Waiting For Clarity

- The still-positive economic backdrop, rising corporate earnings and additional DM policy rate cuts point to further risk-on in the near run, providing the rise in bond yields is no worse than gradual.
- The DM inflation backdrop, however, remains a threat, especially in the U.S. Sticky service sector inflation will persist for as long as labor market conditions remain tight and the global economic expansion rolls on.
- It is uncertain whether protectionism will come to dominate the macro backdrop but, if so, then it could undermine the global expansion and end the bull market in corporate profits. Stay tuned.

MRB *TradeBook Update* *p.8*

- The spike in the U.S. dollar triggered our stop on a long euro position. We will add a 4% trailing stop-buy to capture the eventual turn.

The U.S. election ended uneventfully, and now investors are digesting the selection of Team-Trump. The next (and much more important) hurdle will be getting clarity on the ***actual*** new policies that will be enacted by the incoming Administration. There are a wide range of proposals, which could cause modest-to-potentially huge changes in the economic landscape and, thus, have meaningful asset market impacts.

The main four proposals from President-Elect Trump were the topic of a report this week (see page 9). It is too early to make aggressive bets on the likely outcomes, especially in view of Trump's record of abruptly shifting course, especially when the seas get rough. However, it is not too early to map out the potential opportunities and risks, since Trump did make several major policy changes during his first term.

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This Week's Research

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For now, we bet that the U.S. economy will continue to expand at an above-potential pace. The pre-/post-election stampede into U.S. assets has crested but not reversed (**chart 1**), as there are high hopes for pro-growth policies, at least initially (via fiscal policy and further rate cuts). Despite the latter (rate cuts), Treasurys will remain under pressure from an economy with solid momentum and sticky inflation.

The Treasury market will increasingly have to grapple with the risk of higher underlying inflation and the likelihood that the Fed's estimate of the long-run equilibrium rate will rise further (see page 8), both of which are bond-bearish.

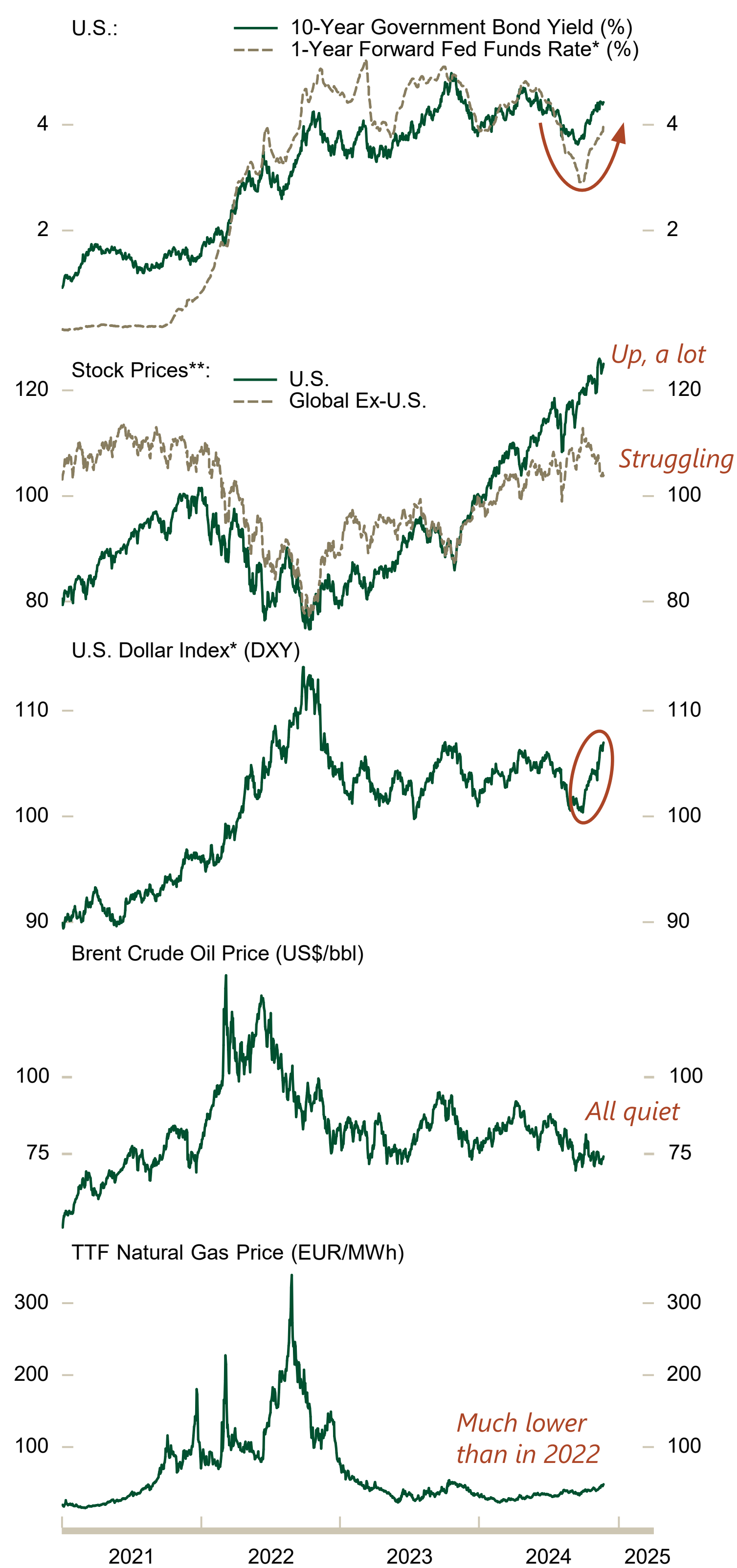
Meanwhile, the avoidance of most non-U.S. equity markets and currencies has persisted. The growth outlook was already favoring the U.S., and has been enhanced further because of the election outcome.

Moreover, other economies are perceived to be at greater threat from the likelihood of a Trump 2.0 trade war. Until the dust settles on what actually is going to occur, ***global investors are unlikely to make the contrary trade of betting against the U.S.*** in favor of non-U.S. markets.

Global geopolitical tensions remain elevated versus recent decades, and seem to have edged higher of late. The main transmission mechanism from current geopolitical tensions to undermining the global economic expansion would be via much higher energy prices and reduced supplies, which have not occurred (**chart 1**, panels 4 and 5). However, these developments likely have had a dampening effect on economic sentiment and risk-taking, especially in those economies closest to the "action" (which also favors the U.S. in relative terms).

Despite these tensions, the overall risk asset backdrop has been more risk-on than risk-off. The global

Chart 1 **U.S. Stampede Has Slowed, But Non-U.S. Still Struggling**



* Source: Bloomberg
** U.S. dollars; rebased to January 2024; source: MSCI
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stock/bond ratio has remained in an uptrend and credit spreads at historic lows (**chart 2**).

The ***yields*** on both U.S. and euro area corporate high-yield bonds have barely edged up and are well below levels reached in recent years. Moreover, the credit taps remain open, and there are good prospects for greater deal-making given ongoing DM policy rate cuts and moderately improving global economic activity.

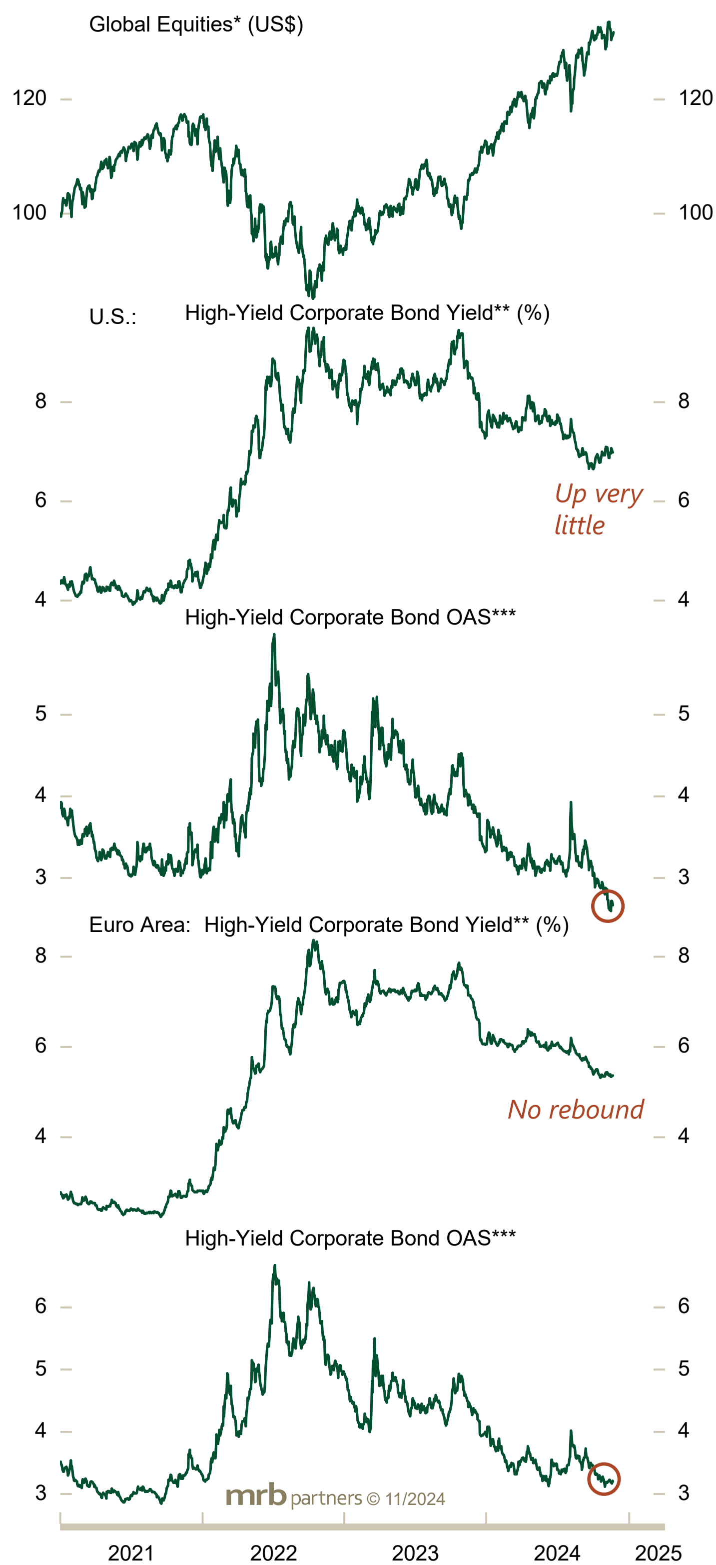
The healthy credit market backdrop underscores that the tightening in overall monetary conditions since 2021 ***never reached restrictive territory*** on a global basis, although some weak-link countries and sectors are struggling due to higher debt-servicing burdens. In aggregate, these negatives are more than offset by areas of economic strength.

Over the long haul, the global stock/bond ratio tracks the trend in forward corporate earnings (**chart 3**). The latter is still positive. We updated our view on U.S. earnings prospects in a report yesterday and concluded that the skies are still mostly blue (see page 11). Positive corporate profits also translate into better hiring and investment, and thus a self-reinforcing economic expansion.

The corporate profit backdrop supports our mildly pro-growth investment stance. However, given the potential for some dark clouds to form in 2025, we recommend a closer-than-normal monitoring of the risks, and greater use of stops to protect profits as the risk-on climate advances.

Rising uncertainty is not good for risk asset prices and economic activity, and undoubtedly has contributed to the sluggishness of the euro area economy since early-2022 (**chart 4**, panel 2). The conditions for much better regional consumption have existed throughout this period, given unprecedented excess

Chart 2 **Global Equities Still High, And Corporate Bonds Are Well Bid**



* Rebased; source: MSCI
** Source: BofA Merrill Lynch
*** Option-adjusted spread; source: BofA Merrill Lynch

household savings, and an historically healthy labor market and solid wage growth.

Moreover, in contrast with 2022, euro area energy prices are far lower and supplies more assured. Lower policy rates should spur some improvement in regional growth, unless trade worries heat up too much. Our base-case remains that euro area growth momentum will gradually improve in the year ahead.

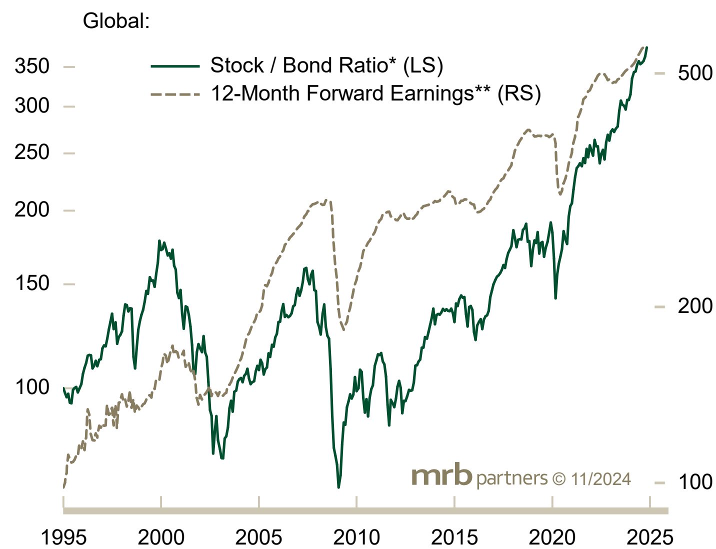
To this end, uncertainty related to U.S. trade policy is on the upswing (**chart 4**, panel 1), and may well eventually dominate the headlines. It is widely assumed that Trump will initially use the threat of more trade tariffs and restrictions as a negotiating tactic. Moreover, in his first term, Trump paused the escalation in tariffs once evidence of economic damage started to show up in the U.S. (not to mention a sizable stock market setback and higher credit spreads[1]).

U.S. manufacturing activity weakened notably at the end of the last decade and global trade contracted, which did not please U.S. corporate executives (who presumably "communicated" this to the president). While Trump continued to ***talk*** tough on trade, his ***actions*** came up short of derailing the global economy and, by extension, he avoided taking too much risk with the U.S. economy.

It is unknowable what will occur down the road on this front but the ***potential*** risks are high, underscoring the importance of not being too dogmatic and ready to make sizable portfolio changes if needed.

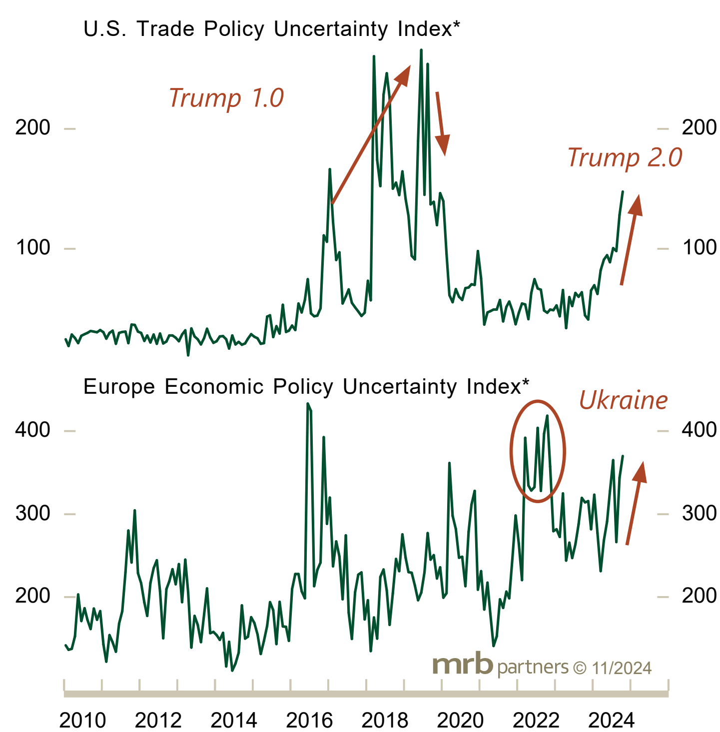
In the meanwhile, we expect investors to incrementally worry about the traditional source of market turbulence in risk assets, namely a bearish bond backdrop. In an unprecedented turn of events,

Chart 3 **As Corporate Earnings Goes, So Goes The Stock/Bond Ratio**



* Global equity total return relative to a GDP weighted basket of G7 10-year government bonds; local currency; rebased
** Local currency; rebased; source: MSCI
Note: Shown in log scale

Chart 4 **U.S. Trade Wars: Here We Go Again?**



* Source: Economic Policy Uncertainty

[1] See chart 3 in **MRB** "***Weekly Macro Strategy: Beware The Fat Tails***", November 8, 2024

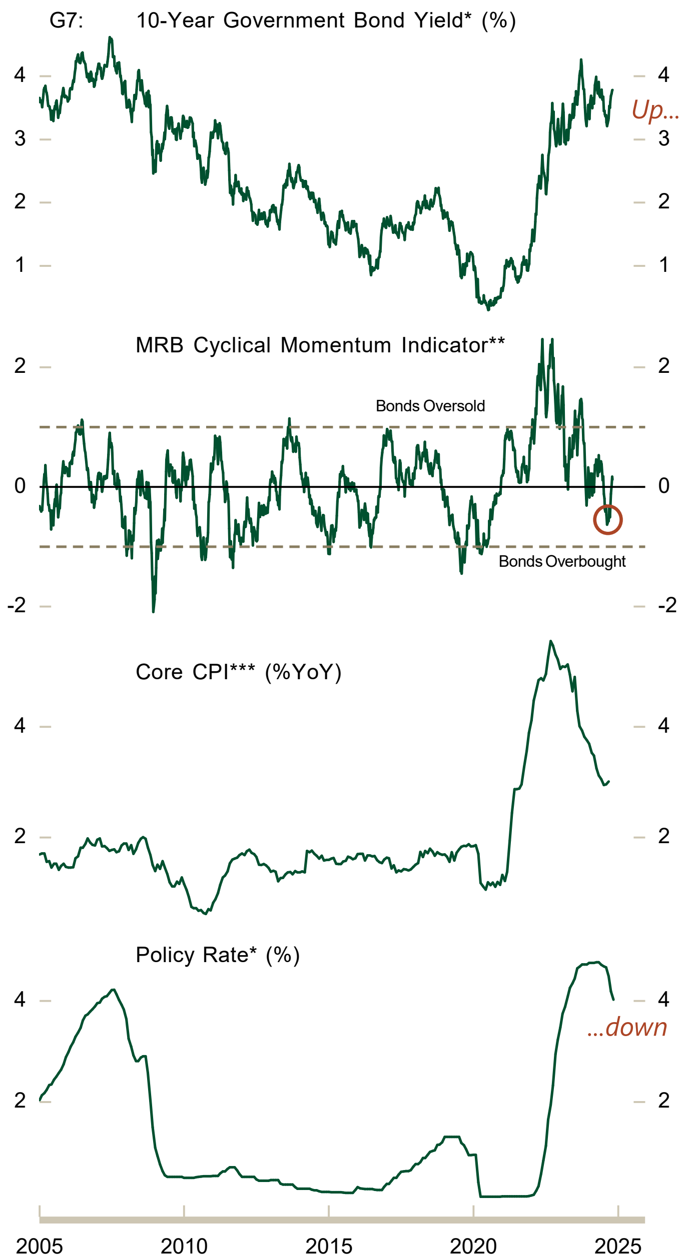
but not surprising to MRB[2], Treasury yields have ***risen*** modestly since the Fed's first rate ***cut***.

After persistently front-running an end to rate hikes and discounting a large rate-cutting cycle in recent years, the Treasury market backdrop has now flipped somewhat. Despite guidance that further rate cuts loom, Treasury yields are likely to continue climbing due to above-potential U.S. economic growth at a time when the output gap is the most positive in many decades. As noted in our report on Wednesday, most of Trump's proposed policy changes would initially be Treasury-bearish.

DM bond markets had unwound previously oversold conditions and even neared overbought levels by this autumn (**chart 5**), setting the stage for a resumption in the cyclical yield uptrend. That yields have risen as policy rates have declined has only added to the list of unique economic and investment developments this decade. The odds favor steeper DM yield curves in the next 6-12 months.

In turn, higher bond yields will eventually trigger ***de***-rating pressures in equity and credit markets. We have flashed a breakout above 5% for 10-year Treasury yields as a critical level, as it would set a new cyclical high and likely force the dovish Fed to pivot once again.

Chart 5 DM Policy Rates Down, Bond Yields Up



* GDP-weighted aggregate
** Standardized
*** Excludes energy and food; source: IMF

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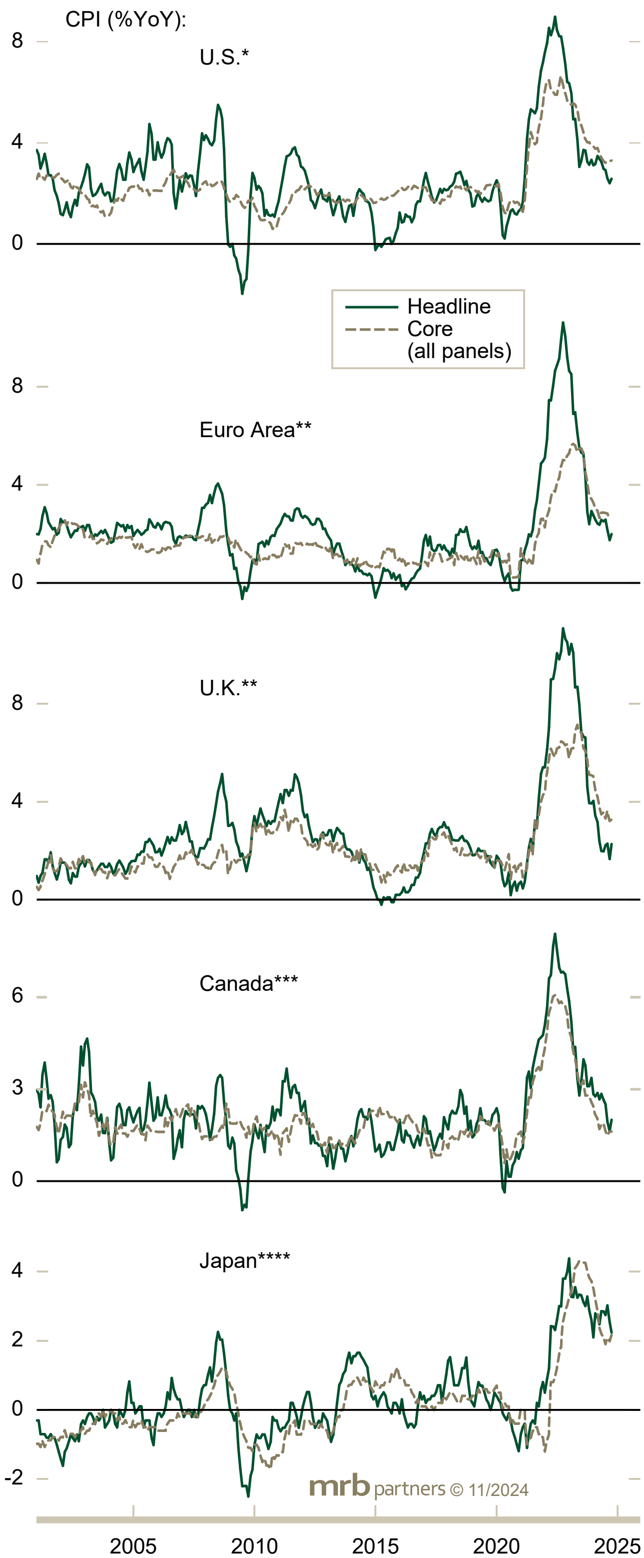
Higher U.S. yields are likely to have a negative contagion on global bond markets. Ironically, the equity market risks are now concentrated in the U.S., given that valuations and profit margins are far higher than when yields last (briefly) visited 5% (whereas the valuations of most non-U.S. markets have not risen).

This week's CPI reports from a number of G7 countries highlighted that core inflation is generally proving sticky and holding above levels seen last decade (**chart 6**). The U.S. has the most positive output gap, and thus is most at risk of higher inflation (**chart 7**).

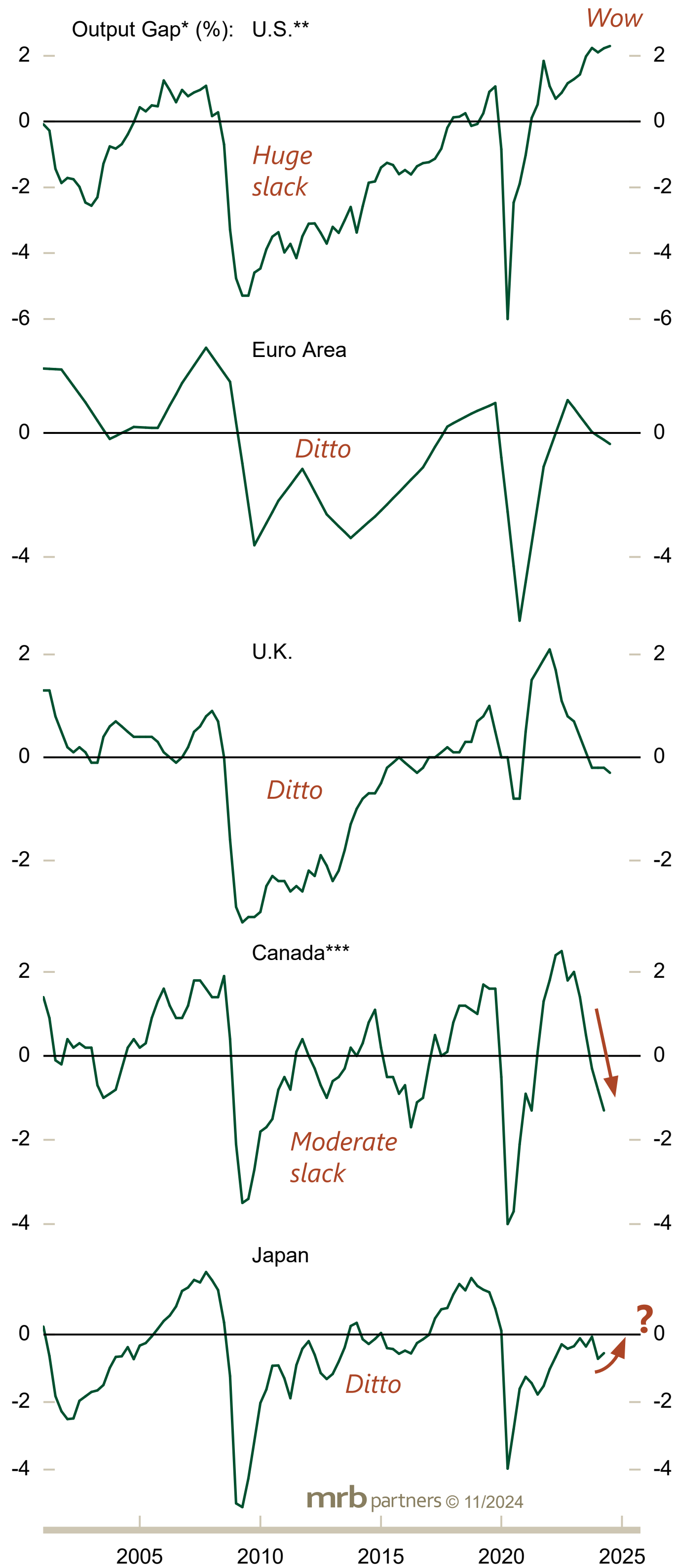
[2] MRB "***Absolute Return Strategy: Sell The News***", August 29, 2024

Chart 6 Sticky Core Inflation



* Core excludes energy and food
** Core excludes alcohol, energy, food and tobacco
*** Core excludes energy and food
**** Excludes tax effects; core excludes fresh food and energy

Chart 7 Far Less Economic Slack Than Last Decade



* Current GDP relative to potential GDP; sources: U.S. Congressional Budget Office, European Commission, U.K. Office for Budget Responsibility, Bank of Canada, Bank of Japan
** Truncated below -6
*** Truncated below -4
Note: Panels 2 and 3 include 2024 and 2025 estimates

The latter represents the downside of having had the strongest economy this decade, aided by excessively easy monetary and fiscal policies. With both policies set to ease further, it means continued above-potential economic growth and U.S. inflation trending up.

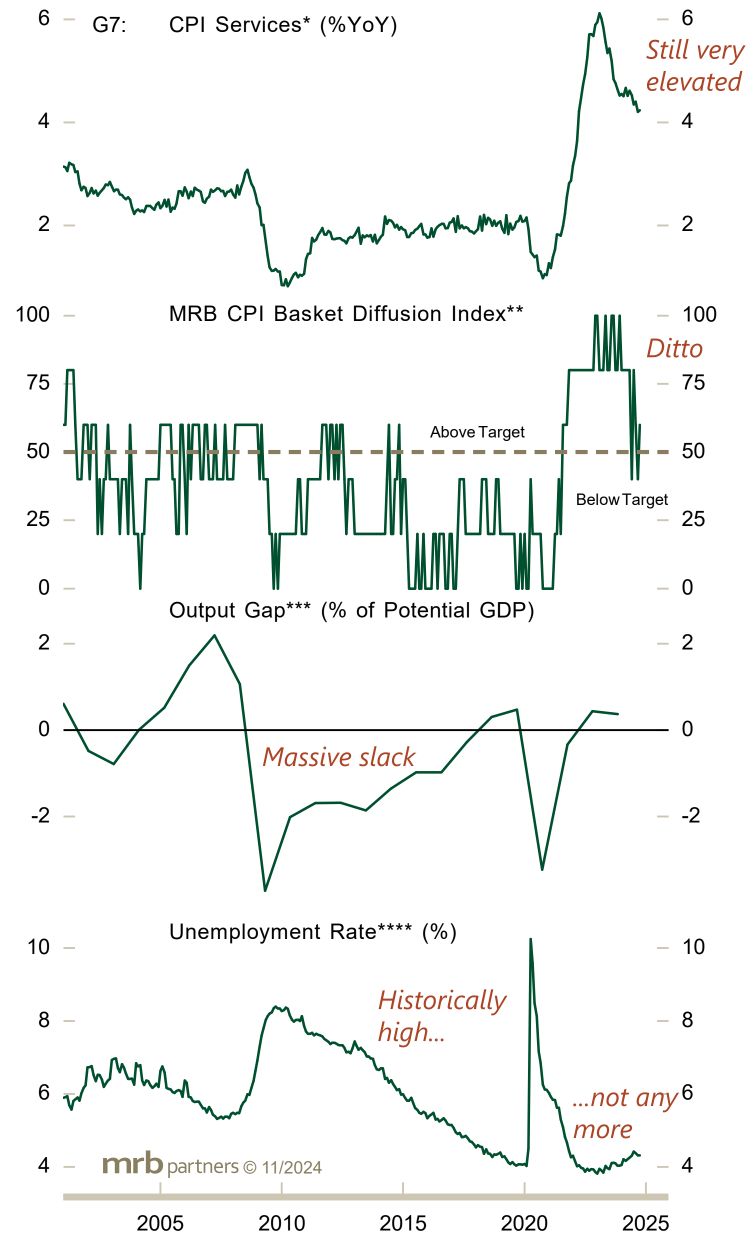
The U.S. is a global price setter, and thus there will be contagion onto the rest of the DM world. A firm U.S. dollar and more trade tariffs will only add to the risk of, at least initially, greater "imported" inflation in non-U.S. economies.

As **chart 8** shows, domestic service sector inflation in the G7 countries remains far above levels in recent decades, and labor markets are far tighter. The goal of returning to low and stable inflation will remain elusive for as long as the global economic expansion rolls on. There will be diverging inflation trends within the major economies, but the overall backdrop will be one of sticky inflation, to the detriment of government bond markets. Eventually, rising bond yields will trigger a de-rating of risk asset markets.

Final Word: *For now, the economic skies are blue, and DM policy rate cuts should keep bond markets relatively calm for a while. This combination is conducive to more risk-on in the near run. However, we expect darker skies ahead, certainly on the inflation/bond-bearish front.*

While it is uncertain whether protectionism will come to dominate the macro backdrop, it is a risk that needs to be monitored as it could undermine the global economic expansion and finally end the bull market in corporate profits. Stay tuned.

Chart 8 **DM Domestic Price Pressures Remain Intact**



* MRB calculation
** Net percent of CPI components with annual inflation rates above central banks' inflation target; equally-weighted aggregate
*** Source: IMF
**** GDP-weighted aggregate; sources: OECD & National Sources

Please see the following pages for the MRB TradeBook update and highlights of this week's research

MRB *TradeBook Update*

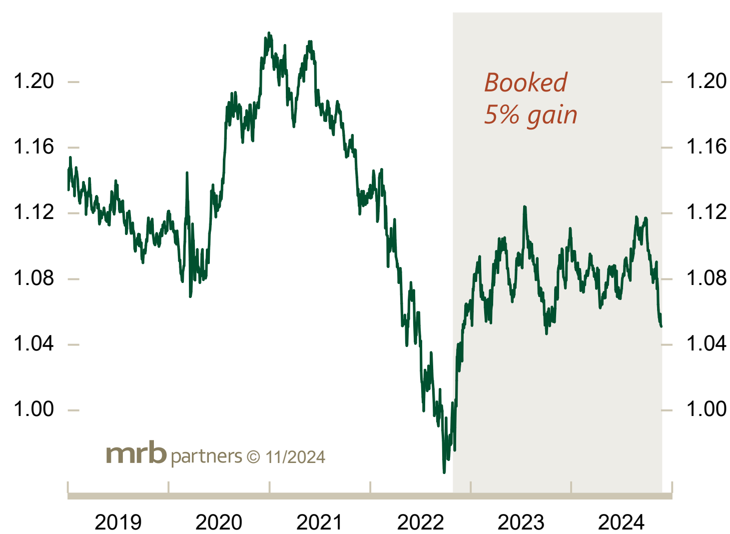
Closing The Long EUR/USD Position

As noted on Wednesday's report (see page 9), the U.S. dollar has had a powerful upleg in response to better-than-anticipated U.S. economic data as well as the expectation for less policy rate cuts compared to other developed markets. This has weighed on this cross rate and, in turn, we are honoring our exit and booking a 5% profit on this position. That said, we have also noted that some of Trump's policy pillars would be relatively negative for U.S. growth, and all lead to comparatively higher U.S. inflation and budget deficits which are ultimately bearish for the currency.

For now, the U.S. dollar has momentum and could appreciate further in the near run, as expectations for Fed rate cuts continue to be pared back. Still, we recommend fading rather than chasing this trend, and will add a 4% trailing stop-buy on this cross rate to capture the eventual turn.

Chart 9 MRB *TradeBook*: Closing Our Long EUR/USD Position

Euro Vs U.S. Dollar Exchange Rate



Note: Shading denotes when MRB held trade

This Week's Research

The Fed Is (Predictably) Talking Up The Neutral Rate

MRB has long held the view that the Fed's estimate of the longer-run or "neutral" policy rate has been unrealistically low for several years. As we had predicted, the Fed finally raised its estimate of the neutral rate at this year's FOMC meetings (**chart 10**). Moreover, the latest communication from Fed members foretells further upgrades to the neutral rate. The Fed is laying the groundwork for a shallower easing cycle and distancing itself from the secular stagnation narrative that was in vogue in the last decade, and still has considerable influence on the Treasury market.

The Fed is laying the groundwork for a shallower easing cycle

Highlights of Monday's report included:

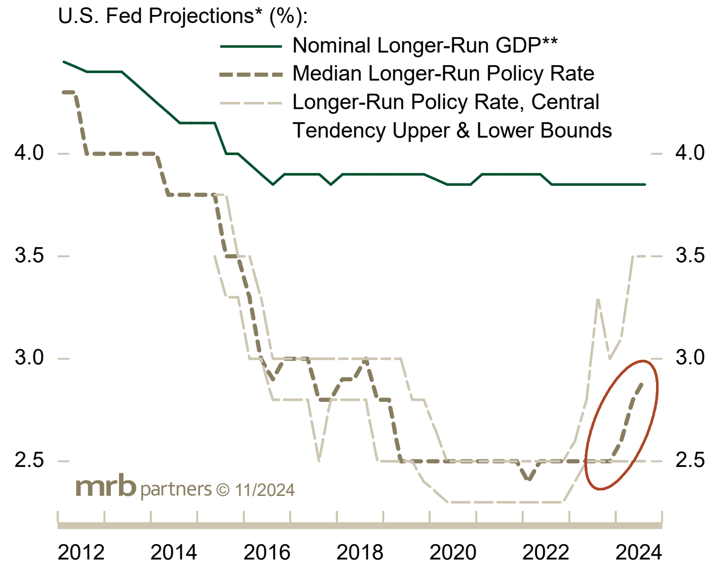
❍ MRB's view is that a realistic estimate of the neutral policy rate for the U.S. should be at least in the 4.5% range.

❍ Even with the long-overdue revisions to the Fed's neutral rate estimate this year, the latter (2.9%) is still too low relative to what is warranted for the U.S. economy.

❍ Note, however, the Fed has been talking up the neutral rate further recently. For the first time (in decades) a Fed member has acknowledged the possibility of the neutral rate being as high as 4.5%.

❍ Investors should expect the Fed's median forecast of the longer-run (or neutral) policy rate to rise ahead.

Chart 10 **The Fed Finally Lifted Its Neutral Rate Estimate This Year**



* Source: Federal Reserve, FOMC meetings SEP
** Midpoint of central tendency plus 2% inflation

❍ The implication is that Fed will ease rates by less next year than what it had signaled in the September dot-plot, and what the bond market has been pricing in.

❍ Future increases in the Fed's neutral rate estimate will have profound implications for U.S. Treasury yields (higher) and the shape of the yield curve (steeper).

Absolute Return Strategy: Positioning For The New Fat Tail U.S. Economy

Trump's policies are a mix of being economically supportive, but also stagflationary

U.S. equities, the dollar and Treasury yields have all risen sharply in response to better-than-expected U.S. economic data, and have received an additional boost from the election outcome. However, investors should be careful not to be dogmatic in their views and positioning since the policies proposed by President-Elect Trump are a conflicting mix of pro-growth fiscal stimulus and stagflationary isolationism.

Although it is too early to know the sequencing of policy objectives, and which of them will ultimately be watered down, Wednesday's report analyzed the four major policy pillars upon which Trump campaigned. The report provided a useful framework for understanding the opportunities and risks that lie ahead for investors (**table 1**).

Table 1 Trump's Policies Fatten The U.S. Economic Tail Risks

	Economic Impact				U.S. Financial Market Implications		
Policy	Growth	Inflation	Debt/Deficits	Uncertainty	Treasurys	Equities	Dollar
Tax Cuts	Up	Up	**Up**	----	**Bearish**	**Bullish**	----
Deregulation	Up	Up	----	----	Bearish	**Bullish**	Bullish
Tariffs	**Down**	**Up**	Up	**Up**	**Bearish**	**Bearish**	Bearish
Deportation & Anti-Immigration	**Down**	**Up**	Up	**Up**	**Bearish**	**Bearish**	**Bearish**

Note: Bold text denotes where policy has greatest impact

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The main takeaways included:

- The consensus view is that the Republican sweep will result in pro-growth policies for the U.S. economy. However, Trump's policies are a mix of economically supportive (tax cuts and deregulation) and stagflationary (widespread tariffs and deportations/anti-immigration).

- In turn, the election outcome has significantly fattened the tails for the U.S. (and global) economy, and it will be crucial to understand which policies will be implemented first, and to what degree.

- Also, the macro environment is now very different from 2016 when Trump last entered the White House. Inflationary pressures are more prevalent today and the bond market is becoming sensitive to widening budget deficits. Indeed, ***most of Trump's policy proposals are bearish for U.S. Treasurys*** and higher yields could again eventually have adverse knock-on effects for equities.

Most of Trump's policy proposals are bearish for U.S. Treasurys, and higher yields could again eventually have adverse knock-on effects for equities

- We are maintaining exposure to equities and corporate bonds for now, but recommend that investors stay flexible in their pro-growth positioning. Only half of Trump's major policies are supportive for equities, and sector selection will be even more crucial to improve one's risk/reward next year.

- The consensus narrative is overwhelmingly bullish for the U.S. dollar, which is worth challenging. Some of Trump's policies are not supportive of the currency, and much will depend on the Fed's response.

Q3 2024 Earnings Review And Outlook: Continued Expansion

The U.S. third-quarter earnings season is winding down, with only a small number of companies left to report results. Corporate profits have been underpinned by the ongoing economic expansion and acted as an important source of support for equity prices.

Yesterday's report examined the key takeaways from the third-quarter reporting season and analyzed whether the strong performance of corporate profits will continue in the coming quarters.

Table 2 Analysts' Forecasts Imply Aggressive Profit Margin Expansion

S&P 500	2023	Consensus Forecasts 2024	2025	2026
Earnings/Share	$217	$236	$270	$305
Growth		*8.8%*	*14.4%*	*13.0%*
Sales/Share	$1,812	$1,899	$2,004	$2,128
Growth		*4.8%*	*5.5%*	*6.2%*
Profit Margin	12.0%	12.4%	13.5%	14.3%
Change (bps)		*40*	$\boxed{110}$	$\boxed{80}$!!

Source: Refinitiv I/B/E/S Global Aggregates mrb partners © 11/2024

Highlights included:

- ❍ S&P 500 companies delivered solid earnings in the third quarter, with a healthy number of index members beating top- and bottom-line estimates.
- ❍ Corporate profits were supported by sturdy revenue growth of more than 5%, reflecting the ongoing strength of the economy.
- ❍ Communication services and technology topped the list of sectors with the best earnings growth, while the energy, materials, and industrial sectors saw their profits contract.
- ❍ Our constructive economic stance implies that the overall earnings outlook remains positive.
- ❍ However, consensus profit expectations for 2025 are aggressive and earnings estimates are likely to adjust to more reasonable levels, especially if the U.S. dollar strengthens further, and uncertainty about the policy priorities of the incoming Trump Administration persists (**table 2**).

Consensus profit expectations for 2025 are aggressive, and earnings estimates are likely to adjust to more reasonable levels

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