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Why We Think Economic Positives Outweigh Negatives for European and Japanese Stocks

After meeting with investors across both coasts for much of the last two weeks, our conversations could best be described as 'all Trump, all the time' with regards to queries and concerns. This reaction is understandable: even omitting discussion around social policy, the election of Donald Trump in the US may in fact represent a sea change for US economic policy, with wide-reaching potential impacts on growth, taxes and trade. In past Weekly Views and in our 2017 Outlook*,* we have detailed our thoughts on the possible economic effects of "Trumponomics" on the US, as well as on China and other emerging markets.

But what about its likely effects across the rest of the developed international markets, i.e. Europe and Japan? Let us first examine the reasons for caution on international stocks in the era of Trump and recognize that they are well-publicized. President Trump appears to be dismissive (if not antagonistic) towards the concept of a united Europe, distancing himself from leaders like Germany's Angela Merkel even as he praises the populist-leaning Brexit movement in the UK. We do not think Trump's support for anti-Euro parties is likely to influence European voters, but we recognize that a victory by Marine Le Pen in the French election could have wide-ranging implications for the future of the euro. We believe it is too soon to handicap the outcome. Secondly, markets highly dependent on global trade, such as Germany and Japan, could be impacted by the implementation of protectionist policies like a US border tax adjustment (discussed in last week's January 23rd Weekly View), should it occur. Thus, we think that policy uncertainty is the main reason for caution.

Despite this uncertainty, in today's piece we want to lay out why we believe Trumponomics will actually prove to be a net positive for equities in Europe and Japan.

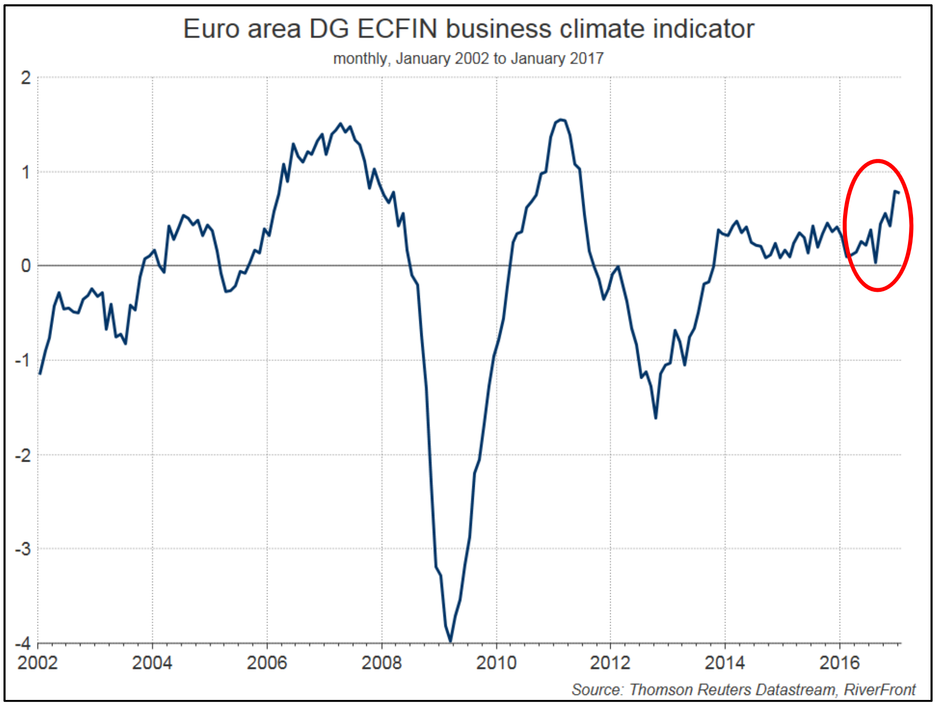
REASON 1: TRUMPONOMICS IS CURRENTLY DRIVING A STRONGER DOLLAR… GOOD FOR EUROPE AND JAPAN EXPORTERS

The US dollar is up approximately +9% since the election versus the Japanese yen, and +3% relative to the euro (through January 27, 2017). Taken in aggregate, Trump's focus on tax stimulus, pro-growth infrastructure spending, deregulation in key industries like energy and financial services, and protectionist trade leanings will all likely continue to place upward pressure on the U.S. dollar relative to many developed and emerging currencies. In addition, we have to acknowledge the possibility that Trump remakes the Fed into a more hawkish-leaning institution given the four seats open for presidential appointment (including the FOMC chairman) through 2018. This could have the effect of driving U.S. interest rates higher, another potential reason the dollar can stay strong. We believe Japanese and Eurozone exporters would continue to respond positively to a weak home currency, given the boost to relative competitiveness. We acknowledge that Trump himself said last week that he prefers a weak US dollar, but what a politician *says* is not nearly as impactful as what he *does*...and we think his cabinet's policies suggest dollar strength.

REASON 2: TRUMPONOMICS IS PRO-GROWTH...AND NOT JUST FOR THE U.S.

As highlighted in last week's publication, small business optimism spiked sharply to a decade high in the US in the wake of the presidential election. We believe that excitement over tax breaks and less onerous regulation could unleash a virtuous cycle among hiring and capital expenditure among small and medium size businesses. This is a positive not only for corporate America but also for large-cap companies in Japan and the Eurozone, for which the US is an important export market. What's also fascinating is that this optimistic impulse is not just a US-specific trend; **business climate surveys in the euro area hit multi-year highs over the last 4 months or so (see *Chart of the Week*, next page.)** Other broad economic indicators, such as manufacturing purchasing managers (PMI) surveys in the Eurozone and Japan, are also at highs not seen in 5+ years, and the Citigroup Economic Surprise Index (CESI) for G10 economies is also at a multi-year high. In short, we think high quality export-oriented companies in the Eurozone and Japan are likely to benefit more from stronger global economic growth than they are to be hurt by the protectionist-leaning parts of Trumponomics.

CHART OF THE WEEK: EURO AREA BUSINESS CONFIDENCE UP SHARPLY SINCE THE SUMMER



Source: Thomson Reuters Datastream, RiverFront Investment Group. Past performance is no guarantee of future results. The Directorate General for Economic and Financial Affairs Business Climate Indicator is calculated in order to receive a timely composite indicator for the manufacturing sector in the euro area. The indicator uses, as input series, five balances of opinion from the industry survey: production trends in recent months, order books, export order books, stocks and production expectations.

We find it interesting that relative strength trends in equity markets since the election seem to support our theory, contrarian though it may be. While all three are up nicely, both the Eurostoxx 50 and the Nikkei 225 in local currency terms have outperformed the S&P 500 since the November 8 election (through January 27, 2017). This outperformance has been obscured to US dollar-denominated investors by weakness in the euro and yen since the election, which underscores the importance of possessing a plan for foreign currency strategy when investing internationally, in our opinion. We'd also note that both Japan and Europe appear to be more contrarian than the US from the perspective of ETF fund flows over the past year; both markets saw major net outflows even as the US-focused ETFs reached record AUM. This suggests to us that investor sentiment surrounding European and Japanese markets is quite subdued, a contrarian positive in our opinion.

This analysis explains why we have started the year generally with a small overweight to Eurozone and Japanese stocks relative to composite benchmarks across our portfolios. It is worth mentioning that we have greater scope to further increase our international weightings if and when we can get greater clarity on the uncertainties cited at the outset. With regard to Eurozone, we are monitoring political developments closely, particularly the French election in late April, as a litmus test on political risk. In Japan, politics are stable, but we are watching central bank policy and movements of the yen closely to gauge risk.

Important Disclosure Information

Past results are no guarantee of future results and no representation is made that a client will or is likely to achieve positive returns, avoid losses, or experience returns similar to those shown or experienced in the past.

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Using a currency hedge or a currency hedged product does not insulate the portfolio against losses.

ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

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Index Definitions: It is not possible to invest directly in an index.

Eurostoxx 50 Index provides a blue-chip representation of supersector leaders in the Eurozone.

Nikkei 225 Index is a price-weighted average of the 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.