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GLOBAL STRATEGY

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Trump Trade, Fed Policy And Investment Strategy

In This Report

In a historic victory, Donald Trump has retaken the White House for his second, non-consecutive presidency. Both stocks and the dollar have jubilated, but bonds have sold off. Financial markets had begun to embrace this outcome since September, but confirmation of Trump's November 5 victory has driven the "Trump Trade" to new highs (**Chart 1**).

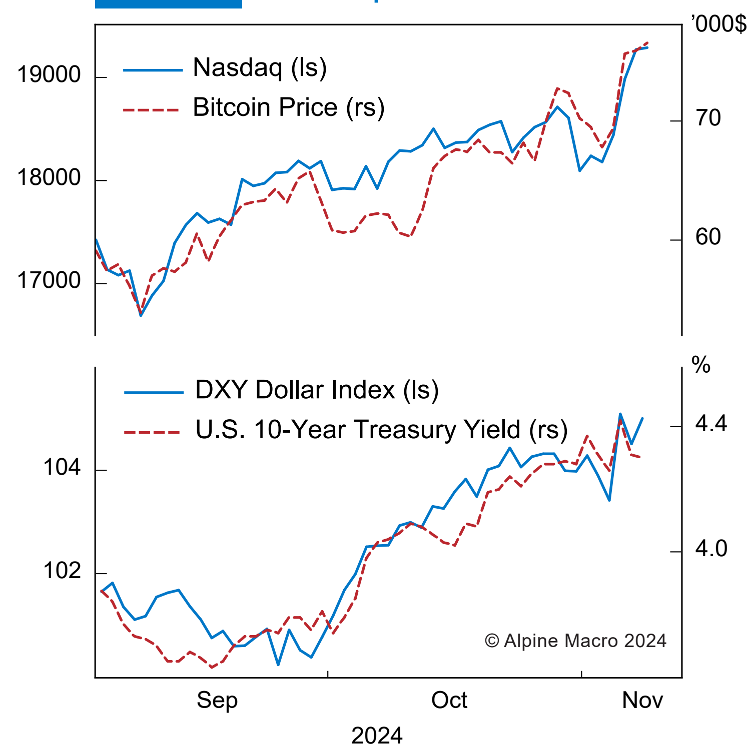
To put the "Trump Trade" in perspective, the S&P 500 Index has been up more than 10%, Bitcoin has soared over 40%, the DXY has climbed 4-5% and 10-year Treasury yields have risen 70 basis points since mid-September when financial markets began to anticipate a Trump win.

Trump Policy: A Redux Of Supply-Siders

Trump's economic policy has been both clear and straightforward since he entered the race. It comprises three key components: deregulate, lower domestic taxes and jack up tariffs to protect domestic jobs. Except for trade protectionism, Trump's economic policy resembles the supply-side economics adopted by Thatcher and Reagan in the 1980s.

Supply-siders have long argued that deregulation will unleash entrepreneurship, boost labor productivity and generate economic prosperity while lowering inflation. Cutting taxes will, in fact, increase tax revenues because of the "Laffer Curve" effect.[1] Supply-siders also embrace free trade, but that is not Trump's piece of cake.

Chart 1 The Trump Trade



1 The Laffer Curve examines the relationship between tax rate and tax revenue: when the tax rate is at either 0% or 100%, tax revenue is zero. Between these two extreme tax rates, tax revenue is shaped like a bell curve. This implies that there is an optimal tax rate that maximizes tax revenue. If the actual tax rate is higher or lower than this optimal rate, the government does not maximize its tax revenue. Supply-siders often advocate for tax cuts because they believe the current tax rate is much higher than the optimal level.

The experience of the 1980s and Trump's first term from 2016-2020 suggests that supply-side economic policy is always a potent cocktail for boosting long-term output growth. In hindsight, Reagan's supply-side policy in the 1980s laid the foundation for the economic boom of the 1990s.

As for Trump, having won both the Electoral College and popular vote, he has a strong mandate to do what he promised on the campaign trail. With the GOP having retaken the Senate and likely winning the House, Trump's pro-growth agenda will be implemented with ease.

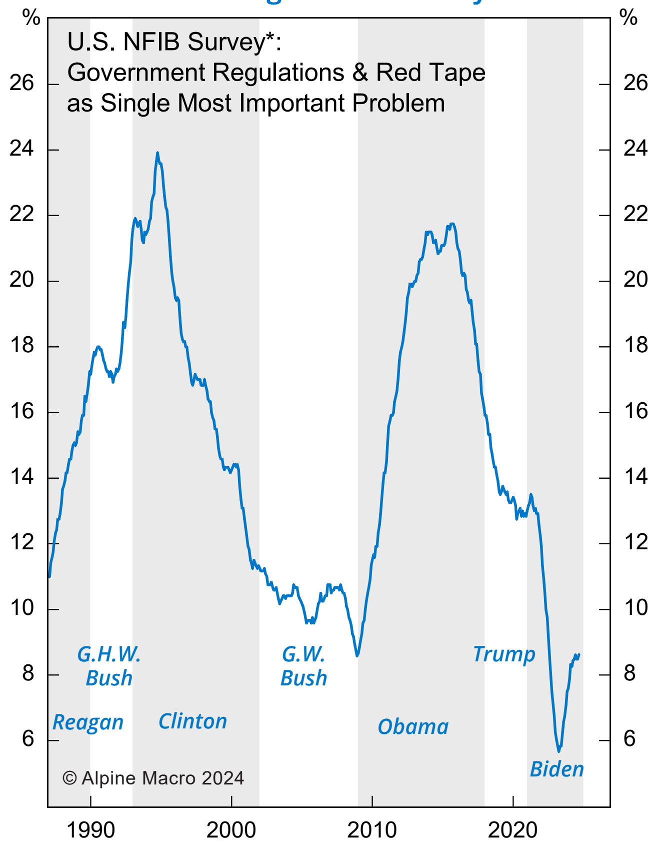
Of course, policy details will be worked out over time, but the general path of the U.S. economy will move decisively towards lower taxes, less regulation and more protectionism under Trump. A few thoughts are worth noting:

On deregulation, the U.S. economy is already the least regulated among the G7. For example, U.S. small businesses no longer view the economy as "over-regulated" (**Chart 2**).

Thus, Trump's deregulation drive will likely target specific areas, such as the financial sector, the fossil fuel industry, and the mining, power and auto sectors. Trump could reverse the Biden administration's climate policies and weed out some of the environmental restrictions on businesses and subsidies for the alternative energy sector.

On tax cuts, it is worth noting that historically, major tax cuts almost always create bigger budget deficits, and therefore, the so-called "Laffer Curve" has never worked in practice (**Chart 3**). The upshot is that lower taxes clearly boost long-term

Chart 2 **U.S.: A Much Deregulated Economy**



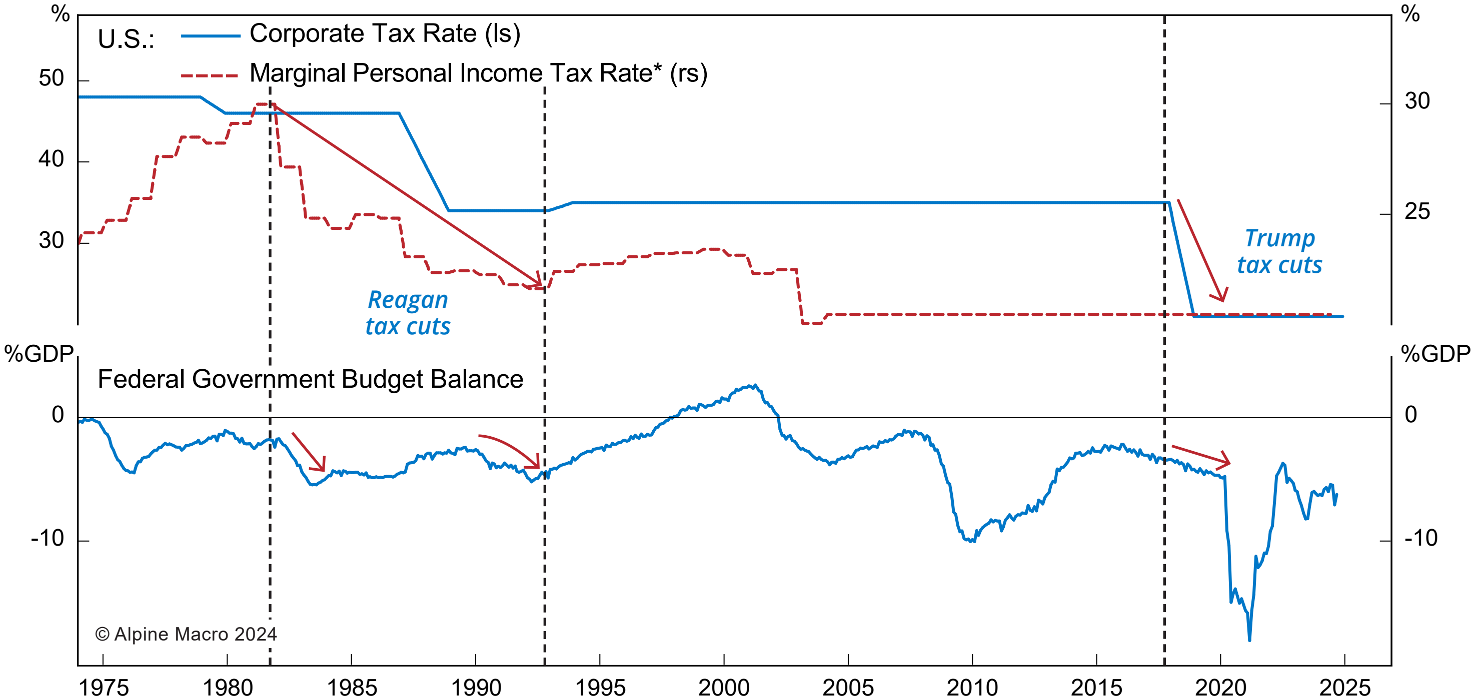
*Shown as 12-month moving average

growth potential, and a bigger budget deficit also represents fresh fiscal stimulus that promotes economic growth in the near term.

Will Trump bring the corporate tax rate down to 15% from 21%? It is possible, but a constraining factor is that neither Trump nor the GOP-controlled Congress wants to see tax cuts blowing a big budgetary hole leading to higher inflation. A key lesson from the 2024 election is that rising inflation is a devastating poison pill for the incumbent government and politicians.

On tariffs, it is not clear at this point whether a 10% increase across the board and a 60% hike on Chinese imports are a bargaining ploy or a credible

Chart 3 Tax Cuts Versus Budget Imbalances



*For taxpayers with household incomes at twice the median

threat. Trump is transactional and will likely use tariffs as a major stick to force the rest of the world, China in particular, to buy more American goods.

Ironically, in this case, the tariff threat could turn into another form of stimulus for growth, as the tariff stick can force other nations to buy more American goods, leading to an increase in net exports.

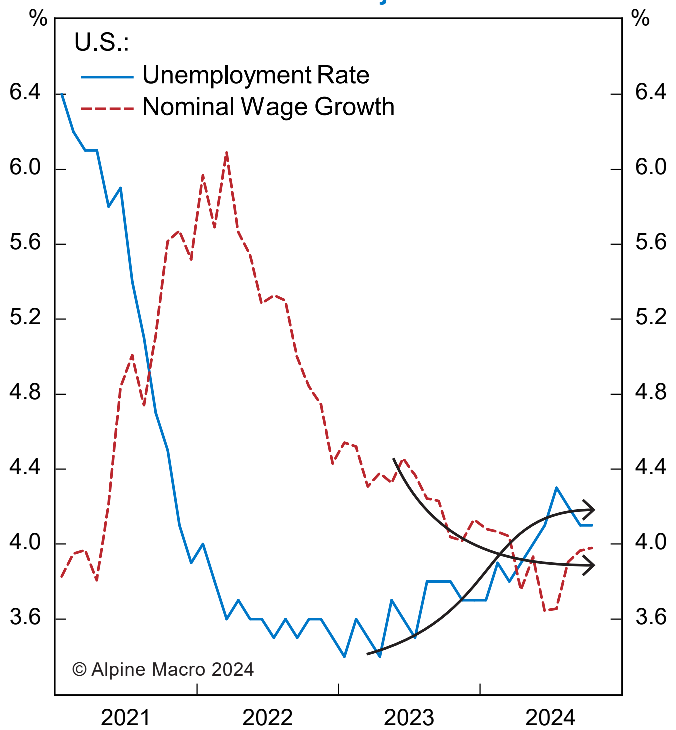
Equities: More Than "Trump Effect"

There is no denying that the expectations of a Trump victory have played a key role in pushing up stock prices (**Chart 4**). However, higher equity prices are also reflective of a strong and improving economy. U.S. economic growth has consistently outperformed expectations, with steady wage growth, falling inflation and a normalizing labor market (**Chart 5**).

Chart 4 Stock Prices Versus Trump's Betting Odds

*RealClearPolitics

Chart 5 U.S. Labor Market: Under No Major Stress



Importantly, the Fed is easing into a growing economy, which historically always leads to a strong equity market. The last time the Fed cut rates in a strong economy was in 1995, and the Fed action sparked a growing equity bubble in technology stocks (Chart 6).

Going forward, a few observations and thoughts are in order:

First, the "Trump Trade" will naturally pause after the recent run: investors will need confirmation that the expected policy changes will be met with reality. In other words, the market will move to a "show me the money" phase.

Second, it will be several months before the new Trump administration can initiate any major policy changes. In the interim, many developments, both economic and geopolitical, could still interrupt the equity market, pushing prices in either direction.

Chart 6 Fed Rate Cuts In A Growing Economy: 1995 Versus 2024

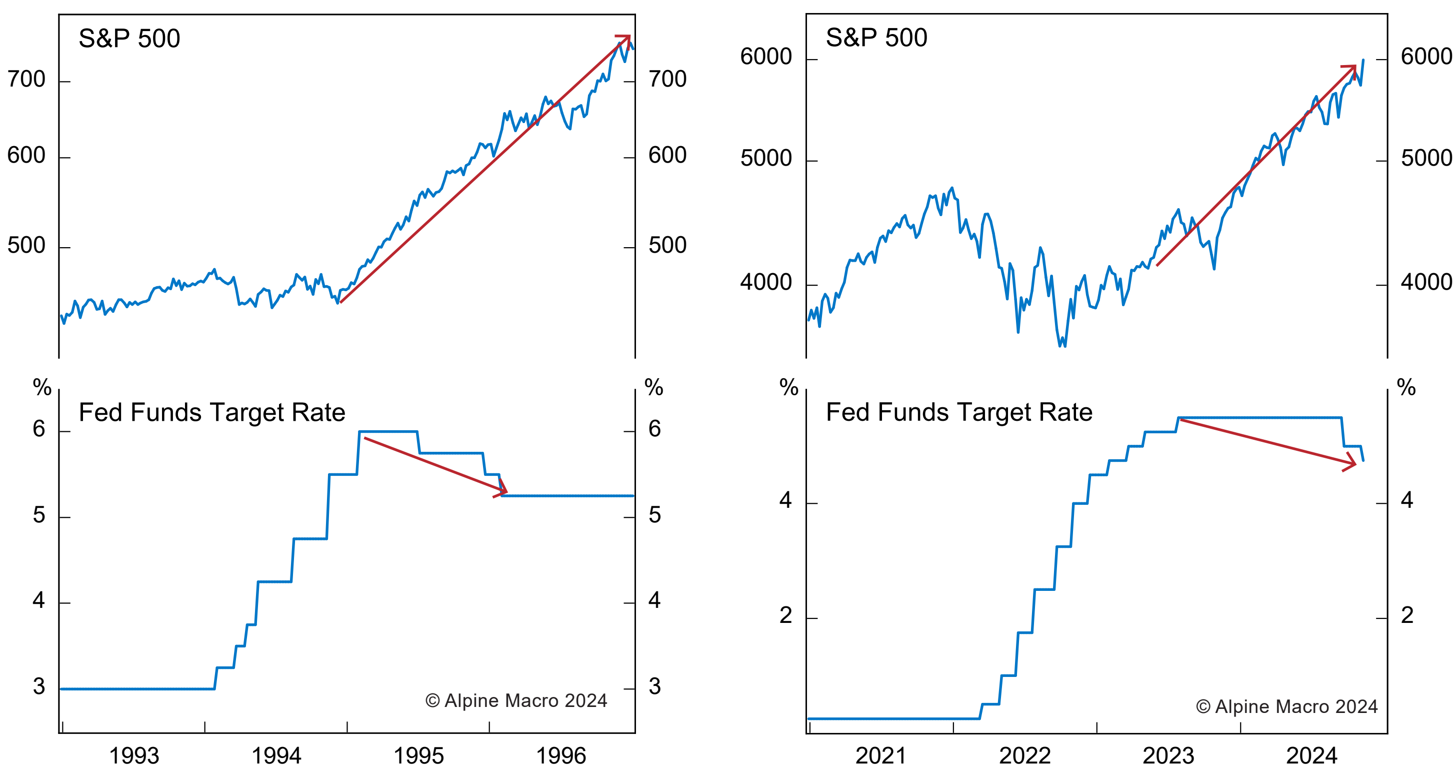
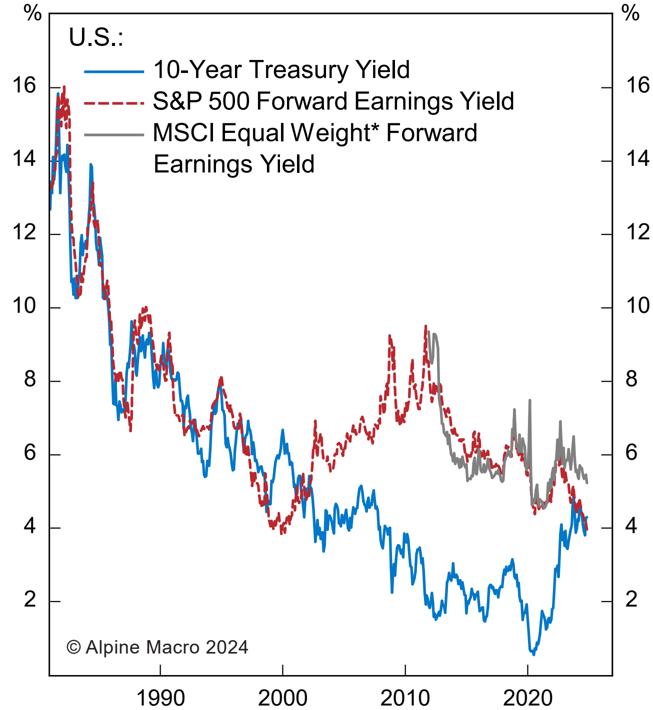


Chart 7 Are Equities Expensive After The Trump Rally?



*Mid & Large Caps

Third, after the stock market rally and bond selloff, the valuation parameters for equities have changed. Chart 7 shows the long-term correlation between 10-year Treasury yields and earnings yields for both cap-weighted and equal-weighted indices. The chart suggests that the cap-weighted index has become expensive due to a rise in bond yields and a fall in earnings yields. However, the equal-weighted index remains undervalued.

Nevertheless, if Trump indeed cuts corporate tax rate to 15% from 21%, it will add to EPS by 6 percentage points, which, in turn, will increase earnings yields by 30 basis points. In other words, a lower corporate tax rate will sharply increase the attractiveness for equities.[2]

Finally, clients should resist the temptation to allocate much capital into EM and European stocks.

Trump is not a conventional politician, and "America First" is the Trump administration's long-held mantra.

This could imply more disruptions in America's bilateral and multilateral relations with the rest of the world and increasing economic friction. With the U.S. being the strongest economy in the world, Trump could use more sticks than carrots in dealing with foreign countries, causing damage to global asset markets.

Bottom line: Overweighting U.S. equities is a safer bet.

What About Bonds?

The bond market dynamic resembles that of the equity market. Specifically, the bond market selloff since September has been partially driven by a strong economy and partially reflective of rising expectations of a shifting policy environment under the new Trump administration.

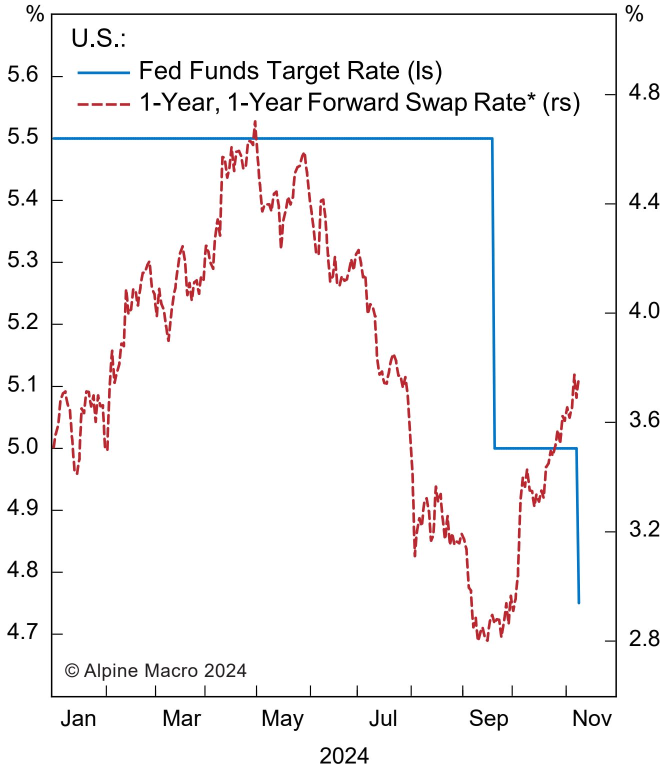
For some time, we have argued that the R* for the U.S. economy has risen since the pandemic crisis due to the end of the deleveraging process, higher labor productivity and an exit from the liquidity trap.[3]

With the U.S. economy having stayed strong throughout this year, the bond market has finally caught up with the reality. Chart 8 shows that financial markets have been repricing their rate expectations since late September, with the bond market coming to terms that the Fed may not ease

2 Alpine Macro *Equity Strategy* "Making $ense Of U.S. Election Outcomes For Equities" (August 28, 2024).

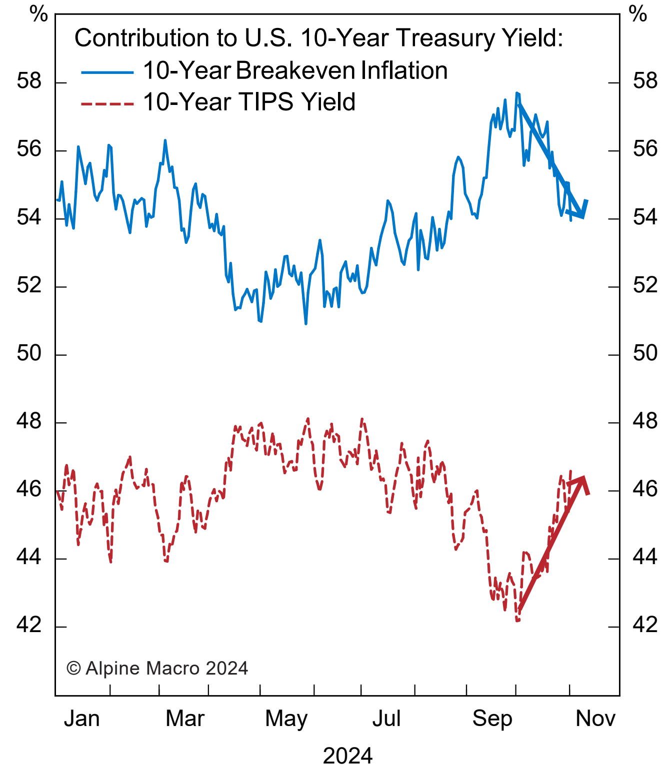
3 Alpine Macro *Global Strategy Special Report* "Why R* May Have Risen" (October 21, 2024).

Chart 8 Market Pricing Of Fed Policy



*Source: Bloomberg Finance L.P.

Chart 9 What Has Driven The Bond Selloff?



as much as previously expected. This means that even without the rising expectations of a Trump victory since September, bond yields would have gone up anyway.

Some sell-side strategists have often blamed the bond market selloff on Trump's proposed tax policy. They say Trump's planned tax cuts could blow a big hole in the U.S. budget, leading to rising inflation and a higher "fiscal risk premium". They are concerned about a "Liz Truss" moment for the U.S.

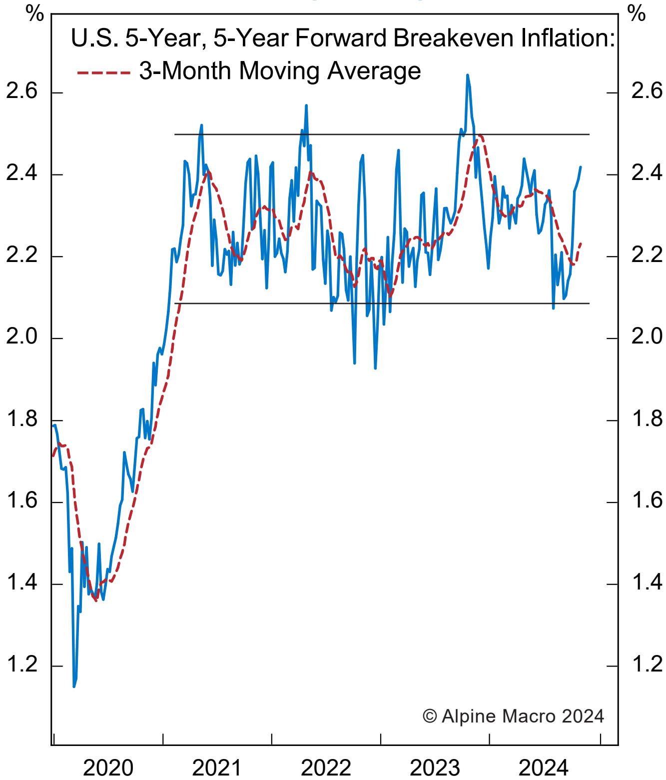
This argument is grossly misleading. **Chart 9** shows that the bond market selloff since September has been primarily driven by rising real bond yields. In fact, rising TIPS yields explain two-thirds of the backup in bond yields, while inflation breakeven accounts for the remaining third.

Importantly, even with the recent uptick, the five-year, five-year forward inflation breakeven rate, now standing at 2.4%, is well within its historical range (**Chart 10**). Thus, it is the expectation of a stronger economy, not a "fiscal risk premium", that has driven bond yields higher.

Finally, a few words on the so-called "Liz Truss" moment. The gilt crisis two years ago was essentially a technical crisis that was put to a quick end by the Bank of England's pledge to buy gilts.

In a fiat money system, central bank liabilities (money supply) and government liabilities (debt) are essentially identical and, therefore, interchangeable. This means that the so-called "fiscal risk premium" is nothing more than a hoax — because a central bank can always use its liabilities to replace government debt obligations.

Chart 10 Inflation Expectations In A Proper Perspective



With the central bank being the ultimate guarantor of government liabilities, how could a government ever default on its debt obligations?

Fed Policy And Duration Strategy

We have been casting doubt over the market pricing of the Fed's terminal rate since September 16[4], arguing that market anticipation of Fed rate cuts is too excessive, and later reiterating why the terminal rate could be around 3.75-4% (see footnote 3 on p.5).

We continue to hold this view, which, if correct, means that long bond yields are roughly in the right place, with term premiums ranging between 30 and 50 basis points. In other words, the long end of the curve neither has much upside potential, nor much downside risk, which is the key reason we have been reluctant to recommend increasing bond duration.

The interesting question is: what will the Fed do when the Trump administration begins to cut taxes and inject a dose of fresh stimulus? Fed Chair Powell made it clear last week that if fiscal policy materially drives up economic growth or inflation, the Fed will recalibrate its policy to account for the change.

In other words, the Fed can cut, hold or even raise rates next year based on economic conditions. The most likely outcome is a slow drift towards 4% for the policy rate.

Tariffs, Dollar And Inflation

Under a Trump second term, we suspect the dollar will likely stay strong:

- The U.S. economy is the strongest among the G7, which suggests that U.S. short rates, though falling, will still be significantly higher than those of other G7 nations. Under these circumstances, it is inconceivable to see persistent weakness in the dollar.
- Tax cuts usually lead to rising stocks and a strong currency. Should fiscal stimulus increase, it could be an added reason for a strong dollar.
- Should Trump slap tariffs across the board, it may prompt currency devaluation among America's trading partners, because a weaker currency is the easiest way to offset the negative impact of tariff hikes.

4 Alpine Macro *Global Strategy* "Debating Federal Reserve Policy" (September 16, 2024).

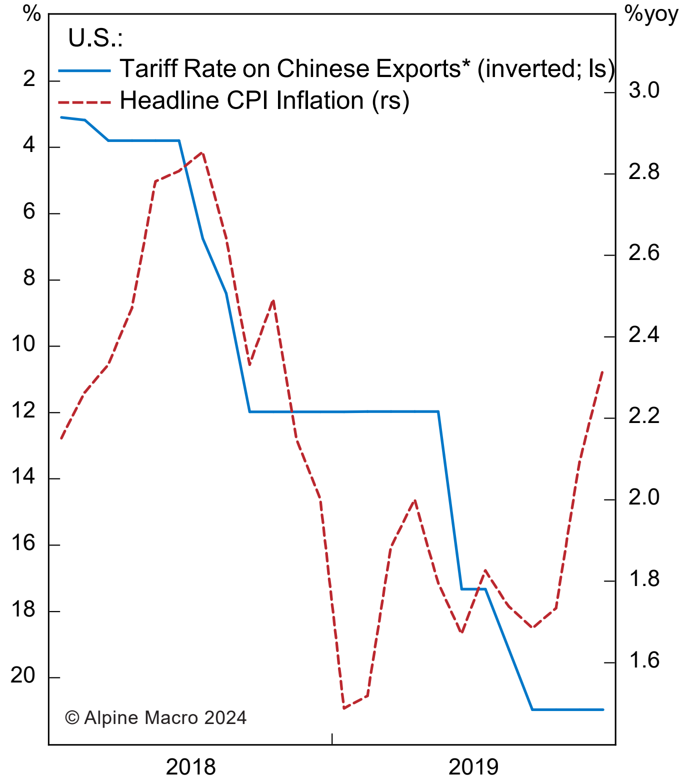
Many believe that a tariff hike could be inflationary for the U.S. This is a misunderstanding. A tariff hike is a relative price shock with a one-off impact on price levels, while inflation stems from excess demand, which drives up prices continuously.

Besides, a tariff hike against a single country usually does not have any meaningful impact on inflation as importers can easily bypass the supplier to source goods elsewhere.

Chart 11 shows that U.S. inflation actually fell during 2018 and 2019, when the U.S. jacked up tariffs against Chinese imports.

Even if the U.S. pushes up tariffs across the board, the rest of the world could opt for currency depreciation to neutralize the impact. For the U.S., a stronger dollar is disinflationary or deflationary, all else being equal.

Chart 11 U.S.-China Tariff War And Inflation



*Source: Peterson Institute for International Economics

Bottom Line

- Maintain a 70/30 split between stocks and Treasury bonds.
- Stay overweight U.S. stocks.
- Continue to overweight financials and banks.
- Although small-cap stocks have received a boost from Trump's victory, the Fed may not cut rates as much as anticipated. Use the rally to trim some small caps.
- Barbell equity portfolios, with growth stocks on one side and value stocks on the other.
- Maintain benchmark duration for U.S. Treasury bonds, as risks to both sides are roughly symmetrical.
- We unwound our EM and China positions a week ago to control risks. Beijing's stimulus package does not seem bold enough. Investors need to understand more about China's stimulus plan before we will move into the Chinese market again.

Chen Zhao
Chief Global Strategist

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	Rolling -8%	-	-	39.3%
Long Gold (ETF: GLD)	04/01/2024	207.82	Rolling -5%	-	-	19.3%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	12.4%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	11.0%
Long Copper [1]	09/30/2024	4.55	-5%	11/06/2024	4.33	-5.0%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	-0.2%
Short Brent Oil	10/22/2024	76.00	-	-	-	2.6%

Note: P&L is calculated using daily closing prices.
[1] The -5% stop loss for our Long Copper trade was triggered on 11/06/2024.

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