October. Over the past few weeks, what had once been a close race has seen Democratic nominee, Hillary Rodham Clinton, gaining steadily. She now has a significant lead, outdistancing Republican nominee, Donald Trump, by around 10% in national polls.

The base-case scenario from ABN AMRO Group Economics is for Clinton to be elected President of the United States on 8 November, with a Democratic majority in the Senate and a Democratic minority in the House of Representatives. Clinton's election is seen as a continuation of current policies. No big effect of the US election is expected on worldwide financial markets. And, if Clinton is elected, there should be no big surprises in terms of US monetary policy, inflation rates or unemployment.

Markets appear unaffected by election rhetoric

Market volatility has remained low in historical terms in the run-up to the election. The mounting political rhetoric was not reflected in market volatility. Based on an internal study by our risk experts, polling results have had little or no effect on markets so far. For example, when Donald Trump was doing well in the polls, there was no

substantial effect seen in global markets – either positive or negative. This was also true when his opponent gained the lead in polls.

Our analysis found that most markets are trading based on their own fundamentals, with no sustainable correlation seen with polling results over the first nine months of the year. This is in direct contrast to the Brexit vote, where the British pound traded in lockstep with the polls. The analysis adds support to the view that if our base-case scenario holds true, there may be some short-term volatility around the time of the elections, but no medium-term market impact is expected.

The election is just the first step

The election of a new US president is just the first step to what will be a gradual process leading to eventual changes in fiscal policy. Important signals regarding the direction of the presidency will be first seen in Cabinet appointments, as the composition of the Cabinet will influence the next four years. Policy announcements will also be key to understanding the new administration. The State of the Union address, which is usually scheduled in late January or early February, will provide a first glimpse into the priorities of the new administration.

Financials sector should benefit from rising interest rates

With global economic growth remaining modestly positive and riskier assets becoming more attractive, we have shifted our sector view toward slightly more exposure to a pick-up in cyclical stocks. Cyclical stocks are characterised by improving as economic activity picks up. This is different from defensive stocks, which are less affected by the economic environment. Our growing shift towards cyclical stocks is signalled by our more positive (from underweight to neutral) view regarding the financials sector. We expect financials companies to benefit from short-term growth momentum and from rising interest rates, which will help margins. At the same time, we have reduced exposure to defensive stocks, by taking a more negative view on the consumer staples sector (moved from overweight to neutral.)

We continue to be positive (overweight) regarding the health care and information technology sectors and remain most negative (underweight) on the industrials and utilities sectors. We take a neutral stance to all other sectors (energy, consumer discretionary and telecoms).

What should clients do?

We suggest that our clients consider increasing the portion of their investment portfolio dedicated to equities and to fund any new positions from cash. In particular, we find the stocks of emerging markets Asia companies attractive, as well as global companies exposed to the emerging-markets consumer. In terms of sectors, clients can also consider selling consumer staples stocks in favour of financials companies. We favour insurance companies and diversified financial companies over banks. In general, we prefer US financials over European institutions and defensive and well-capitalised companies throughout the sector.

Global Investment Committee

Didier Duret, Chair

didier.duret@nl.abnamro.com



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