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Will the Trump market rally begin to rewind?

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1. Looking back from the start of 2017 until the end of April

The advanced economies remain robust

Let us look back at the last few months of the world economic trends. The advanced economies remain robust. For the U.S. economy, the divergence is widening between strong 'soft' qualitative data (represented by business confidence etc.) and somewhat weak 'hard' quantitative data (represented by economic performance figures), thereby leading to an increased level of uncertainty. However, it seems reasonable to judge that the "high-pressure economy" is further pressured as signaled by a fall of the unemployment rate to 4.5%. (The figures for the first quarter GDP growth, which will be announced at the end of April could be considerably low due to some technical factors and hence the market maybe being temporarily upset, but this is most likely to be transitory). For the European economy, the economic outlook has been favorable due to the weak Euro, and the economic sentiment indexes of major countries such as Germany and France have remained at high levels, so the best-performing condition continues.

In Japan, the economy also maintains growth at a speed faster than the expected as private consumption expands steadily underpinned by improving household income condition, while recovering exports and capital expenditures, implementation of the supplementary budget continues. The unemployment rate has now dropped below 3%, which was long considered to be the rock-bottom, at 2.8%, indicating that a considerable pressures mounted over the Japanese economy too.

Increasing clouds over the Trump market rally?

Nonetheless, the market trend seems to have changed slightly around the end of March. The momentum of the U.S. stock market, which had been reaching record highs everyday up until that point, has weakened, and the trend is shifting somewhat downward. In addition, long-term interest rates have been falling after the Fed (Federal Reserve Board, FRB) decided an interest rate hike at the March FOMC (Federal Open Market Committee). Actually, this situation is not unique to the United States. Even in Europe and Japan, stock prices are trending down with long-term interest rates also gradually falling. The discussions regarding rewinding the ultra-monetary easing within the year that were once made a lot of noise in the market have now subsided. The largest factor behind such a market change is, of course, a rise in doubts over the ability of the U.S. Trump administration to execute its policies. This was particularly true when the Obamacare replacement bill, which was said to be the "easiest", was forced to withdraw without being able to find agreement within the Republican Party. This event was a major blow for the

Trump administration in two ways. Firstly, the inability of collaboration within the Republican Party became apparent. In particular, the difficulty to find a compromise with the "Freedom Caucus" that leads the far-conservatives among Republicans has been reconfirmed. Additionally, the confidence in Vice President Pence and House Speaker Ryan who were expected to play the key roles in negotiating with these factions have dropped significantly, which is another factor that make it harder to foresee cooperation within the Republican party.

Another reason is that improvement of fiscal balance cannot be expected from the Obamacare replacement bill, making it even harder to pass other bills such as a tax reduction bill. The Republican Party of the United States traditionally emphasizes the balance of the budget. Also, in the case of the United States, the system makes easier for bills that are neutral to fiscal balance in a long-term perspective to pass through the Congress. As for the Trump administration, it has becoming difficult to submit only the tax reduction bill by itself unless passing through a bill to ensure new fiscal revenue sources.

This diminishing expectations for the fiscal stimulus of the Trump administration has surely been a factor behind a gradual falling interest rates in advanced countries, but also the indications of the top central bankers of major countries that “it is premature” to expect changes toward a "hawkish direction" of monetary policy has strongly affected this. For example, FRB Chair Yellen has recently implied that it is not in any way "leaning forward" for another rate hike after somehow abrupt rate hike in March. Similarly, ECB (European Central Bank) President Draghi and BOJ (Bank of Japan) Governor Kuroda have shown their doubts on the need to discuss possible policy changes for neutralization, as expected by the market, anytime soon.

Resilient Chinese and emerging economies

Under these circumstances, the growth of the Chinese economy seems to be slightly accelerating mainly owing to boosts in real estate investment and public investment. Private consumption also do not seem so gloomy partly thanks to the wealth effect associated with real estate prices rise, except for automobile sales that saw falling numbers as results of reversal of last-minute dash buying in 2016. Thus, the current Chinese economy looks speeding up by a strong accelerator by the government investment and monetary easing, much more than the speed limit for “sustainable” safety drive.

As the Communist Party Congress is approaching in autumn, it is extremely rational of local government bureaucrats to avoid downside risks that have a major impact on their personal evaluation every five years, rather than upside risks of inflation and signs of bubbles approaching. However, they entails the ballooning financial asset bubble to be addressed eventually after President Xi strengthens his own political apparatus (otherwise, the bubble will burst in a disorderly manner, and the economic and financial system will fall into chaos). Once President Xi secures his long-term government in the Communist Party Congress this fall, he is likely to embark on such large economic and financial adjustments as early as possible in order to preserve his own legacy.

The current environment with a mixture of robust Chinese and advanced economies, lowering interest rates in the U.S. and relatively high price of crude oil partly due to mounting geopolitical risks, are also a very favorable environment for the other emerging economies. For example, the Russian and Brazilian economies that had long been stagnated have finally been bottoming out when they began to ease its monetary policy thanks to drastic drop of inflation rate. Other resource-rich countries also have enjoyed their economic stability, with the exception of South Africa and Venezuela, which are shaken by political turmoil. Meanwhile, the non-resource rich economies including Southeast Asian countries are also experiencing a gradual accelerating growth on the backdrop of boosting exports to China and advanced countries.

Rising geopolitical and political risks

Along these lines, the world economy as a whole including the emerging economy is returning to a very strong condition though the risk-on sentiment in the market is showing some signs of abating in advanced countries. This is actually a very different world from the one which, at the beginning of the year, frightened us with possible impacts of rapid interest rate hikes in the U.S. and sharp slowdown in the Chinese economy.

Still, even under this environment, a strong risk-off wind derived from geopolitical and political factors will sometimes blow over the world market. One of the most important events, again, can be found in the Trump administration's policies in the U.S. By abandoning the diplomatic isolation policy originally called by the regime, whilst actively intervening in the conflict in the Middle East and East Asia, geopolitical risks over the Middle East and North Korea are suddenly rising. Ease tensions with Russia, which has been expected earlier, was also being brought back to the original state. In addition, the Islamic State (IS) forces have been weakened in the Middle East, while its fighters gradually return to their home countries, thereby leading recent terrorism to become active again in Europe, Russia, etc.

Political risks continue to be high in Europe. In the Dutch general election, the extreme-right party did not grow as much as expected, and on the contrary, the largest ruling party and the left-wing pro-EU political parties fought well. Hence, concerns about a right-wing swing in Europe and the collapse of the EU, seem to be a little relieved. Furthermore, after the first-round vote in the French presidential election held at the end of April where Emmanuel Macron of the center-left and Marine Le Pen of the far-right were chosen as expected, Mr. Macron is expected to win by a landslide in the run-off to be held in early May. In this way, the political risks in Europe have not progressed to the fearful point once many have envisioned. However, it is still early to sit back as some major threatening events remained on the horizons, such as the Italian banking system and Greece's debt repayment, as well as general elections in the UK, Germany, Italy, etc. Although negotiations over Brexit between the UK and the EU are scheduled to begin soon, whilst skirmish has already started over many issues, for example, repayment of "hand-over money," handling of EU citizens residing in the UK, and the status of the Irish border and Gibraltar status.

Outside Europe, a referendum to strengthen the power of the President was held in Turkey, and the constitutional amendment led by President Erdogan was supported by a close margin. Although this result contributes to the stabilization of the Turkish economy in the short term, there is a high possibility that the economy will become unstable due to deterioration of relations with Europe in the long term. In South Korea, President Park is finally impeached, and the new president is expected to be elected at the beginning of May. It is becoming a battle between a left candidate and a center-left candidate. Especially when the leftist candidate is elected, in the midst of a tense situation over North Korea, deployment of the ground deployed missile interception system (THAAD) by the U.S. may not go smoothly.

Almost as expected?

How has the global economic trend so far been compared with the forecast at the beginning of the year? Although the Trump rally in the U.S. lasted a little bit longer than expected, this momentum seems to be waning partly owing to the chaotic management by the administration in the oval office. This is exactly along my scenario at the beginning of the year, where the movement of risk-on will be softened but not collapsed as the doubt is raised over the ability of the administration to execute its policies and this situation will continue for the time being. Also, the situation where the advanced economies have remained steady overall though the trends of Yen depreciation and rise of interest rates in Japan are somewhat weakened due to the gentle "rewinding back" of the Trump market rally is almost the same as the outlook. Furthermore, in Europe, the prediction of weakening in the far-right swing during the elections turned out to be true, at least thus far.

Slightly out of my expectation is the strength of Chinese and the emerging economies. This is primarily due to the fact that the Chinese government's stance was more cautious about adjustment policies than anticipated, and as a result, the Chinese economy is overheating. Consequently, other emerging economies are getting more stabilized than expected. This situation is likely to continue until at least the People's National Congress in autumn.

Another discrepancy in the forecast is the rising geo-political risk from the "change of heart" of the Trump administration. The Trump administration has originally pledged to minimize the U.S. military intervention in the costly security areas, including the implied withdrawal of the U.S. forces from Europe and East Asia. Although it was anticipated to some extent, as the members of the government is becoming more dominated by a group of former military personnel and corporate executives, the regime takes back its previous remarks so easily. It is beyond the prediction how quickly the administration changes its claims.

2. Outlook for the year ahead

Will the Trump rally be revived?

What is important to contemplate the outlook is the future policy implementation by the Trump administration, and its consequence on the Trump rally and the U.S. economy. In this regard, my perspective continues to be somewhat optimistic. Concern over the Trump administration's capability to execute its policies is likely to hover until this summer, but after that, finally senior officials from each ministry will be nominated, enhancing the policy planning ability, while momentum grows to cooperate with the Republicans in preparation for the mid-term election next year. Although the scale is smaller than initially assumed, I assume that the government will manage to pass a tax reduction bill within this year. On the other hand, at least Treasury Secretary Mnuchin will judge that other pledges such as border adjustment tax would be a too risky adventure for the current government.

The U.S. economy will remain robust for a while, even if it is left untouched by the administration. The markets, which were depressed by weak 'hard data' mainly due to technical factors, will gradually become bullish towards summer when strong hard data will gradually line up. Prices and wages are also likely to rise sharply in the future. Therefore, after this summer, once again, FRB's monetary policy will draw attention. There will be times when the market gets tense over the number of interest rate hikes within the year and the timing for FRB to shrink its balance sheet. Under these circumstances, interest rates also follow an upward trend, and exchange rates gradually move towards the dollar appreciation.

The biggest risk scenario for the U.S. economy in the latter half of this year may be the growing concern that the FRB's response is delayed in response to accelerated inflation. In that respect, President Trump's confession that he does "like a low-interest policy" sounds eerie. In the coming months, as the administration fills three FOMC member posts, the administration's possible pressure on the FRB policies will dramatically affect the outlook for the market inflation, and eventually the long-term interest rate. The stronger the inflationary pressures in the latter half of the year, the more likely that conflict between the Trump administration and the FRB will intensify.

There is surely a risk that the rewinding of the Trump market rally develops in full swing, and the economy falls into another disinflation rather than inflation since the Trump administration cannot implement any new policies. Given the strength of the current U.S. economy, however, the probability of this scenario is not so high.

Another potential but not necessarily recognized risk for the U.S. economy may be a breach of the administration's words for deregulation. The biggest contributing sector for the Trump market rally up to now is the financial industry, which is led by expectations for steepened yield curves as well as relaxation of financial regulation that had been extensively tightened after the Global Financial Crisis. Recently, while strong arguments continue with regards to deregulation for small- and medium-sized community banks, however, for major banks, discussions are developing across parties towards simpler yet stricter regulations (for instance, raising the leverage ratio to 10%, separating banking and securities businesses). If the financial industry (especially major financial institutions), which is the source of growth, suffers from "suffocation" again due to the regulations, it is also undeniable that the U.S. economy may decline.

The emerging economy will gradually see more adjustment pressures after the year end

As discussed earlier, the Chinese economy is likely to continue pressing on the accelerator of the economy until the People's National Congress in autumn, thus there are less chances for a downturn. It may be around the end of the year or beginning of next year when the adjustments on monetary and structural policies will be gradually strengthened. Therefore, in terms of risk, rather than the Chinese economy, other emerging economies require more attention. These emerging economies will remain stable while the Chinese economy is strong, but some caution might be warranted against the situation where the U.S. interest rate suddenly rises, or the FRB speeds up the hike. In particular, countries with mounting debt, large fiscal deficits or current account deficits, and politically instability (i.e. Turkey, South Africa, Malaysia etc.) are to be monitored with extreme caution.

The geopolitical risks in East Asia and the Middle East are expected to further increase as long as the voices of the former military and corporate executives in the Trump administration continue to gain ground. In the Middle East, future of the relationships with Iran that has a presidential election approaching, and course of the civil war in Syria are the key focus. In East Asia, it is vital to watch how the U.S. can contain North Korea's missiles and nuclear development through the relations with China and South Korea, which also awaits a presidential election soon.

Political risks continue to be the biggest risk event in Europe

In the run-off voting of the French presidential election in early May, Emmanuel Macron is very likely to defeat the far-right Marine Le Pen. Nevertheless, Europe may have the problem of 'Greece' again afterwards. A large debt repayment to ECB is pending for Greece in July. In April, Greece managed to reach an agreement on the austerity measures with the Eurozone Finance Ministers, but the biggest challenge that has been left behind is how to drag the IMF into financial assistance to Greece. If this cannot be done, Chancellor Merkel of Germany who has been pledging to make financial assistance on the premise of participation of the IMF will be cornered into a political predicament. Especially, the Federal elections will be held in Germany in this fall. Meanwhile, should Adam Lerrick will be confirmed as the U.S. Deputy Treasury Secretary (who will be in charge of the IMF and international organization), as far as based on his past behavior, the U.S. will demand the IMF to take a very cautious attitude toward Greek intervention. As a result, negotiations over financial assistance for Greece will deepen into turmoil until just before the debt repayment in July, and the risk-off sentiment of the market will be strengthened each time.

The negotiations over Brexit will also deepen the confusion. In particular, the birth of President Macron in France, and furthermore the possible victory of Mr. Schultz of the Social Democratic Party in the coming German elections, it is highly likely that these Pro-EU, center-left governments will take stringent stance retaliating against EU "traitor". In terms of negotiations between UK and the EU over Brexit, while negotiations over the '"hand-over money' takes time to resolve, the situation might gradually deepen into the shape of "economic war".

Can the Japanese economy ride the second wave of Trump market rally?

If the confusions over policy management by the Trump administration continues for a while, and this in conjunction with weak ‘hard-data’ abate a little the Trump market rally, the current Yen depreciation and high stock prices situation that has been helping the Abenomics may be temporarily set back. However, as already mentioned above, the U.S. economy keeps its steam. If there is a high possibility that some kind of fiscal stimulus will be added to it after this fall, this alone will be enough for the Trump market rally to regain its momentum. As a result, the Yen's depreciation and high stock prices in Japan will expected to start again over the latter half of the year. While the Japanese economy itself is in a relatively steady state, with this "tailwinds", it is great opportunity for Japan to "regain the inflation" after a long time.

The biggest risk that Japan will miss the opportunity of this "arrival of inflation" will be that the Trump market will not regain it after all, but it will rewind completely. However, the possibility is considered not so high, for the reasons described in the U.S. section in this article. The scary scenario is rather, when such opportunity comes around, Bank of Japan and other policymakers may not be able to respond appropriately.

In Japan, the unemployment rate has fallen to about 2.8%, and the tightening of the labor market is approaching the limit. Under such circumstances, it seems that extra inflationary pressure accumulated in the dam so that it is cracked and water spills little by little. To date, the Bank of Japan had assumed the unemployment rate of 3% as a warning point of dam breakdown, which has already been exceeded. Certainly, the hole is beginning to open little by little in the dam, as evidenced by some courier companies’ historic price increase. Furthermore, more pressures in the dam (inflationary pressure) is going to be added as the government initiated "Work Style Reform" is starting. Of course, there is no problem if the government could raise productivity at the same time with this restriction on overtime work. Given that overtime work mentality still constitutes as a "part of the Japanese culture", this new reform initiative could only strengthen labor supply constraints and consequently entail a substantial wage increase.

If the inflation in Japan rises rapidly over the end of the year, or if the inflation in the U.S. begins to rise and the interest rate also rises, it is noteworthy how Bank of Japan would handle this situation. At the policy decision meeting of the Bank of Japan, which is now dominated by dovish members, the scene of confronting the rising inflation concerns may come unexpectedly early. Even if the second wave of Trump market rally is like a big wave that all surfer in the world envies, if the situation is mishandled, there is a possibility that it will be drunk by the wave without being able to overcome it.

The other risk that Japan should be aware of is a sudden weakening of Chinese and the emerging economies. At least within the rest of the year, however, as the Chinese authorities' "hustle" to keep its steam is expected, the likelihood of such risk to materialize is low. It may be in next year that the Chinese government will be forced to take after the financial bubble which has further been inflated by this "hustle", and this aftermath may become the biggest risk for Japan.

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