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Independent Investment Strategy
WEEKLY MACRO STRATEGY
November 15, 2024

U.S. Consumer Price Levels, Or The Inflation Rate?

- The stampede into U.S. assets may be slowing, but is unlikely to reverse in the near run, given the prospects for additional economic stimulus and, thus, even higher earnings expectations.
- The avoidance of non-U.S. assets is also unlikely to reverse until there is some clarity on prospects for trade war 2.0.
- The main risk factor, aside from renewed protectionism, is the budding uptrend in DM government bond yields and rate expectations even in the face of lower ***actual*** policy rates. The inflation threat, especially in the U.S., is not over.

Policy *p.9*

- Some Fed members are (finally) supporting our view that the neutral rate might be as high as 4.5%, with bearish implications for Treasurys (and will likely cause the yield curve to steepen).

MRB *TradeBook Update* *p.11*

- We reiterate some important stop-shorts in view of the powerful post-election rally in U.S. assets, and added two new fixed-income positions.

The stampede into U.S.-dollar assets slowed a bit in recent days, but the avoidance of non-U.S. assets has persisted. The latter are under pressure because they will not (relatively) benefit from the expected fiscal stimulus courtesy of the incoming U.S. Administration, yet are exposed to the looming threat of another round of potentially sizable U.S. trade tariffs. The most expensive assets are now even more expensive and the laggards, which are relatively cheaper, are still lagging.

It takes a significant headwind to undermine an economy with solid momentum, whereas it does not take much to trip up a struggling economy. The U.S. economy already has solid momentum and initially is in line to receive a further boost based on the incoming president's proposed policies.

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Conversely, a meaningful trade war could easily trip up the global economy, much as occurred during the trade war late last decade.

Still, for now, we remain positioned for an improvement in the global economy in the coming months, aided by lower borrowing rates and moderately depressed energy prices.

From an aggregate global perspective, the investment picture appears bright (**chart 1**). The global equity benchmark is at a new high, credit spreads are at historically very tight levels, and there are growing hopes for much stronger deal flows as DM policy rates move steadily lower. However, the aggregate global stock index masks a huge relative shift in equity performance (more below).

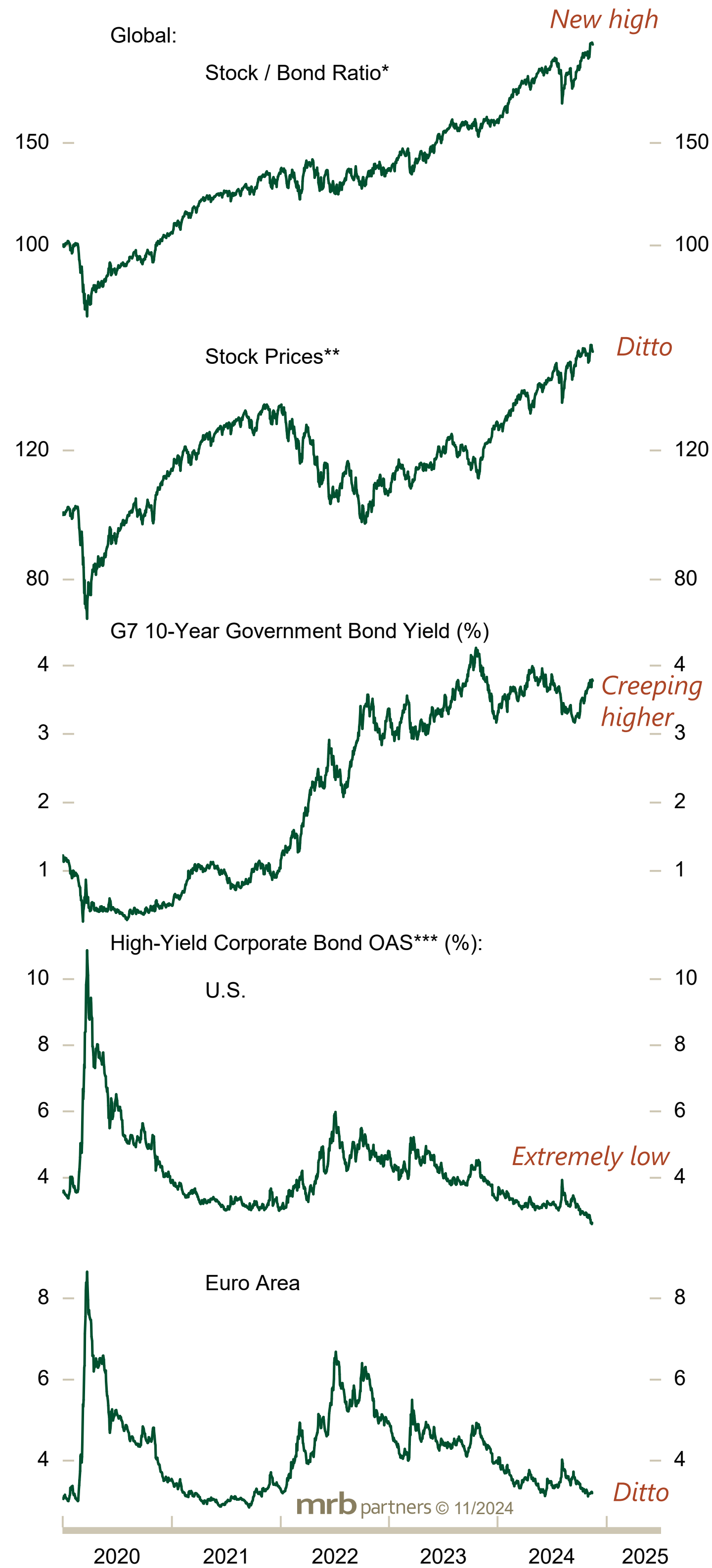
A potential warning sign for risk asset markets is that DM government bond yields have reversed course and moved higher, although to varying degrees (more below). Rich aggregate valuations in stocks and credit at a time of rising government bond yields usually ends badly.

The last significant such episode was in 2022 when bond yields rose far higher than investors envisioned; the latter had been conditioned to expect record low yields to persist "forever". And even after the recent rise in yields, few bond investors currently are positioned for new cyclical highs in yields, underscoring the potential for a selling panic.

For now, we are sticking with a mildly pro-growth investment stance favoring stocks over bonds, credit within a fixed-income portfolio (and overweight inflation protection, see page 13), and would refrain from shorting the U.S. dollar until the post-Trump rally has run its course (but remain underweight the weak-link currencies[1]). We also have two short

[1] The MRB weak-link countries are: Australia, Canada, New Zealand, Norway, Sweden and the U.K.

Chart 1 **Global Equities And Credit Are "Hot", But Watch Government Bond Yields**



* Global MSCI stock market total return index divided by G7 10-year government bond total return index; local currency; rebased; source: MSCI
** U.S. dollars; rebased; source: MSCI
*** Option-adjusted spread; source: BofA Merrill Lynch

Treasury positions in our absolute return portfolio, including one relative to Bunds[2].

Looking out beyond the near run, some significant portfolio changes could develop depending on the ***actual*** policy changes taken by the new U.S. Administration and the possible "responses" from other countries. In contrast with our comments about the low odds of undermining a strong U.S. economy, the same is not true of U.S.-dollar asset markets, which are richly priced and thus vulnerable to shocks.

There are several potential catalysts that could trigger meaningful price setbacks, with the budding uptrend in Treasury yields at the top of the list should the rise gain a head of steam.

It is Treasury-bearish to goose the already solid U.S. economy (via both fiscal and monetary policies) ***at time when the output gap is positive and inflation is "sticky"***. By extension, and given current stretched valuations, a bearish Treasury market will eventually become a threat to other asset prices.

A bearish Treasury market will eventually become a threat to other asset prices

Moreover, even in the absence of a negative catalyst, what other positives will there be to discount for U.S. assets and the dollar beyond the near run? Unfortunately, the answer to the opposite question for many non-U.S. markets (what further could go wrong) is not encouraging: the outlook could easily darken beyond what is currently feared.

Next year holds the potential to significantly alter the investment landscape. For now, we can only say "stay tuned", as there are a lot of uncertainties about what will actually happen (and when) and how investors will react. The Middle East and the war in Ukraine remain wild cards, and thus global energy prices warrant close monitoring. Trump's bold steps during his first term were not all bullish for the U.S. equity and credit markets, nor the economy, as discussed last week[3]. However, Trump also showed that he could quickly pivot when faced with threats to the economy.

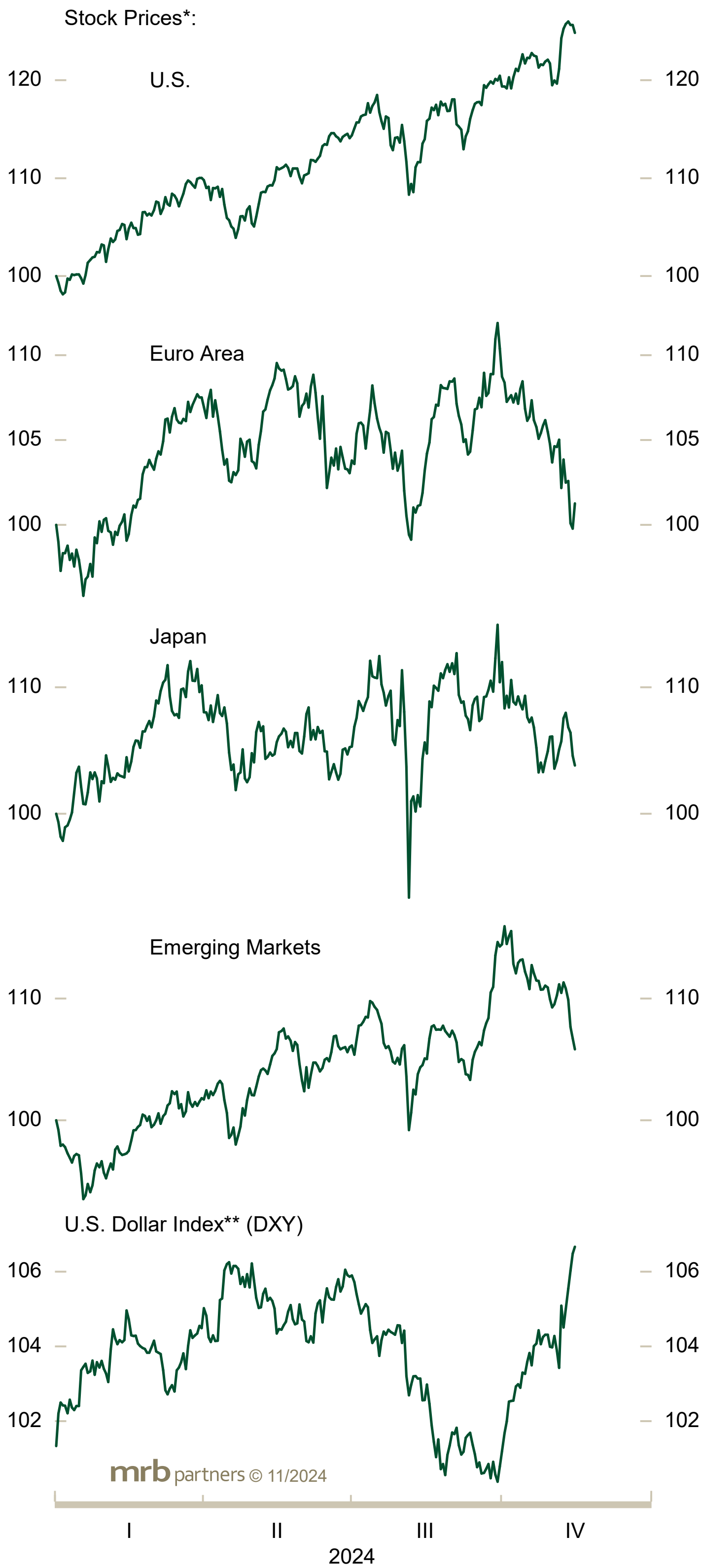
In his first term, Trump showed that he could quickly pivot when faced with threats to the economy

Chart 2 highlights the stunning shift in equity market performance since it appeared that Trump would win the election. Investors want to be long an equity market that already had a solid corporate profit trend, and will now get a further boost.

[2] See the **MRB *TradeBook***

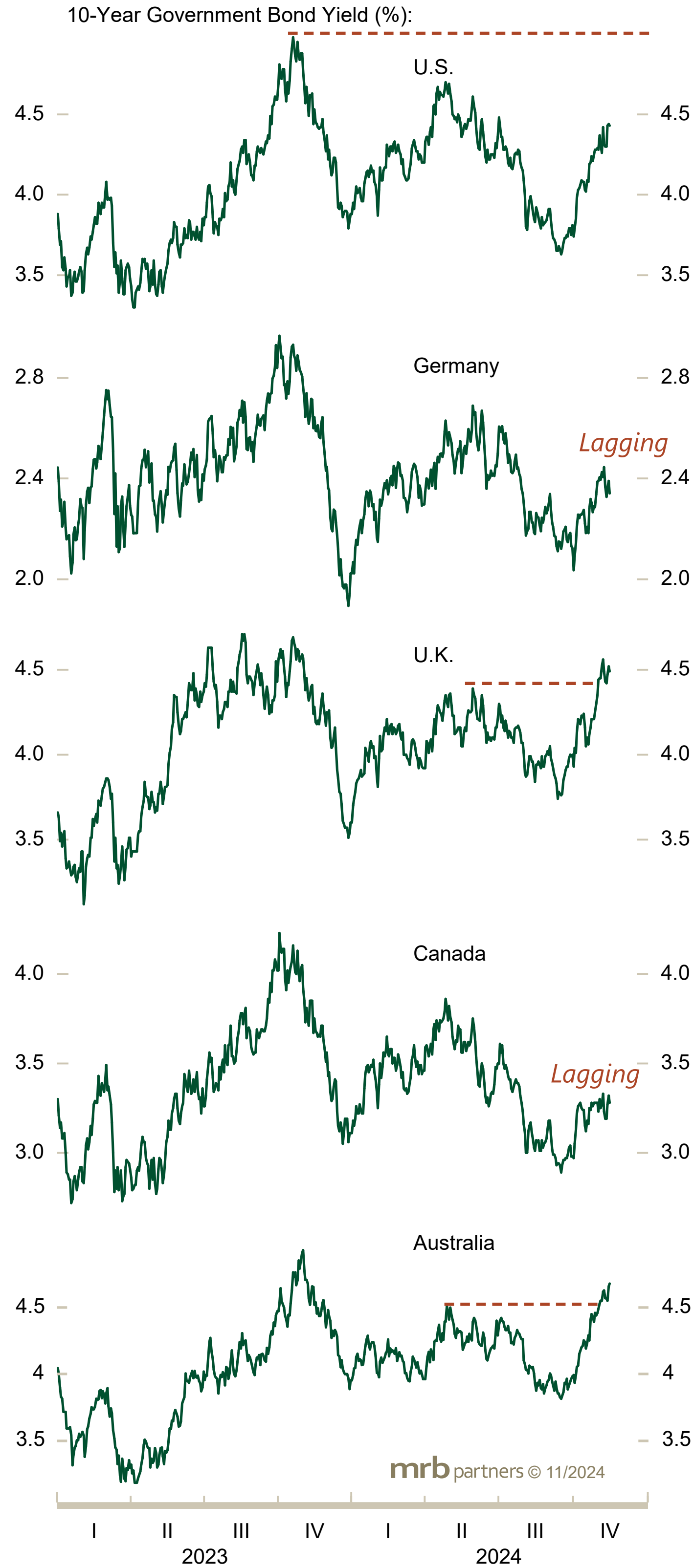
[3] See the discussion and **chart 3** in the **MRB**: "***A Uneventful Fed Rate Cut, A Less Certain Policy Path***", November 8, 2024

Chart 2 The U.S. Is Hot, Everyone Else Is Not



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

Chart 3 Diverging DM Bond Yields, But Upward Pressures Building



Conversely, non-U.S. bourses are suffering from a "*why take the risk*" mindset that is hard to refute for now. Leaning against these trends will prove challenging as the headlines will be biased towards U.S.-positive news in the coming months.

While DM government bond yields have modestly diverged of late, all markets have witnessed higher yields in the past month or two (**chart 3**, previous page). While the heathier economies in the euro area and Japan can withstand higher yields, the weak-link countries will be vulnerable if their yields get dragged up meaningfully further as Treasury yields move higher. Weak-link economies should be monitored for cracks that could herald the next global recession.

Ultimately, the U.S. Treasury market holds the key for equities in 2025. Normally, equities rally on the back of rising earnings expectations when the Fed is lowering policy rates in a non-recessionary backdrop. And earnings expectations will continue to rise given the ongoing solid economic expansion.

The longer the economy grows above its potential rate, the greater the pressure on the Fed to lift its estimate of the neutral rate

Yet, it is reasonable to assume that the yield curve will also steepen, with long-term bond yields rising as inflation concerns return and the term premium in the Treasury market grinds higher[4]. Meanwhile, the longer the U.S. economy continues to grow at an above-potential rate, the greater the pressure on the Fed to ***further*** lift its estimate of the neutral rate, which is bond-bearish and likely to cause the yield curve to steepen (see page 9).

Absent something that undermines the U.S. economic expansion, bond yields are likely to ***eventually*** rise to the point where equity markets will de-rate.

The damage to equities should be limited until the U.S. 10-year Treasury yield rises above 5%

In terms of magnitude, we anticipate that any damage to equities should be limited and temporary until the U.S. 10-year Treasury yield rises above the 2023 peak of 5%. If (or rather when!) yields breach 5%, then investors will start to worry that the ceiling for yields is open ended and the Fed will pivot again and resume tightening. At that point, an equity de-rating phase would be likely. This could also heighten tensions between the next president, who wants low interest rates to boost growth, and the Fed.

Critical to the outlook will be whether U.S. inflation is as sticky as we anticipate, or eventually reverts to 2% as the Fed and many bond investors expect. As an aside, polls

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4 **MRB**: "***Absolute Return Strategy: The Return Of The Term Premium***", October 31, 2024

have noted that ***"inflation" played a meaningful role in the U.S. election***, albeit as seen through the eyes of voters, rather than via what the Fed targets and bond investors monitor.

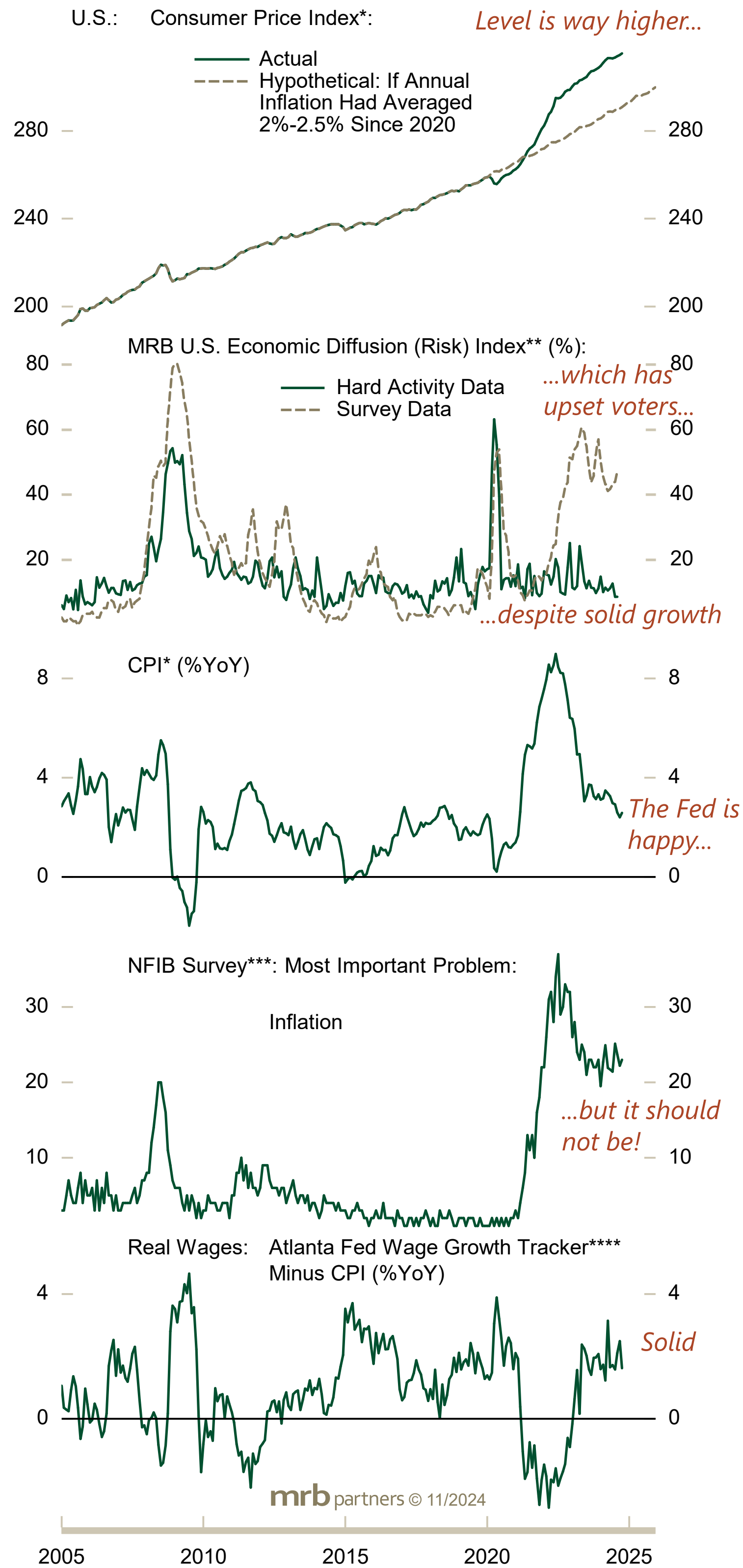
Chart 4 highlights two very different perspectives on U.S. "inflation" this decade:

❍ In panel 1 we show the ***level*** of consumer prices and a "trend" line extrapolating where price levels would be today if inflation had stayed static at its pre-pandemic ***rate***. A huge gap developed between these two lines as price levels soared earlier this decade, and the gap has since continued to widen (although at a slower pace). Voters said they were extremely dissatisfied with "inflation", which really reflected the massive price increases in everyday items, particularly food and essentials, as captured by this panel.

❍ Panel 3 shows that the headline CPI rate has decelerated to near the Fed's target after soaring during the pandemic and re-opening phase. This panel shows headline inflation, whereas underlying measures of inflation that are not impacted by global energy and/or food prices show a similar initial picture but a less significant deceleration and, more recently, a levelling off well above the Fed's 2% target (panel 4, and more below).

Panel 2 in **chart 4** shows the huge gap between survey measures (perceptions) of the economy and actual hard data: elevated readings in our risk indexes indicate a high risk of weak growth, and vice versa. The unprecedented divergence of these indexes in recent years reflects the huge gap between how Americans perceive the economy versus the hard economic data which has been solid (i.e. the hard data risk index has stayed low).

Chart 4 **U.S. Price Levels Rose A Lot, Upsetting Consumers And Businesses**



* Source: U.S. Bureau Of Labor Statistics
** Percent of standardized components over 1 standard deviation below mean; MRB calculation based on 580 underlying data series
*** Source: National Federation of Independent Business
**** Median %YoY

There are other reasons for the unprecedented divergence between the two risk indexes besides "inflation". However, elevated price levels have been a sizable part of the negative perceptions towards the economy (and thus negative opinions towards incumbent politicians).

Surveys of how consumers and businesses perceive the broad economy have ***not*** reflected how the economy has ***actually*** performed, with persistent above-potential growth (**chart 5**), historically low unemployment, high nominal and more recently solid real wage gains, a massive increase in wealth, etc.

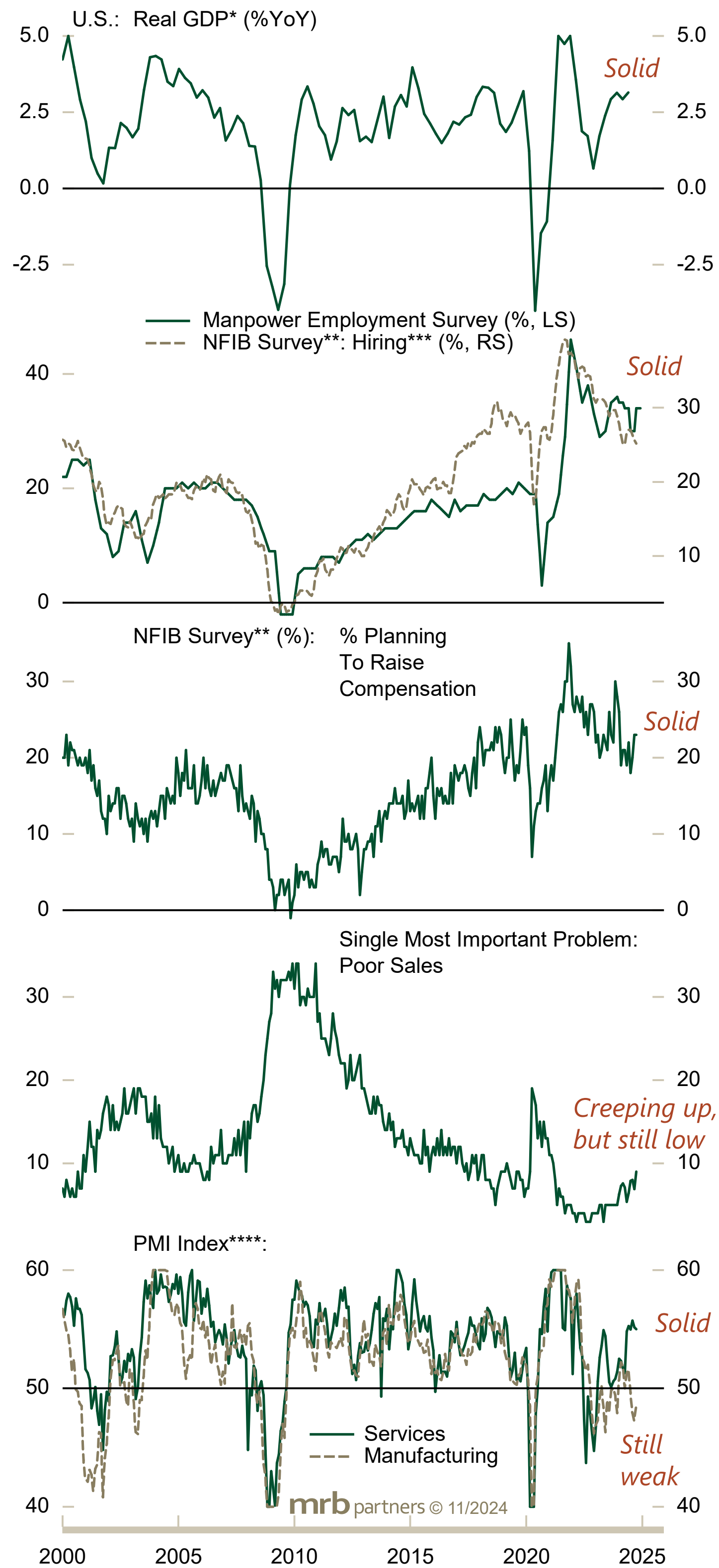
This week's U.S. small business sector's survey from the NFIB confirmed that underlying economic conditions are still quite positive. Hiring trends and compensation are solid. The only possible early warning sign is that the "poor sales" index is slowly rising, although it is still at an historically low level.

It will be interesting to see by how much this survey's responses shift in the next few months, as the members of the NFIB generally favor the Republican Party. There are great hopes for less regulation and bureaucracy, and lower taxes among small business owners (as well as hopes for lower borrowing costs).

To this end, initial post-election consumer surveys have shown a sharp jump in sentiment among Republican voters and a parallel decline among Democratic voters.

These politically-influenced sentiment shifts underscore that investors need to focus on hard economic data and how households and businesses are progressing, and to be wary of general economic views and opinions, which have been very misleading this decade. To repeat: ***hard data continue to show above-potential U.S. growth, while many surveys and opinions suggest the opposite***.

Chart 5 The U.S. Economy Has Solid Momentum



* Truncated above 5 and below -4; source: U.S. Bureau of Labor Statistics
** Source: National Federation of Independent Business
*** Average of hiring plans and job openings
**** Truncated above 60 and below 40; joined to ISM prior to 2010; sources: S&P Global & Institute for Supply Management®

This week's U.S. CPI report would normally have upset bond-bulls with another 0.3% reading for the core rate. However, there is such an entrenched belief that the inflation threat is over and a return to the 2% area is inevitable that investors have stayed sanguine in their long-term inflation outlook, as measured by CPI swap rates and inflation breakeven rates.

The bottom three panels in **chart 6** highlight a worrisome picture for the U.S. inflation outlook. Domestically-focused inflation rates, especially in services, remain sticky and well above 2%. More companies plan to increase prices than last decade: the NFIB planned price changes index is well below the peak briefly hit during the economy's re-opening, but is currently still historically elevated. Critically, ***the U.S. economy has the largest positive output gap in decades***.

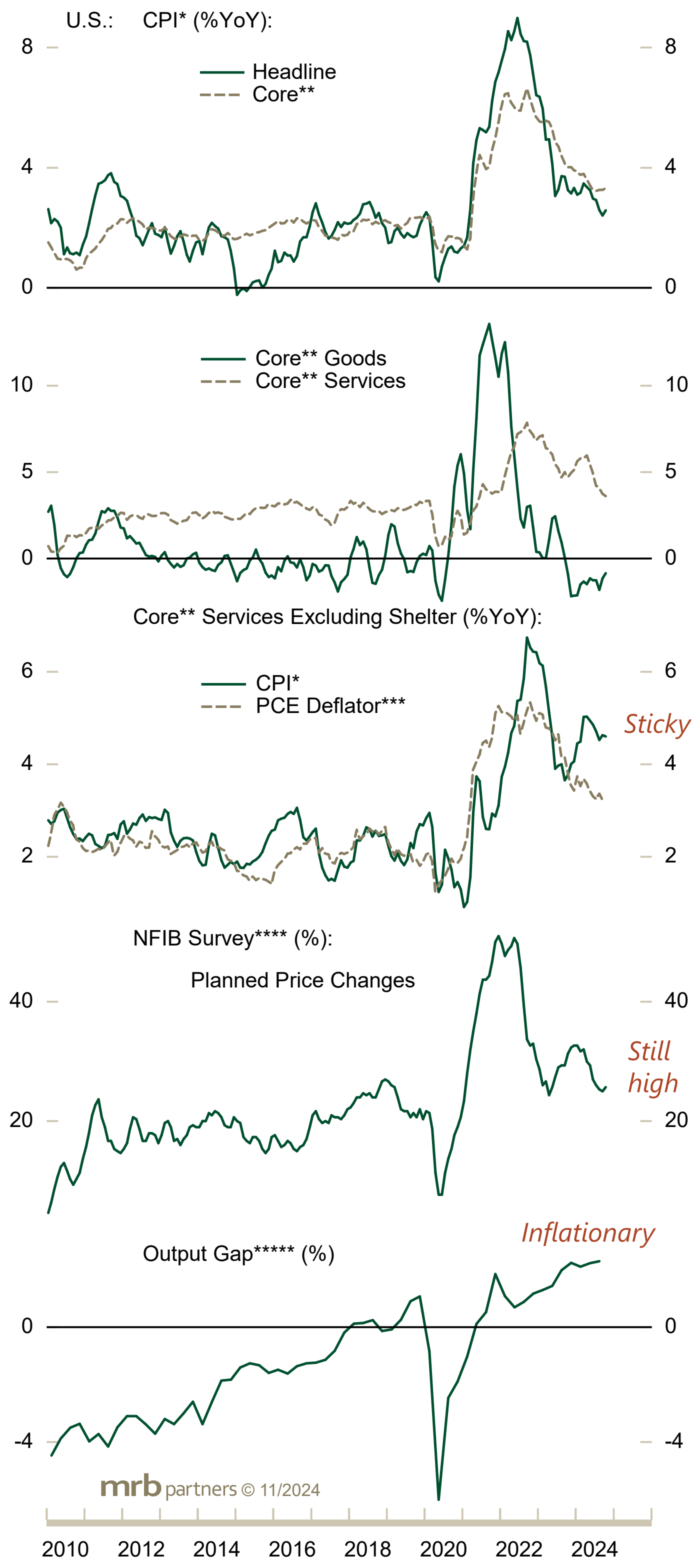
U.S. inflation is not going to return to the levels of the 2010s until the next recession arrives, which is necessary to undermine labor's bargaining power and companies' ability to lift selling prices.

The next 6 to 12 months will prove challenging for investors, as there are some powerful ***potential*** cross-currents. Global growth is improving, led by the U.S., and DM central banks are pro-growth. The already hot U.S. economy is set to receive even more stimulus.

Conversely, and in the face of lower actual policy rates, DM government bond yields and rate expectations are biased to the upside. And then there is the potential elephant in the room: will the U.S. ramp up its trade war, and extend it to trading partners other than China?

For now, investors are embracing the positive influences on U.S. growth but hedging against a trade war by abandoning non-U.S. equity markets

Chart 6 **U.S. Inflation Will Remain Historically Elevated**



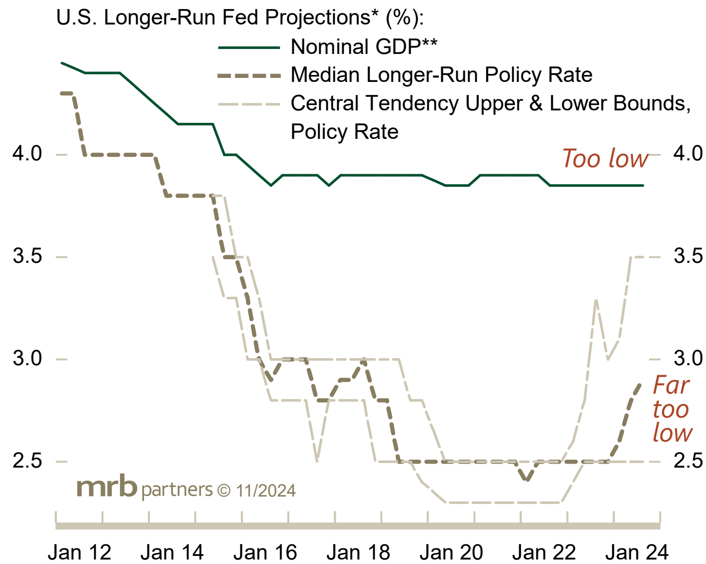
* Source: U.S. Bureau of Labor Statistics
** Core excludes food & energy
*** Source: U.S. Bureau of Economic Analysis
**** Smoothed; source: National Federation of Independent Business
***** Current GDP relative to potential GDP; truncated below -6; source: U.S. Congressional Budget Office

and currencies. We remain mildly pro-growth, but with a tight leash.

Final Word: *The stampede into U.S. assets may be slowing, but is unlikely to reverse in the near run, given the prospects for additional economic stimulus and, thus, even higher earnings expectations. The avoidance of non-U.S. assets is also unlikely to reverse until there is some clarity on prospects for trade war 2.0.*

The main risk factor, aside from renewed protectionism, is the budding uptrend in DM government bond yields and rate expectations even in the face of lower actual policy rates. The inflation threat, especially in the U.S., is not over.

Chart 7 The Fed's Neutral Rate Estimate Is Up But It Will Rise Further



* Source: Federal Reserve
** Midpoint of central tendency plus 2% inflation

Policy

The Fed Is (Predictably) Talking Up The Neutral Rate

MRB's long-standing view has been that the Fed's estimate of the longer run or neutral[5] policy rate (i.e. the nominal "R-star") has been unrealistically low for many years, embedding a secular stagnation bias developed in the aftermath of the Global Financial Crisis[6]. We predicted that the Fed would eventually be forced to revise its estimate much higher (as it became clear that the economy was resilient despite the increase in policy rates and as inflation remained sticky and elevated)[7].

Unsurprisingly, the Fed finally raised its estimate of the neutral rate from 2.5% in December 2023 to 2.9% by this September **(chart 7)**. This revision has been an important development, but the fact is that the Fed's neutral rate estimate is still too low relative to what is warranted for the U.S. economy.

MRB's view is that a realistic estimate of the neutral policy rate should be at least in the 4.5% range or possibly even higher. Given our view, we believe that ***the Fed will raise its estimate of the neutral rate further over the coming months.***

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

[5] The "equilibrium" or "neutral" policy rate is used interchangeably to refer to the rate that is consistent with aggregate output at its potential growth rate and stable inflation at the central bank target in the medium-to-long term.

[6] **MRB** "***R-Starring The U.S. Economy***", September 6, 2023 and **MRB** "***U.S. Treasurys: Understanding The Fed's Influence***", September 13, 2022 and **MRB** "***How Are U.S. Treasurys Being Valued?***", October 1, 2021

[7] **MRB** "***U.S. Fed: Cautious, But Still Dovish In Intent***", June 13, 2024 and **MRB** "***The Impact Of A Higher Neutral Fed Funds Rate***", July 17, 2024

Recent "Fedspeak" Foretells Such A Move…

The latest Fed member to talk up the neutral rate was Dallas Fed President Lorie Logan, who noted in a speech[8] this week that "*when I look at the available evidence…I see substantial signs that the neutral rate has increased in recent years, and some hints that it could be very close to where the fed funds rate is now.*"

The Fed's view of the neutral rate has for a long time been dominated by too-low estimates generated by the New York Fed's Laubach-Williams model (whose flaws we have critiqued before). Interestingly, Logan's speech marked the first time that a Fed member explicitly acknowledged the possibility of a much higher 4.5% nominal neutral rate (which is in line with MRB's view):

The Fed will likely ease rates by less than what it indicated in the September dot-plot, and what the bond market is discounting

"*Among widely consulted models, point estimates of the neutral real interest rate currently range from 0.74%[9] to 2.60%[10]. Adding in the 2% inflation target, those figures correspond to a neutral fed funds rate of 2.74 to 4.60%…the fed funds rate stands today at 4.58%, right at the top of that range… when policymakers look at mid-range estimates that suggest there's meaningful room to cut before reaching neutral, I think we should recall the technique of a ship captain whose depth finder might mistake mud for water. If we cut too far, past neutral, inflation could reaccelerate and the FOMC could need to reverse direction. In these uncertain but potentially very shallow waters,* ***I believe it's best to proceed with caution.*** *[emphasis added]*"

To summarize, Logan is in the camp of those that think the neutral rate is much higher than the Fed's official median estimate and is actively guiding investors' attention to alternative research that supports such a view (perhaps even to MRB's research!).

Future increases in the neutral rate will add to upward pressure on Treasury yields and steepen the yield curve

In short, investors should expect the Fed's median forecast of the longer-run (or neutral) policy rate to rise ahead. Moreover, the Fed will likely ease rates by less next year than what it indicated in the September dot-plot, and what the bond market has been pricing in[11] (although rate-cut expectations for end-2025 have come in by 50 bps in recent weeks!).

Amid the Fed's pivot to policy easing this year, the rise in the Fed's neutral rate estimates to-date has flown somewhat under the radar, but future increases, especially as they will coincide with a ***curbing*** of rate-cut expectations, will add to upward pressure on

[8] **Federal Reserve Bank of Dallas** "*Navigating in shallow waters: Monetary policy strategy in a better-balanced economy*", November 13, 2024

[9] **Federal Reserve Bank of New York** "*Measuring the Natural Rate of Interest*"

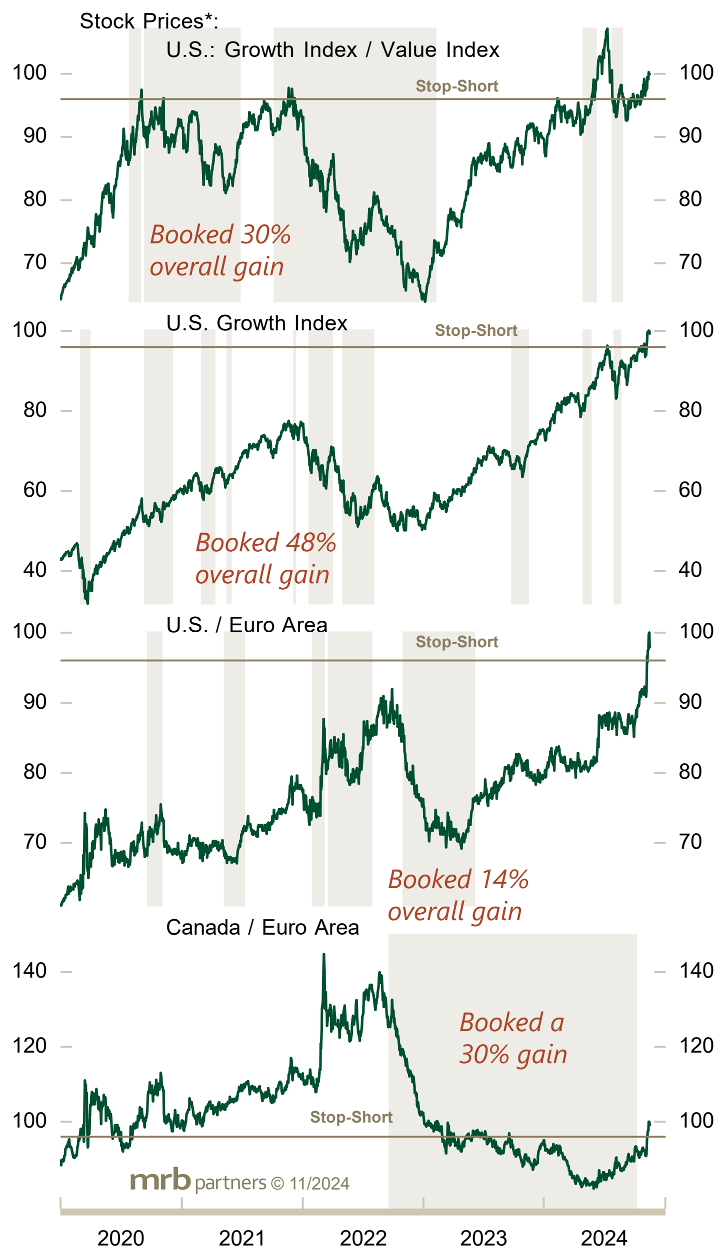
[10] **Federal Reserve Bank of Richmond** "*Lubik-Matthes Natural Rate of Interest*"

[11] **MRB** "*U.S. Fed: The Makings Of Another Dovish Error*", September 19, 2024

U.S. Treasury yields and encourage a steepening of the yield curve[12].

Final Word: *As we had expected, the Fed finally raised its estimate of the economy's neutral policy rate this year, from 2.5% to 2.9%. MRB's view is that the Fed will raise its estimate of the neutral rate further over the coming months. Recent communication from Fed members appears to support this view, for the first time explicitly acknowledging the possibility that the neutral rate might be much higher than the Fed has thus far let on, close to 4.5% (which has been MRB's long-standing view). Future increases in the Fed's median longer run policy rate, especially as they will coincide with a curbing of rate cut expectations, will add to upward pressure on U.S. Treasury yields and encourage a steepening of the yield curve.*

Chart 8 MRB *TradeBook*: Stop-Short Reminder



* Rebased; source: MSCI
Note: Total return rebased at initiation of trade; vertical line denotes when MRB initiated trade; shading denotes when MRB previously held trade

MRB *TradeBook Update*

Stop-Shorts Reminder And Two New Positions

U.S. assets have massively outperformed in the aftermath of the U.S. election and have become overbought. In turn, we are taking this opportunity to reiterate some stop-shorts of several *Shadow Trades* that would benefit when the stampede into U.S. assets ends (**chart 8**)*:*

- **Short U.S. Growth Stocks:** U.S. growth stocks have rallied materially both in absolute terms and relative to its value counterpart in recent weeks. We have a 4% trailing stop-short on both positions to capture an eventual meaningful correction.
- **Short U.S./Long Euro Area Stocks:** U.S. stocks have recently massively outperformed their euro area counterparts, and are now overbought and overvalued. We still recommend having a 4% stop-short on this position.
- **Short Canada/Long Euro Area Financial Stocks:** Canadian financials have outperformed their euro area counterparts. We are setting a 4% trailing stop-short on this position (note that we previously booked a 30% gain on this position).

❍ **New Fixed Income Positions:** Wednesday's report recommended some appealing new opportunities (see page 13). In the **MRB *TradeBook***, we will add a short position in 10-year Japanese government bonds and a short position in the U.S. 5-year CPI Swap Rate.

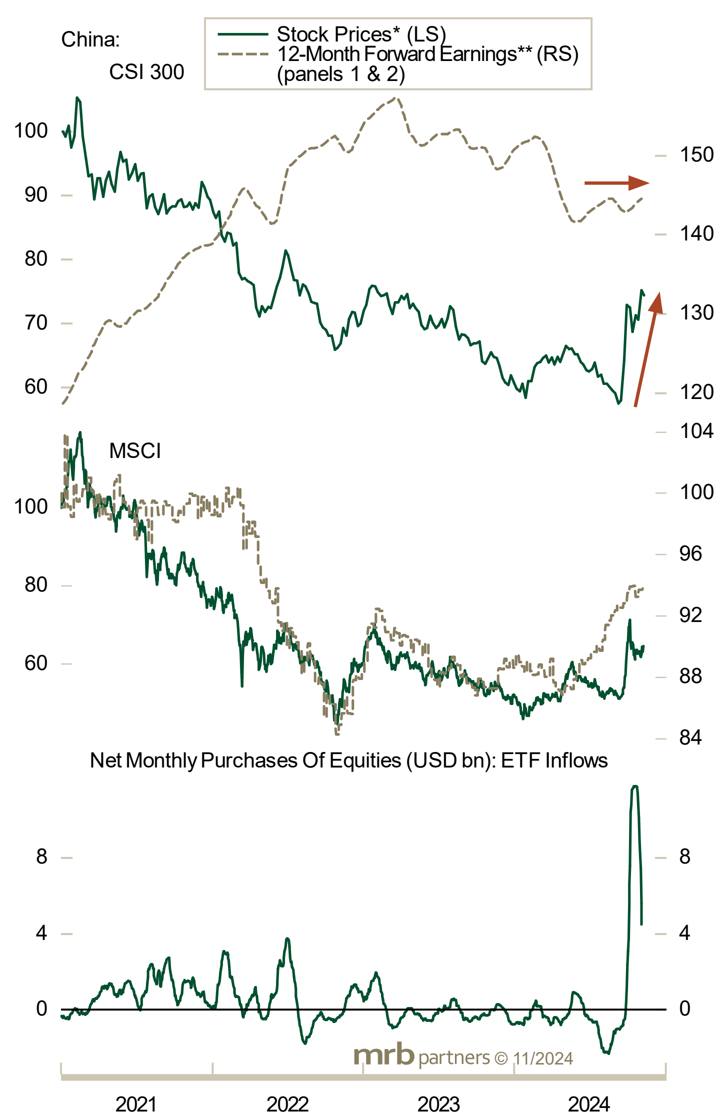
This Week's Research

China's Feel-Good Fiscal Non-Stimulus

Chinese policymakers' charm offensive that began with monetary easing in September has continued with an impressive sequence of market-friendly announcements. Last week it was the turn of the Standing Committee of the National People's Congress (NPC) to convince investors that fiscal stimulus will reinforce monetary stimulus, and that this year's 5% GDP growth target will be achieved.

The reality is far more prosaic, albeit relatively constructive enough to encourage investors in CSI 300 stocks (**chart 9**). On the one hand, "around 5%" growth was anyway achievable (doubtless with some help from upward revisions) because current growth momentum is already accelerating thanks to very strong exports and improving consumer sentiment and spending. On the other hand, the impressive numbers being banded about for government bond issuance largely represent refinancing, rather than new spending aimed at goosing growth.

Chart 9 Stock Prices Outpacing Earnings Expectations



* Local currency; rebased; sources: Bloomberg, MSCI
** Local currency; rebased; source: Refinitiv I/B/E/S Global Aggregates

Highlights of Monday's report included:

❍ New bond issuance worth 10% of current GDP, but spread over several years, will be primarily used for debt swaps rather than new spending…

❍ …but the debt swaps will nonetheless help heal local government balance sheets and improve sentiment.

❍ Stocks are pricing in the government's charm offensive, rather than earnings growth. We await evidence of stronger and broader earnings growth before upgrading Chinese stocks.

New bond issuance worth 10% of GDP will be primarily used for debt swaps rather than new spending

- Economic momentum is improving, led by strong export growth and recovering consumer spending.

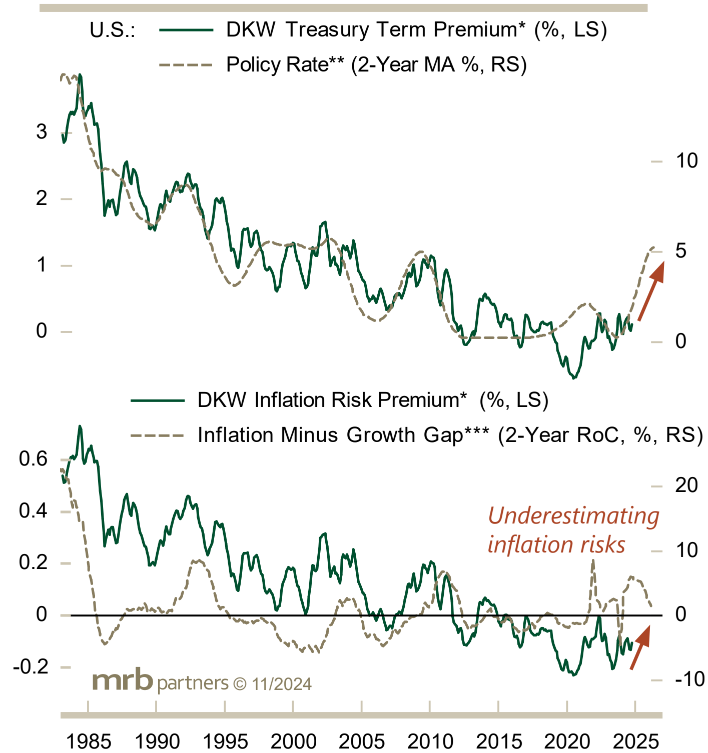
- There are signs the housing recession is bottoming out, which will remove a major headwind to economic growth.

Fixed Income – Trump 2.0: What It Means For The Fixed Income Market

The U.S. election outcome provides a platform for Trump and the Republican party to undertake substantial policy changes, which will have dramatic ramifications for U.S. Treasurys and regional bond markets.

Wednesday's report analyzed the impact of Trump's proposed policies and the related investment strategy for the fixed income market. The main takeaways included:

Chart 10 The Term & Inflation Premia Are Underpriced



* D'Amico, Kim & Wei (DKW) No-Arbitrage Term Structure Model; smoothed; source: Federal Reserve
** Advanced 18 months
*** Difference between core CPI and GDP growth on 2-year basis; advanced 18 months; sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics

- An apparent Republican sweep will provide the Trump Administration with ample flexibility to push forward with major policy changes, but will also increase macro uncertainty. This reinforces our expectation for higher U.S. Treasury yields and a greater term premium (**chart 10**). Stay below benchmark duration, underweight government bonds and short U.S. Treasurys.

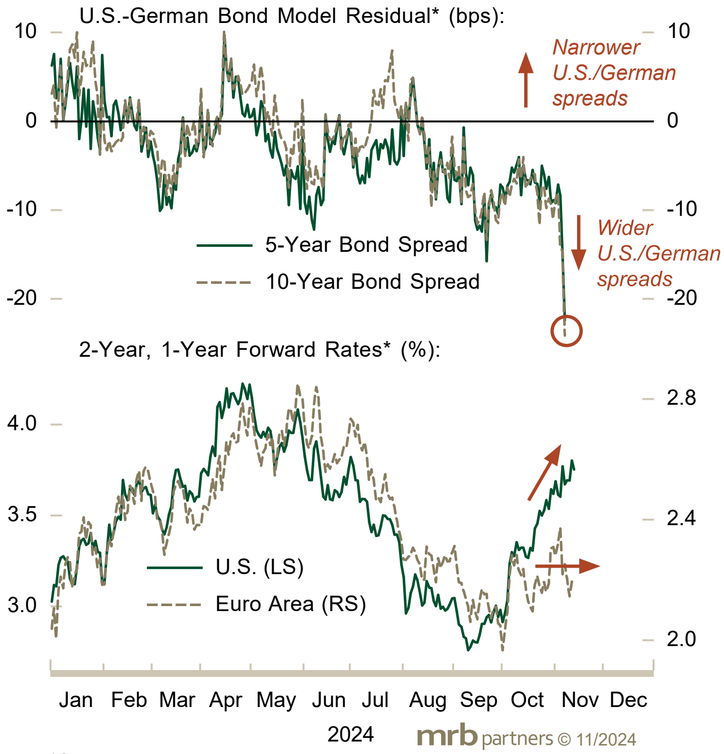
- The bond market is also significantly underpricing inflation risks. Stay overweight inflation protection and go long U.S. CPI swaps.

- Bond investors are likely to continue shifting from earlier expectations of deep Fed rate cuts in 2025 to only a few cuts, and then to anticipating an extended pause. We recommend shorting the June SOFR contract (M5) to capture this trend. If Trump again puts intense pressure on Fed Chair Powell to cut rates, the bond market is unlikely to respond favorably this time around, leading to a much steeper yield curve. Continue to bet on a bear steepening.

- Divergences between U.S. Treasurys and other developed bond markets will persist, particularly versus the euro area. We remain overweight German bonds versus U.S. Treasurys, and continue to bet on a wider spread between these markets (**chart 11**).

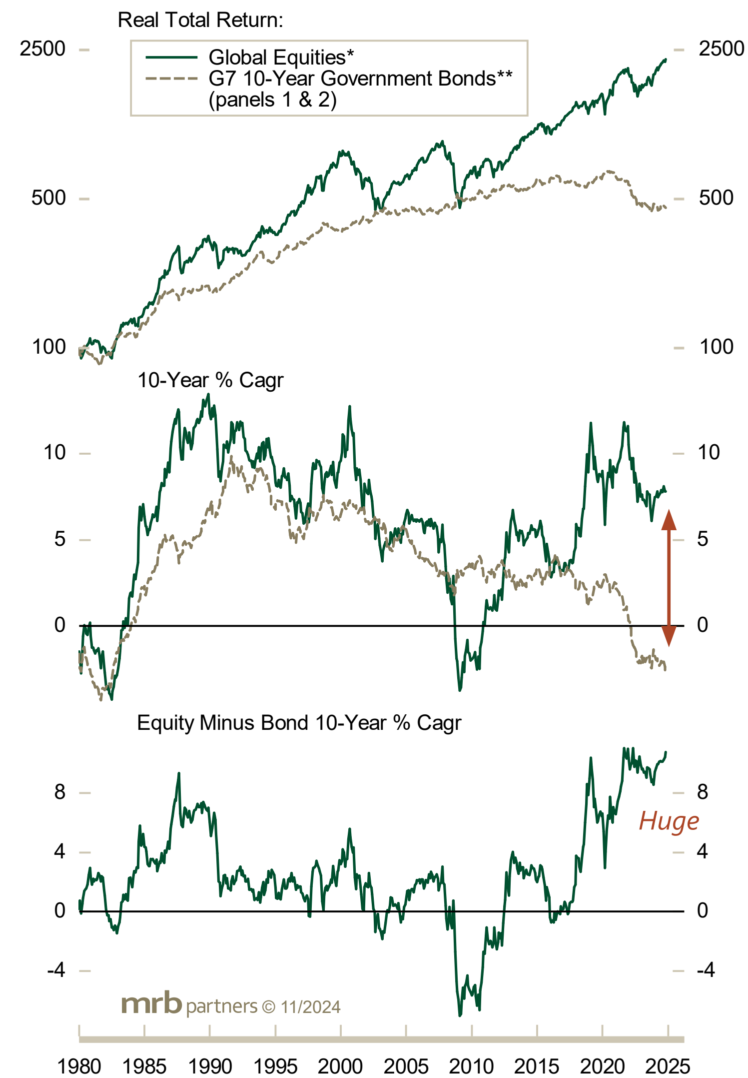
Investors will continue shifting from expecting deep Fed rate cuts to only a few cuts, and then to anticipating an extended pause

Chart 11 More Room For U.S./German Bond Spreads To Widen



* Source: Bloomberg and MRB calculations

Chart 12 Equity-Bond Performance Divergence Will Narrow



* Local currency; rebased; source: MSCI
** Local currency; weighted average; rebased; source: Bloomberg
Note: Panel 1 shown in log scale; shaded for NBER-designated U.S. recessions

❍ The Bank of Japan will need to become more hawkish to discourage a rebuilding of carry trades and stem yen depreciation. Bond investors are underpricing the likelihood for a normalization (rate ***hikes***) of 25 bps per meeting in the coming year. Stay underweight Japanese government bonds and add a short position on 10-year JGBs.

Long-Term Returns: Perpetual Reflation Is Unsustainable

Real returns should be mildly positive after the losses of the past 10 years for government bonds

The capital markets landscape is set to change markedly over the next decade, with the huge gap in recent performance between stocks and bonds set to narrow or even reverse (**chart 12**). Moreover, the benefits that investors have enjoyed in the past four decades from the persistent reflationary policies of the U.S. and other major economies will inevitably lose momentum.

Highlights of Thursday's report included:

❍ Investors should expect lower real returns on a 60/40 equity-bond portfolio over the next 10 years compared with the last decade as equity returns are expected to moderate. Only a modest structural overweight on equities versus bonds is appropriate.

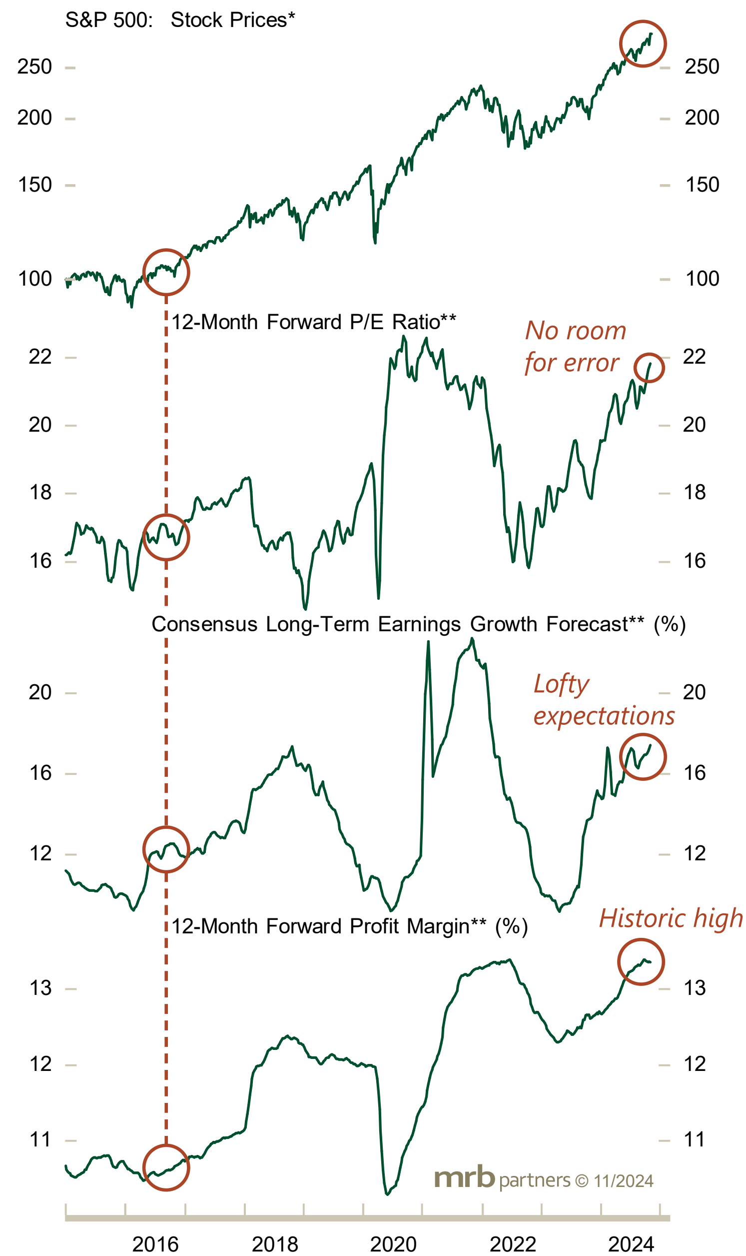
- G7 10-year government bond yields will rise further over the next decade, but real returns should be mildly positive after the losses of the past 10 years. Credit will outperform government bonds, albeit by less than the average in the past.

- U.S. equities will deliver near zero real returns in the decade ahead, weighed down by high starting valuations and earnings. Non-U.S. equity real returns will be solid and boosted by healthy dividend yields. EM, euro area and U.K. are projected to be comparative winners.

- Commodities prices are projected to edge lower in real terms, reflecting lower real gold prices and only modestly higher real industrial commodity and crude oil prices. Commodity prices will thus underperform other risk assets.

- The U.S. dollar is projected to depreciate on a real trade-weighted basis over the forecast horizon given its elevated starting point.

Chart 13 The Set-Up For Equities Is More Demanding Than At The Start Of Trump 1.0



* Rebased; shown in log scale; source: Bloomberg
** Smoothed; source: Refinitiv I/B/E/S Global Aggregates
Note: Vertical line denotes 2016 election

U.S. Equities: The Implications Of A Red Sweep

The U.S. equity market has rallied sharply in the aftermath of Former-President Trump's decisive election victory. Besides winning the White House, the Republicans also regained control of the Senate and kept the House of Representatives. Republican control of the government will give Trump the executive and legislative capacity to enact sweeping fiscal and regulatory changes.

Thursday's report discussed what the GOP sweep means for the equity market outlook and analyzed the implications for key sectors. Highlights included:

- The prospect of lower taxes and deregulation should keep risk appetite buoyant and drive U.S. stock prices higher in the near run.

- However, the longer-term set-up for the equity market is demanding given the high starting point for valuations and already elevated earnings expectations (**chart 13**). Upgrades to earnings estimates will be needed to fuel further significant upside in equity prices.

- For now, we are maintaining a moderate pro-cyclical stance, with a preference for the financial, energy, and health care sectors.

- These sectors should all see regulatory relief under the incoming Administration, with financials (especially banks) the biggest beneficiaries.

- Conversely, renewable/green energy stocks will face uncertain prospects given Trump's proposed rollbacks of tax credits and subsidies for electric vehicles and green energy investments.

- Uncertainty about the fate of the funding authorized by the Inflation Reduction Act could eventually spill over to industrial stocks linked to the electrification theme and the buildout of green energy infrastructure.

For now, we are maintaining a moderate pro-cyclical stance, with a preference for the financial, energy, and health care sectors

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