MacroResearchBoard
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Independent Investment Strategy
WEEKLY
MACRO STRATEGY
November 29, 2024

Beware The Bite, Not The Bark

- It is premature to bet against the U.S. economy or position for a protectionist-induced global recession. The former still has solid momentum, especially in terms of consumption.
- The rush into U.S. asset markets may continue in the near term, although technical conditions are becoming stretched. Conversely, investors may continue to avoid non-U.S. assets and currencies given the threats of new U.S. trade tariffs.
- DM central banks will ease further in the near run, but are likely to stop at some point in 2025 if, as we expect, growth firms and domestic inflation proves sticky and holds above target levels.
- The implication is that upward pressure on bond yields will build in 2025, acting as a brake on risk asset markets, and eventually triggering a broad risk-off phase when Treasury yields break out to new cyclical highs.

Global financial markets are still digesting the U.S. election result and the predicable tweetstorm from President-elect Trump, with the opening round of what promises to be a long game of ***threatened*** trade tariffs and restrictions this week. This, in turn, has reinforced investment flows into U.S. asset markets and away from non-U.S. equities and currencies (**chart 1**).

Investors need to be prepared for higher volatility and occasional bouts of risk-off whenever aggressive protectionist actions are threatened. This was the pattern during Trump's first term and will be repeated. Aside from a lot of noise, the key question is whether he will risk triggering a global recession with contagion onto the U.S., or judiciously back off when significant economic damage looms?

We are currently positioned for him ultimately backing off even though we expect some meaningful tariffs. That said, we are not dogmatic and will make meaningful portfolio changes if needed. The tail risk of damaging protectionism could occur and, thus, necessitate large positioning changes.

Still, we would remind readers of what occurred during Trump 1.0 when, despite a lot of threats, the net result was modest and came up short of what was "promised". For instance, despite maximum barking about constructing a Mexican Wall to prevent illegal immigration and making its North American partner pay for the wall, the actual outcome came up considerably short of the stated objectives (and the southern border remains porous).

In other words, expect a lot of barking and considerably less "biting", at least in terms of his economic policies. This is not to say that little will occur, and any radical agenda always risks unintended consequences. Protectionist actions last decade caused global trade to contract and meaningfully slowed the U.S. economy, forcing the Fed to reverse course and cut rates.

Importantly, Trump stopped escalating the protectionist threats and additional tariffs once the financial markets signaled that his policies risked

Chart 1 The Pro-U.S. (Assets) Trump Effect

* U.S. dollars; rebased to January 2024; source: MSCI
** Source: Bloomberg

going too far and other countries retaliated: equities corrected sharply and credit spreads widened.

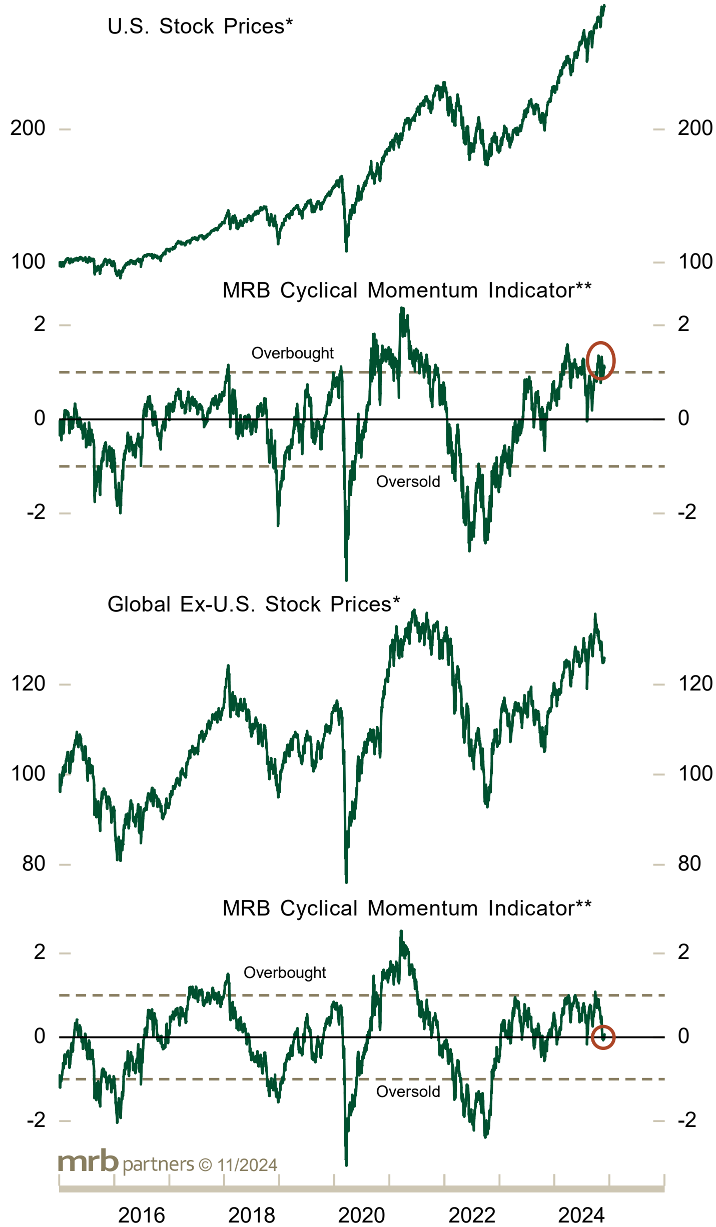
It promises to be a noisy next four years, but it is premature to bet on either a never-ending economic boom or a protectionist-induced bust. Note: this week's **MRB *Webinar*** examined the biggest trade clash, namely between the U.S. and China (see page 7).

In the near run, the pro-U.S. investment landscape may well persist, with few investors willing to take a contrary bet and rush into non-U.S. equity and FX markets. Investors are still keen to discount the economic and earnings positives for the U.S. from a Trump Administration (tax cuts, de-regulation), but not yet the potential risks.

On a 6-12 month horizon, we remain positioned for ongoing robust U.S. economic growth and a gradual improvement in most non-U.S. economies. DM policy rates will continue to decline providing support to many currently sluggish economies. Energy prices have defied the heightened geopolitical backdrop and held at (low) pro-growth levels.

There are some pockets of weakness, primarily in global manufacturing, but this has been more than offset by growth in service sectors and overall final demand, particularly in the U.S.

Chart 2 U.S. Stocks Are Overbought, Non-U.S. Stocks Are Not



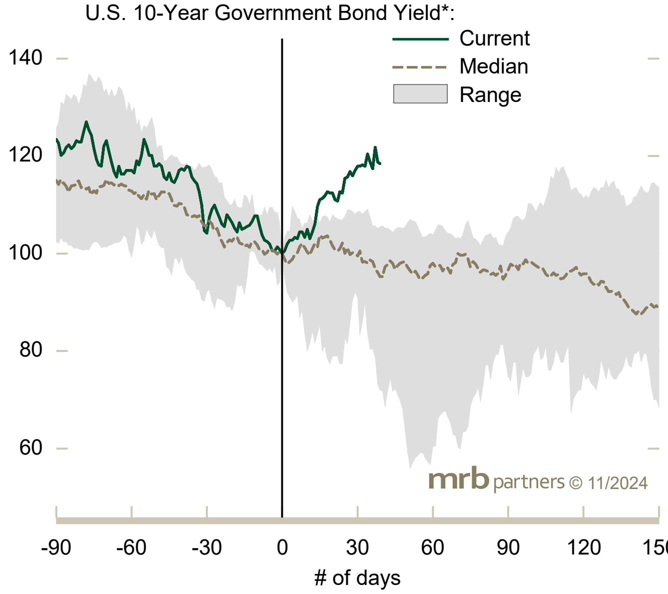
* U.S. dollars; rebased; source: MSCI
** Standardized

We will update our multi-asset recommendations in next Friday's **MRB *Asset Allocation Strategy***. We are long equities over bonds, and favor credit within fixed-income portfolios, despite already historically tight spreads. Bond markets are overdue for a consolidation, but it will only be a brief reprieve as we expect more yield upside before the cycle ends, especially in the U.S. (see page 8).

U.S. equities are becoming overbought, but will benefit from rising corporate earnings

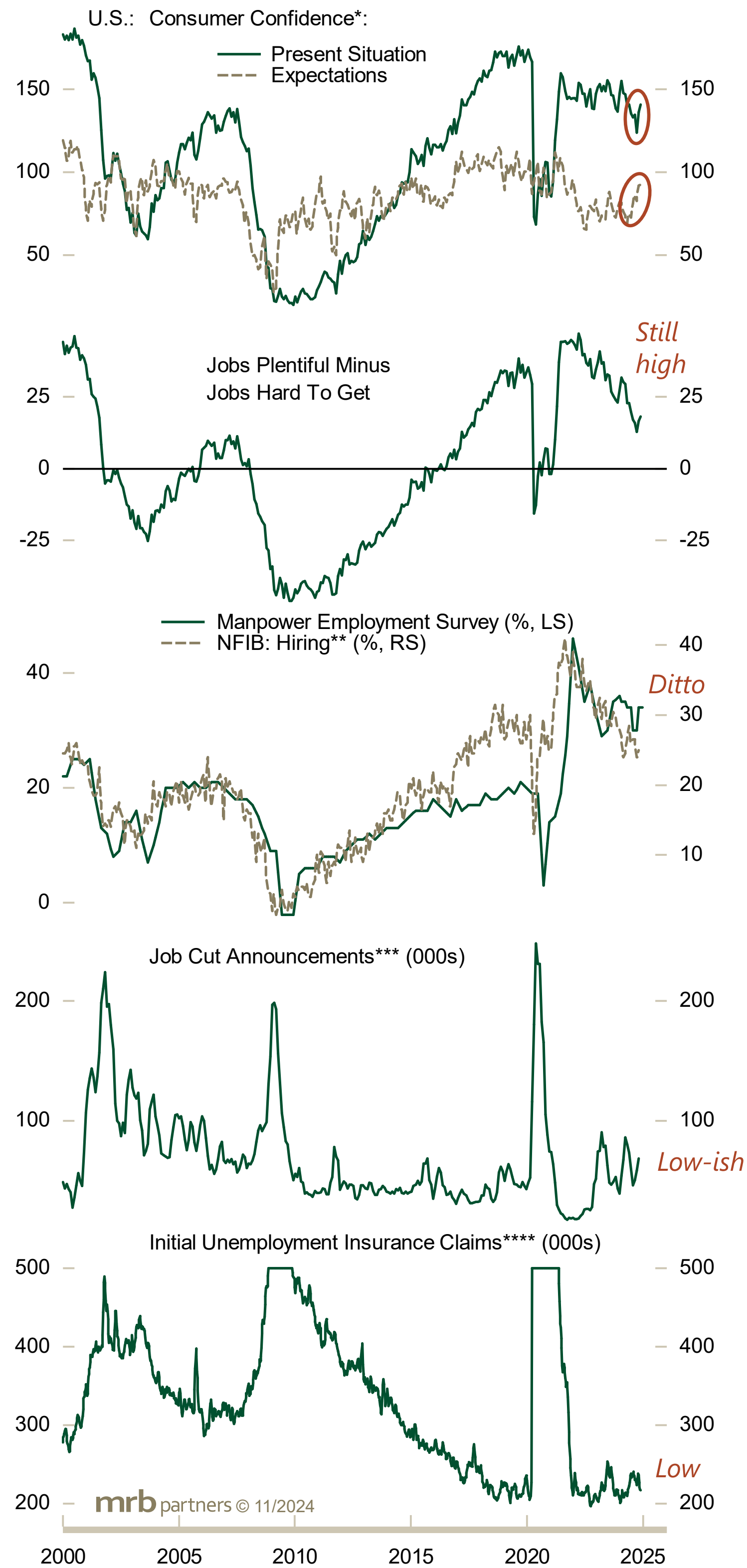
U.S. equities are stretched in valuation terms and becoming overbought (**chart 2**). Still, barring an overshoot in Treasury yields, stocks are likely to remain well supported by rising corporate earnings.

Chart 3 **Treasury Yields Are Bucking The Typical Fed Easing Cycle**



* Rebased to first Fed rate cut since 1995=100; source: Bloomberg

Chart 4 **U.S. Consumers: Below Peak Readings, But Still In Solid Shape**



* Source: The Conference Board
** Average of hiring plans and job openings; source: National Federation of Independent Business
*** Smoothed; truncated above 260,000; source: Challenger, Gray & Christmas
**** Truncated above 500,000; smoothed; source: U.S. Employment and Training Administration

Ironically, U.S. equity prices may have the most downside on a global basis if investors start to fear significant economic fallout from protectionism. This is because, in contrast with the overbought and pricy U.S. bourse, non-U.S. markets are unloved, and much more reasonably priced and far less stretched (**chart 2** also).

Absent trade policies that undermine the global and U.S. economic expansion, we expect sticky DM inflation to limit how far monetary conditions can be relaxed. In the case of the U.S., ***no*** rate cuts were warranted, as decisively signaled by the ongoing strength in risk asset markets, and the recent action in the Treasury market.

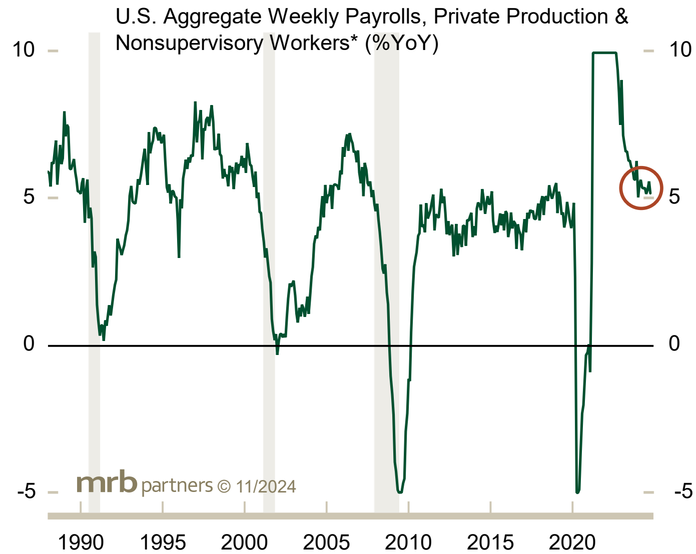
Chart 3 highlights the unprecedented rebound in Treasury yields since the Fed began its easing cycle[1]. This is a clear warning that the Fed is making a (dovish) mistake. The latter point was further supported by yet another round of sticky underlying inflation readings in this week's PCE data release.

[1] This outcome was not a surprise to MRB, see **MRB** "***Absolute Return Strategy: Sell The News***", August 29, 2024

While this was a light week for global economic data, the U.S. Conference Board (CB) consumer survey provided additional confirmation that consumption growth will remain solid and continue exceeding the economy's potential growth rate. Note: we examined the U.S. economic outlook in detail in a report this week (see page 9).

The CB present situation index rose further in November, and even the perennially lagging (and depressed) expectations index rose (**chart 4**, previous page). The strength of the U.S. labor market remains a key feature of this decade. While most gauges are well below their peak readings, they are still at historically elevated levels.

Chart 5 **U.S. Income Growth Is Historically Very Strong**



* Truncated above 10 and below -5; source: U.S. Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

A tight labor market and reasonably strong job security have manifested in solid U.S. wage gains and overall income growth (**chart 5**). The latter are well in excess of inflation, and thus supportive of consumption. Moreover, if mass deportations occur, then it will put further upward pressure on wage growth.

The strength of the U.S. labor market remains a key feature of this decade

The persistent worries about a looming U.S. recession since 2022, once the Fed started to raise rates meaningfully (from the absurd starting point of zero!), have been puzzling to MRB. The key drivers of growth have been overwhelmingly positive: rising corporate earnings, solid hiring plans and low layoffs, and healthy private sector balance sheets after last decade's deleveraging and aided by persistent asset inflation.

The unprecedented mountain of excess U.S. household savings built up during the pandemic is now mostly spent. However, ongoing strong income growth and rising household wealth bode positively for consumption, which continues to expand at a strong pace (**chart 6**).

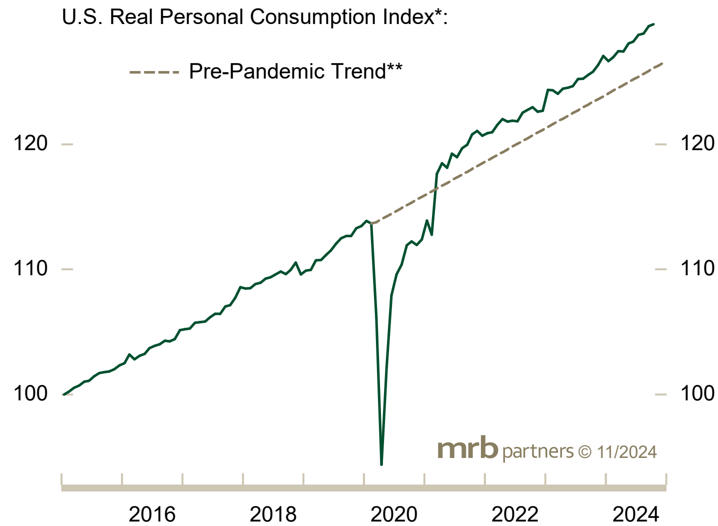
Ongoing strong income growth and rising household wealth bode positively for U.S. consumption

"Shorting" U.S. consumers has usually been a losing trade, especially in recent years. Who knows, perhaps another ***re***-leveraging phase might even take hold if confidence in the future returns and job security stays so supportive, providing a further boost in consumption.

Adding it up, there are some meaningful ***potential*** threats on the horizon, but it is far from certain that these risks will fully blossom. The U.S. economy currently has solid momentum and there are good prospects for global growth to gradually firm. In addition, upward pressure on DM bond yields should be limited for a while longer as central banks lower their policy rates.

However, the growing divergence between U.S. Treasury yields (up) and the fed funds rate (down) is a warning that the typical bond/rate relationships may not hold going forward. The rebound in Treasury yields alongside Fed easing is a warning that the central bank could lose control over the long end of the curve if it ignores ongoing economic resilience and a creeping up in inflation. At a minimum, in the next few months, investors will continue to unwind their expectations for meaningful U.S. rate cuts in 2025 and move towards pricing in a pause.

Chart 6 **U.S. Consumption Is Well Supported By Income And Balance Sheet Trends**



* Rebased to 2015; source: U.S. Bureau of Economic Analysis
** MRB calculation

Moreover, we expect sufficient global economic growth in 2025 to eventually cause many DM central banks to go on hold. At that point, sticky underlying DM inflation should cause upward pressure on bond yields to intensify. Eventually, this uptrend in yields will spur first a de-rating in equity markets and, later on, valid concerns regarding weaker future earnings. A decisive breakout of the U.S. 10-year Treasury yield above its October 2023 high could be such a catalyst.

Investors will continue to unwind their expectations for meaningful U.S. rate cuts in 2025, and move towards pricing in a pause

Final Word: *It is premature to bet against the U.S. economy or to position for a protectionist-induced global recession. Still, the threat of the latter is a major potential risk that must be monitored given President-elect Trump's track record in his first term, although he ultimately proved more bark than bite.*

The rush into U.S. asset markets may continue in the near term, although technical conditions are becoming stretched. Conversely, the avoidance of non-U.S. assets and currencies may persist given the threats of new U.S. trade tariffs.

There are good odds that DM central banks will go on hold beyond the next 3-6 months, as growth firms and domestic inflation proves sticky and holds above target levels. At that point, upward pressure on bond yields will build, acting as a brake on risk asset markets, and eventually triggering a broad risk-off phase when Treasury yields break out to new cyclical highs.

There are good odds that DM central banks will go on hold beyond the next 3-6 months

Please see the following pages for highlights of this week's webinar and research

This Week's Webinar & Research

Watch Now

Are China Stocks A Buy? And If They Are, Does That Make EM ex-China A Sell?

In Wednesday's **MRB *Webinar***, Mehran Nakhjavani and Amr Abdel Khalek discussed the outlook for EM assets amidst the cross currents of strong U.S. demand and recovering global trade, China's recent stimulus and the curveballs associated with the incoming Trump Administration's apparent desire to raise tariffs. The first elements are typically associated with EM stock and currency outperformance, while the latter throws up several risks.

Highlights included:

- Threats vs. negotiations: don't draw hasty conclusions.
- Trump tariffs: negative ***initial*** market reaction for Chinese assets (i.e. China is a net exporter, U.S. is a big net importer).
- But also problematic for U.S. corporations who rely on China supply chains (Apple, Tesla, etc.).
- Huge incentives for evasion: effective tariff < nominal tariff rate, pass-through countries winners/losers.
- Strong dollar/weak yuan already softening the blow for China, but potential pressure on yuan peg if a negative outcome develops.
- Stagflationary second-order consequences.
- Be prepared for surprises... could Trump "make a deal" that includes geopolitics, e.g. North Korea/Iran, Taiwan?

Trump tariffs: negative for China, but also problematic for U.S. corporations that rely on China supply chains

U.S. Treasurys: The Calm Before Another Storm

U.S. Treasury yields have risen sharply in response to better-than-expected U.S. economic data, and a paring back of expectations for deep Fed rate cuts in 2025. Government bonds faced additional selling pressure from the election outcome, due to expectations for greater fiscal stimulus and much larger federal government budget deficits. That said, after the recent melt-***up*** in U.S. Treasury yields, we expect a (temporary) period of reprieve.

Monday's report provided an outlook on our outlook for the U.S. bond market. The main takeaways included:

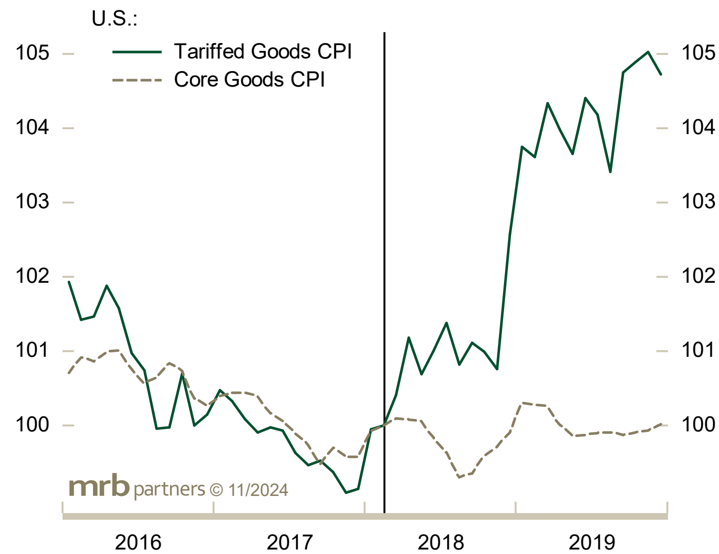
- U.S. Treasury yields are consolidating after surging since mid-September. This period of calm may persist in the near run, but fundamental drivers point to higher bond yields. Indeed, we expect the 10-year Treasury yield to eventually retest its cyclical high of near 5%.

- The selling pressure on U.S. Treasurys has primarily been in response to investors realizing economic growth is stronger and more resilient than they expected, which has also reduced the need for Fed rate cuts. This is a constructive environment for equities and corporate bonds.

- However, the next major upleg in U.S. Treasury yields is likely to be driven mostly by higher inflation expectations (**chart 7**), a greater term premium, and an ongoing upward adjustment in the projected nominal neutral fed funds rate. If so, this will create fresh storm clouds for the risk-on rally.

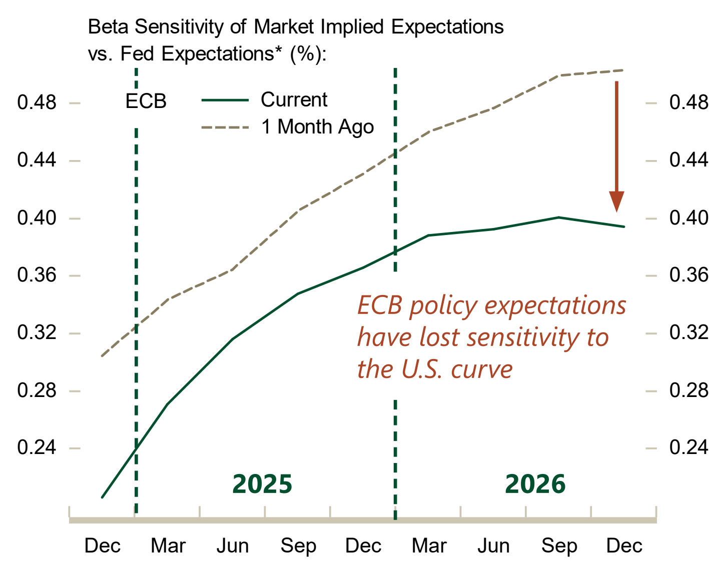
- For now, we recommend maintaining a pro-growth bias. Stay below benchmark bond duration, overweight inflation protection and corporate bonds, while underweight U.S. government bonds within both fixed-income and multi-asset portfolios. We

Chart 7 Tariffed CPI Rose While Core Goods Bottomed In Trump 1.0



* Rebased to February 2018 = 100; sources: U.S. Bureau Of Labor Statistics, MRB Calculations
Note: Vertical line denotes tariff implementation

Chart 8 ECB Policy Expectations Have De-Coupled From The Fed



* 3-month rolling beta on Euribor daily changes vs U.S. SOFR; source: Bloomberg

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also have short recommendations on the 10-year U.S. Treasury outright and on 5-year U.S. Treasurys versus German bonds (**chart 8**), and have tightened the stops on these profitable positions. We are also long U.S. high-yield corporate debt and 5-year CPI swap rates.

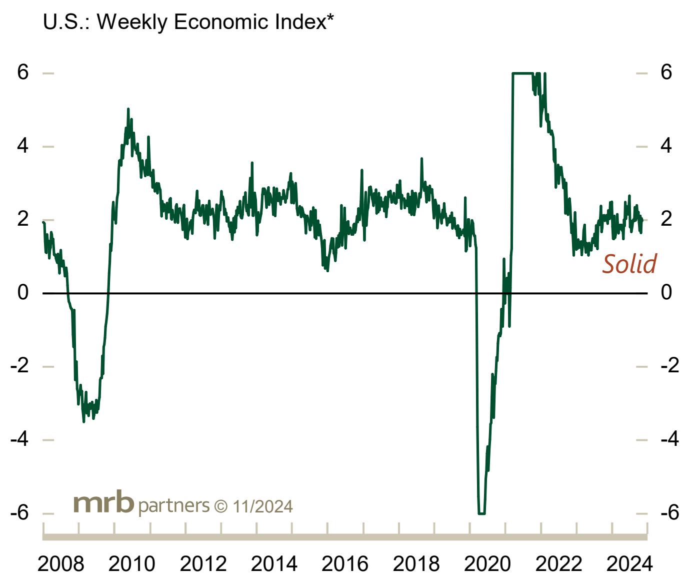
U.S.: The Economy Is Still Humming

Considerable policy uncertainty looms over 2025, but recent economic indicators show that the U.S. economic expansion remains solid, with growth running at an above-potential rate. The election outcome has fattened the tails for the U.S. economy, but healthy underlying fundamentals support a positive growth outlook. The Fed is in easing mode, but will dial its dovish intent down next year, amid sticky inflation and upside risks to inflation from above-potential growth as well as trade and other policies.

Highlights of Tuesday's report included:

- High frequency data underscore solid economic momentum (**chart 9**), with Q4 real GDP growth tracking a 2.6% gain.
- Economic surprises have turned positive over the past two months (**chart 10**).
- The outlook for consumption remains upbeat.
- Manufacturing activity is in a funk, though post-election business sentiment surveys have perked up.
- Prospects for the housing market remain tepid.
- Inflation remains sticky above the Fed's target, and risks are tilted to the upside.
- The Fed will likely temper its easing plans in the next dot plot, ultimately easing less than the current (much diminished) market expectations.

Chart 9 **Growth Momentum Is Solid**



* Truncated at +/- 6; source: Federal Reserve Bank of New York

Chart 10 **Economic Surprises Have Been Positive**

* Source: Citigroup

The Fed will likely temper its easing plans in the next dot plot

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Independent Investment Strategy

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