Sizing Up Markets & The Economy (Post-Election)

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The recent U.S. presidential election was unusually close, with Donald Trump winning exactly 50.0% of the popular vote. The political views of the candidates and their parties have become more divergent. Collectively, the outcome of the election leaves half of Americans optimistic about economic and political conditions, while the other half is less optimistic.

We don't look at markets or the economy through a political lens. We are mindful of the risks and opportunities associated with potential policies and calibrate accordingly. As is the case with any campaign, not all proposals or promises will materialize. Moreover, President-elect Trump is known for making bold statements and being willing to adjust or compromise from there. Therefore, it's hard to make definitive calls on expected policies. However, one can position according to probabilities and opportunities. That is the approach we are electing to take.

With a red sweep outcome now known, we wanted to provide an update on our outlook for the economy, markets, and how we plan to navigate both as we look ahead.

Tariffs, Immigration, and Tax Policy

From an economic standpoint, the Trump campaign's three dominant policy focuses — tariffs, immigration, and taxes — are expected to significantly influence economic dynamics. While markets anticipate these policies to have a substantial impact, the effects of tariffs and immigration during the first Trump administration were relatively limited. This time, however, the initial policy targets are more ambitious, suggesting the potential for greater impact than before.

The international trade component of the Trump platform suggests an initiation of tariffs on all imports and more significant tariffs (as high as 60%) on imports from China. At this point, it's unclear how much of this policy is a negotiating strategy versus an actionable policy. Should the policies go through as proposed, the initial impact will likely lead toward higher prices on raw materials or goods manufactured in foreign countries. Over time, if this trade policy proves successful, a benefit could be an uptick in U.S. manufacturing as cost competitiveness from domestic producers would improve.

When seeking to size the potential economic impact of the proposed tariff policies, we start by looking at the China tariffs applied during the first Trump administration. Research conducted by J.P. Morgan indicates that the previous China tariff policies in 2018-2019 resulted in an average effective tariff of 20%.[1] This, however, was largely offset by a depreciation in the Chinese renminbi, which made these goods cheaper in U.S. dollars. Given these offsetting factors, importers ultimately did not pass on the cost of the tariff to the end consumer. Should imports from China be assessed at a 60% tariff as proposed, the renminbi could not weaken to an offsetting level without having more catastrophic impacts on the Chinese economy. Therefore, if trade policies were implemented as proposed, the likely impact would be higher prices as the added cost of the tariff is passed on.

Immigration is another contentious policy of the administration. From an economic standpoint, over the past five years, we've seen the labor force participation rate decline as the workforce ages. The cohort of Americans aged 25-54 has achieved a record high participation rate in the workforce. Therefore, we don't believe there is a lot of slack in the labor market. There has been a gradual migration toward a 1:1 ratio of open positions per unemployed person, down from as high as 2:1 in 2021. However, we should note that nearly 50% of job growth has been in education or healthcare. Thus, other sectors of the economy may have greater slack in employment levels compared to aggregate trends. Ultimately, we suspect that immigration policies will constrain the size of the labor force and drive wages higher.

[1] J.P. Morgan, China: The storm across the Pacific: Tariff war 2.0 and impact on China. November 8, 2024.

Lastly, tax policy is an area of considerable ambiguity. The Tax Cuts and Jobs Act (TCJA), passed in late 2017, is set to sunset at the end of 2025. During his campaign, President-elect Trump suggested an extension to many of the policies in the TCJA along with a proposal for a lower corporate tax rate. The extension of TCJA removes a concern that consumers (in aggregate) will face higher taxes and therefore alleviates consumption pattern concerns. A reduction in corporate taxes would provide a one-time boost to corporate earnings, likely driving stock prices higher. Markets are apt to view easier tax policies as an immediate positive for the economy. We do, however, hold concerns on whether the prospect of lower tax revenue, in conjunction with elevated deficits, will reduce investors' willingness to purchase Treasuries without an additional risk premium.

A parallel can be drawn to the United Kingdom under the brief tenure of Prime Minister Liz Truss in September 2022. In that instance, the yield on the 30-year Gilt jumped by 1.5% in less than a week, forcing her to reverse policy and ultimately leading to her resignation. We aren't expecting this degree of reaction given there aren't any readily available alternatives to U.S. Treasury bonds that have a more superior credit profile.

When we consider potential policies around tariffs, immigration and tax cuts, the economic ramification is the potential for upside risk to inflation. Tariffs pose a risk that higher input costs lead to higher prices for consumers. Tighter immigration policies would lower the pool of available workers, which poses a risk that wages may need to move even higher. Lastly a more favorable tax policy could fuel greater spending, which could also be inflationary.

The typical investment playbook for an inflationary environment is to own energy, commodities and real estate. The challenge in guarding against higher inflation in the current environment is that traditional inflationary sectors face their own challenging fundamental backdrop. For example, the energy sector is projected to see an acceleration in production during the second half of 2025, which if this transpires, could weigh on oil prices. Real estate could benefit from higher rental rates should inflation accelerate; however, valuations may be challenged as borrowing costs could remain elevated. Lastly, commodities may face challenges as sluggish economic growth outside the U.S., particularly in China, could dampen demand and put downward pressure on prices.

We see greater opportunities in less direct, but still inflationary sensitive sectors with more favorable fundamental characteristics. These include industries such as insurance and manufacturing. In addition, infrastructure assets and inflation protected bonds could play a role in portfolios where appropriate.

Geopolitics and Foreign Impacts

The number of geopolitical uncertainties that exist today are likely to have greater ambiguity with a new presidential administration taking over. The outcomes of wars in the Ukraine and between Israel and Hamas could influence regional alliances. These potential outcomes alongside proposed tariff polices, could lead to an evolution in global trading partnerships. This coincides with a general trend toward deglobalization that has been brewing for several years. It's unclear how this will play out, but we do expect it will alter supply chains of U.S. corporations and drive greater need for infrastructure to support the further evolution in onshoring/nearshoring trends.

An additional expectation for a Trump administration is the prospect of a stronger dollar. This is contrary to campaign rhetoric which suggested a desire for a weaker dollar. In our view, the combination of greater inflationary pressures and higher interest rate expectations will lead to appreciation in the U.S. dollar. A stronger dollar will serve as a headwind to returns for U.S. investors converting their dollars into foreign currencies to purchase international stocks.

Our Convictions

The conclusion of the election and greater transparency around policy direction strengthens our conviction on portfolio positioning. Listed below are some of our dominant themes that influence how we think about portfolio positioning going forward:

- We are more optimistic about domestic stocks relative to international stocks in the near term, driven by expectations for a stronger dollar and the potential impact of Trump administration policies on certain international markets. More attractive valuations for international stocks make this segment appealing over a long-term horizon.

- Given our view that inflation risks are to the upside, we prefer segments of the market positioned to benefit from higher prices. These may be less apparent sectors such as manufacturing and insurance companies. Depending on valuations, we may also look at segments of the bond market such as asset-backed or inflation protected securities as ways to protect against the risk of higher inflation.
- In recent years capital market activity has been subdued, both in terms of below average mergers and acquisitions (M&A) volume and fewer initial public offerings (IPOs). Expectations are that a Trump administration will offer a more favorable anti-trust environment. This shift, alongside pent-up transaction volumes, could lead to an uptick in capital market activity benefiting M&A advisor firms, private investment managers, exchanges and brokerages.
- As trends in artificial intelligence (AI) migrate past the initial infrastructure build to the deployment and usage of AI models, we expect the beneficiaries to evolve. As such, we expect opportunities within the technology sector to remain, however, we project we will be moving toward a stock pickers market within the sector.
- We have begun to see a gradual reversion in growth rates between the technology dominant Magnificent Seven stocks and the rest of the market. Over the coming quarters, expectations are for the growth rates between the two cohorts to converge. Given the significant variation in valuations of Magnificent Seven[2] stocks (higher) and rest of the market (lower), we would expect this outcome to lead to a broadening of the market where the Magnificent Seven stocks are no longer garnering outsized returns.
- Regardless of policies by the Trump administration, the buildout and reconstruction of the nation's energy and power infrastructure will continue. The growing demand for power generation and the long lead times involved highlight the need for expanded renewable energy capacity and power storage. In addition, the necessity to upgrade and reconfigure the U.S. electrical grid will require significant investment. We believe this trend offers opportunities to make investments in businesses that benefit from further buildout in energy infrastructure.

Conclusion

As we assess the outcome of the election and its impact on the economy and market, we see a mix of both opportunities and areas of concern. Knowing the general direction of policy over the next four years affords us the opportunity to position to where we see greatest opportunities. Much of the opportunity we see is unlikely to be materially impacted by the election or Trump administration policies. Knowing the political landscape and any potential headwinds or tailwinds allows us to invest with greater conviction. We recognize that risks remain, particularly concerning inflation, interest rates and geopolitical conflict. We acknowledge these risks and are focused on adding diversified exposures to protect portfolios should one of these risk considerations present themselves.

For those investors that are concerned with the presidential election outcome, we wanted to share some perspective.

First, it's important to separate one's political views from economic rationale. No one knows exactly what policies will be enacted, how they will be implemented, and at what cadence. It is our responsibility to monitor this and recalibrate. If policy is implemented that we believe increases risk to a particular asset class, we will adjust.

Second, focus on your financial objectives, not the daily market returns. Investing only during Republican or Democrat administrations would have been materially costly relative to remaining fully invested regardless of administration.

In fact, if you have concerns about downside risk, now is a good time to reassess how much risk you are comfortable with. Bonds offer reasonable yields and if you have concerns and want to reduce risk, we can help you with that assessment.

Lastly, we believe in diversification for a reason. Even if some assets are negatively impacted by political policies, we seek to build portfolios that have assets that can perform when others are out of favor.

[2] The Magnificent Seven grouping includes Apple, Alphabet, Microsoft, Meta, Amazon, NVIDIA, and Tesla.