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Independent Investment Strategy

U.S. EQUITIES

November 14, 2024

The Implications Of A Red Sweep

- 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. 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 Trump 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.

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. As a result, President-Elect Trump will be presiding over a unified government for at least the next two years.

The Republican sweep will give Trump the executive and legislative capacity to enact sweeping fiscal and regulatory changes

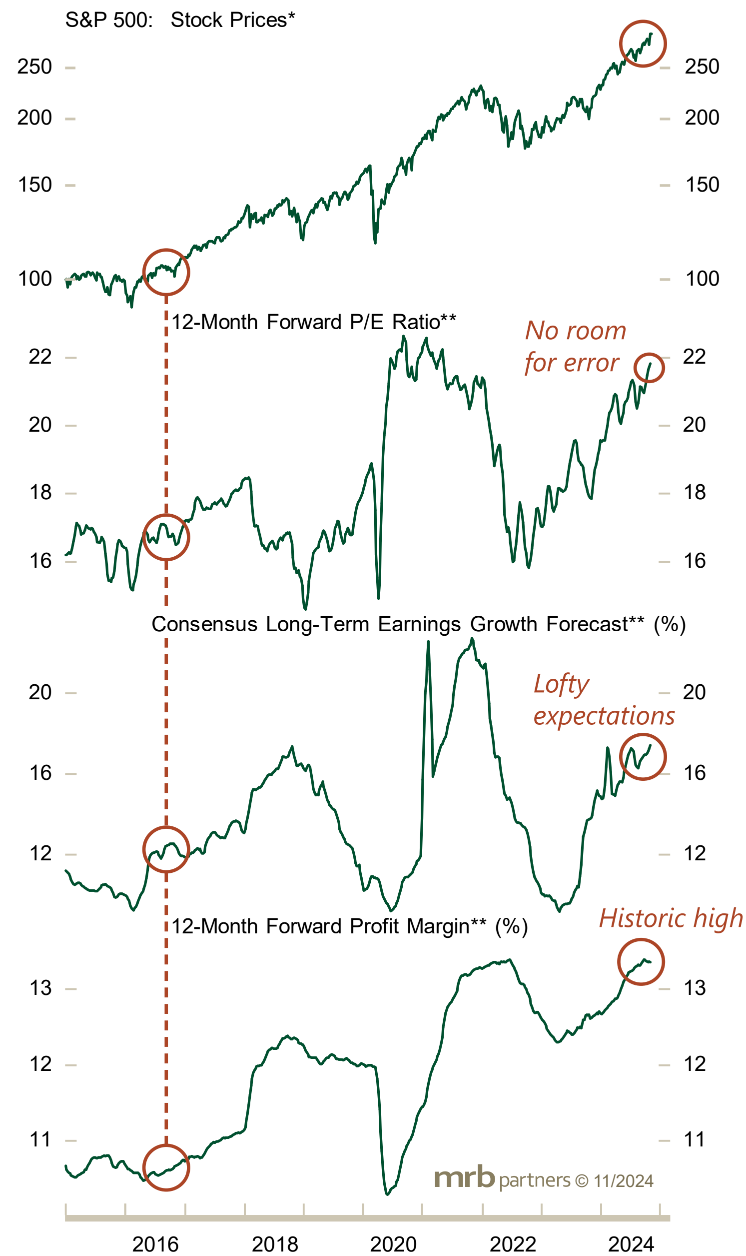
The Republican sweep will give Trump the executive and legislative capacity to enact sweeping fiscal and regulatory changes. That said, the House majority will be thin, which implies that negotiation and compromise will likely still be needed to pass major legislation.

While Trump's policies present both opportunities and risks, markets are likely to continue to focus on the pro-growth aspects of his agenda in the near run. Trump's re-election has come on the back of an economy that was already growing at an above-trend pace, supported by strong consumer spending. Thus, the prospect of lower taxes and deregulation should keep risk appetite buoyant in the near term. As such, we anticipate that stock prices will continue to climb into year-end.

While the upside momentum for stocks will remain strong, a repeat of the post-2016 election rally that saw the S&P 500 rise by more than 20% in the 12 months following Trump's first victory will be tougher to achieve. The current set-up for the equity market is less attractive. Indeed, today's elevated valuations and earnings expectations leave considerably less room for stock prices to rise (**chart 1**). The S&P 500 is trading at nearly 22x 12-month forward earnings compared with 16.5x when Trump was first elected to the White House in 2016. Consensus earnings growth forecast for the next 5 years are approaching an eye-popping 18% per annum versus 12.5% in late-2016, and forward S&P 500 profit margin expectations are at their historic highs.

Macro conditions are also vastly different than in 2016. Back then, the economy was operating with more slack and underlying inflation was muted (**chart 2**). Hence, it had greater capacity to absorb pro-growth policies without overheating. Moreover, the federal deficit as a share of GDP was half as large as today. In the current macro backdrop, there is a greater risk that the combination of Trump's pro-growth agenda, rising fiscal deficits, and upside inflation surprises driven by tariffs and slower immigration could push bond yields meaningfully higher and, ultimately pose a threat to equity prices.

Chart 1 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

The more demanding set-up for the equity market underscores that investors should position in sectors that are not dominated by the mega-cap companies. The latter, are mostly fully valued and offer a less appealing risk-reward trade-off. Accordingly, we recommend maintaining a moderate pro-cyclical stance, favoring the financial, energy, and health care sectors.

As heavily regulated sectors, financials and energy should be major beneficiaries of Trump's deregulation agenda. While the implications of the elections are less straightforward for health care stocks, we do not anticipate that the sector will be disrupted by significant regulatory changes under the incoming Trump Administration given the entrenched nature of the Affordable Care Act (ACA) and recent legislative wins in negotiating drug prices under Biden's presidency.

Below, we provide our initial take on the implications of the election for some key equity sectors.

Chart 2 The Economy's Capacity To Absorb Pro-Growth Policies Is Less Than In Trump 1.0

* Core excludes food & energy; source: U.S. Bureau of Labor Statistics
** GDP as a percent of potential GDP; truncated below -5; sources: Bureau of Economic Analysis and Congressional Budget Office
Note: Shaded for NBER-designated U.S. recessions; vertical line denotes 2016 election

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Financials

The financial sector is potentially the biggest beneficiary of the election. Republican control of the Senate will enable Trump to replace the heads of agencies such as Consumer Financial Protection Bureau (CFPB) and the Office of the Comptroller of the Currency (OCC) with watchdogs that are more philosophically aligned with his lighter approach to regulation. Both of these officials sit on the five-member board of the Federal Deposit Insurance Corporation (FDIC). As a result, the above moves, when completed, will give Trump a Republican majority on the FDIC board, thereby allowing him to influence bank regulations. With these changes, the odds that the Basel III Endgame capital rules will be further watered down or jettisoned altogether have increased[1]. In addition, banks are likely to face more predictable stress tests and a friendlier stance towards industry consolidation under the new regulatory regime.

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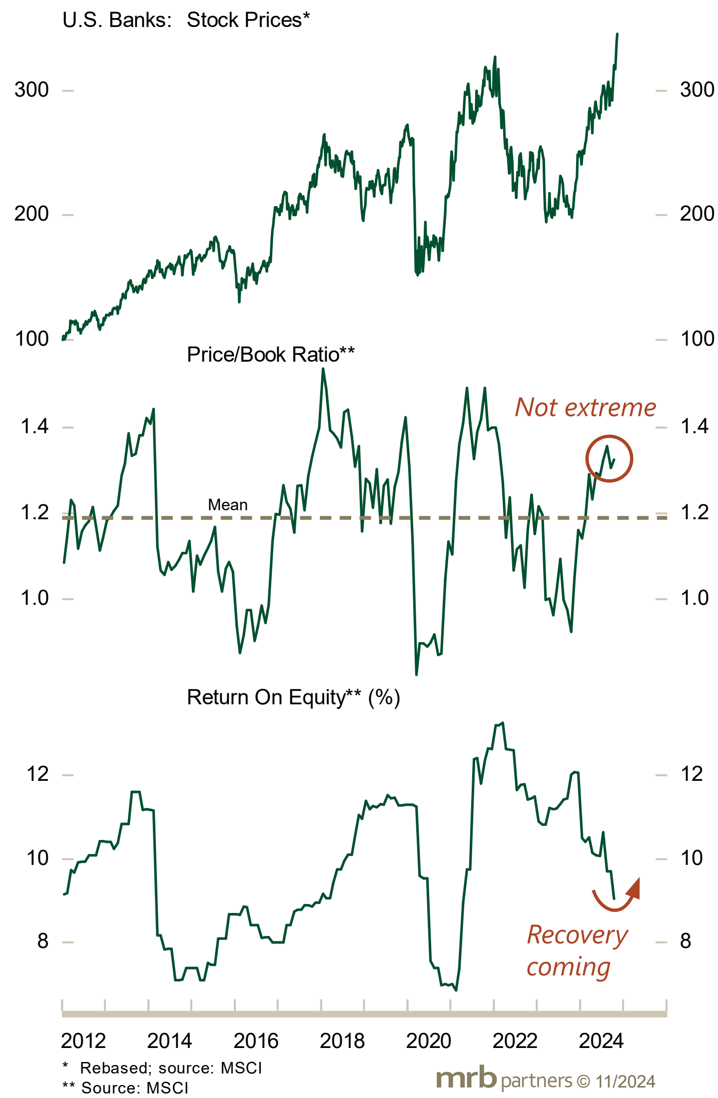
Other parts of the sector are also set to benefit. For example, new leadership at the helm of the CFPB will mean that credit card issuers will see an easing of efforts by regulators to implement stricter consumer protections. The likely replacement of Securities & Exchange Commission (SEC) chair Gary Gensler should lead to a reduction in enforcement actions against the crypto industry, and a rollback of environmental and corporate governance initiatives for asset management firms.

[1] **MRB** "*U.S. Elections 2024: How Will The Vote Shape Financial Regulation?*", October 10, 2024

The lighter regulatory environment will reduce compliance costs for the broad financial sector and position banks to increase shareholder payouts, thus improving their ROE (**chart 3**). Furthermore, to the extent that Trump's policies unleash animal spirits and lead to a steeper yield curve, banks and broker-dealers should see a pickup in their revenue prospects from a rebound in M&A activity and loan demand.

Chart 3 Bank Stocks Still Have Room To Re-Rate



Bank stocks and the broader financial sector have rallied in response to Trump's election and both are technically overbought and due for a pause. However, earnings upgrades and prospective share buyback announcements give the sector plenty of additional catalysts to further re-rate over time. Hence, we are maintaining our positions in bank stocks and would be buyers on any meaningful near-term dips in performance.

Energy

Trump's victory will potentially reshape U.S. energy policy by prioritizing fossil fuels while rolling back initiatives to fight climate change[2]. His pro-fossil fuel agenda should be positive for the traditional energy sector, at least initially. Trump is expected to increase leasing on public lands and waters, ease regulations on the oil & gas industry's emissions, speed up the building of pipelines, and lift Biden's ban on new liquified natural gas projects. These actions should reduce drilling and operating costs for oil & gas producers, while opening up new revenue opportunities for the broad sector.

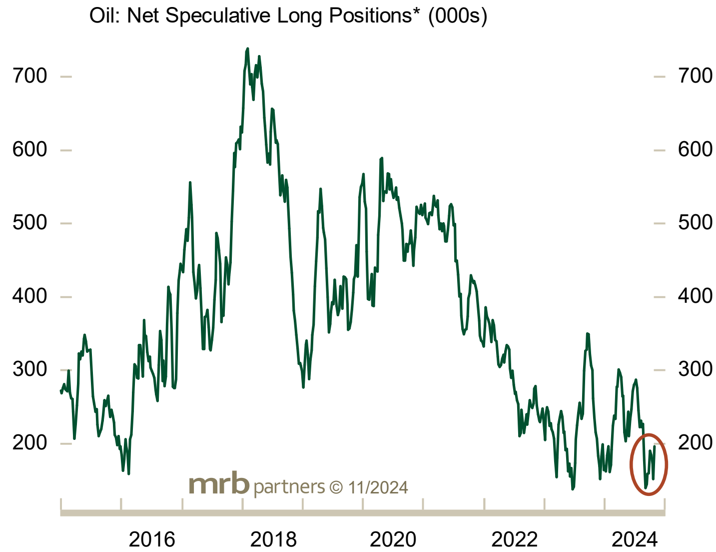
Trump's victory will potentially reshape U.S. energy policy

The increased production that Trump's policies are intended to spur could ***eventually*** depress energy prices, thus hurting the longer-term profitability of the industry. However, the impact of federal policy on energy prices is often over-estimated. The changes proposed by Trump will take time to impact U.S. production. Even then, there are no guarantees that oil and gas producers will aggressively increase output given

[2] **MRB** "*U.S. Election 2024: Biden's Energy/Climate Policies At A Crossroads*", October 16, 2024

the industry's focus on capital discipline. Ultimately, oil prices will be determined in international markets and influenced by a host of factors including global economic prospects and geopolitics.

Chart 4 Speculative Positioning Is At A Bearish Extreme



* Total long positions minus total short positions; source CFTC Commitment Of Traders Report

Crude oil prices have softened in recent months on concerns that weak Chinese demand will lead to an oversupplied market in 2025. Our view is that the narratives surrounding Chinese demand erosion are overly negative and oil prices have upside from their current levels due to the underappreciated demand growth potential of other EM economies, extreme bearish positioning by speculators, and the lack of a geopolitical risk premium in prices at a time when Middle East tensions remain elevated (**chart 4**).

Accordingly, for now, we remain overweight the energy sector, but acknowledge that the outlook for oil prices is complicated by several potential crosscurrents that will need to be closely monitored over the coming months. These include the impact of tariffs on global economic growth, and the fallout of potential foreign policy pivots by the incoming Trump Administration on Iran and the Russia-Ukraine war.

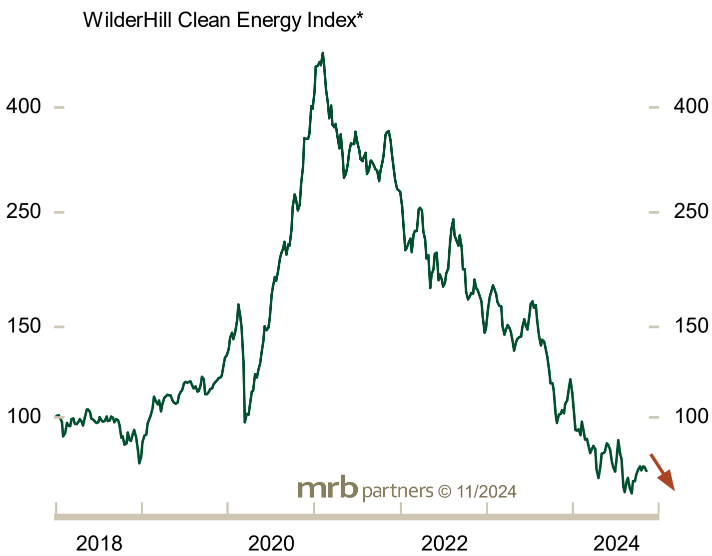
Renewable/green energy stocks are relative losers from the election

Conversely, renewable/green energy stocks (i.e. wind, solar, and electric vehicle companies) are relative losers from the election, as has been reflected in their recent price action. Trump's plans to roll back emission standards under the Environmental Protection Energy (EPA) and eliminate consumer credits for the purchase of electric vehicles, could undermine demand for these cars. His pledge to rescind the unspent funds from the Inflation Reduction Act (IRA) also puts the subsidies and government grants supporting clean energy investments at risk.

It may be difficult for Trump to significantly gut portions of the IRA

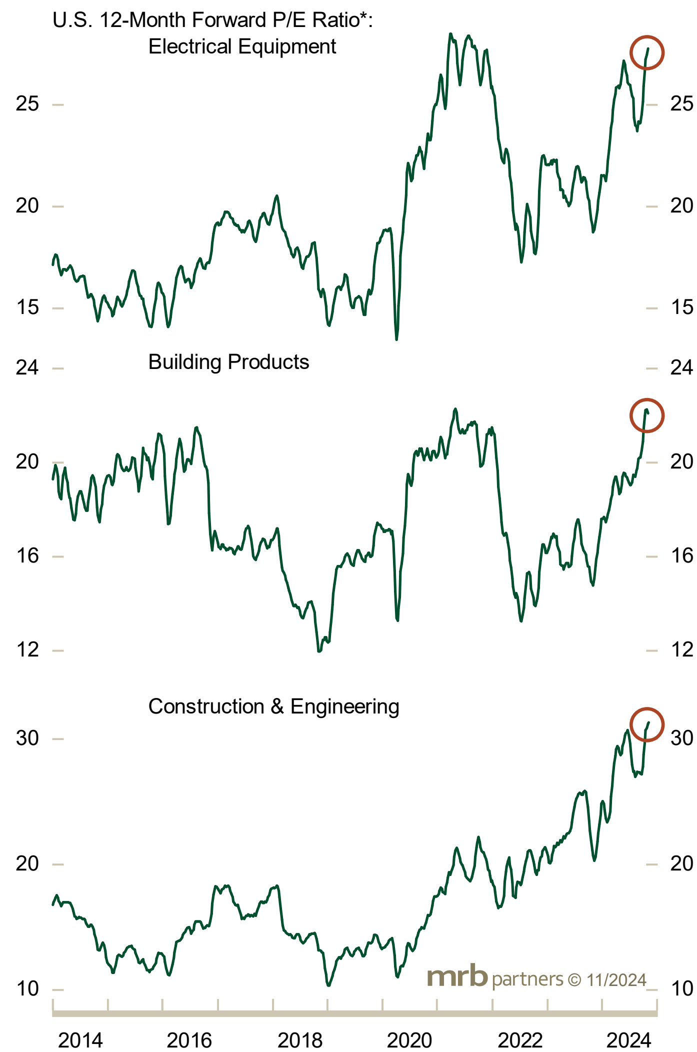
It remains to be seen whether Trump will be able to make good on his promise to repeal the climate provisions of the IRA. He is likely to be pressured to keep many of the climate provisions of the law by Republican districts benefiting from clean energy investments. Moreover, with Republicans controlling the House by only a thin majority, it may be difficult for Trump to significantly gut portions of the IRA. Regardless, uncertainty about the status of the clean energy grants and subsidies in the months ahead will likely continue to weigh on the shares of clean/green energy stocks (**chart 5**).

Chart 5 **Clean Energy Stocks Are Likely To Remain Out Of Favor**



* Rebased; shown in log scale; source: Bloomberg

Chart 6 **Industrial Stocks Leveraged To The IRA Spending Provisions Are Expensive**



* Smoothed; Source: Refinitiv I/B/E/S Global Aggregates

The uncertainty could eventually spill over into industrial sub-groups benefiting from the buildout of renewable energy infrastructure and grid modernization such as electrical equipment, building products, and construction & engineering stocks. As **chart 6** highlights, many of these IRA beneficiaries trade at elevated valuations, thus leaving them vulnerable if sentiment turns cautious because of doubts about the funding for renewable energy and grid modernization projects.

Health Care

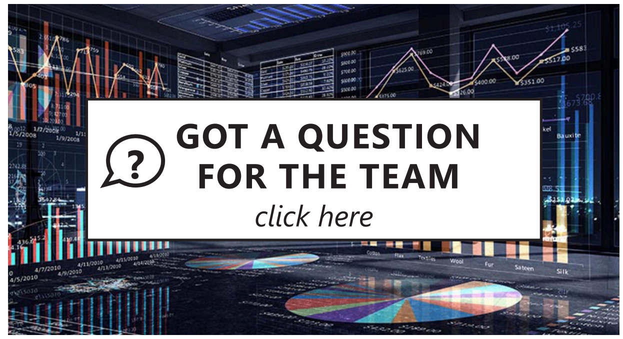
The regulatory outlook for the health care sector is less clear given that Trump did not reveal specific plans during the campaign. On balance, the sector should face a more relaxed regulatory environment under the new administration, but Trump's unpredictability and willingness to break with orthodox Republican views on health care policy inject an element of uncertainty into the mix[3]. Add to that, weirdo RFK Jr.

The health care sector should face a more relaxed regulatory environment

Backed by a Republican Senate and House, Trump has the capability to pursue significant health care reforms. However, enacting major health care legislation is

[3] **MRB** "*U.S. Elections 2024: What's At Stake For The Health Care Sector?*", October 8, 2024

unlikely to be a top priority of his administration, which instead will be primarily focused in the coming year on issues such as securing the southern border, extending the 2017 tax cuts, and cutting environmental regulations. Moreover, there is no appetite to attempt another wholesale repeal of the Affordable Care Act (ACA) given the latter's popularity with voters, although Trump is likely to weaken the law.



Where Trump's victory will have a clearer impact is in shifting the fortunes of payers and providers within the sector, with the incoming administration likely to show a friendlier stance towards programs such as Medicare Advantage, but greater hostility towards Medicaid. As a result, private health insurers that provide Medicare Advantage plans should benefit from a loosening of regulatory requirements and higher reimbursement rates.

The incoming administration is likely to show a friendlier stance towards programs such as Medicare Advanatge

On the flip side, health insurers focused on Medicaid and the Obamacare exchanges could see tougher times ahead as the new Republican Congress is unlikely to re-authorize the enhanced ACA subsidies that were put in place with previous COVID-19 legislation when they expire at the end of 2025. Efforts to cut funding to state Medicaid programs to help pay for tax-cut extensions are also expected. To the extent that these actions lead to an increase in uninsured patients, they will also create headwinds for hospitals. However, with the shares of hospital companies and Medicaid insurers comprising only a small portion of the overall health care index's market cap, they should not be a significant drag on the performance of the broader sector.

Trump was silent on the issue of drug pricing during the campaign. The Medicare drug price negotiations enacted under Biden are not popular with Republicans. However, repealing them comes with almost no political upside. Furthermore, achieving consensus on a replacement plan could be challenging, even with a unified government. In the absence of viable alternatives, Trump is likely to retain Medicare drug price negotiations, albeit with measures that will probably be more conciliatory to the pharmaceutical and biotechnology industries.

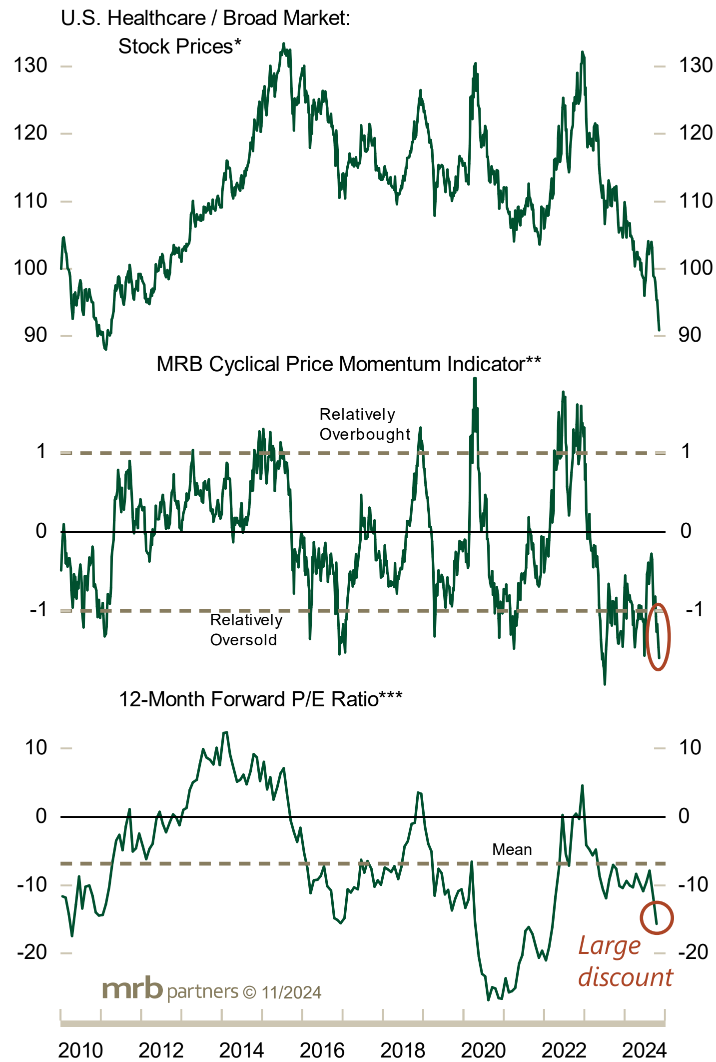
The Medicare drug price negotiations enacted under Biden are not popular with Republicans

Indications that Robert Kennedy Jr. will be given a role in health care policy have bred speculation that there could be fresh attacks on the drug industry. These concerns are overdone. It seems more likely that Kennedy will have an informal role, rather than the type of senior-level position that will require Senate confirmation given his lack of formal medical training, vaccine skepticism, and other nonconventional views.

Well well well....

Despite an unusually benign election cycle, health care stocks have lagged year-to-date, but with technical conditions relatively oversold, valuations at a deep discount to the overall market, and long-term drivers of demand growth intact, the upside opportunity in the sector outweighs the downside risk (**chart 7**).

Chart 7 The Relative Performance Of Health Care Stocks Is Washed Out



* U.S. dollars; rebased; source: MSCI
** Standardized
*** Percent premium (+), discount (-); source: MSCI

Technology

Trump's victory implies a series of modest positives and negatives for the tech sector that mostly offset each other. The expected appointment of more business-friendly enforcers at agencies such as the Department of Justice (DoJ) and the Federal Trade Commission (FTC) under Trump mean that tech companies should have an easier time completing deals. Moreover, A.I. start-ups will face fewer compliance costs if Trump follows through on his pledge to repeal Biden's A.I. executive order, which erected guardrails around the safe use and development of the technology.

However, the anti-trust cases against Big Tech will likely proceed, although efforts to regulate tech behemoths will remain slow-moving given the prospect of lengthy court cases, the lack of easy remedies to rein in the market power of these companies, and national security considerations[4]. Trump's tariff proposals and hawkish policies towards China could also be disruptive for parts of the tech sector such as the semiconductor and hardware sub-groups, which manufacture in Asia, while also selling into the Chinese market.

The anti-trust cases against Big Tech are likely to proceed

Republican control of the White House and Congress also puts the rollout of the Biden Administration's Broadband Equity Access and Deployment (BEAD) program in doubt. The program, which was designed to funnel US$42 bn to U.S. states for the buildout of broadband in underserved communities, has come under heavy GOP criticism. The incoming Trump Administration could push states to redeploy the

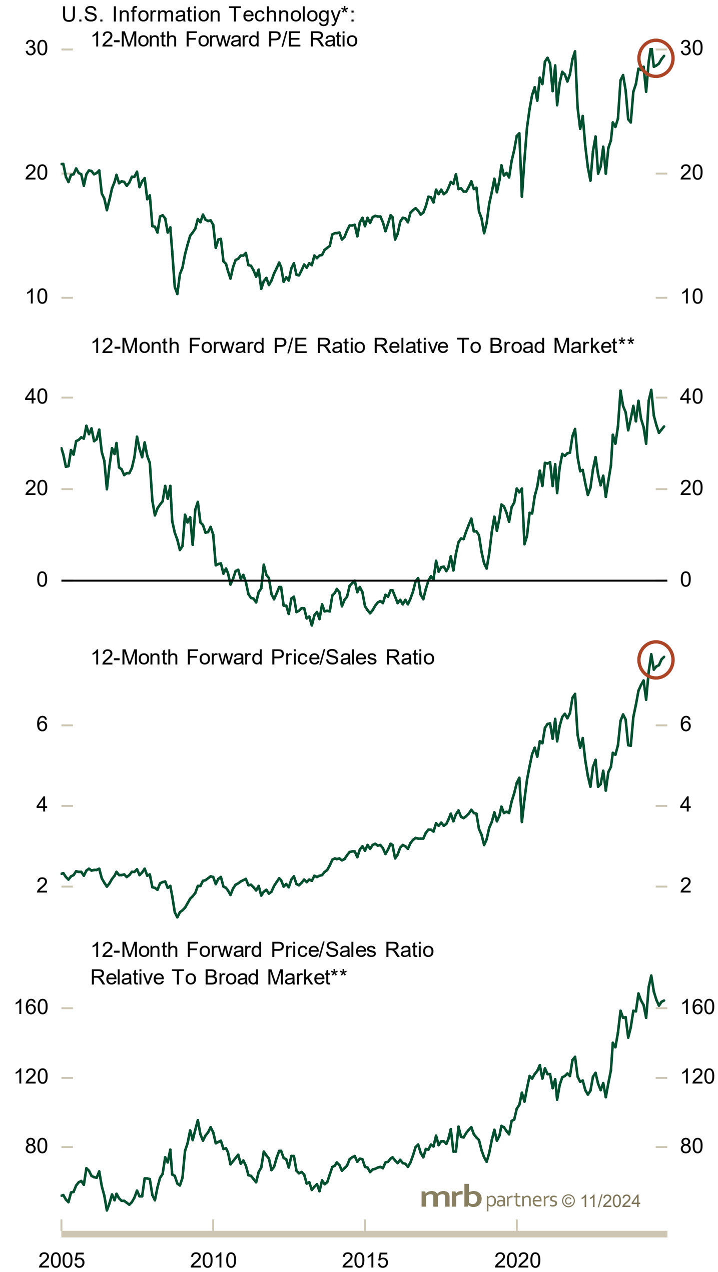
[4] **MRB** "*U.S. Election 2024: Where Harris And Trump Stand On Technology Regulation*", October 18, 2024

program's funds towards satellite operators such as Elon Musk's Starlink, thereby depriving fiber-based internet service providers and network equipment companies of the spending windfalls.

Despite criticism levelled at the CHIPS Act by Trump during the final week of the election campaign, the law is unlikely to be rolled back given the strong bipartisan support for the onshoring of advanced manufacturing. While modifications to some of the provisions of the bill and rebranding the program are possible, most of the CHIPS Act will likely remain in place, with the grants benefiting semiconductor manufacturers and chip equipment companies.

Overall, the election is not a game changer for the tech sector. The ability of tech companies to deliver on the elevated earnings growth expectations that are currently implied by their high valuations will be a far more important driver of their performance in the year ahead (**chart 8**). Given the high bar for positive surprises, rich valuations, and A.I. hype, our assessment of the risk-reward in the sector is unappealing, thus keeping us at an underweight allocation.

Chart 8 Tech Valuations Embed A Lot Of Optimism About Future Earnings



* Source: Refinitiv I/B/E/S Global Aggregates
** Percent premium (+), discount (-)

Final Word: *The anticipation of tax cuts and deregulation under the incoming Trump Administration will continue to fuel risk-on sentiment 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 high earnings expectations. Moreover, sticky inflation and upward pressure on bond yields could eventually challenge the positive market sentiment. Upgrades to earnings estimates will be needed to fuel further meaningful upside in equity prices.*

For now, we are maintaining a moderate pro-growth stance, with a continuing preference for the financial, energy, and health care sectors. These sectors should all see some form of regulatory relief under the new Trump Administration, with financials (especially banks) poised to be the biggest beneficiaries of the election outcome. On the flip side, *renewable/green energy stocks will remain under a cloud of uncertainty given Trump's proposal to roll back tax credits and subsidies for electric vehicles, and the buildout of green energy infrastructure. Uncertainties about the future of clean energy credits could also eventually spill over into industrial stocks linked to electrification and green energy investments. We view the election outcome as mostly neutral for the technology sector, whose performance will remain dependent on the ability of tech company earnings to live up to the high expectations discounted in their valuations.*

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Strategist, U.S. Equities

Please see the following page for a full summary of our U.S. sector and industry sub-group recommendations.

MRB U.S. Equity Sector And Industry Sub-Group Recommendations

Sector	–	N	+	Industry Ratings* Underweight	Neutral	Overweight
Consumer Discretionary	■	□	□	Automobiles Consumer Discretionary Retail Household Durables	Auto Components Hotels, Restaurants & Leisure Textile, Apparel & Luxury Goods	
Communication Services	□	■	□		Media & Entertainment Telecom Services	
Consumer Staples	□	■	□	Tobacco	Consumer Staples Retail Food Products Household & Personal Products	Beverages
Energy	□	□	■			Energy Equipment & Services Oil, Gas & Consumable Fuels
Financials	□	□	■		Capital Markets Consumer Finance Financial Services Insurance	Banks
Health Care	□	□	■		Health Care Providers & Services	Biotechnology Health Care Equipment & Supplies Pharmaceuticals
Industrials	□	■	□	Machinery	Electrical Equipment Ground Transportation Industrial Conglomerates	Aerospace & Defense Air Freight & Logistics
Information Technology	■	□	□	IT Services Semiconductor & Semi Equipment Technology Hardware & Equipment	Software	
Materials	□	■	□		Chemicals Metals & Mining	
Real Estate	□	■	□		Real Estate	
Utilities	□	■	□		Utilities	

* 6-12 month horizon; relative to the U.S. equity benchmark
Note: + = overweight, N = neutral, – = underweight

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