GLOBAL FIXED INCOME & CURRENCY STRATEGY

December 13, 2024

Assessing Three Upside Risks To Inflation

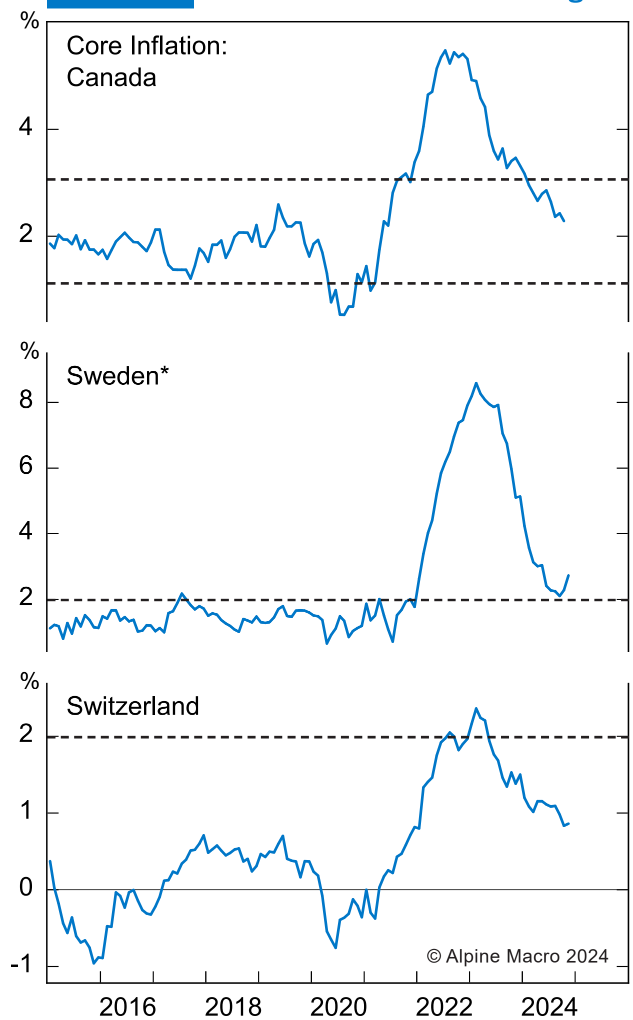
- Under a new Trump administration, investors are worried that higher tariffs, easier fiscal policy, and a renewed tightening in the labor market could lead to higher inflation.
- Higher tariffs can lead to a temporary increase in inflation, but it will ultimately give way to renewed disinflation by lowering disposable incomes.
- We expect Trump to govern more moderately than his campaign rhetoric would suggest and fears of sharply larger fiscal deficits are overblown.
- Tighter border controls can slow the growth in the labor force, but this could be offset by stronger productivity growth that keeps unit labor costs in check.
- Investors should keep duration in fixed income portfolios at benchmark for now.
- The U.S. dollar should remain firm, especially against the euro as the ECB will be more dovish than the Fed.

EDITORIAL TEAM

Harvinder Kalirai Chief Fixed Income & FX Strategist	**Tony Boeckh** Editor-in-Chief
Chen Zhao Chief Global Strategist	**David Abramson** Chief U.S. Strategist & Director of Research
Mark McClellan Chief U.S. Bond Strategist	**Bassam Nawfal** Chief Asset Allocation Strategist
Henry Wu Chief Quantitative Strategist	**Tenzin Chozin** Research Analyst

Our view has been for inflation rates in the major developed economies, including the U.S., to return to the central banks' targets. This has already happened in some smaller G10 economies like Canada, Sweden, and Switzerland (**Chart 1**). In fact, Swiss inflation is too low for the SNB's comfort, which prompted a 50bps rate cut yesterday.

Chart 1 Inflation Rates Return To Target



*CPIF excluding energy & unprocessed food

In recent months, the downtrend in U.S. inflation appears to have stalled. This week's data showed that core CPI inflation stood at 3.3% in November, unchanged from where it was in July 2024.

While the recent data have been a little disappointing, U.S. core inflation outside of shelter is largely back to 2%. Chart 2 shows that shelter is the main component holding up the overall core inflation rate. As shelter inflation continues to decelerate, it should pull core inflation down to 2%.

Nevertheless, investors are becoming increasingly concerned that the bulk of the disinflation process in the U.S. is over and upside risks to inflation are building once again. Under a new Trump administration, investors are worried that higher tariffs, easier fiscal policy, and a renewed tightening in the labor market could lead to higher inflation. Are these concerns justified?

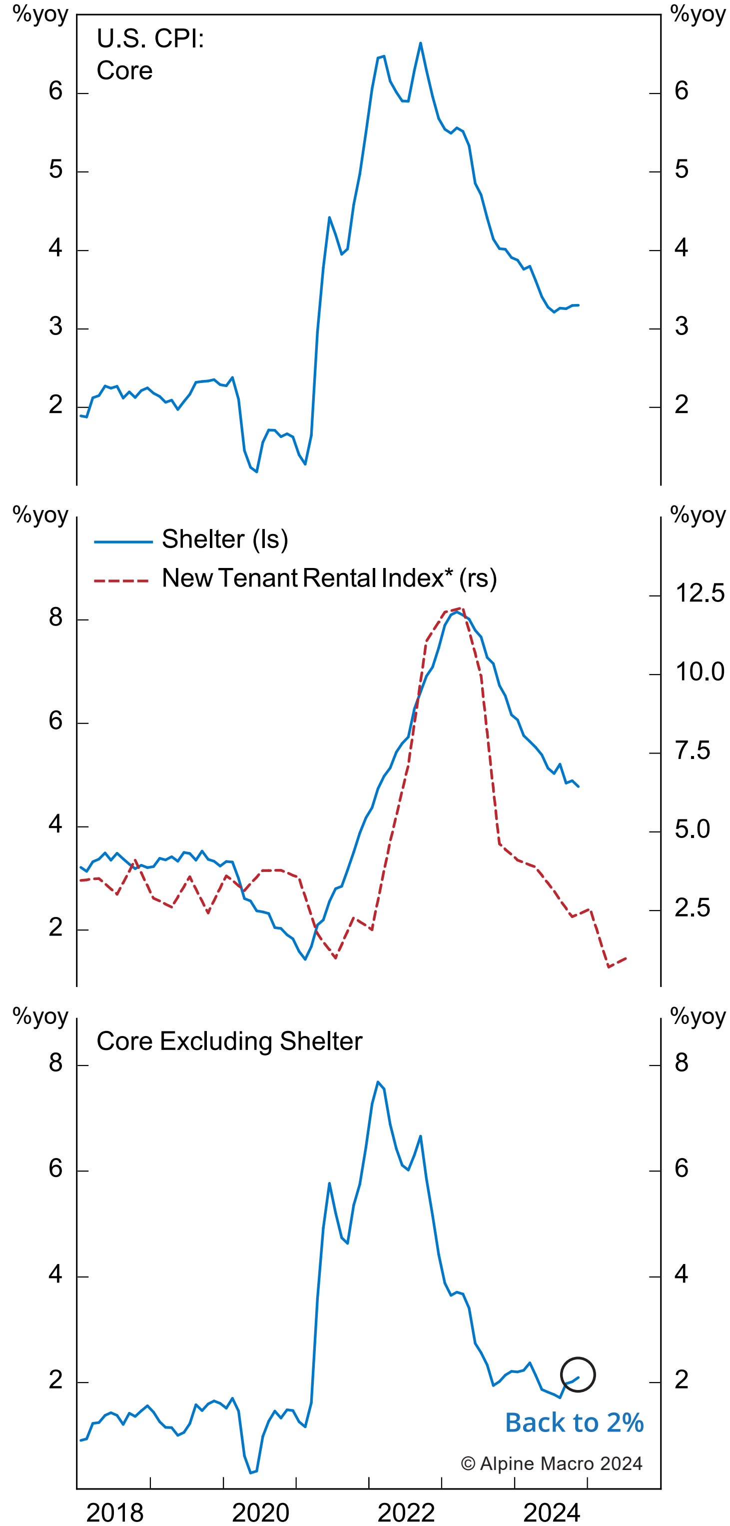
Tariffs

We discussed the impact of higher tariffs on the U.S. economy in detail last month.[1] In a nutshell, we do not believe that an increase in tariffs will lead to a sustained rise in inflation.

At worst, higher tariffs can lead to a temporary increase in inflation that will ultimately give way to renewed disinflation. A tariff is like a consumption tax and Japan offers a useful example of how tax hikes impact inflation.

As seen in Chart 3, periodic increases in the VAT led to spikes in Japanese inflation. However, the

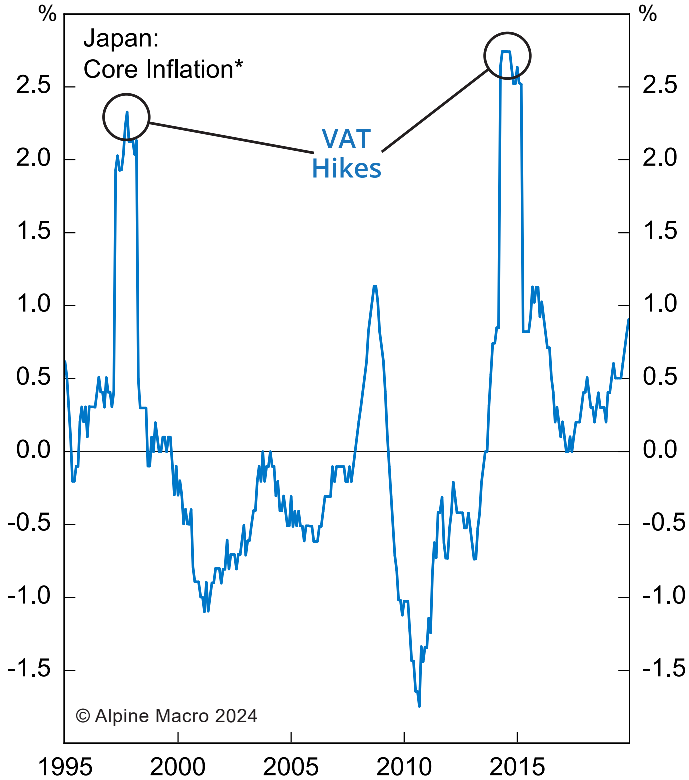
Chart 2 Shelter Continues To Hold Up U.S. Core Inflation



*Advanced by 10 months; source: BLS

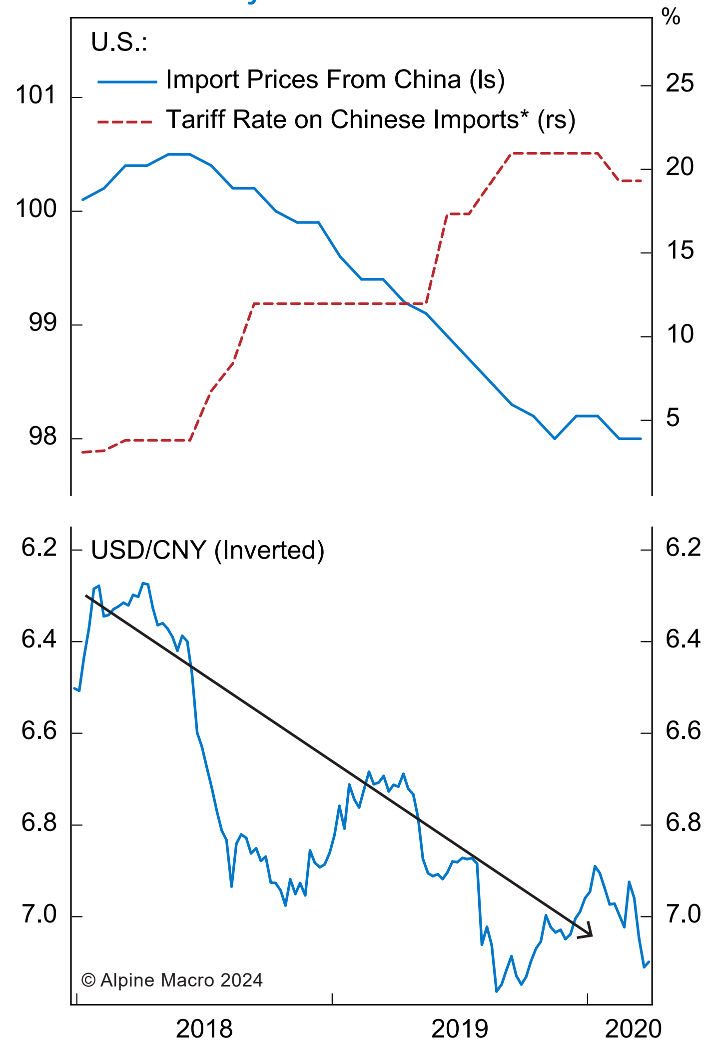
1 Alpine Macro *Global Fixed Income & FX Strategy* "Tariffs, The Trade Deficit, The Dollar & Inflation" (November 22, 2024).

Chart 3 Tax Increases Do Not Lead To Sustained Inflation



*Excluding fresh food and energy

Chart 4 Higher Tariffs Were Offset By A Weaker CNY



*Source: Peterson Institute for International Economics

effect washed out of the annual inflation rates after a year. Also, without a commensurate increase in nominal incomes, the higher taxes acted as a drag on consumers' spending power and inflation.

Whereas tax increases must be passed on to households, the same is not necessarily the case for tariffs. The impact of tariffs on consumer prices can be mitigated in two ways. First, importers can take a hit on their profit margins. Second, FX rates can adjust to offset higher tariffs. For example, if a 10% tariff is imposed on all imports, but the dollar also appreciates by 10%, then it is a wash for consumers.

The experience of the trade/tariff war between the U.S. and China in 2018/19 shows that consumers did not face higher prices. Despite rising tariffs, U.S. import prices from China actually declined during this period. A key reason for this was the depreciation in the Chinese renminbi (**Chart 4**).

A repeat of 2018/19 looks to be in play again. Trump's threat of higher tariffs against Canada, Mexico, and China has already led to a depreciation in their currencies. Indeed, there were news reports this week that the Chinese authorities are considering a weak currency policy for 2025 to offset higher U.S. tariffs.

Fiscal Policy

Investors are fretting that Trump's fiscal plans could stoke inflation. To begin with, Trump wants to extend the Tax Cuts and Jobs Act of 2017 that is set to expire at the end of next year. He also wants to reduce the corporate tax rate from 21% to 15%. Additionally, Trump is offering tax breaks to individuals, such as exempting tips, overtime pay, and social security benefits from income tax and removing the cap on state and local tax (SALT) deductions.

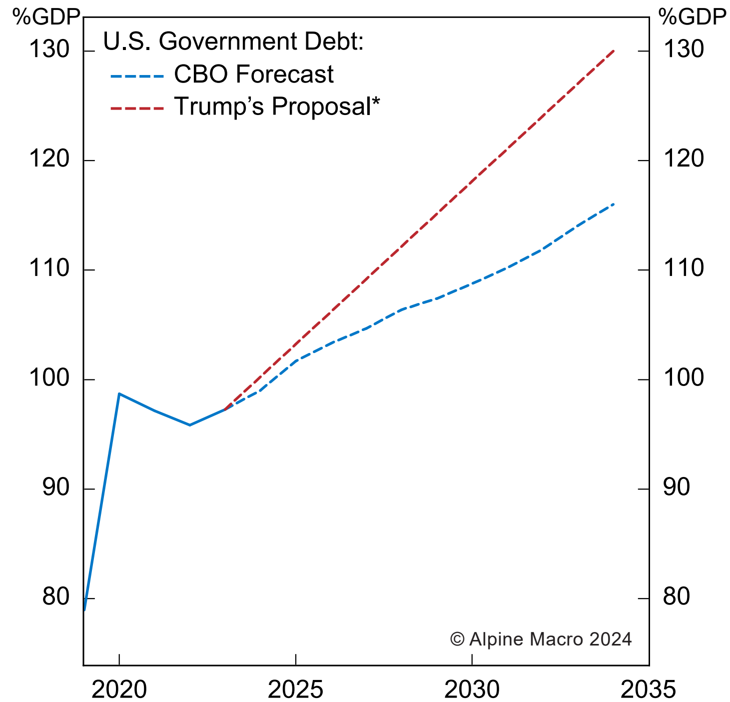
Taken at face value, Trump's proposals would lead to larger deficits and higher debt levels. The Penn Wharton Budget Model suggests that Trump's campaign policy proposals would add an additional 14 percentage points to the debt-to-GDP ratio over the next decade compared to the CBO's baseline projections (**Chart 5**).

Our *Geopolitical Strategy* team is arguing that Trump will govern more moderately than his campaign rhetoric would suggest and fears of sharply larger fiscal deficits are overblown:

- First, the Trump administration will want to maintain market and economic stability. For Trump, market performance has long been a measure of his own governing success. Therefore, he is unlikely to enact policies that would significantly disrupt the financial markets, such as much larger fiscal deficits.

- Second, Trump's economic team will include Wall Street veterans, with Scott Bessent being nominated as Treasury Secretary. These advisors are likely to dominate Trump's economic team and will tend to be market-friendly.

Chart 5 **Will Trump Blow Out The Debt?**



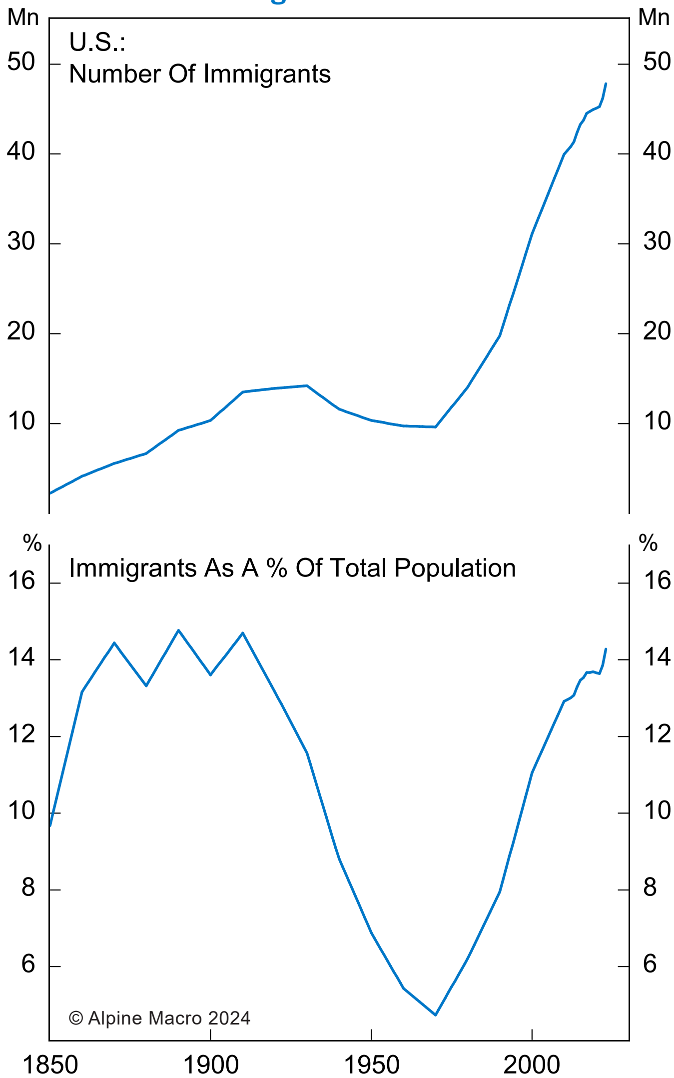
*Penn Wharton Budget Model estimate

- Third, even with the GOP winning both the Senate and the House, the majorities are razor slim. The Republicans do not have a filibuster-proof majority in the Senate. In the House, a few fiscal hawks could stonewall new legislation.

- Fourth, in addition to lowering taxes, Trump is looking for ways to cut spending. Elon Musk and Vivek Ramaswamy have been nominated to reduce government waste. To some degree, spending cuts will dampen the potential fiscal thrust.

- Fifth, Trump should understand that higher inflation courts political defeat. Inflation spikes have been a blow to incumbent governments in the U.K., France, Japan, and the U.S. Higher inflation would spell trouble for the Republicans in the mid-term elections in two years, leaving Trump as a "lame duck" president.

Chart 6 Record High Immigrants



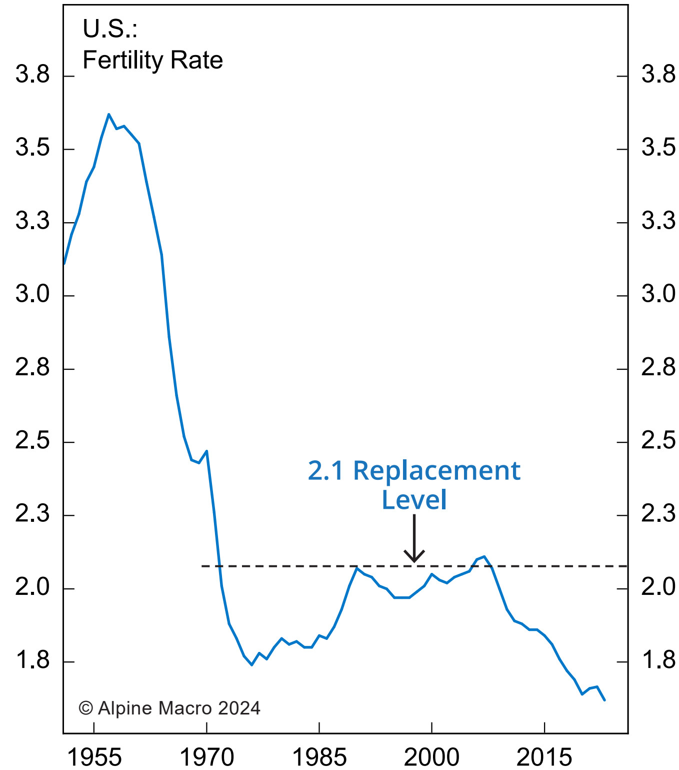
Source: Migration Policy Institute

The Labor Market

An influx of immigrants, both legal and illegal, has been a boon for the U.S. labor force. An increase in the labor supply has allowed for strong growth in jobs and a moderation in wage gains. The former kept real GDP growth strong and the latter helped to bring down inflation.

Chart 6 shows that the foreign-born population is approaching 50 million, which accounts for nearly

Chart 7 U.S. Fertility Rate Hit A Record Low



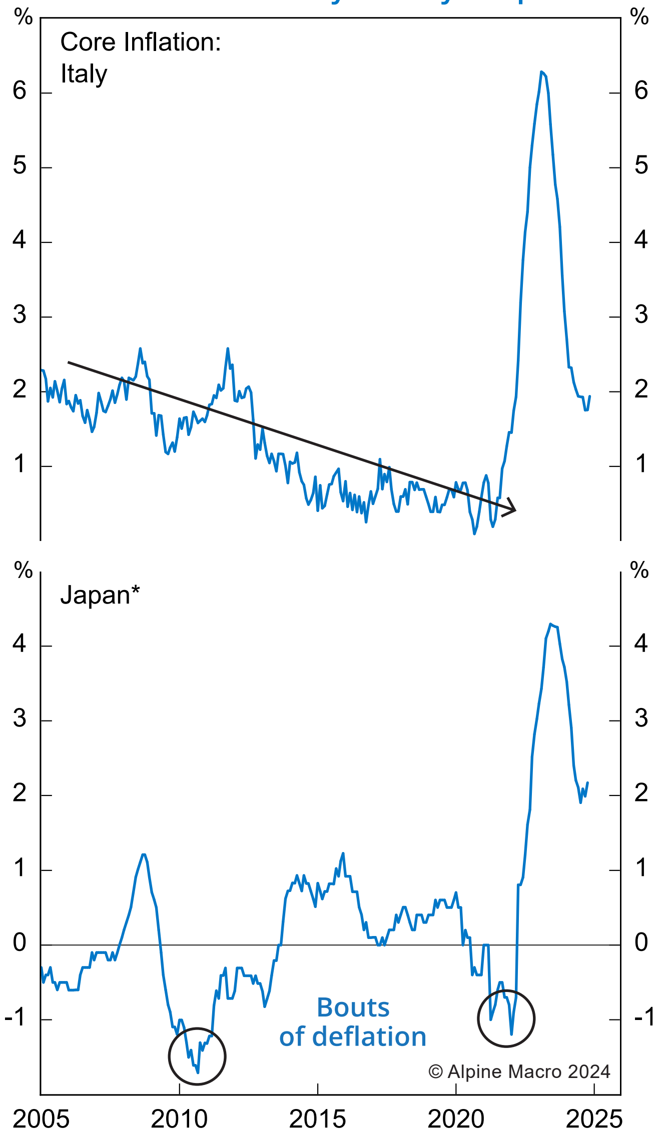
Source: United Nations, World Bank, CDC

15% of the total population. This is close to the record highs witnessed in the late 19th century when the U.S. was experiencing heavy immigration from Europe.

Without immigration, the population and the labor force of the U.S. would eventually begin to decline. The CDC reported that the America's fertility rate fell to a record low of 1.62 in 2023. This is well below the replacement rate of 2.1 that is needed to prevent the total population from declining (**Chart 7**).

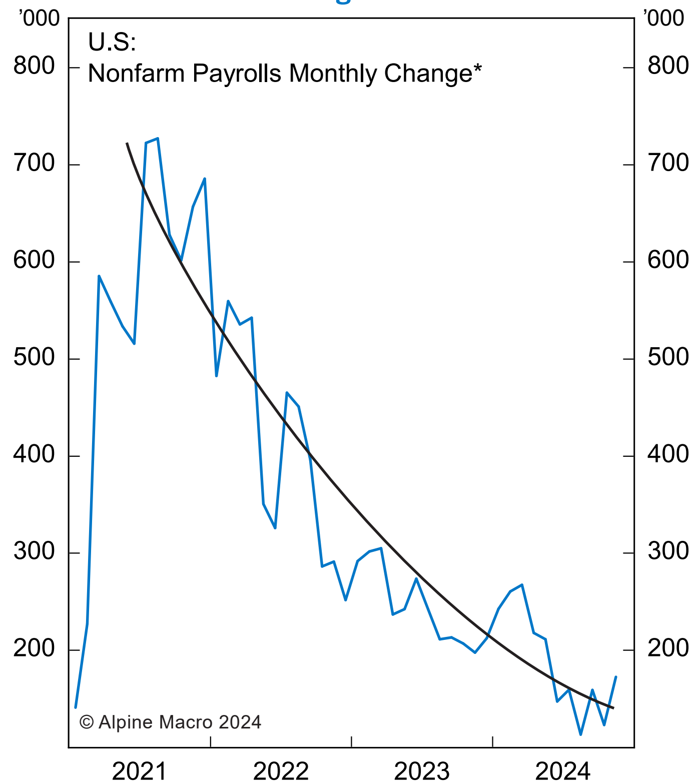
Trump has said that he would deport an estimated 11 million undocumented immigrants. Putting aside whether this is even feasible, would shrinking the population prove to be inflationary? On the surface, it would mean fewer workers and higher wage

Chart 8 Falling Populations Were Not Inflationary For Italy & Japan



*Excluding fresh food and energy and VAT effects

Chart 9 Labor Demand Is Cooling



*Shown as 3-month moving average

pressures. However, it would also mean significantly less demand. The former is inflationary, but the latter is deflationary.

The experience of countries like Japan and Italy highlight that shrinking populations are not inflationary. Declining populations lead to weakness in household spending and business investment, which weighs on aggregate demand and inflation.

Chart 8 shows that outside of the pandemic spike, Italian inflation has generally tracked below the ECB's 2% target for the last two decades, while Japan has gone through periods of deflation.

Even if Trump is unable to enact mass deportations, he can slow the pace of new immigration through stricter border controls. This would slow the growth in the labor force and lower the economy's speed limit. Whether this turns out to be inflationary will depend on the demand for labor and productivity growth.

Although the last few months have been distorted by the weather and strikes, the underlying trend in nonfarm payrolls has been slowing (**Chart 9**). With the unemployment rate drifting higher, the growth

Chart 10 Is A New Wave Of Stronger Productivity Growth Starting?

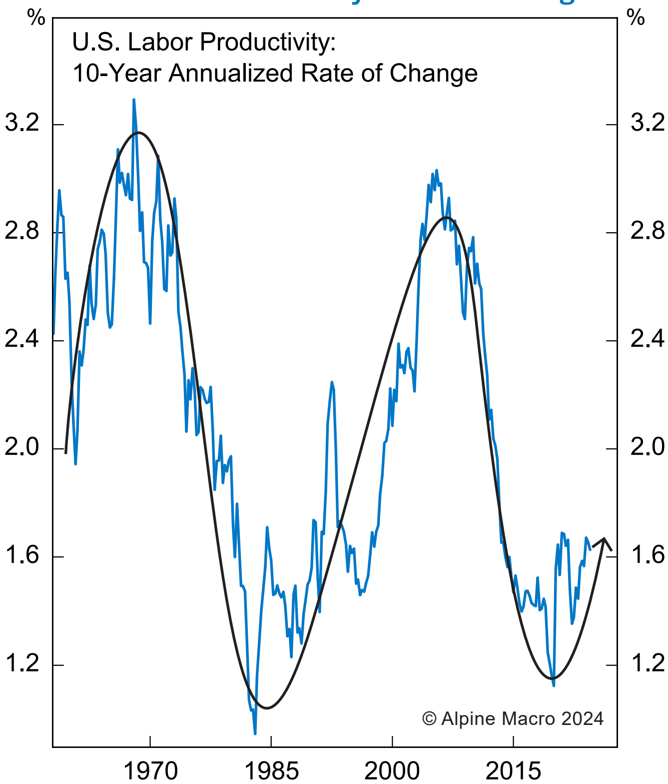
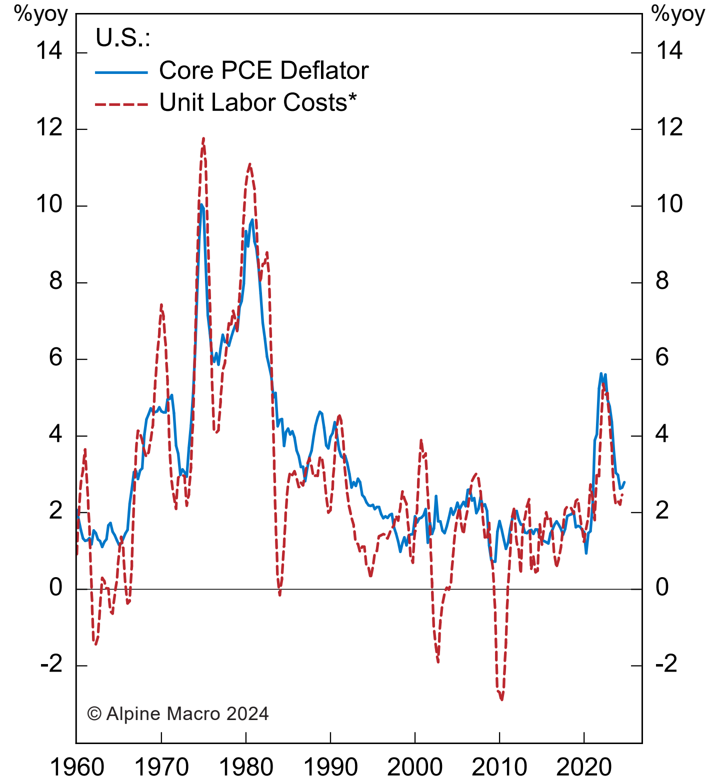


Chart 11 Unit Labor Costs & Core Inflation



*Shown as a 4-quarter moving average

in U.S. jobs has been unable to keep pace with the labor force. A tandem slowdown in new jobs and the labor force should not be inflationary.

Even if wage gains begin to accelerate, there could be an offsetting improvement in productivity growth. As discussed in our *Macro Outlook 2025*, the U.S. could be on the cusp of an AI-driven technological wave.[2] With Trump's push for deregulation, fewer restrictions could even hasten the adoption of AI. Moreover, cheap energy and lower taxes could further stimulate business investment and boost productivity growth (**Chart 10**). Stronger productivity growth will hold down unit labor costs and inflation.

2 Alpine Macro *2025 Outlook*"Boom Or Bust? An Investor's Playbook For 2025 & Beyond" (December 9, 2024).

This week's revised figures showed that unit labor costs rose just 0.8% at an annualized rate in 2024 Q3. Continued tepid growth in unit labor costs should keep U.S. inflation in check (**Chart 11**).

Summary & Investment Conclusions

We still believe that U.S. core inflation should head to 2%:

- Higher tariffs are unlikely to lead to sustainably higher inflation and could be disinflationary in the longer term by taxing consumption and lowering disposable incomes.

- An extension of the Tax Cuts and Jobs Act of 2017 will avoid a "fiscal cliff", but significantly larger budget deficits are unlikely.

- Tighter border controls will slow immigration and the growth in the labor force. This could support wages, but an offset could come from stronger productivity growth.

Lower inflation should allow the Fed to continue trimming interest rates. However, Trump's pro-growth policies will limit the degree of rate cuts.

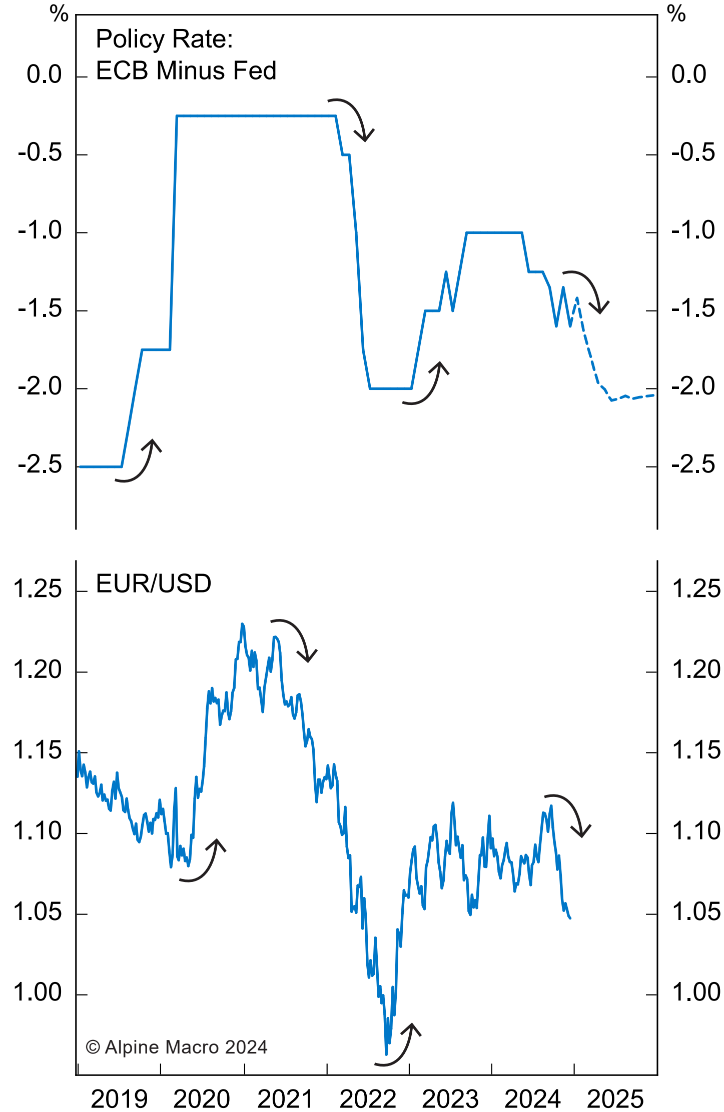
3.75-4.0% could be the floor for the Fed's policy rate. A 50bps term premium would put 10-year Treasury yields at 4.25-4.50%. Duration should be kept neutral for now. Investors should consider adding to duration if yields approach 5% and reducing duration if yields drop below 4%.

The U.S. dollar should stay strong, especially against the euro as the ECB will be much more dovish than the Fed (**Chart 12**). The ECB has gained greater confidence that inflation is heading back to 2% on a sustained basis. Moreover, the ECB's staff economists have downgraded their forecasts for growth. If Trump threatens the eurozone with tariffs, the economy could fall into a recession. This would require even easier monetary policy and a much weaker euro.

Harvinder Kalirai

Chief Fixed Income & FX Strategist

Chart 12 A Dovish ECB Will Push The Euro Lower



Note: Dotted line denotes market expectations from OIS curve

Currency Outlook

Vs THE DOLLAR		
	1-3 Months	9-12 Months
EUR	FLAT	DOWN
JPY	FLAT	UP
GBP	FLAT	DOWN
CHF	FLAT	FLAT
CAD	FLAT	DOWN
AUD	FLAT	DOWN
NZD	FLAT	DOWN

Vs THE EURO		
	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	3
Japan	1
Eurozone	4
Core	5
Periphery	2
U.K.	2
Switzerland	2
Norway	4
Sweden	3
Canada	3
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	4.36%	-4.09%	0.27%
Long Gold	2022-03-04	1,928	-	-	39.21%	-	39.21%
Short EUR/JPY	2024-11-08	165.17	-	Rolling -3%	3.28%	-0.23%	3.05%
Short EUR/GBP	2024-11-08	0.8318	-	Rolling -3%	0.64%	0.13%	0.77%
Short EUR/AUD	2024-11-08	1.6172	-	Rolling -3%	-1.73%	0.13%	-1.60%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	86.90 bps

ALPINEMACRO

A Unique Mind On The Markets