Self-Regulating Markets And The Trump Factor

- The rise in real bond yields and the dollar reflects underlying economic trends. Capital markets are self-regulating in the face of a perfect U.S. macro landing, the Trump agenda and a bleak growth outlook abroad.

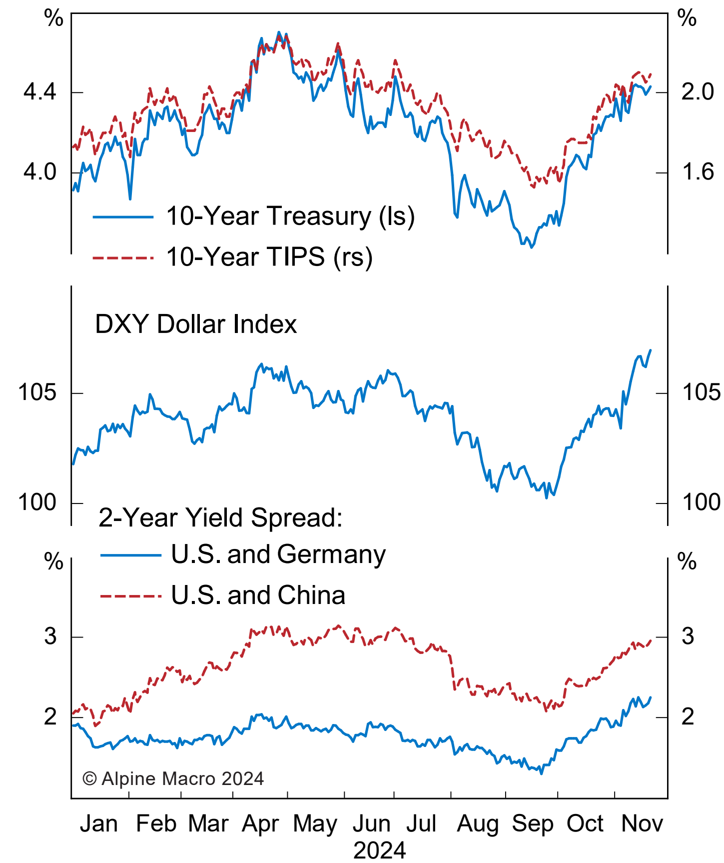
- The widening U.S. current account deficit reflects plentiful savings in the rest of the world. The U.S. consumer remains the only game in town.

- Stay at benchmark bond duration, initiated on August 5 after 10-year yields dropped to 3.8%. Boost duration if yields spike above 4.75%.

- Upside Q3 earnings surprises fit with our equity overweight versus bonds. Big Tech continues to have bubble potential but equity volatility will rise with the Fed becoming less dovish.

- Crude prices have downside. No rush to over-weight conventional energy stocks.

Chart 1 Self-Regulating Market Forces



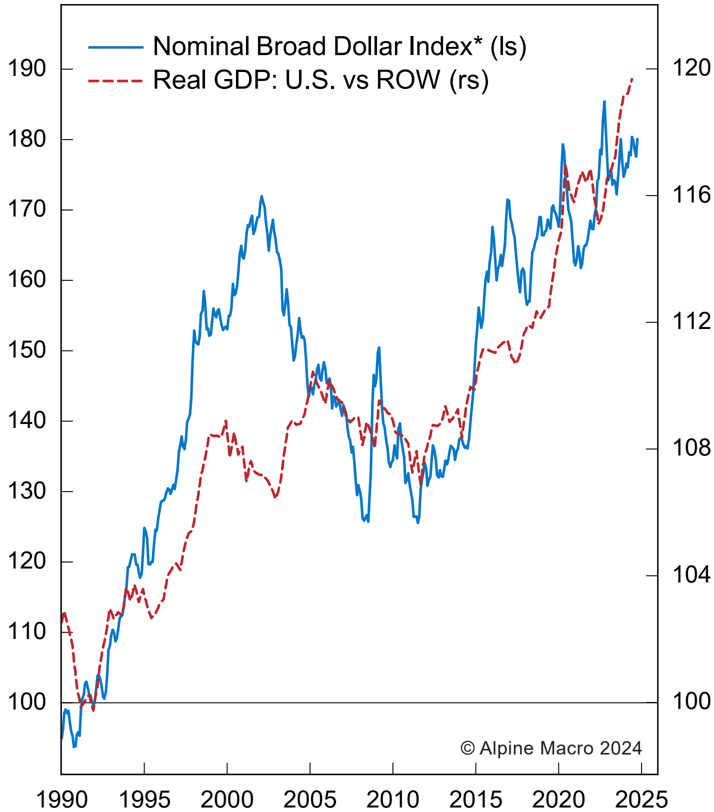
Theme 1

Self-Regulating Markets

Chart 1 shows that bond yields, especially their real component, and the dollar have been on a one-way upward tear since October. The Trump agenda, discussed in recent Alpine Macro reports and webcasts,[1] plays a role given the economic benefits from deregulation and corporate tax cuts, as well as the protection to domestic producers through tariff increases. However, the incoming President will inherit an economy that is on a perfect macro

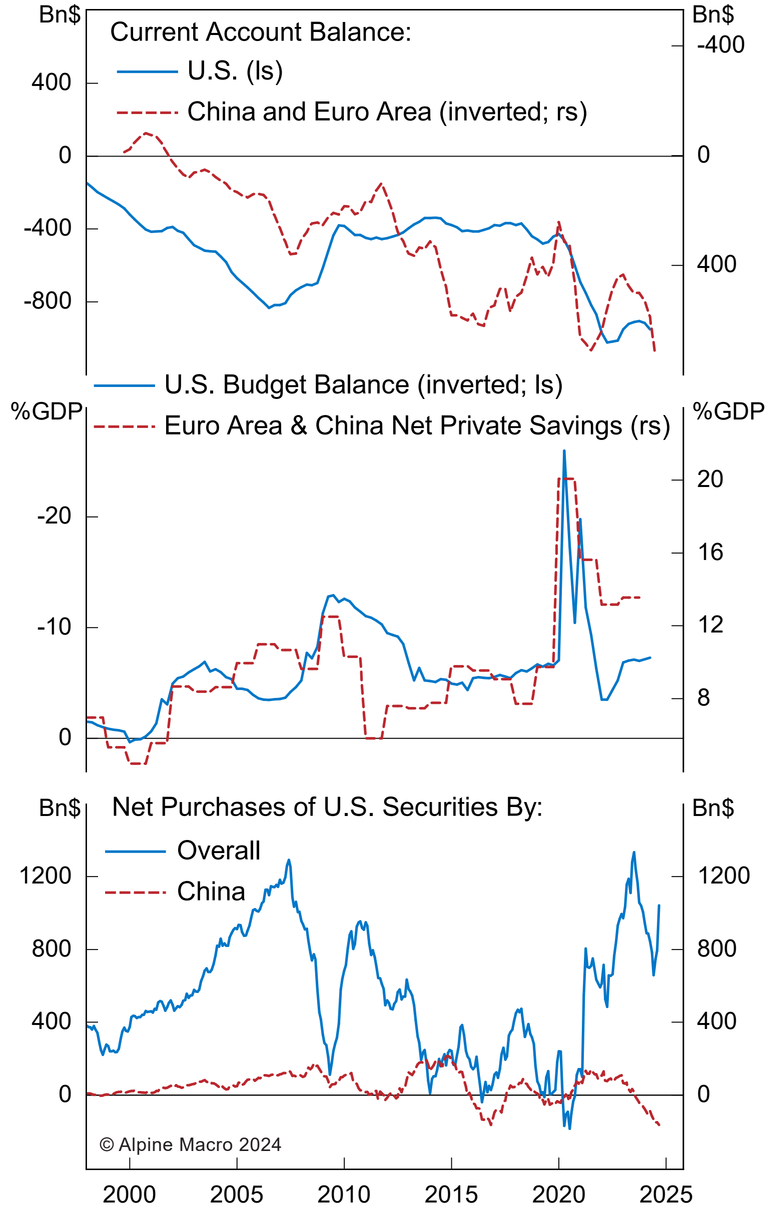
1 Alpine Macro *Global Strategy* "Trump Trade, Fed Policy And Investment Strategy" (November 11, 2024), *Geopolitical Strategy* "United States: Trump's Comeback – Brace For Headlines, Expect Policy Surprises" (November 7, 2024) and *Webcast* "Sizing Up Policy Shifts and Market Implications in the Wake of U.S. Elections" (November 13, 2024).

Chart 2 Global Divergences = Higher Dollar



*Source: Federal Reserve
Note: Both series are rebased to Q1 1992=100

Chart 3 Current Account Deficit Reflects Dollar-Bullish Reality



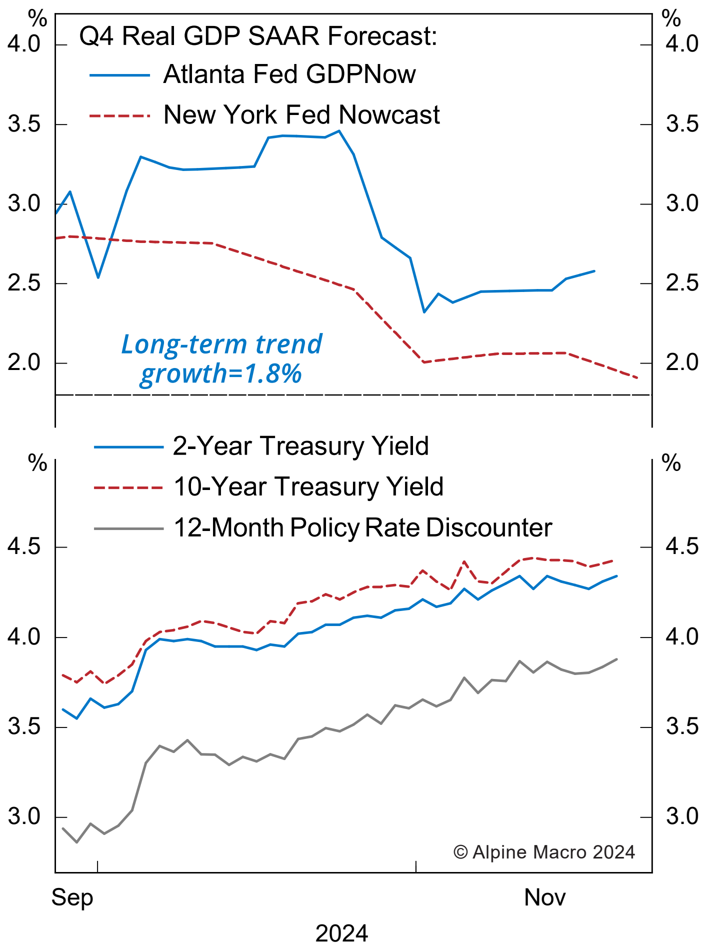
landing path that allows for Fed rate cuts even though the odds of recession are low.

The rally in Trump-sensitive risk assets, including equities, has gotten ahead of itself. Nevertheless, strategy must also take into account the self-regulating nature of capital markets in the face of U.S. resilience relative to ailing major economies elsewhere. The path of least resistance will be high real bond yields and a firm dollar, which, in turn, warns against expecting a hawkish Fed pivot unless the current macro backdrop changes. More specifically:

- **U.S./Rest of world (ROW) growth divergence**: The dollar moves closely in line with relative U.S./ROW real GDP, which has been in a well-established uptrend over the past decade, after having been flat in the previous 15 years (**Chart 2**).

- **Dollar-bullish U.S. current account deficit:** The near-record U.S. deficit is the flipside of a record combined China and euro area current account surplus (**Chart 3**). The main driver is prolonged

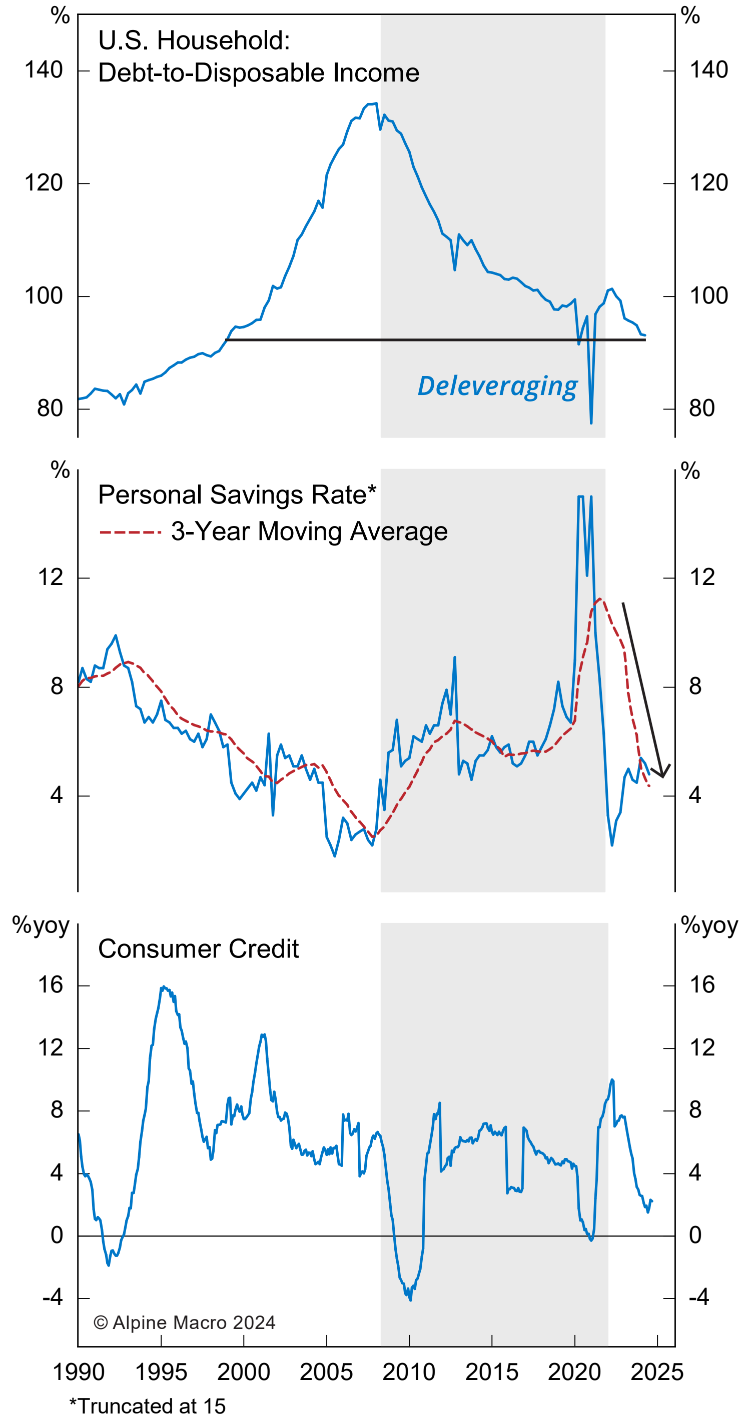
Chart 4 Tracking Another Above-Trend Quarter



upward pressure on ROW private savings, which far exceeds the U.S. budget deficit, and lower interest rates abroad. One corollary is that total net foreign purchases of U.S. securities exceed $1 trillion, even though China is an increasing net seller.

- **U.S. economy still tracking above trend:** Atlanta and NY Fed GDP trackers both project Q4 growth above the long-term trend of 1.8%. This is despite the earlier extended monetary tightening cycle and recent recovery in short-term and long-term yields (**Chart 4**).

Chart 5 U.S. Consumer Can Spend



- **Lack of consumer vulnerability:** The U.S. consumer is well-positioned to absorb excess supply abroad. **Chart 5** provides evidence that the post-GFC retrenchment is over, although there is also no sign of releveraging: household debt burdens are manageable; the personal savings rate is off the bottom but remains low by historical standards; and consumers have not gone on a credit binge since before the GFC.

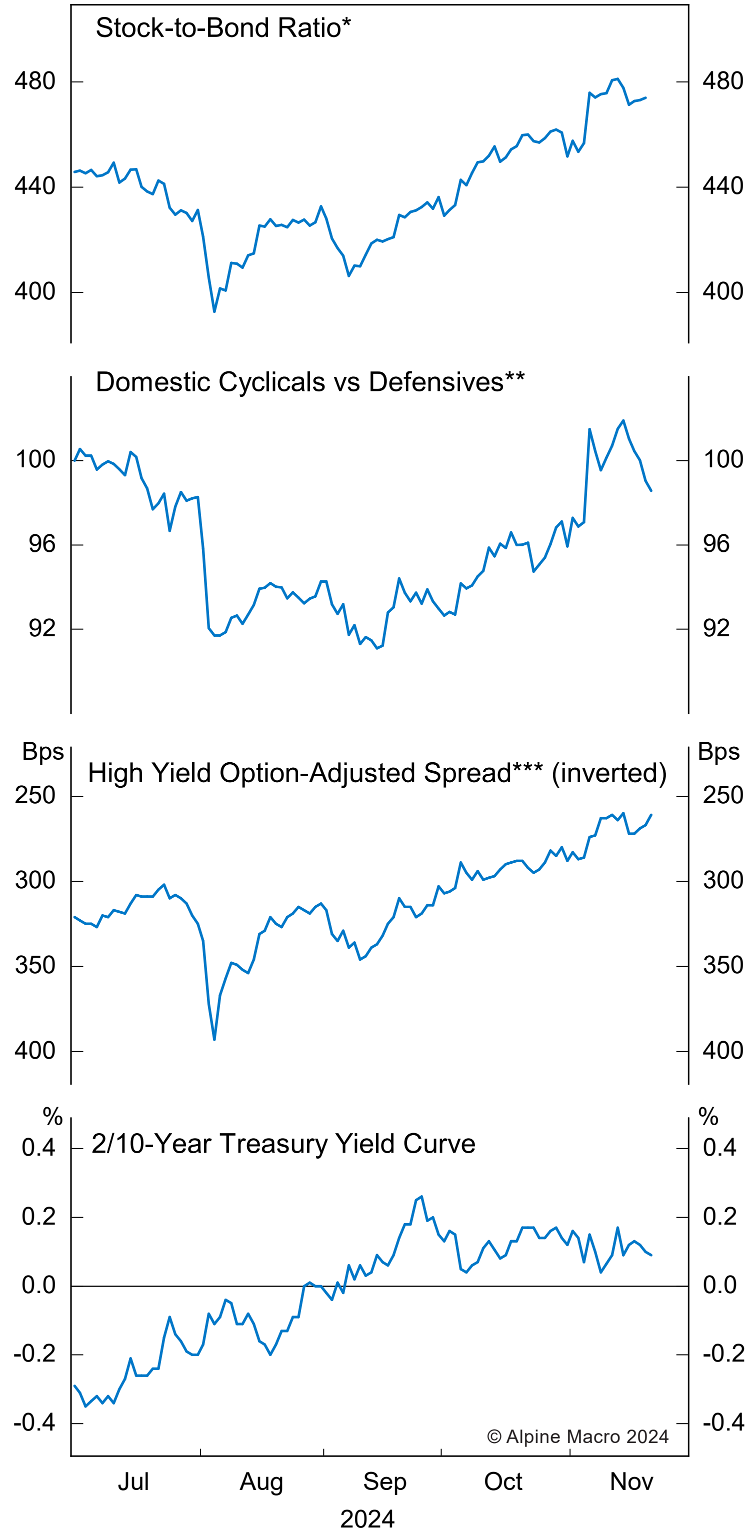
- **Tariffs benefit the dollar:** The latest report from our *Global Fixed Income & FX Strategy* service makes the case that tariffs will be dollar bullish.[2] ROW firms still need to sell into the U.S.

- **Markets not signalling a recession**: Traditional capital market indicators that are sensitive to the business cycle are holding steady despite the backup in interest rates (**Chart 6**). Stocks are outperforming bonds. Domestic-oriented cyclical stocks are not much below 2024 highs relative to their defensive counterparts. Junk bond spreads are holding tight (shown inverted). The yield curve remains sloped upward.

All in all, the post-Trump victory environment remains consistent with our baseline scenario of "macro calm": an expanding economy, subdued inflation and moderate rate cuts. However, the potential for supply-side reforms that would boost business confidence and profits skews the balance of risks on the side of higher growth and away from recession.

We are monitoring labor markets particularly closely. Leading employment and wage indicators have been trending lower this year, but that downtrend may be bottoming. Average hourly earnings growth has stabilized around 4% since April; unit

Chart 6 No Recession Warning From Markets



*S&P 500 total returns divided by 10-year Treasury total returns
**Rebased to Jul 2024=100; source: Bloomberg Finance L.P., Goldman Sachs
***Source: BofA Merrill Lynch

2 Alpine Macro *Global Fixed Income & FX Strategy* "Tariffs, The Trade Deficit, The Dollar & Inflation" (November 22, 2024).

Chart 7 Wages Should Soften Further

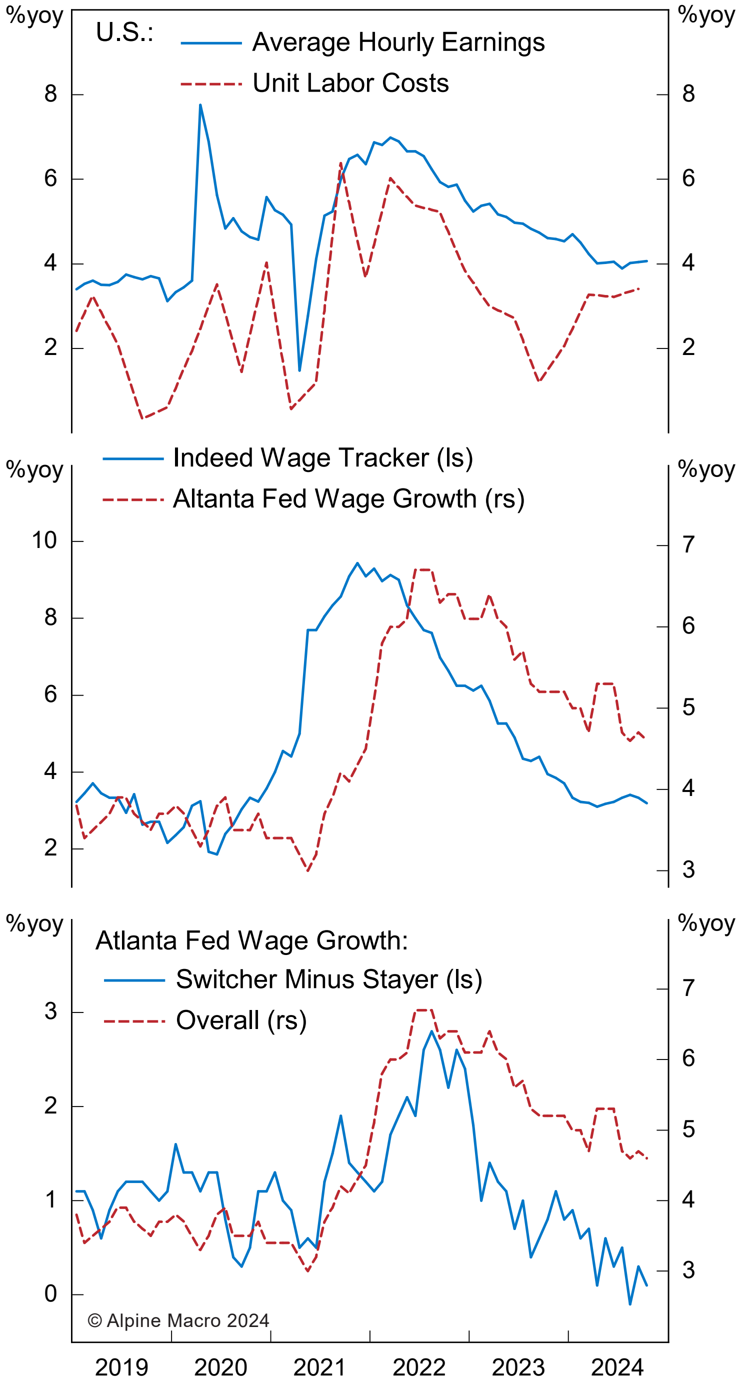
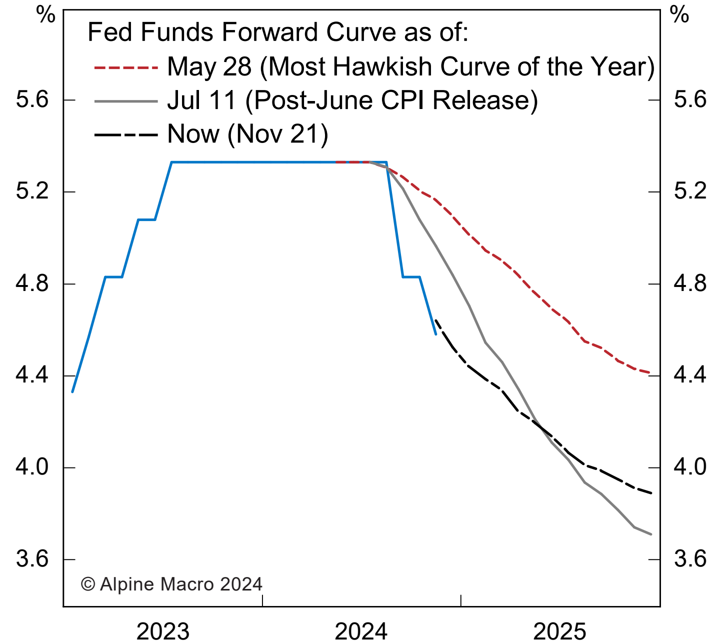


Chart 8 Paring Back Expected Rate Cuts



labor costs were recently revised upwards; and the Indeed Wage Tracker has also stopped falling (**Chart 7**). This measure led the mid-2021 trough in the Atlanta Fed measure by nearly a year.

Bottom line: Upward pressure on global savings will underpin yields and the dollar, while keeping the U.S. economy between boom and bust. The U.S. consumer remains the "only game in town". Money market expectations of 66 bps of easing by December 2025 are "about right" (see next **Theme**).

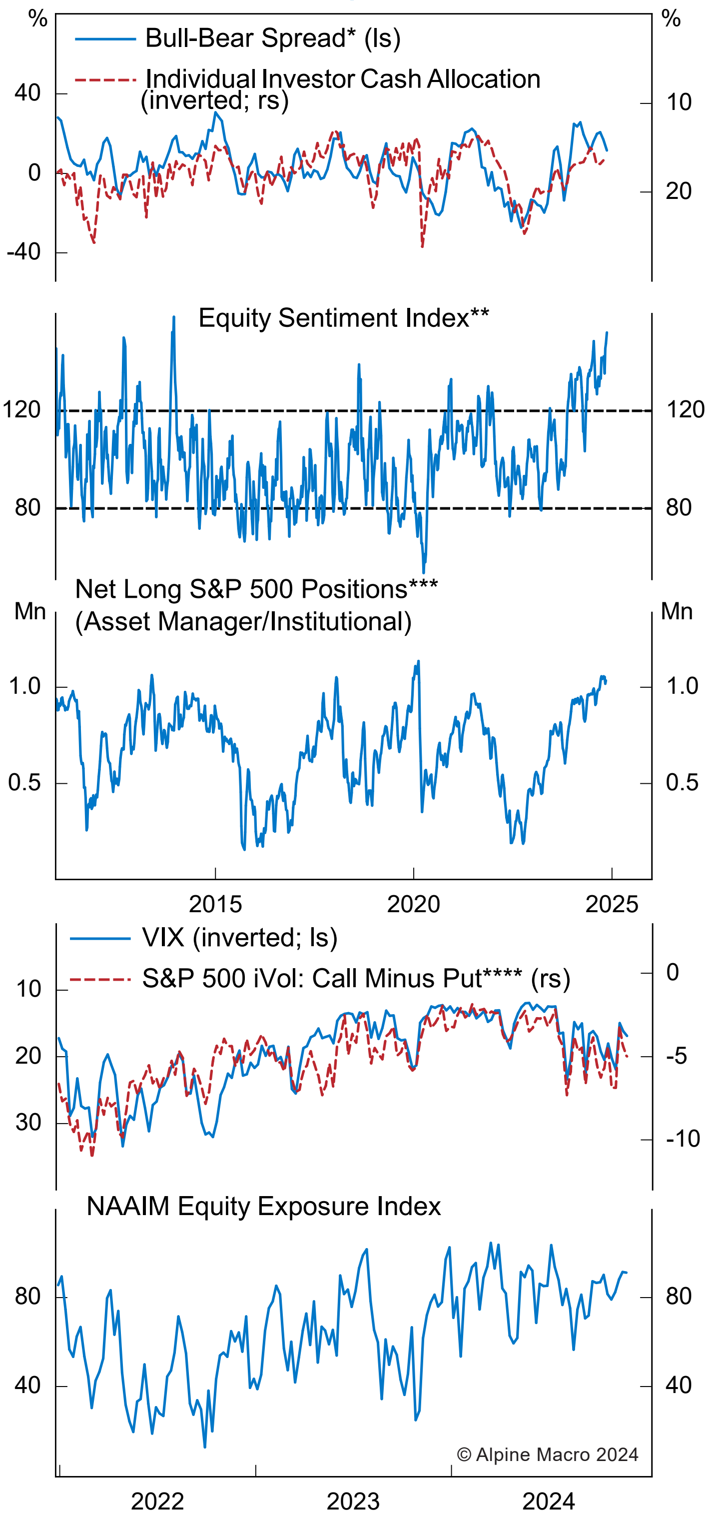
Don't agree

Theme 2

Volatile Equity Uptrend

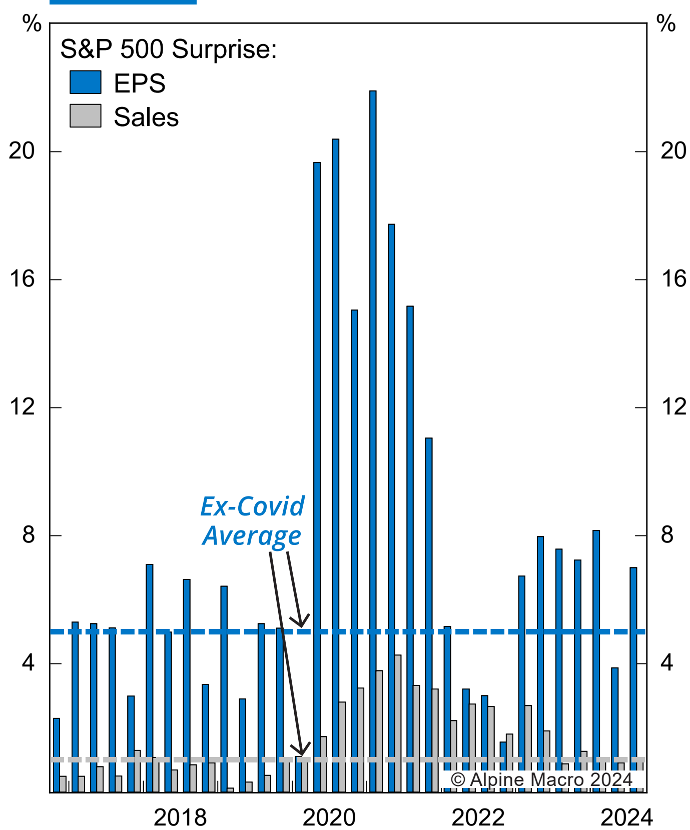
Our baseline forecast of macro calm and Fed rate cuts justifies our bullishness on equities and overweight *vis-à-vis* bonds. However, it does not imply low equity volatility as investors pare back expected monetary stimulus, which in turn limits the potential for earnings multiple expansion. Expectations of bigger Fed rate cuts by December 2025 would require economic disappointment, which would undermine earnings prospects (**Chart 8**).

Chart 9 Equities Overbought After Trump Boost



*Shown as 3-month moving average; source: AAII
**Shown as 4-week moving average; source: ISE
***Shown as 2-week moving average; source: CFTC
****25-Delta 2nd month contract; source: Bloomberg Finance L.P.

Chart 10 Upside Q3 Profit Surprises

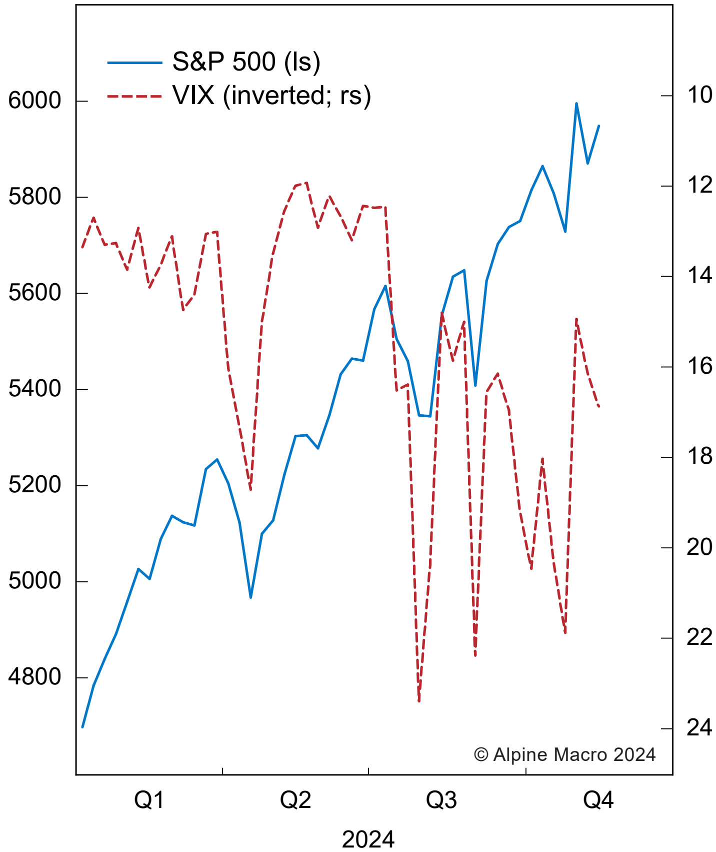


Note: Horizontal dotted lines denote averages; source: Bloomberg Finance L.P.

Short-term, a correction could come at any time, although it will be difficult to time. The broad equity market is overbought on a wide range of measures (**Chart 9**). That includes everything from low individual investor cash allocations to net long S&P 500 institutional positions flirting with a 15-year high.

The bigger issue is whether or not the underlying equity uptrend will persist, and how to generate alpha. We believe the bull market is intact and that Big Tech remains attractive but so do small caps. Q3 profit surprises were to the upside, even without the benefit of business-friendly Trump policies that lie ahead (**Chart 10**). The upside surprises were even larger for small caps.

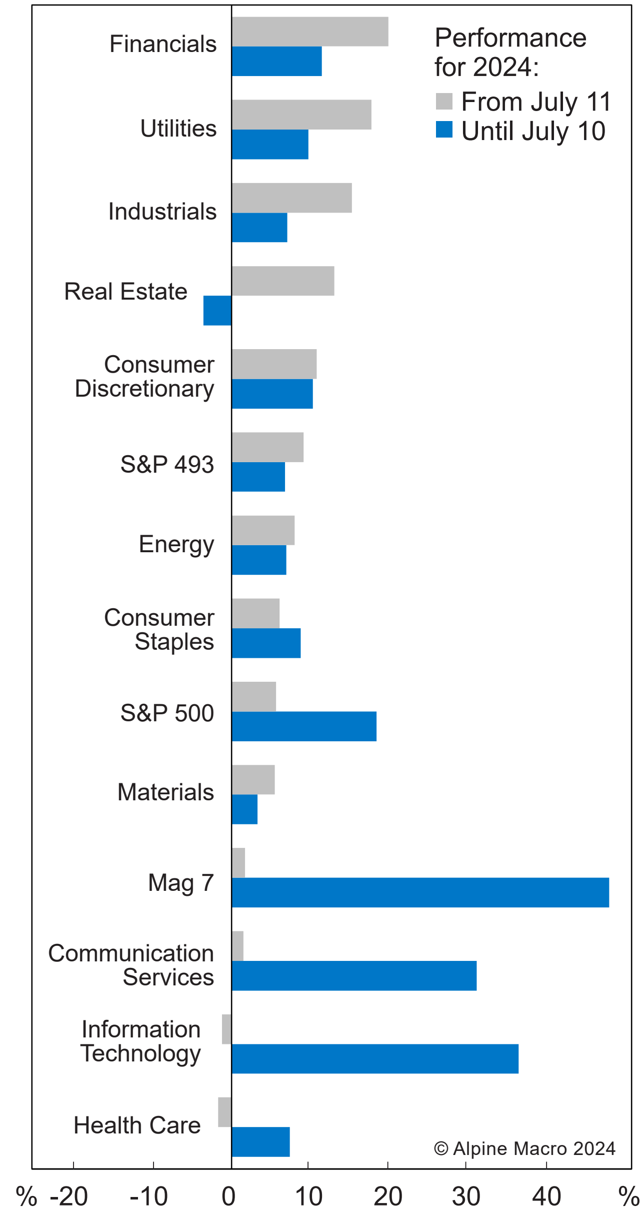
Chart 11 Equity Volatility Headed Higher?



These crosscurrents allow for a rare combination of increasing equity volatility and market breadth. The equity VIX usually is the mirror image of the S&P 500 index, but the recent higher VIX range of 16-22 (**Chart 11**, shown inverted) seems appropriate given the S&P 500 Forward P/E ratio of 25, flat bond yields and moderate Fed easing.

An overshoot in Big Tech stocks cannot be ruled out, as we have argued in previous reports.[3] **Chart 12** shows the change in equity leadership since mid-July as inflation moved lower but economic growth surprised to the upside. Since then, the Mag 7 tech stocks have risen in absolute terms but lagged the rest of the market ("S&P 493"), especially cyclicals and interest-rate-sensitive

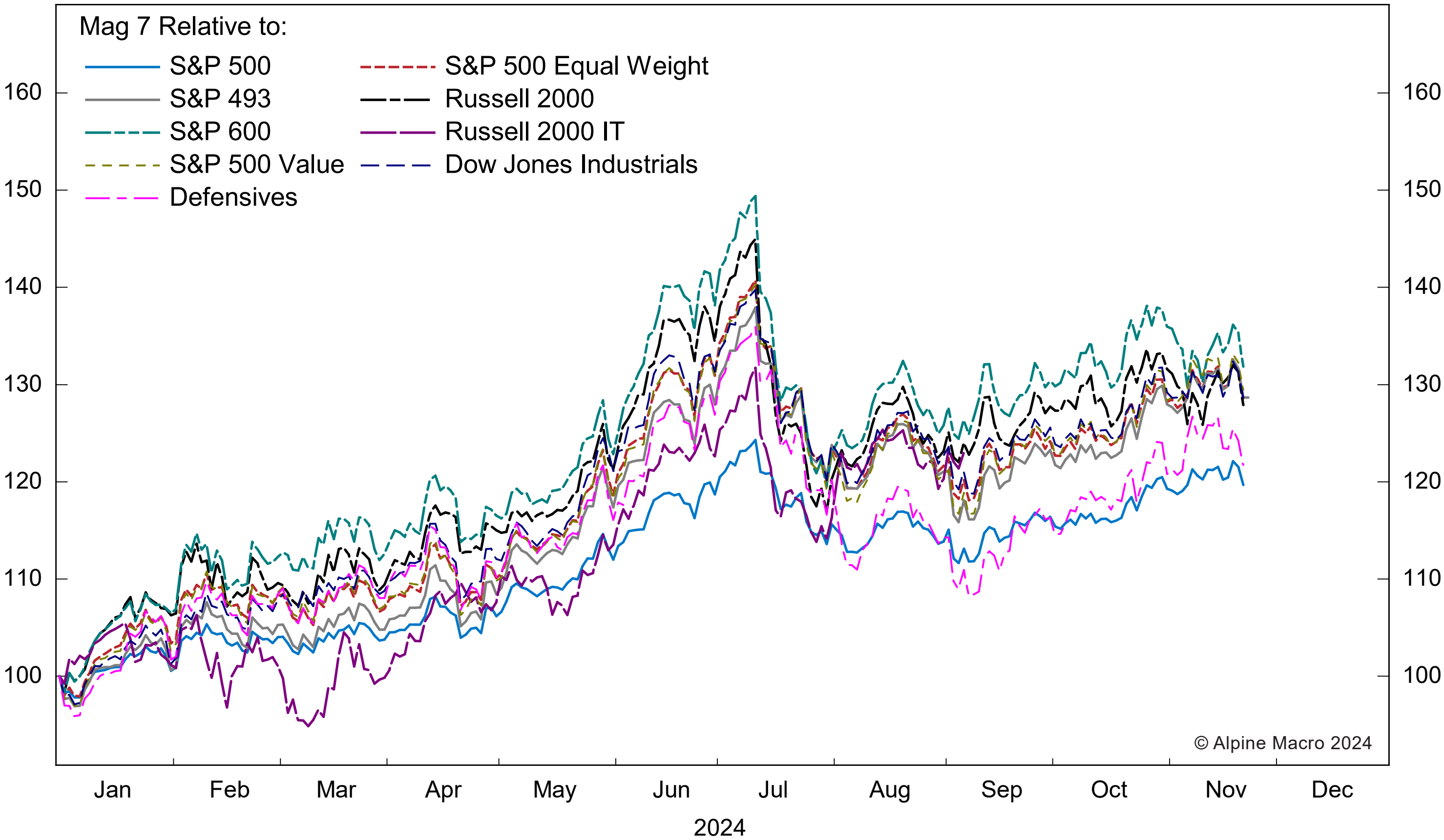
Chart 12 Tech Has Lagged Since July



defensive sectors. More recently, however, Mag 7 have held up against "almost everything else" (**Chart 13**). Underlying fundamentals remained impressive in Q3 for these stocks.

3 Alpine Macro *Monthly Special Reports* "Mania Roadmap: AI And Macro Drivers" (April 17, 2024) and "Magnificent 7: Potential Mania Waiting For A Catalyst" (November 17, 2023).

Chart 13 Mag 7 Holding Up Versus Rest Of Market Lately



Note: All series are rebased to Jan 2024=100

Bottom line: The equity uptrend will persist and broaden into 2025 on the back of business-friendly policies, continued macro calm and Fed rate cuts. Nevertheless, Wednesday's *Special Report* will make the case for increased volatility with both multiples and profit margins unlikely to expand much.

Theme 3

Trump, Energy Stocks And Prices

Market expectations of a "Drill Baby Drill" Trump policy have given energy stocks a boost above their tight historical correlation with crude prices (**Charts 14** and **15**). This "Trump bump" is well advanced at a time when the balance of risks to crude prices is to the downside:

- **China demand/U.S. supply:** **Chart 16** shows the ratio of Chinese oil demand to U.S. crude output. This ratio tends to lead cyclical oil price swings. China is the marginal buyer of the world's oil, while the U.S. is the marginal supplier outside the OPEC cartel. The ratio is close to its low point of the past decade.

- **OPEC oil glut:** Global spare capacity of oil supply is estimated by the IEA to be nearly 7 million barrels/day (mbd), just below a multi-decade high.

Chart 14 A Trump Trade

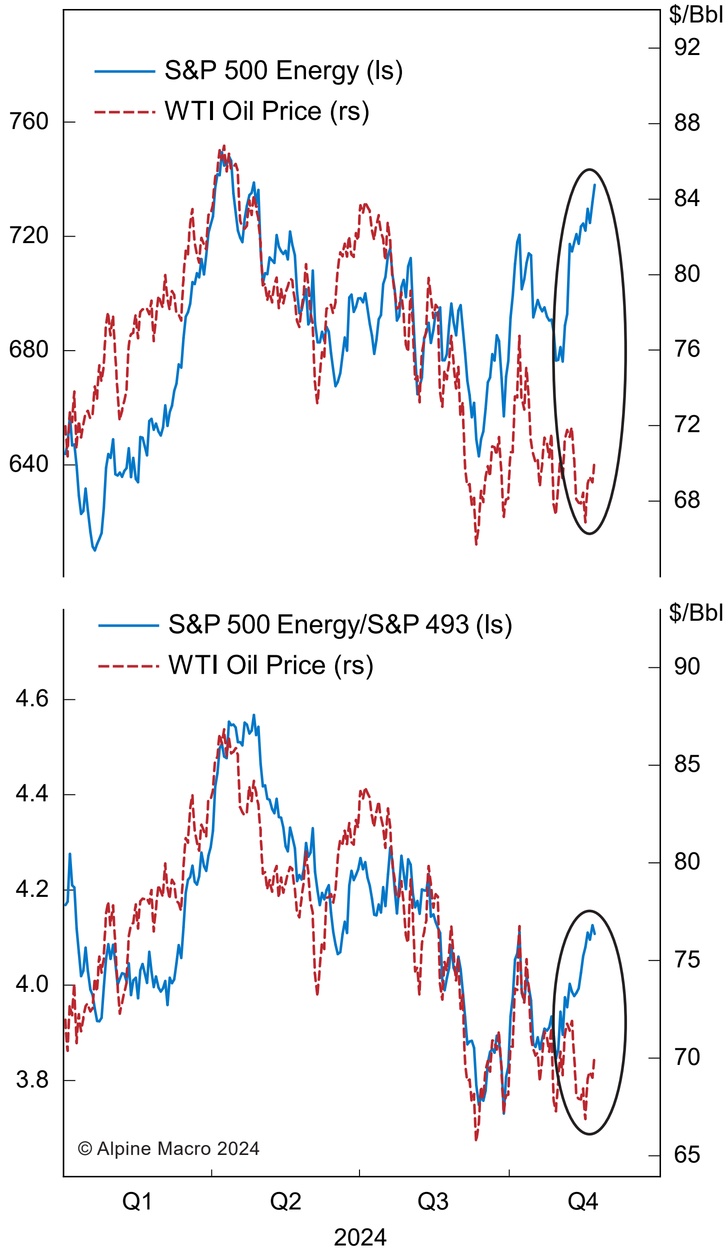
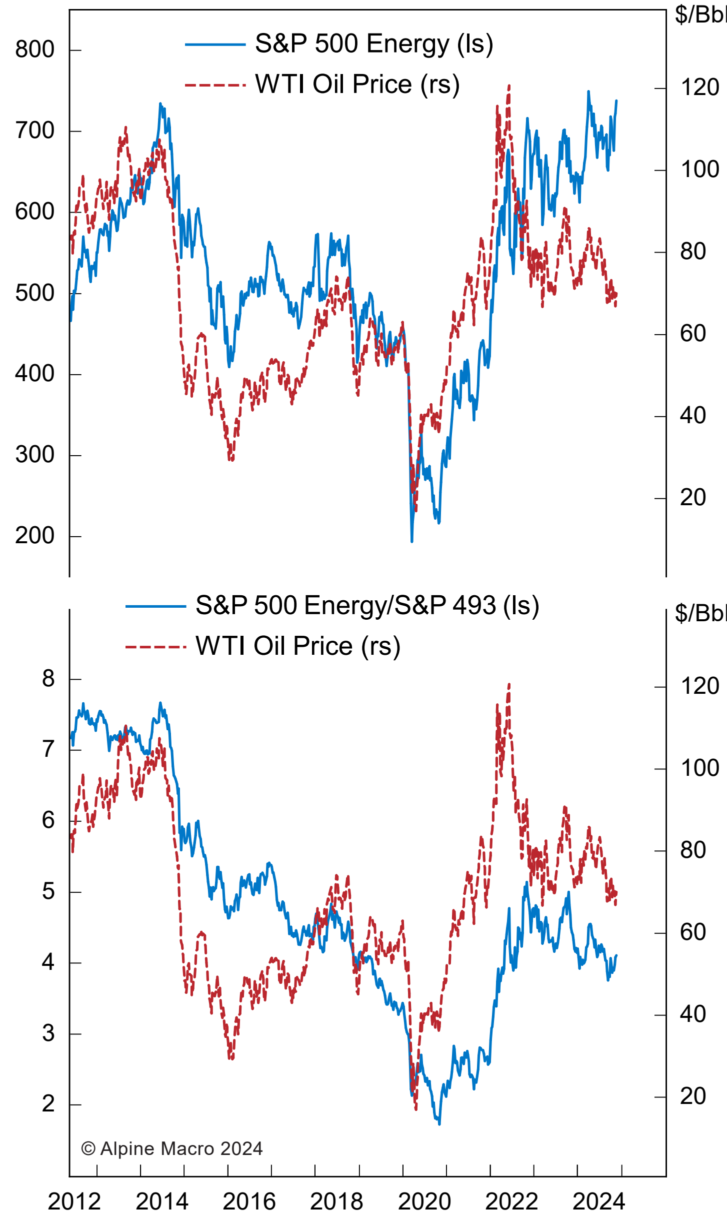


Chart 15 Energy Stocks Vs Crude Prices

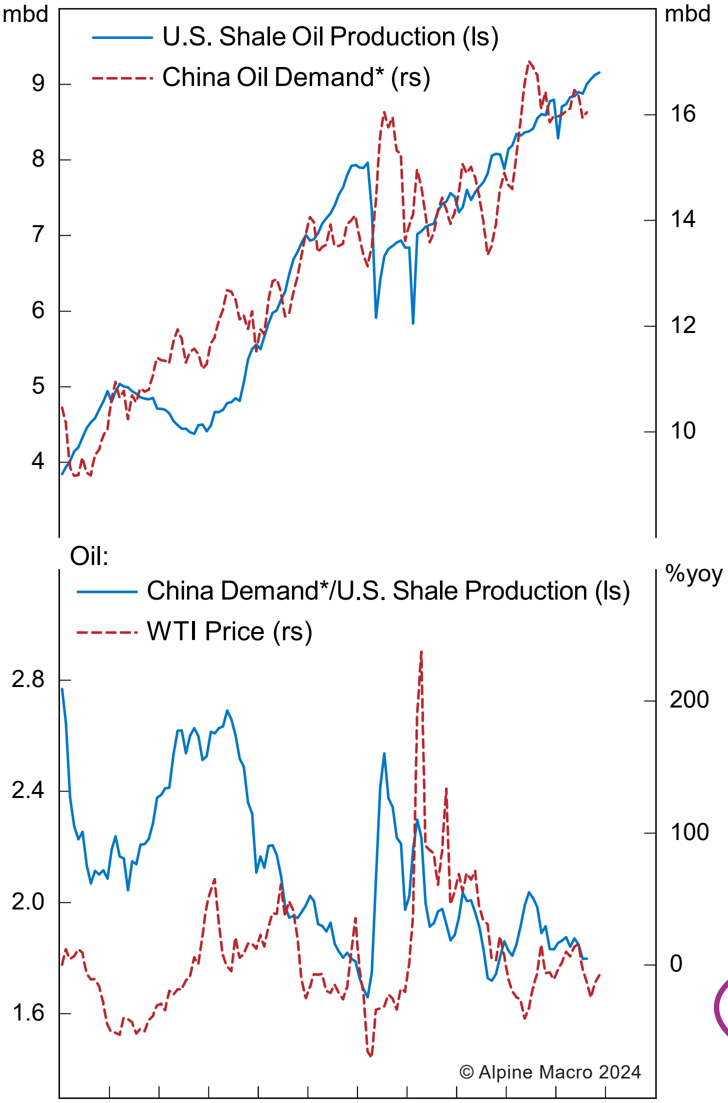


- **Pressure on Iran:** Iran has been unable to re-establish deterrence after Israel degraded both Hezbollah and Iranian military capabilities. Prospects for an incoming hawkish U.S. administration could convince Iran to push for peace in 2025, although this is not a time to be dogmatic.

  Game theory also allows for desperate actions to restore deterrence. A miscalculation could lead to Iran lashing out, resulting in a violent oil spike.

Granted, the Trump administration will restore sanctions on Iranian oil, which will reduce exports. Nevertheless, this alone will not move the needle

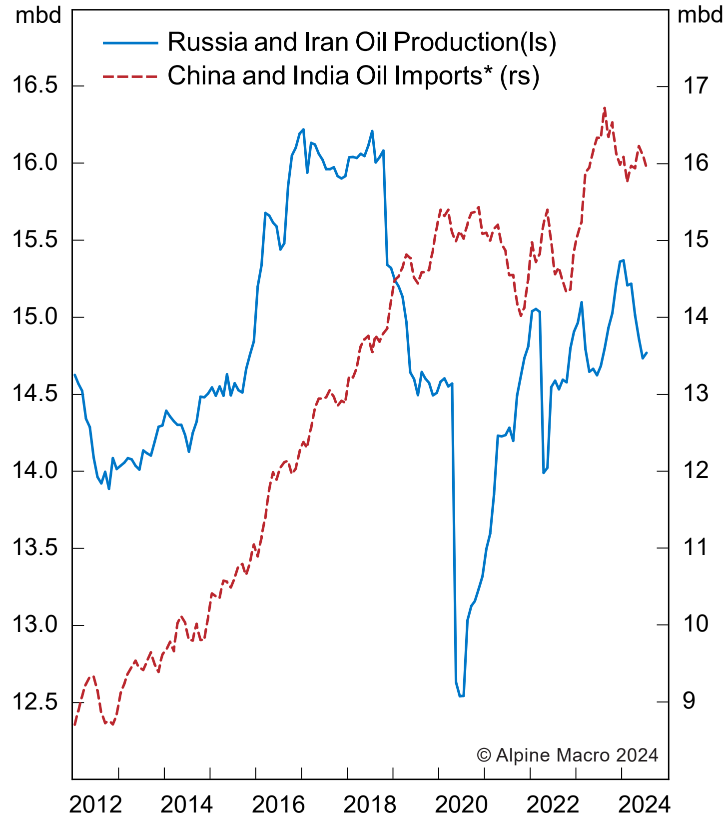
Chart 16 Weak China Demand/ U.S. Supply Ratio



*Shown as 3-month moving average
Source: EIA, JODI

on the global energy supply/demand balance. When the Joint Comprehensive Plan of Action (JCPOA) nuclear deal with Iran was suspended in 2018 by President Trump in favor of a "maximum pressure" approach, Iran's oil production fell from 4.9 mbd to 2.9 mbd. This time around, production is about 4.4 mbd, and Iran appears to have become smarter at skirting sanctions. On balance,

Chart 17 Could This Change In 2025?



*Shown as 6-month moving average

new sanctions would only remove about 1 mbd of supply, roughly 1% of world daily oil output.

The upside risks to oil prices would increase if Russian and Iranian sanctions became more effective and/or their main buyers, China and India, boosted demand. **Chart 17** shows that this is not currently the case. Russian plus Iranian production has held up between 12 and 13 mbd since 2021, while Chinese plus Indian imports have lost momentum since the straight-line uptrend that preceded the pandemic. Stay tuned.

Our baseline expectation of a grind lower in oil prices fits with our view that bonds are in the middle of a trading range, even though risks of a U.S. recession are low. Bond market inflation expectations from 1-year CPI swaps to 5-year/5-year forward inflation breakevens closely correlate with oil prices (Chart 18). Ergo, bonds are unlikely to have a sustained selloff if oil continues to trade flat to lower.

Bottom line: The Trump boost to energy stocks is well advanced. Global excess oil supply justifies waiting for a better entry point to go overweight on a 12-18 month horizon.

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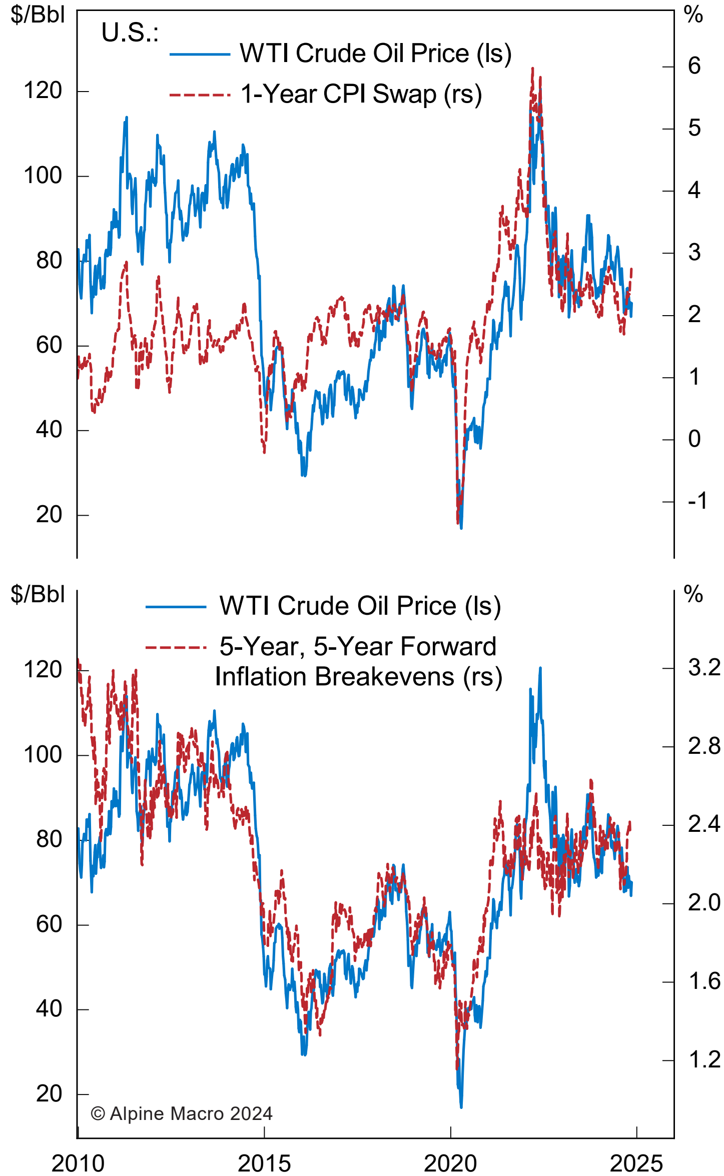
Chart 18 Sharp Oil Drop Would Keep Inflation Tame



A Unique Mind On The Markets