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Now What?

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I think we can all agree it's been a momentous and hectic few months. Since equity markets went into their tailspin in early August, there have been few moments when there has been time to stand back from the action and take stock. The build-up to the US Presidential election and the UK Budget dominated the headlines; we have had an initially exciting but ultimately disappointing economic stimulus package announced in China; and we have had a corporate earnings season which (in the US) has seen the biggest daily share price moves in reaction to results since the Global Financial Crisis.

But with these events fading in the rear view mirror, to what should we now turn our attention? It's fair to say that the ripples from both the election result and the Budget (at least for us here in the UK) will be spreading for a long time to come, but it might be quite a while before planned policies are implemented and even longer before their effects are felt. We will focus on some of the more immediate issues first.

There is no escaping the fact that the lead actors for the current market are in the US, with the main parts being taken by President-elect Donald Trump and Federal Reserve Chairman Jerome Powell. Supporting roles are filled by China's President Xi and Russia's Vladimir Putin. I'm afraid Sir Keir Starmer's credit is going to be something like "third man at bus stop", although it's possible that Andrew Bailey, Governor of the Bank of England, will get a small speaking part.

And so what should we be looking out for next, at least at the macro level? US government policy has to be top of the list, and that will depend, to some degree, on the appointments that Donald Trump makes. I'm not going to critique the initial proposals in detail here but suffice to say that eyebrows have been raised by some of his planned appointments and it's not too controversial to speculate that he has a masterplan to gain control (or at least considerable influence) over the judicial system, financial regulation and the media.

The slightly worrying thing is that it is also possible to make a case that some of the things he plans to do could be positive for the economy and markets in the short term and thus gain support, but that they might also be sowing the seeds of future misery. For example, an unfettered and deregulated financial sector could deliver increased Merger & Acquisition activity, a boom in Initial Public Offerings and greater speculative activity in financial markets. Need I say how that usually ends? Goosing the economy with bigger fiscal deficits is equally unsustainable, as I discussed last week.

Specifically, one might look for more details on the following policies. The first and most contentious subject is probably tariffs because they directly affect other economies. China is at risk of having the highest (60%) tariffs imposed, but Europe is also in the firing line (owing to its big trade surplus with the US), and that has been reflected in poor relative performance for European equities and in a weak euro. A big question will be whether team Trump uses the threat of tariffs as a bargaining tool and, if so, what concessions he will be able to wangle out of trade partners.

Second, I would watch closely his plans on immigration. It's one thing to reduce the numbers coming into the country, but quite another to start sending people back to where they (or their parents) came from. I have heard numbers higher than ten million deportations if his word is taken to the extreme, although that seems highly improbable (and impractical). But the key point is that any reduction in labour force supply could be disruptive, potentially causing an unpleasant combination of lower growth and higher inflation.

Then there is the fiscal situation, driven initially by the extension of existing tax cuts and possibly some new ones (with a cut in the corporate tax rate being most probable). Announcements around taxes could well be market moving, but the big question is where will they sit on the Laffer Curve? The economist Arthur Laffer famously sketched his theoretical curve on a napkin, proposing that cuts in tax rates would yield more tax revenue owing to higher growth. That has proven to be the case, although there is sweet spot – after all, nobody would bother getting out of bed if all income was taxed at 100%, and no taxes would mean no revenue at all! The trouble is, as with so many economic theories, nobody can be sure where that sweet spot is.

As I mentioned last week, there have been some considerable shifts in US interest rate expectations in recent weeks. For example, as recently as mid-September, the futures market was pricing in a Fed Funds rate of 4% by the end of this year; now it is saying almost 4.5%. It's been a rollercoaster year for rate expectations as investors have grappled with shifts in growth and inflation forecasts, with the range for the December 2024 future having been as low as 3.65% in January and as high as 5% in May.

Some of the recent move (higher) has been the positive effect of better-than-expected growth, with Citigroup's US Economic Surprise Index rising from -47 in June (data much worse than forecasts) to a current +43 (data coming in better than expected). But we have also seen the less benign influence of higher inflation expectations. This has led to some changes in the Fed's messaging about the path of interest rate reductions. Whereas just a few weeks ago the members seemed to be pretty much all in on a faster pace of cuts, now they are saying that there is not so much of a hurry. Every word that Chair Powell utters will now be parsed to within an inch of its life to extract some hint of direction.

We had thought that rate expectations had got ahead of themselves and current pricing does feel a bit more realistic. And as we always remind ourselves, one has to bear in mind why central banks are cutting interest rates: is it "because they can" or "because they have to"? The latter is potentially much more damaging for risk assets because it comes with the prospect of lower growth and profits.

Of the two supporting characters, President Xi has more influence on economic outcomes and Putin on geopolitical ones (assuming that China is not imminently going to invade Taiwan). The initial enthusiasm for China's stimulus package is in danger of giving way to disillusionment, although we still judge that the government wants to put some sort of floor under activity levels. While in the longer term a heavy debt burden and poor demographics represent major headwinds for China, any announcements that could improve consumer confidence and release potentially enormous pent-up demand from savings would be taken positively.

As for the situation in Ukraine and Russia, we will have to see whether President-elect Trump is able to uphold his promise to end the hostilities on "day one" in office. In the meantime, though, we note that outgoing President Biden has authorised the use of some long-range missiles to be fired into Russia, which increases the risk of escalation in the short term.

Much of what I have discussed here involves potential shifts in short-term sentiment but our principal focus remains on investing in high-quality equities which can compound their value over the longer term combined with safe (less volatile) assets in balanced portfolios.

Economic Commentary

FTSE 100 weekly winners

Just Eat Takeaway.com N.V.	25.8%
Burberry Group plc	12.6%
DCC Plc	11.4%
Smiths Group Plc	10.6%
Flutter Entertainment Plc	8.5%
Lloyds Banking Group plc	6.4%
Aviva plc	6.3%

FTSE 100 weekly losers

Intermediate Capital Group plc	-8.8%
Fresnillo PLC	-7.4%
Experian PLC	-7.1%
BAE Systems plc	-6.6%
Ocado Group PLC	-6.2%
GSK plc	-5.8%
RELX PLC	-4.4%

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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