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WEEKLY DIGEST | 12 November 2024

Trump 2.0

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Is it my imagination, or is almost everything that happens these days described as “pivotal” or “era-defining” or something similar? The outcome of last week’s US Presidential election was described in some circles as having the potential to change the course of history. It’s a bit early to make any judgements on that claim, but the initial verdict of investors was resoundingly positive, at least from an American perspective.

The facts are these: US equities had their best ever performance on the day following a Presidential election and continued to make consecutive new all-time closing highs, with the S&P 500 Index hitting that mark for the fiftieth time this year on Friday. However, what is good for the US is not necessarily as good for the rest of the world. European shares, especially, lost ground owing to the increased probability of tariffs being imposed on exports to the US, with the investment bank Goldman Sachs immediately downgrading its GDP growth forecasts next year for the UK and the eurozone.

Even so, nothing is certain. We will have to wait and see exactly how President-elect Trump decides to use the tariff threat, with the optimistic view being that he uses it to extract various concessions from trading partners. As one commentator I heard put it: "Trump does not have enemies, only competitors; and everything is up for negotiation". In any event, nothing can be enacted until the end of January at the earliest, with inauguration day being the 20th. There have also been hints to suggest that tariffs could be layered in gradually to ease the price effect on US consumers. We shall just have to wait and see.

Within the US market, and reflecting further extremes of policy differences, the biggest single share price winner (+40%) on Wednesday was a company called GEO Group which operates prisons and so will benefit from the incarceration of undocumented and illegal immigrants (although probably not former US Presidents). The biggest loser was Sunrun, an installer of residential solar panels (-30%). Trump is seen to favour fossil fuels over cleaner, greener transition technologies, although it seems hard to believe that the underlying trend towards greater adoption of carbon-free energy solutions will not continue, especially if Trump's decision-making is going to be influenced by his new best friend and advisor, Elon Musk. Shares in Musk's company Tesla gained 29% last week, consolidating his status as the richest man on Earth (and possibly one day on Mars).

Was the Trump victory the only cause of the US stock market's rally? There is a school of thought to suggest that it would have risen even had Kamala Harris won because trading funds had taken a lot of chips off the table ahead of election day and also because a lot of insurance had been taken out against potential volatility via the options market. The elevated level of, for example, the VIX (equity) and MOVE (bond) volatility indices allowed for the possibility of those hedges being unwound in the event of a decisive result and so it turned out. In many respects, it was the comprehensive nature of the victory that was celebrated because it reduced the uncertainty and squashed any concerns over civil unrest or arguments about the integrity of the democratic process.

We have a balanced opinion about what happens to US equities next. A simple replay of the post-2016 election "Trump Trade" which saw the S&P 500 Index rally almost 40% by the end of January 2018 is alluring but heading into the realms of wishful thinking. There are plenty of differences between now and then, not least the current valuation of the market, currently sporting a Price/Earnings ratio of around 22x vs 16x eight years ago. Headline inflation of 2.4% today compares with a level of 1.6% when Trump was elected previously and it was his policies contributing to inflation rising above 2% again which had a hand in the Federal Reserve tightening monetary policy through 2017 and 2018. Interest rates were just 0.5% on election day 2016 vs 4.75% now, and the 10-year Treasury yield hovered around 2.3% through the first year of the presidency vs 4.3% today.

But tempering upside expectations is not the same as being bearish. We remain in the "no-recession" camp as far as the US economy is concerned and continue to acknowledge what one might describe as "US exceptionalism". We're not particularly scared by the high share of market capitalisation given to the leading companies and the concentration of leadership in Technology-related sectors – they are, and should remain, extremely profitable. And there is the

added bonus of less potential regulatory interference under a Trump administration. Indeed, some commentators have gone so far as to assert that Big Tech is now effectively running the White House!

More tactically in the short term, the passing of the election frees investors from uncertainty just as we are heading into a period that tends to be seasonally positive for returns. November and December are the biggest months of the year for share buybacks (after a period of suspension during the results season) and annual fund allocations often get made around the year end. There is a constant underlying bid for US equities from domestic investors directing monthly contributions more and more into index funds while non-US investors continue to increase their allocations to global equity benchmarks, of which around two-thirds are taken up by US equities.

What could upset this Utopian outlook? Barring any exogenous shock, the primary candidates are a loss of faith in the US bond market and/or an unwelcome burst of higher inflation necessitating more monetary tightening. On the basis that the latter could trigger the former, let's take it first. Inflation has been on a clear downward path. And while the headline rate is below central banks' 2% target in many countries including the UK, it remains stubbornly higher in the US at 2.4% (with the core rate at 3.3%). Although Federal Reserve Chair Jerome Powell was at pains last week to emphasise that everything is on track to reach 2%, seeing is believing for many. Trump's policies are inflationary in nature. Tariffs will raise the price level of imports (unless either exporters or the US distribution chain take the hit instead), and tax cuts will continue to support demand. There is no concrete plan to reduce the fiscal deficit. Elon Musk's putative Department for Government Efficiency is touting $2 trillion of savings, but with only $1.7 trillion of discretionary spending in the annual budget(AI), one wonders where the savings could come from. Maybe the adoption of Artificial Intelligence will provide the magic productivity bullet, but that's a big bet to make.

Some of this expectation of potentially higher inflation has already found its way into market pricing. Just a month ago, the 2-year breakeven rate (the expected average rate of inflation inferred from the relative prices of index-linked and conventional bonds) was 1.47%. Today it is 2.57%. Because the inflation fears are front-loaded (and there is an expectation that the Fed would fight inflation), the 10-year rate has not risen as dramatically, but it has still gone from 2.05% to 2.36%.

These moves have reverberated through interest rate expectations and the bond market. A month ago, the futures market was pricing in a Fed Funds rate of 2.77% at the end of 2025; that is now 3.76%. That still implies another full percentage point of rate reduction from here, which should be a market tailwind as long as growth remains resilient, but it illustrates how quickly investors can reprice expectations.

As for bond yields, the US 10-year Treasury yield has risen from 3.6% to 4.3%. This is an important point because this is the effective benchmark discount rate for global financial assets, and an increase in its level, all other things being equal, reduces the net present value of future earnings/cashflow/dividends, etc. Of course, all other things are rarely equal, and the fact that US equities have rallied into the higher rates can be attributed to a combination of positive growth expectations and a reduction in the equity risk premium (with the latter being a useful tool to explain away market movements that cannot be ascribed to more concrete factors!).

In turn, higher bond yields mean that it costs the US government more to service its (rapidly increasing) pile of debt, which also eats into its ability to provide the services it has budgeted for- without borrowing even more. Much is made of the unsustainability of government debts around the world, with constant sightings of the infamous "bond vigilantes" who will bring governments to heel by selling their bonds. The spike in bond yields following

the Truss "mini" Budget was an example of this, and there was something of a scare in the US bond market in October 2023 (which was cleverly circumvented by the US Treasury shortening the maturity of its debt issuance to attract funds that had been tied up in the central bank – but it can't really play that card again). France's bonds now demand a bigger premium over German bonds than at any time since the eurozone crisis (barring a short period when there was fear of a Le Pen election win in 2017) as it grapples with its deficit problems.

And yet, shorting the bond market and expecting a collapse of financial markets has been a classic "widow maker" trade in, for example, Japan, because the central bank has consistently hoovered up all the supply, despite the government having a deficit which runs to well over 200% of GDP (vs around 100% in the US, UK and France). Of course, something has had to give, and that is the currency, with the yen having lost around half its value vs the US dollar since former Prime Minister Abe launched his "three arrows" reflation policies in 2012. Even accounting for the Brexit-related currency reset, the pound now buys almost 200 yen against 120 in 2012. Japan has gone from being a costly destination for tourists to a reasonably good value one, especially as inflation has remained very low there.

And so where does this end? The Panglossian argument is that AI sparks a productivity revolution and economies help governments grow out of their debts (as nominal GDP grows faster than the debt). That's not impossible, but hard to make as one's central case. Explicit default on the debt (either by not paying it back or reducing the interest payments) is even more improbable for a developed economy.

Which brings me around (yet again) to inflation and the risk of financial repression (whereby the price level is allowed to rise while the return offered by safe financial instruments is artificially depressed, thus also reducing the debt in real terms). It's exactly what the United States did to help reduce its liabilities after the Second World War. A form of it can be seen in the fact that the UK government is not increasing income tax thresholds in line with wage inflation. A lot will depend on who blinks first. Any country that follows Japan down this route on its own will see its currency heavily sold, and so it might ultimately be preferable for everyone who needs to (and it is almost everyone who matters) to act in concert. That would mean their currencies would have to devalue against something else. Assets with exposure to nominal growth would do well, including equities. For example, Japan's equity market has delivered a total return of 316% in yen since the end of 2012 (although only 132% in dollar terms). It's also a reason to continue to consider Gold as a portfolio component.

Economic Commentary

FTSE 100 weekly winners

International Consolidated Airlines Group SA	10.0%
BAE Systems plc	8.6%
InterContinental Hotels Group PLC	7.8%
Ashtead Group plc	7.6%
Flutter Entertainment Plc	6.4%
3i Group plc	5.8%
Sage Group plc	5.7%

FTSE 100 weekly losers

Schroders PLC	-15.7%
ITV PLC	-15.1%
AstraZeneca PLC	-10.2%
Persimmon Plc	-10.0%
Auto Trader Group PLC	-7.9%
Taylor Wimpey plc	-6.7%
J Sainsbury plc	-5.9%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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