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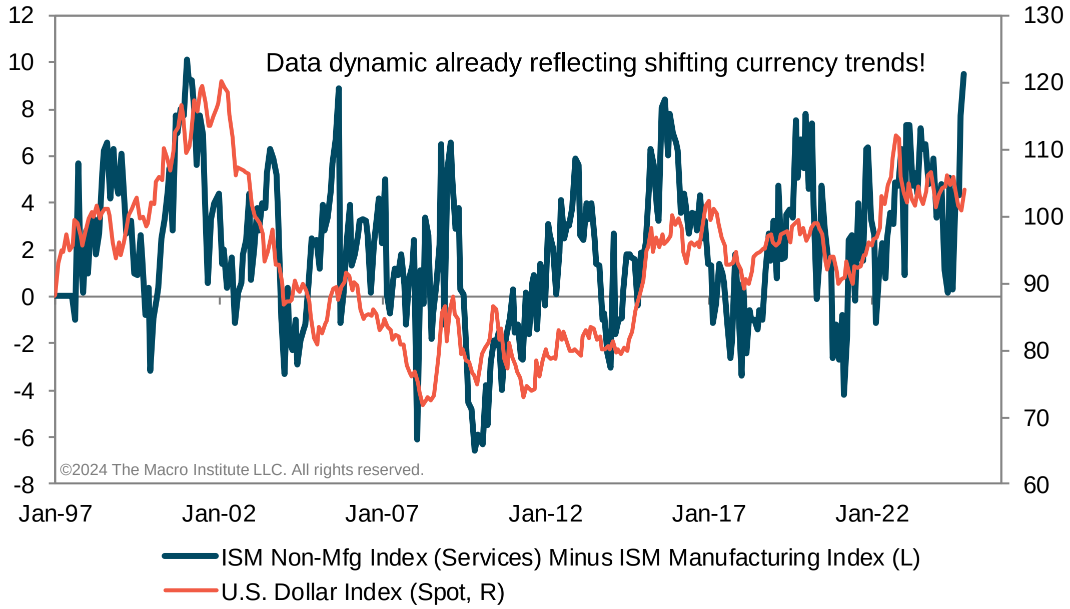
November 19, 2024

Interesting Client Questions From Last Week's Conference Call

There are still a lot of unanswered questions about what the new administration's policies will end up looking like when all the details are revealed. We know what was promised on the campaign trail, but that is usually very different from what ultimately gets implemented. Also, two of the three main policy proposals are unprecedented in U.S. history (mass deportations of undocumented workers and extreme fiscal austerity) and the third has been little used in the last 100-odd years (tariffs). The point is that things are very dynamic at this time and anyone that claims to know what will happen is likely fooling themself.

A Stronger USD "Normally" Favors Services Over Manufacturing



Let's stick with what has been established. Protectionist policies are U.S. dollar bullish because, all else equal, they are inflationary in the near-term and add up to slower growth prospects in the rest of the world. We don't know to what degree that will happen as some tariffs will simply shift trade from one country to another (less China, more Mexico?). That said, the U.S. consumer has been the largest source of trade demand in the world and if we are going to increasingly "buy American" that will be problematic for economies largely focused on exports. That is virtually every country around the world.

The U.S. dollar catching a bid and the rest of the world facing slower prospects seems like the most obvious conclusions we can draw at this stage. We made a strong push for emphasizing U.S.-centric investments in last week's conference call. If this dynamic does endure for the foreseeable future, then we should expect it to have a significant impact on economic data. The chart above shows that a stronger dollar tends to favors services (more U.S.-centric) than manufacturing (more export-oriented). Time will tell if some of the other proposed policies influence this relationship. We cover this topic in more depth on page 4 and tackle some of the best questions we have received since last week's conference call (replay here). Hope you find this interesting – we certainly do. Wishing you a great rest of your week. All the best. Francois

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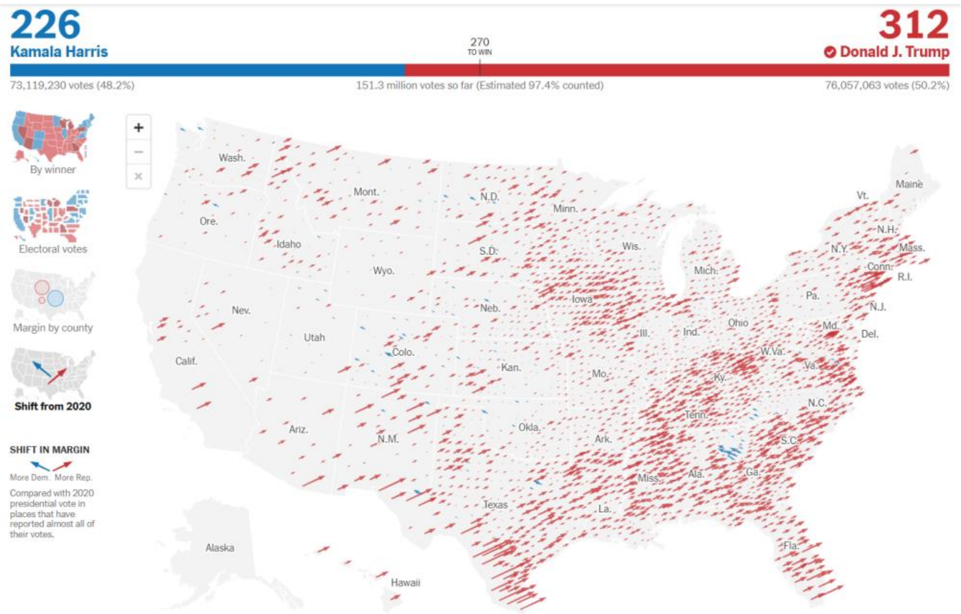
Q1: Is There One Variable That Explains The Election Result?

It seems clear that concerns over inflation played a large role in the U.S. election results. Inflation is somewhat of a unique topic as we must distinguish between what the consumer is thinking and feeling versus how the Fed views inflation, its reaction function, and the flow through to financial market behavior. In monetary policy terms, the inflation rate has certainly declined dramatically and is now approaching a trend consistent with its 2% mandate. That said, this is not how consumers view the persistent rise in prices of everyday consumables and durable goods.

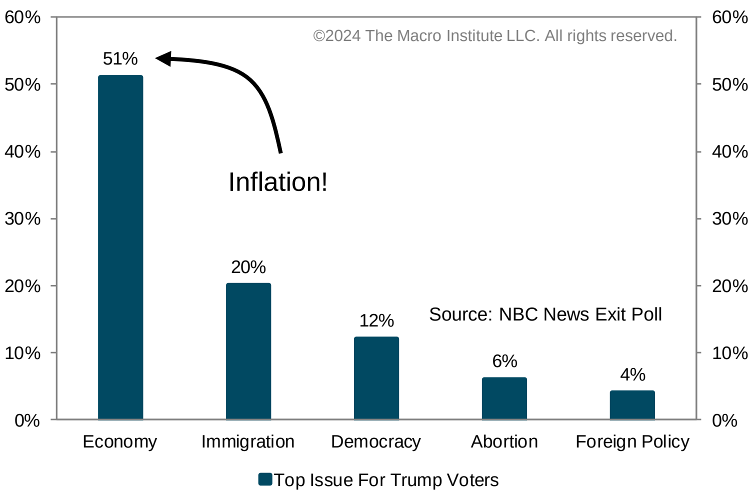
A Broad-Based Victory For The Republican Party



Source: New York Times

Heading into the voting booth, the University of Michigan's consumer sentiment survey of the bottom tertile of income was 53 – an 18-point decline from year-ago levels and below the lows seen at the depths of the GFC! Clearly, there is a lot of economic discontent in this demographic, and we can see from exit polls that the U of M data on the economy and inflation was the most important issue in voter's eyes. Another Republican, President Reagan, also stumped on and was victorious with a campaign platform committed to ending inflationary trends. Like Reagan, Trump will enter office with monetary tightening in the pipeline (see slides from recent call on this topic).

Exit Polls Show Key Role Of Inflation In 2024



Inflation Also Influential In Past Elections

1980 Presidential Debate Reagan vs Carter	**"Are you better off than you were four years ago**? Is there more or less unemployment ... than there was four years ago?"
1981 Reagan's Inaugural Address	"**Ending inflation means freeing all Americans** from the terror of runaway living costs … We have every right to dream heroic dreams."
General Quote	"**Inflation is as violent as a mugger,** as frightening as an armed robber and as deadly as a hit man."
1984 Campaign Ad "Morning In America"	"This afternoon 6,500 young men and women will be married, and **with inflation at less than half of what it was just four years ago**, they can look forward with confidence to the future."

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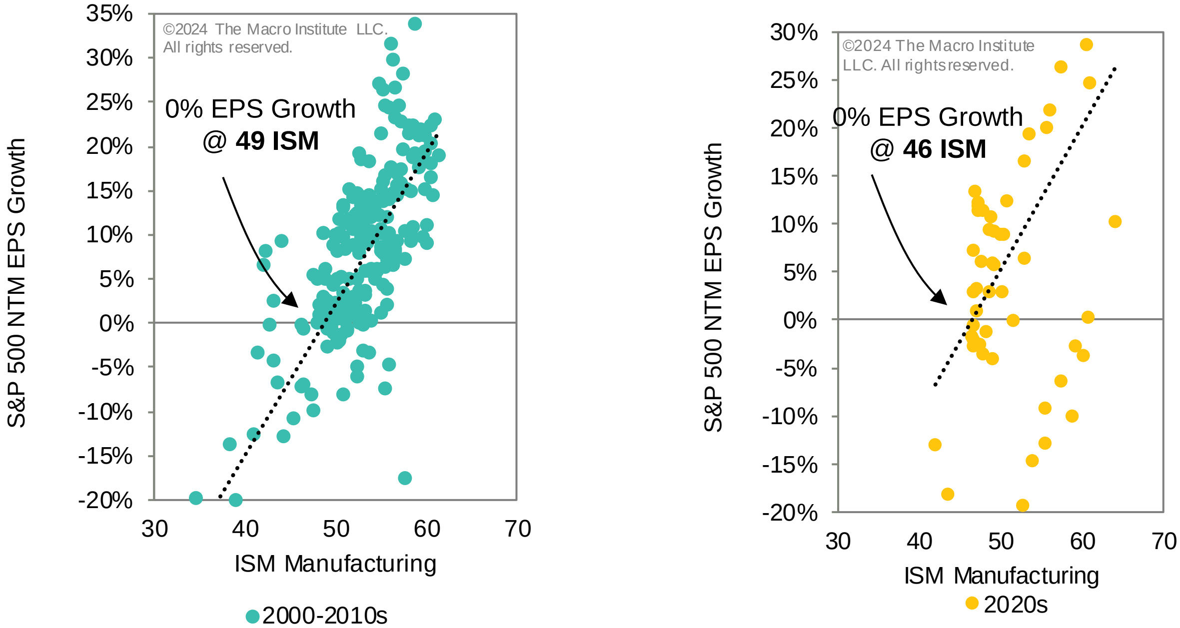
Q2: Is The ISM No Longer Reflecting What's Happening In The S&P 500?

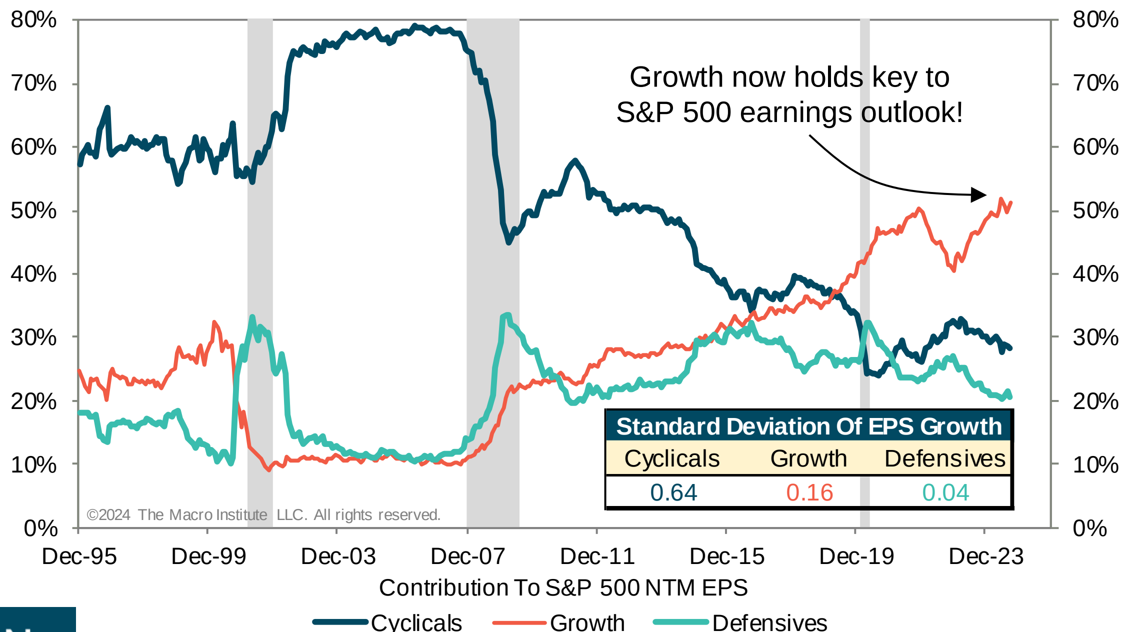
This question speaks to the recent divergence between the rallying S&P 500 and other uninspiring LEIs such as the ISM Manufacturing Index, which has been below 50 for the last seven months. First, this dynamic is not unprecedented in the history of the ISM. Second, S&P 500 earnings growth remains robust at +11.5% y/y but nonetheless is slower than growth rates from this past summer. Third, the relationship between LEIs and corporate earnings changes over time. The two scatter plots below show the ISM Index alongside S&P 500 forward EPS growth. From 2000-2010, 0% S&P 500 earnings growth was consistent with an ISM at **49** compared to a **46** reading thus far in the 2020s.

ISM / EPS Relationship Has Changed Alongside S&P 500 Composition



What explains the change in this historical relationship? We attribute it to the changing composition of the Index. Growth stocks now account for more than 50% of S&P 500 earnings. When Value was a larger contributor to earnings from 2000-2010, LEIs only needed to contract a little (**49**) for earnings to come under pressure. Today, however, Growth stocks and their secular tailwinds demand a weaker macro drop (**46**) for broad equity market earnings to contract.

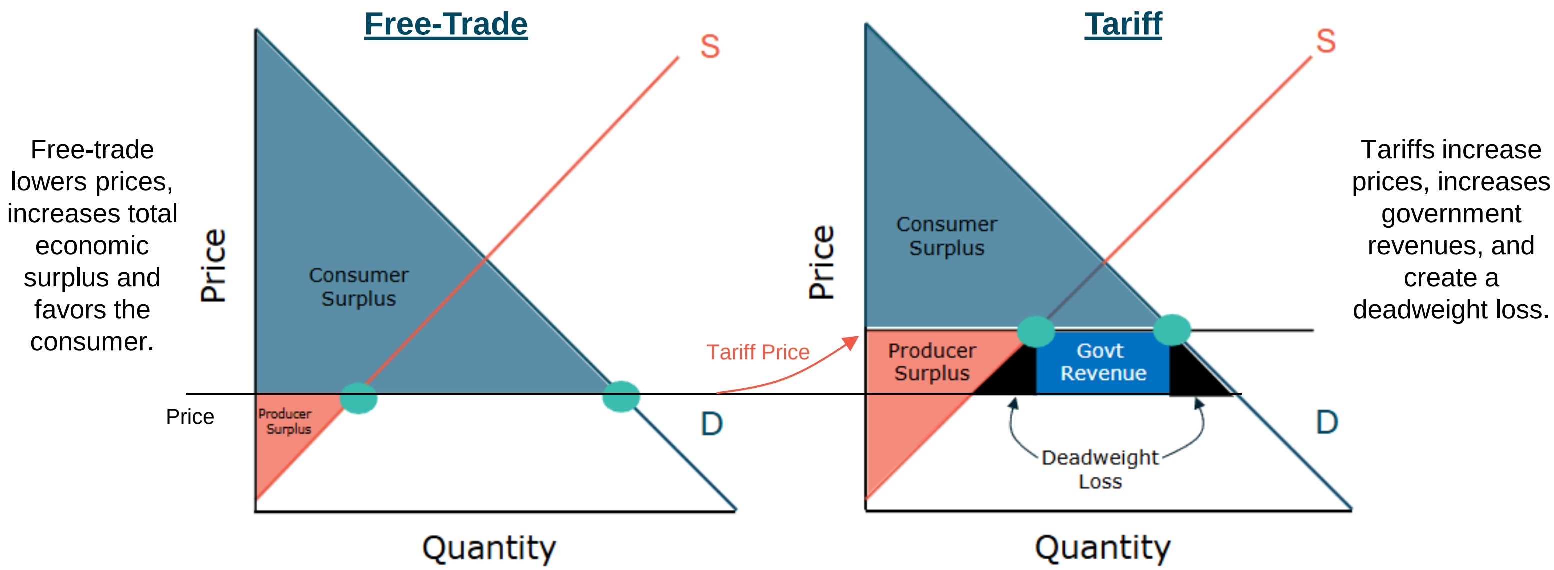
Growth Stocks Now Account For Over 50% Of S&P 500 Earnings



Q3: What Is The Likely Tariff Impact? Won't They Just Move Operations?

Until we have details on the size and scope of tariffs, it's difficult to forecast the exact impact on GDP, inflation, and the fiscal deficit. We also wonder if some of the campaign rhetoric was merely a bargaining tool to bring foreign nations to the trade negotiation table. Compared to a free-trade economy, the imposition of tariffs establishes higher prices for consumers and benefits goods producers and government revenues. The loss in consumer welfare can be thought of as the deadweight loss, or inefficiencies, that arise from an artificial price floor.

Cost Of Trade Tariffs Usually Disproportionately Borne By Consumers



The most appropriate comparison we can offer on trade is the tariffs that were implemented in 2018. To answer the question in the title – some corporations did indeed move operations out of China to avoid tariffs. That said, establishing new supply chains outside of China is not quick or easy. The two quotes below regarding tariffs from recent earnings calls for SWK and RL highlight the difficulty in reshoring. The impact of tariffs on U.S. earnings is difficult to estimate, but new impediments to trade will create global macro risks from potential headwinds to export-heavy China and the Eurozone.

Corporates Already Prepped For Tariffs?

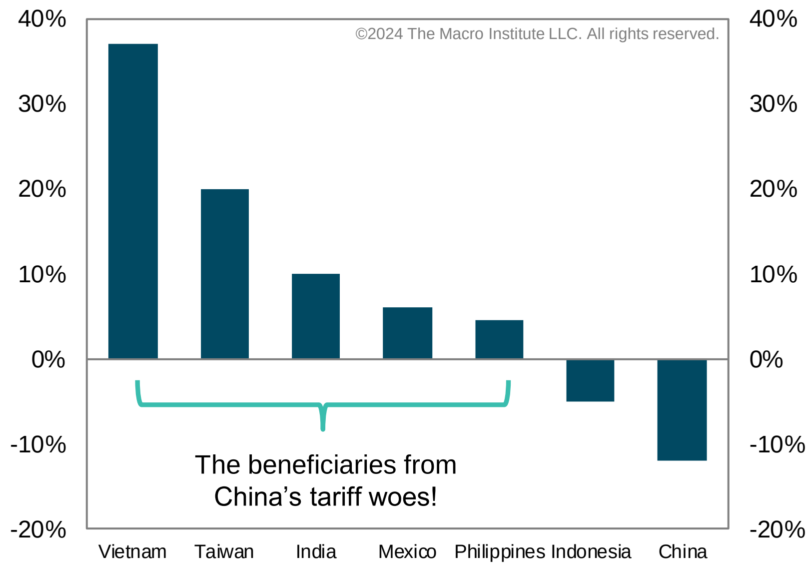
"The second thing is we've built a fairly robust plan of how we would mitigate over the next two years these tariffs by moving production and aspects of the supply chain to different parts of the world. And some of that would be potentially moving things from China to other parts of Asia, maybe to Mexico … unlikely that we're moving a lot back to the US, because it's just not cost effective to do. And there's questions about whether we even have the labor to actually do that in this country."

- ***Stanley Black & Decker (SWK)***

"We've significantly diversified our sourcing footprint over the past seven-plus years and developed alternate production for our key product categories, as well as near-shoring capabilities for our regions as part of that global diversification, China now represents about a high single-digit percentage of our globally sourced units [which is] about the same as our China sales penetration."

- Ralph Lauren (RL)

Source Of U.S. Imports (1H'19 vs. 1H'18)



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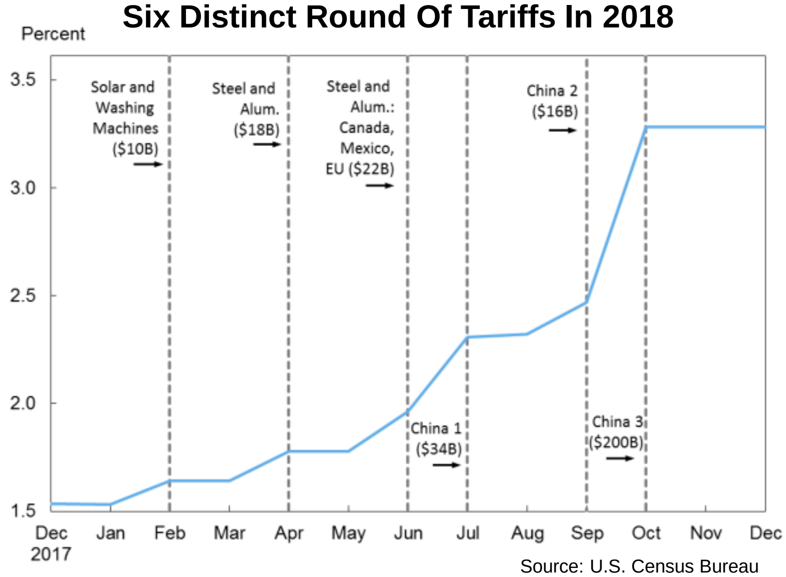
Q4: What Can We Learn From The 2018 Tariff Experience? (1/2)

If we dust off the 2018 tariff playbook, we can expect a layered approach to their implementation. This hinges on the level of retaliation and the success of the Trump Administration in securing acceptable terms to new trade policies from foreign nations. The final $200B in tariffs enacted on China in September 2018 speaks to the potential for trade wars to escalate quickly should either side balk at a deal. Given that tariffs are front and center for the administration – as well as the funding mechanism for the TCJA extension – we believe that the administration will likely be playing hardball.

Six Distinct Round Of Tariffs In 2018



Source: U.S. Census Bureau

Tariffs Are A Two-Way Street

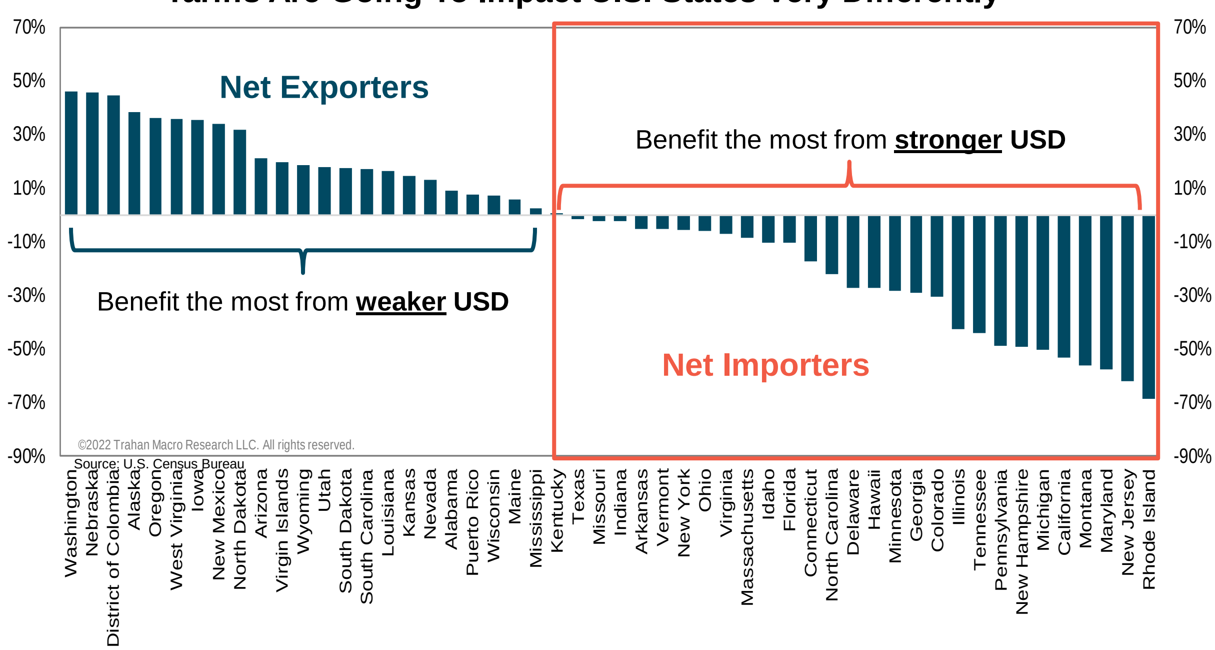
Panel A: Tariffs on U.S. Imports Enacted by U.S. in 2018						
Tariff Wave	Date Enacted	Products (# HS-10)	2017 Imports (mil USD)	(%)*	Tariff (%) 2017	2018
Solar Panels	Feb 7, 2018	8	5,782	0.2	0.0	30.0
Washing Machines	Feb 7, 2018	8	2,105	0.1	1.3	32.2
Aluminum	Mar-Jun, 2018	67	17,685	0.7	2.0	12.0
Iron and Steel	Mar-Jun, 2018	753	30,523	1.3	0.0	25.0
China 1	Jul 6, 2018	1,672	33,510	1.4	1.3	26.2
China 2	Aug 23, 2018	433	14,101	0.6	2.7	27.0
China 3	Sep 24, 2018	9,102	199,264	8.3	3.3	12.9
Total		**12,043**	**302,970**	**12.7**	**2.6**	**16.6**

Panel B: Retaliatory Tariffs on U.S. Exports Enacted by Trading Partners in 2018						
Retaliating Country	Date Enacted	Products (# HS-10)	2017 Exports (mil USD)	(%)*	Tariff (%) 2017	2018
China	Apr-Sep, 2018	7,474	92,518	6.0	8.4	18.9
Mexico	Jun 5, 2018	232	6,746	0.4	9.6	28.0
Turkey	Jun 21, 2018	244	1,554	0.1	9.7	31.8
European Union	Jun 22, 2018	303	8,244	0.5	3.9	29.2
Canada	Jul 1, 2018	325	17,818	1.2	2.1	20.2
Russia	Aug 6, 2018	163	268	0.0	5.2	36.8
Total		**8,073**	**127,149**	**8.2**	**7.3**	**20.4**

Source: UCLA

Below are the states which will be most impacted by tariffs due to their status as **net** importers. According the OEC, imports to Rhode Island were largely from Mexico and Germany, while New Jersey sources from China and Italy. As of 2022, California was the largest importer of goods in absolute terms with $470B of imports. The top categories were cars, computers, and crude petroleum. Tariffs will clearly impact U.S. states differently, and "net exporting" states are not immune to potential problems. After all, the likely slower global growth rates from U.S. tariffs will impact these states as well. Trade retaliation – as we saw in 2018 – could also prove a significant headwind.

Tariffs Are Going To Impact U.S. States Very Differently



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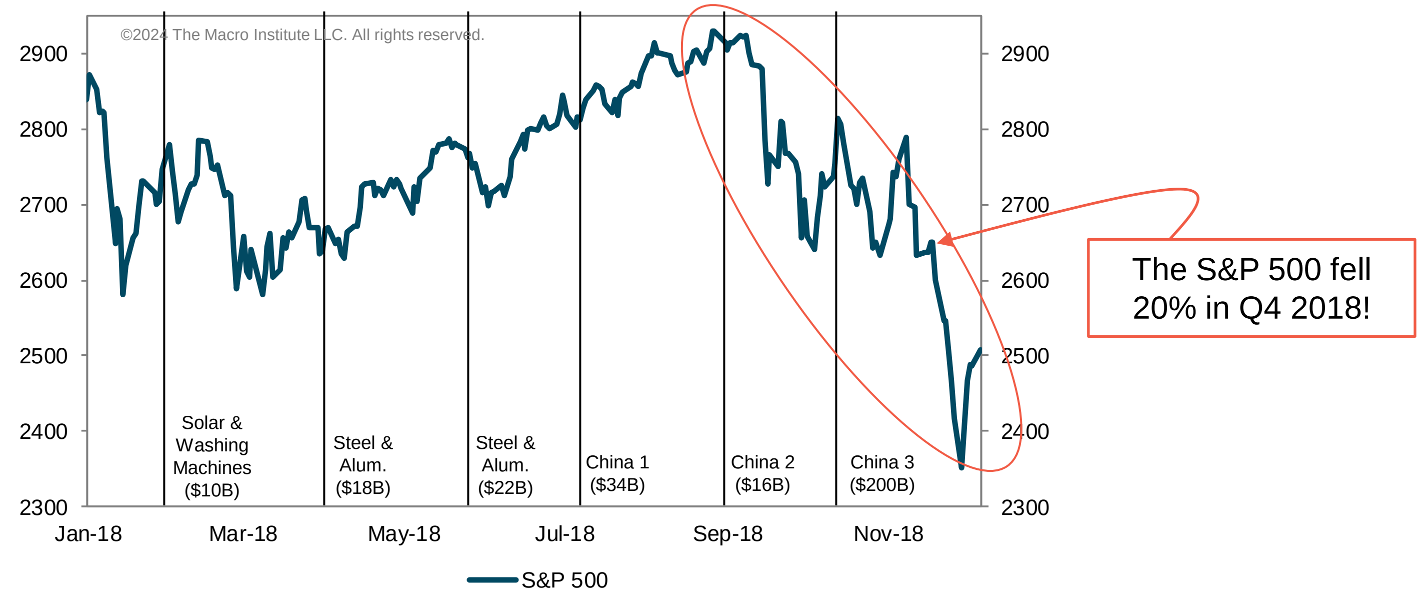
Q4: What Can We Learn From The 2018 Tariff Experience? (2/2)

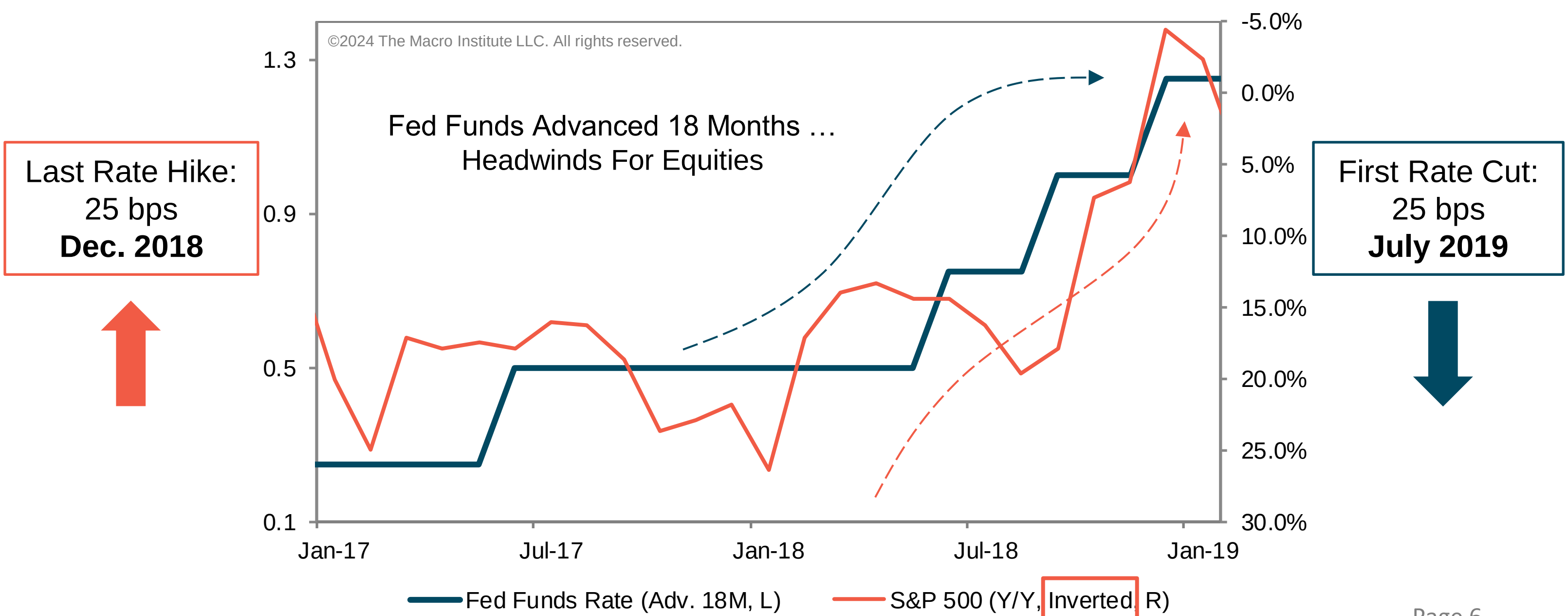
It's always difficult to isolate the causality of any market move but it's clear that the six rounds of tariffs played a hand in the equity market meltdown in Q4 2018. The sell-off began just as the second round of China-specific tariffs were imposed and it was the fifth round of protectionist policies introduced that year. The mere fact that they kept coming one after another created uncertainty in the marketplace – especially for companies with large international footprints.

Wall Street Was Eventually Spooked By 2018 Tariffs



Trade policy was not the only trouble for markets in 2018, however. The Fed was also tightening policy, or, as it was described at the time, "normalizing" official rates away from ZIRP. The uncertainty from monetary policy only added fuel to the fire of tariffs. At the end of the day, higher rates were an immediate problem for the lofty P/Es of the Growth space, which is a segment that also had a large international revenue footprint. This combination propelled the ever-popular Growthy stocks and sectors to lead the decline in the overall market. How the Fed reacts to the proposed trade policies in 2025 will prove very interesting.

Tariffs + Higher Interest Rates = Perfect Storm For Equities



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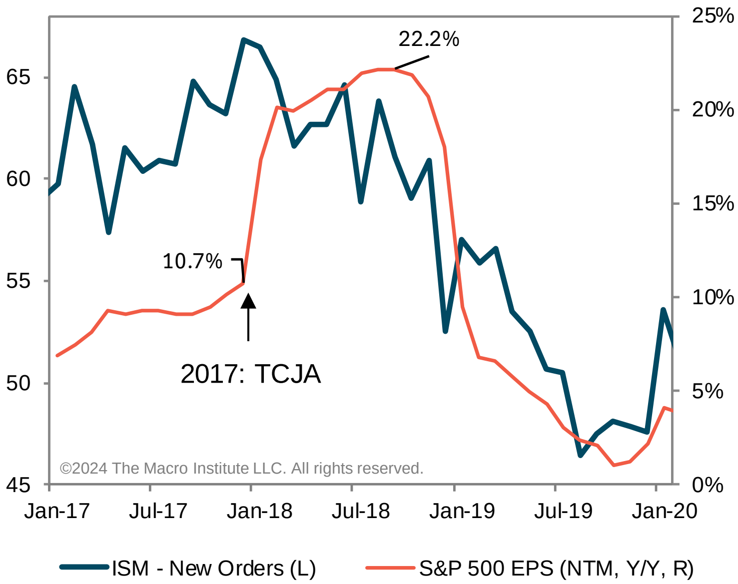
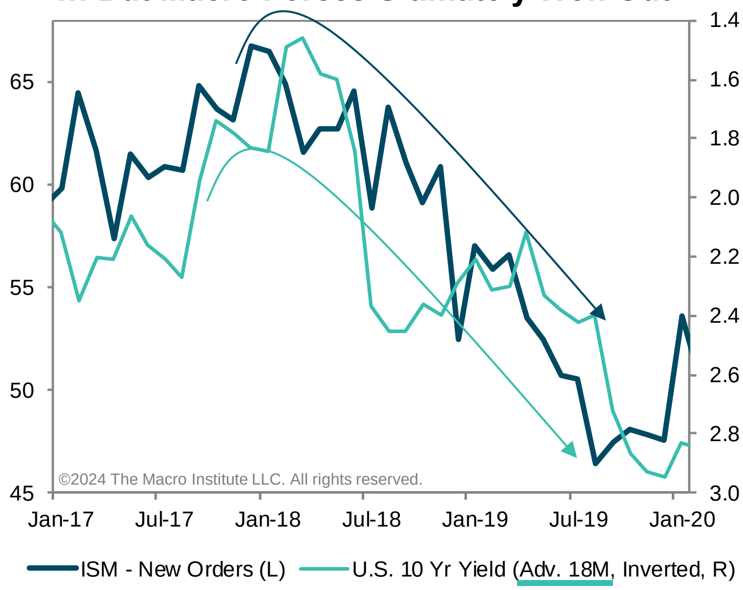
Q5: What Does A Lower Corporate Tax Rate Mean For Equities?

Equity investors tend to be a "glass half full" bunch, so the marketplace initially celebrated corporate tax cuts. Indeed, the S&P 500 roared higher in January of 2018. The momentum would prove short-lived, however, as economic prospects still lost ground despite the tax cuts. Indeed, the lagged effects of earlier Fed tightening (see chart below right) was finally beginning to catch up with leading indicators, including equity returns. This would ultimately culminate in the massive, albeit short-lived, sell off in Q4'18.

Tax Cuts Gave A Short-Term EPS Boost …



… But Macro Forces Ultimately Won Out



The tax cuts implemented in late 2017 were oddly timed compared with what we have seen in the past. Indeed, the stimulus bill was introduced as the Fed was actually tightening policy. This was a major departure from what typically had happened historically. It's difficult to identify the specific impact of policies on the stock market, but clearly the tax cuts, while extremely beneficial for earnings, added fuel to an already solid economy. This in turn created uncertainty about the Fed's future path in light of a VERY Growthy S&P 500 Index at the time.

Financial Statement On 2017 TCJA

"The impact of the tax reform signed into law in December will have a significant impact on our income and effective tax rates. As a result of changes in the law that reduces the federal corporate tax rate from 35% to 21%, we were required to revalue our deferred tax liabilities in Q4 at the new lower rate of 21%. **This drove a onetime non-cash tax benefit of $144 million and was the primary driver of our fourth quarter effective tax rate, which is a benefit of approximately 149%, or $1.94 increase to our diluted EPS."**

– Advanced Auto Parts (AAP)
February 2018

Tax Rates For Select Industries

Industry	Tax Rate
Chemicals (Diversified)	44.3%
Metals & Mining	35.3%
Apparel	32.2%
Paper & Forest Products	30.9%
Oil & Gas Integrated	29.5%
Auto Parts	27.9%
Beverages (Alcoholic)	25.6%
Trucking	25.5%

Source: NYU

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My question? mashaAllah mashooq bhai

Q6: How Will The Fed React To The Trump Administration's Policies?

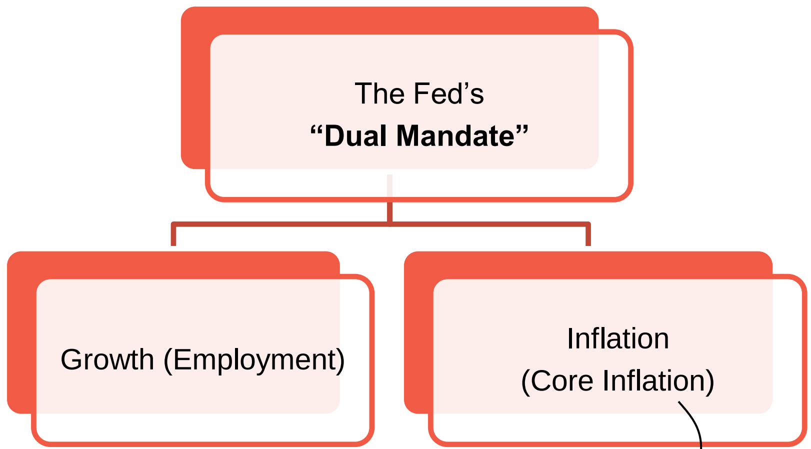
This is the million dollar question! Truth be told, it is easy to speculate BUT difficult to know given that the policy proposals are for the most part unprecedented for today's generation of investors. While it is still unclear (no matter what anyone says) what the results of the proposed policies will be on net employment, it seems fairly obvious that the policies will be inflationary, all other things equal. This may not send the Fed back into extreme tightening mode, but it will probably result in interest rates that are higher than would otherwise be the case (i.e. less easing).

The Federal Reserve's "Dual Mandate": The Evolution of an Idea

Since 1977, the Federal Reserve has operated under a mandate from Congress to **"promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates"—what is now commonly referred to as the Fed's "dual mandate."** The idea that the Fed should pursue multiple goals can be traced back to at least the 1940s, however, with shifting emphasis on which objective should be paramount.

By Aaron Steelman, Richmond Fed, December 2011
[The Federal Reserve's "Dual Mandate": The Evolution of an Idea]

The Fed's Dual Mandate



The three biggest influences for ***Core Inflation:***

1) Wage inflation 2) Import prices 3) Shelter inflation

Those who are worried about Fed independence can probably rest easy for the time being. Indeed, Fed Chairman Alan Greenspan made it clear on a few occasions that he felt pressure from the Treasury Department during his tenure, BUT, he added that it was ultimately futile as policy is conducted by a committee and not just one person. Greenspan did comment on the state of U.S. fiscal policy at times so clearly the administration does have an influence on the conduct of monetary policy. Chairman Powell has made comments on the level of debt in the U.S. economy before, and the proposed policies would only lift debt/GDP further, even with strong economic growth.

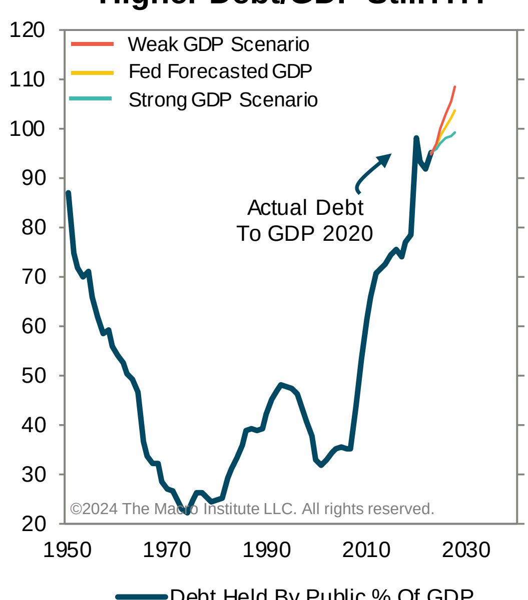
The Balance Of Monetary and Fiscal Policy

"I often had to go across the street and sit down and look the Secretary of the Treasury in the eye and say, "We just raised discount rates," and what came back at me was steely eyes of discontent. And so it's an uncomfortable issue, but it does not in any way affect the policy."

– Alan Greenspan

Federal Reserve Board Oral History Project (2009, 2012, 2013)

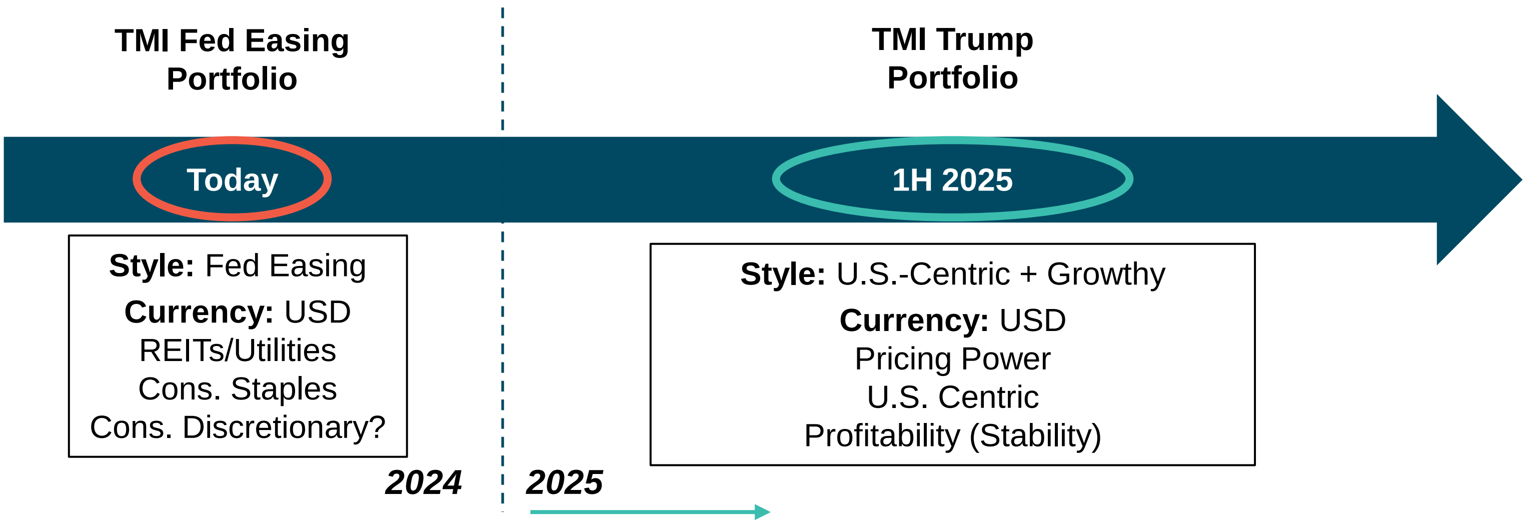
Higher Debt/GDP Still?!?!



Q7: Positioning For The Trump Administration's Proposed Policies???

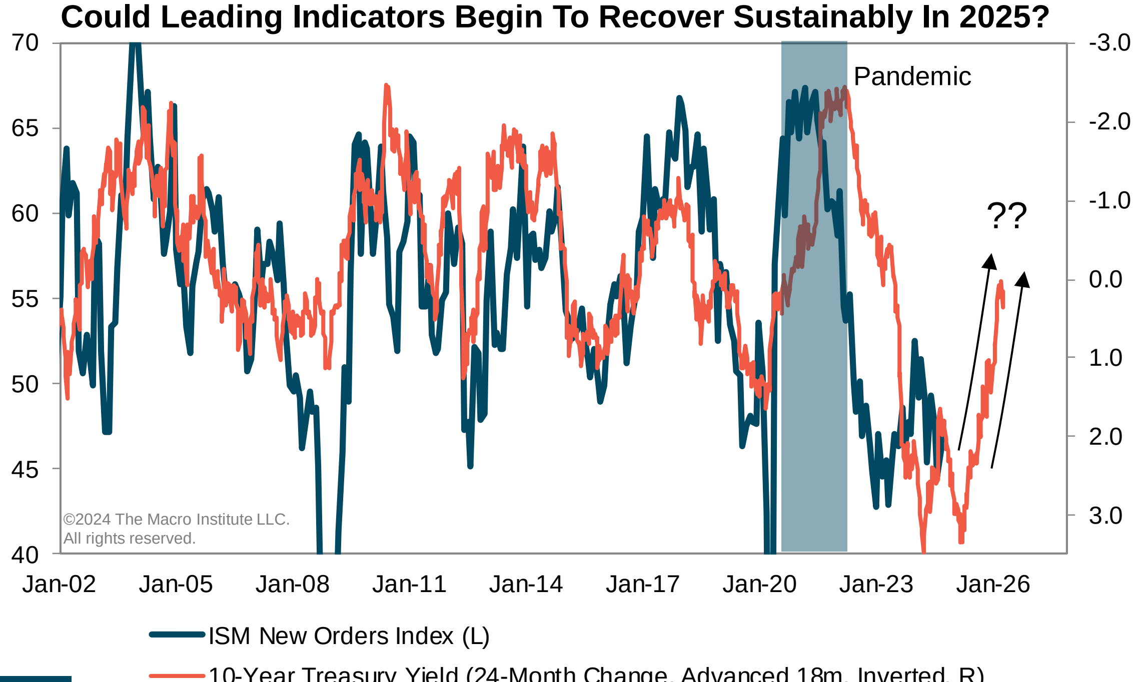
How do we position portfolios for all of these macro and political crosswinds? For now, it's important to acknowledge that the lagged effects of earlier Fed tightening are still in play. While this won't last forever, it does seem to be the primary force for markets at this time. As we covered in the email text accompanying this report, the S&P 500 has given up much of its post-election celebratory gains and Defensive sectors have been at the top of the sector rankings thus far (ex-healthcare, for obvious reasons). We would expect things to change given the policy proposals, however.

What Is Likely To Work Over The Next 18 Months???



The one theme for the coming years that seems clear is for U.S.-centric investments to shine given the protectionist tones at play. IF the proposed policies do end up being implemented, even in a diluted way, inflationary pressures should revive somewhat. That would make pricing power another important characteristic to emphasize alongside U.S. sales-centricity. Lastly, federal austerity AND the potential for retaliatory tariffs should add up to some uncertainty for equity investors – a backdrop that typically favors profitability metrics and stability or visibility. That's the factor combination we believe will be effective as the lagged effects of Fed tightening finally fade in 2025.

Could Leading Indicators Begin To Recover Sustainably In 2025?



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It's Not Too Late – The Conference Call Replay Has Shelf Life!

We are doing work on the new administration's policy proposals on an ongoing basis. That said, the initial body of work included in the conference call has shelf life and provides a great primer on what are largely unprecedented policies. Needless to say, we don't know what will ultimately get implemented but it seems clear that it will likely differ from the norms of the modern era.

Click Here To Download Slides

Click Here To Watch Replay

Below is an example of the three themes likely to dominate markets during the coming Trump administration. Here we use one of our favorite models, the TMI F&G Model, as a proxy for stability as it is largely dominated by profitability metrics. Market share and margin growth are two factors we turn to when it comes to pricing power. Meanwhile, the domestic revenue factor speaks for itself.

A Sample Stock Listing Of TMI Trump Portfolio

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Lower Deciles Rank Better In All Categories

Universe: S&P 500
TMI Trump Portfolio

Ticker	Name	Trump Portfolio	F&G Model	Domestic Revenue	Margin Growth	Market Share Growth	Price	Market Value	Sector	Industry
CINF	Cincinnati Financial Corporation	1	1	1	1	2	$ 148.69	23,242.5	Financials	Insurance
ERIE	Erie Indemnity Company Class A	1	1	1	1	5	$ 427.42	19,905.1	Financials	Insurance
GILD	Gilead Sciences, Inc.	1	1	3	1	1	$ 96.57	120,222.7	Health Care	Biotechnology
PGR	Progressive Corporation	1	3	1	1	1	$ 261.52	153,201.4	Financials	Insurance
TRV	Travelers Companies, Inc.	1	1	2	1	3	$ 256.89	58,318.9	Financials	Insurance
TT	Trane Technologies plc	1	2	3	1	1	$ 410.58	92,390.3	Industrials	Building Products
WEC	WEC Energy Group Inc	1	3	1	1	3	$ 97.59	30,873.0	Utilities	Multi-Utilities
ALL	Allstate Corporation	1	3	2	1	2	$ 196.90	52,139.8	Financials	Insurance
NI	NiSource Inc	1	3	1	1	4	$ 35.97	16,790.0	Utilities	Multi-Utilities
O	Realty Income Corporation	1	4	2	1	1	$ 57.51	50,333.4	Real Estate	Retail REITs
CLX	Clorox Company	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	Consumer Staples	Household Products
ECL	Ecolab Inc.	[illegible]	2	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	Materials	Chemicals
IRM	Iron Mountain, Inc.	1	3	3	1	2	$ 119.71	35,130.1	Real Estate	Specialized REITs

For complete list, different benchmark, or monthly model updates:

Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

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