Philequity Corner (February 6, 2017)
By Wilson Sy

20000

Last January 25, the Dow crossed the historic 20,000-point milestone on the back of a post-election run-up in US stocks. What is the significance of the Dow's 20,000-point milestone? And what does it mean when a stock or index reaches a new all-time high?

New high means higher

In page 190 of our book "Opportunity of a Lifetime", we discussed the application of Newton's law of inertia to the stock market. This states that stocks or indices which make new all-time highs will likely continue moving higher unless the move is met with a drastic change in fundamentals or sentiment that can overturn the trend. The Dow established a new all-time closing high of 20,101 on January 26. Along with it, the other major US indices – the S&P 500, the Nasdaq and the Russell 2000 – also reached new all-time highs recently.

Law of round numbers

Aside from reaching a new all-time high, the Dow's crossing of the 20,000-point threshold marks a major milestone for the US stock market. Round numbers serve as psychological resistance levels for many traders and investors. Thus, there is much excitement in the investment community whenever a round number resistance is breached. The milestone makes headline news, resulting in increased investor awareness and interest in the stock market. This usually prods additional buying from retail investors.

In a previous article (*Numbers Game*, March 19, 2012), we discussed The Rule of Round Numbers. This states that when a round number is reached then significantly hurdled, it becomes a major support. This follows a tenet in technical analysis, which says that a resistance level becomes a support level after it is broken considerably. Thus, the 20,000-point threshold should function as a significant support for the Dow – but only after the level has been significantly breached. Note that the longer the consolidation around the round number, the stronger it is when it becomes a support level.

Travel ban and border wall

After reaching an all-time closing high of 20,101, the Dow corrected to a low of 19,732 before regaining ground and closing at 20,071 last Friday. The main reason for the pause in the US stock market rally is Trump's executive order (EO) which imposed a travel ban on citizens from seven predominantly Muslim countries. Though the EO was supposedly crafted to protect the US from terrorist threats, its implementation had an unintended and disruptive global impact. Since the US is the biggest economy in the world, the sudden and confusing implementation of the travel ban sparked nationwide protests in the US and a global outcry. CEOs of major American companies, especially those from the technology sector, came up with a strongly worded statement against the travel ban and anti-immigration policies.

Trump also announced that he will build a wall along the US-Mexico border, which he said will be paid by Mexico. Though this was one of his campaign promises, people were still shocked to hear that Trump will actually build the border wall now that he is President. Moreover, Trump has made various pronouncements about the implementation of protectionist and isolationist policies, which risks creating a full-blown trade war and may isolate the US from its major trading partners.

Exceptional uncertainty

Ray Dalio, founder of Bridgewater Associates, was one of the most bullish fund managers after Trump's election. Dalio cited the extensive business experience of Trump's Cabinet secretaries, which he said would lead to the implementation of pro-business and pro-growth initiatives. Dalio also said that Trump's pro-business agenda will spark a virtuous cycle that will ignite animal spirits and unlock capital in the US economy. However, after the imposition of the controversial travel ban, Dalio changed his tone. Most recently, he said that the implementation of populist policies may undermine the benefits of the administration's pro-growth agenda and eventually hurt the global economy. Dalio also said that investors should watch whether Trump is 'aggressive and thoughtful' or 'aggressive and reckless', as the current investment environment is marked by 'exceptional uncertainty.'

Buffett buys heavily after Trump's election

Whereas Ray Dalio has changed his tone on Trump, Warren Buffett reported that he bought $12b worth of stocks from the election up to end-January. Despite campaigning for Hillary Clinton in the election, Buffett is bullish on Trump's pro-business agenda. This is seen in his massive post-election buying spree, which eclipsed the pace and amount of his purchases in previous time periods.

Catalysts for the US stock market

In a previous article (*The Trump Card*, December 12, 2016), we enumerated the reasons behind the run-up in US stocks. Below, we reiterate some of the catalysts that may sustain the US stock market rally.

1. **Infrastructure spending.** Trump has repeatedly said that his administration will spend one trillion dollars to rebuild the country's outdated highways, bridges, tunnels, schools and hospitals. Given this, Trump's infrastructure budget will end up as one of the biggest in the country's history.
2. **Fiscal stimulus and reflation story.** The previous administration relied on accommodative monetary policy to revive the US economy in the past eight years. The new administration led by Trump plans to use fiscal stimulus to sustain the US recovery and support the country's reflation story.
3. **Pro-business Cabinet and agenda.** Many of Trump's Cabinet secretaries are billionaires, experienced businessmen and Wall Street veterans, thereby giving credence to the administration's pro-business and pro-growth agenda.
4. **Lower corporate taxes.** The lowering of corporate taxes will be earnings accretive for American companies. It will also attract the opening of new businesses and the expansion of existing ones.
5. **Deregulation.** Initiatives to roll back regulations will allow companies to conduct their businesses more freely. Trump has called for a review of the Dodd-Frank law which will ease regulatory burden on banks. Likewise, he called for a halt of the Obama fiduciary rule, which will open more options for investors.
6. **Repatriation of offshore US dollars.** Trump has said that he will encourage the repatriation of offshore US dollars held by US companies by giving incentives. If implemented, this may precipitate more investments, share buybacks and M&As in the US.
7. **Meeting with businessmen and captains of industry.** Trump has been busy meeting with the business sector. Recently, he has met with CEOs from different industries, such as auto and pharma, to persuade them to bring back and create more jobs in the US.

Risks to the US stock market

Though the US stands to benefit from the implementation of a pro-business and pro-growth agenda, investors will also have to grapple with the risks associated with a Trump presidency.

1. **Anti-immigration policies.** Trump's travel ban and plans to build a wall in the US-Mexico border highlights his desire to implement anti-immigration policies. The travel ban may eventually affect many American companies who have immigrant officers and employees.
2. **Protectionist policies.** The US President has repeatedly made pronouncements about implementing various border taxes against different countries. These may end up isolating the US from its biggest trading partners and from the rest of the world.
3. **Currency and trade wars.** So far, Trump has shown that he will follow through with his campaign promise of implementing isolationist and protectionist policies. He has also made aggressive comments regarding the currency movements of other countries. These actions may spark retaliation from affected countries and result in destructive currency and trade wars.
4. **Unpredictability.** Trump's aggressive behavior, brash off-the-cuff statements and sudden Twitter outbursts highlight the US President's extremely unpredictable personality and behavior. The confusing and disruptive implementation of the travel ban is a perfect example of this. These show that Trump is bent on effecting belligerent campaign promises that may end up being detrimental to the US economy, the US stock market and the global economy.
5. **Faster than expected rate hikes and US dollar becoming too strong.** Investors should continue to watch the Fed, which may end up implementing three rate hikes in 2017 vs. market expectations of two rate hikes (*Three, Not Two*, December 19, 2016). Faster than expected rate hikes may result in a stronger US dollar. An overly strong US dollar will be a headwind for the US economy.

Trump watching

Moving forward, it will be important for investors to watch the Trump administration as it implements various policies and rolls out its agenda. The US is the biggest economy and the biggest stock market in the world. Thus, it will dictate how the tide will turn for global stocks.

Since the Philippines has a strong domestic economy, it will not be as adversely affected by potential trade headwinds as compared to other export dependent countries. Still, we have to be vigilant and monitor how Trump's policies may affect our country's trade, capital flows and foreign direct investments (FDIs). Special attention should be given to the BPO sector, as it is perceived as the most vulnerable to possible changes in US policies.

Execution is key

For the domestic stock market, the PSEi has corrected from an all-time high of 8,118 to an intraday low of 6,499. Since then, the index has recovered, closing at 7,227 last Friday. These wild swings happened even as our country's economic growth has remained strong, as seen in the 6.8% GDP growth in 2016. We note that the Duterte administration's economic agenda, which focuses on tax reform and infrastructure spending, is similar to the Trump administration's agenda. We thus believe that our government has correctly identified priority initiatives that will allow our country to sustain economic growth which is both strong and inclusive. It is therefore important for the Duterte administration to be able to successfully implement its economic agenda, as this will determine the fate of our economy and stock market.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 689-8080 or email ask@philequity.net.