CIO Strategy Bulletin

July 20, 2024

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Markets Preview Trump Administration

Key Takeaways

- Two discrete events – an act of political violence and a Presidential debate – have caused polls and prediction markets to sharply upgrade the probability that Donald Trump will win the November election. These clear market moves reveal how investors view Trump's impact on policy and the economy.
- The immediate response was to boost US domestic small caps and cyclical industry shares, with banks and energy stocks the strongest sectors. In contrast, clean energy, China and European shares fell.
- The Treasury yield curve steepened as investors viewed a Republican sweep in Congressional elections as more likely, raising the odds of tax cuts along with other inflationary policies.

Potential Portfolio Implications

- Markets are not irrational for lurching ahead in an attempt to sort out political winners and losers. However, there is so much room for surprise still ahead. Congressional election polls are notoriously unreliable, for one example.
- Enlarged trade tariffs (and immigration restrictions) may be a given under a Trump administration. Congressional action on taxes is far less certain. New "filibuster-proof" legislation would need to pass to prevent personal income tax cuts from expiring at the end of 2025. New taxes on imports (tariffs) may come first. The impact would be *tighter, not easier* fiscal policy for at least a time.
- Deregulation is potentially quite effective medicine for business confidence and investment. However, for the energy industry, even stronger US oil output could reduce oil prices, weakening profits. Amid the possibility that OPEC will increase supply at the same time, we have removed US energy producers from our Outlook 2024 top potential opportunities list after a 17.8% gain since December 7.

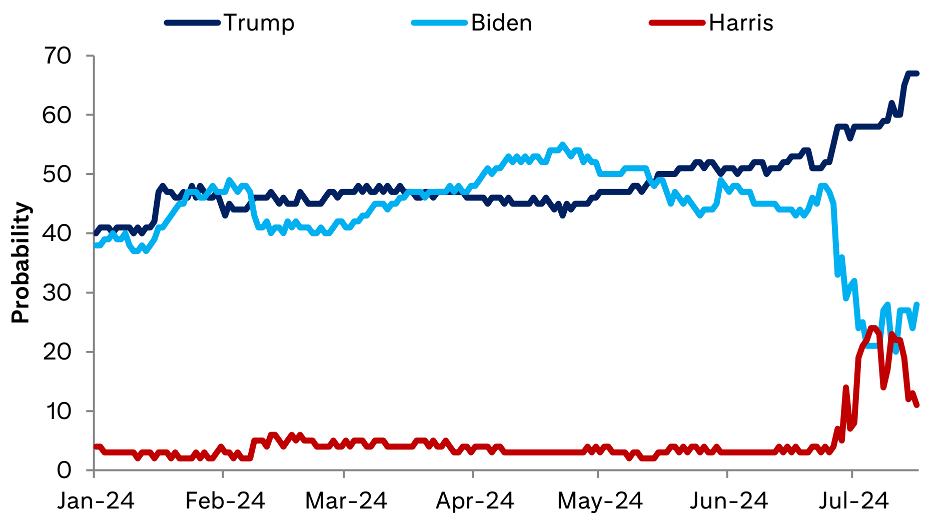
Markets Preview A Trump Administration

The first assassination attempt of a US President or Presidential candidate in more than 43 years stands as a stark reminder of the polarization gripping the nation. The loss of an innocent bystander's life in the incident adds to the collective shock.

During such events, financial and prediction markets are constantly (and coldly) assessing the impact on potential future economic and corporate outcomes. According to PredictIt, a market that assesses election probabilities, President Trump has risen to a 67% chance of being elected in November following the July 13 attempt on his life at a campaign rally. This is up 7 percentage points and up 15 points since the June Presidential debate when worries over President Biden's performance surged (see **FIGURE 1**).

Equity, bond, and foreign exchange markets have all reacted swiftly to shifting probabilities, providing us a window into the market's assessment of potential winners and losers from a Republican sweep in the November elections. While other factors beyond politics – the trajectory for the economy, profits, central bank policy, and trends in AI – will arguably matter more to the trajectory for markets in 2025, election themes are likely to dominate the market narrative over the next few months.

FIGURE 1: Odds of a Trump victory have risen sharply



Source: Bloomberg as of July 16, 2024.

The market's Trump trades

To assess the market's views, we analyzed the specific reactions in the trading sessions immediately following the June Presidential debate and the assassination attempt. Both days saw similar market reactions, with US small caps, banks, and energy shares perceived as winners while Chinese equities, clean energy and utilities stocks underperformed.

Banks and traditional energy stand to potentially benefit from potential deregulation of their respective industries. US banks currently face the prospects of much higher capital requirements to align with Basel III global standards, but these rules could get watered down in a Republican administration (Federal Reserve officials have already suggested changes were to come). Meanwhile, Trump has promised to reduce red tape when it comes to new oil and gas projects in the US.

Domestically-oriented small cap stocks could benefit from a pro-business administration (see **FIGURE 2**). They also could be more insulated from a potential trade war than larger multinationals, including retaliation to tariff steps by the US.

Turning to the biggest potential losers, investors remain cautious about the outlook for Chinese equities. While the Chinese equity selloff on Monday, July 15th was in part driven by concerns about weaker domestic data, China is also likely to face the brunt of Trump's trade policy. Candidate Trump has vowed to place 60% tariffs on all Chinese imports to the US if elected.

At the sector level, rising odds of a "red sweep" have also put pressure on stocks tied to renewable energy, with clean energy shares down 4% following the attack on Trump (see **FIGURE 3**). Republicans have vowed to repeal the Inflation Reduction Act, which despite its name mostly provided subsidies for clean energy projects.

FIGURE 2: Regional and style performance around moments of rising Trump victory odds

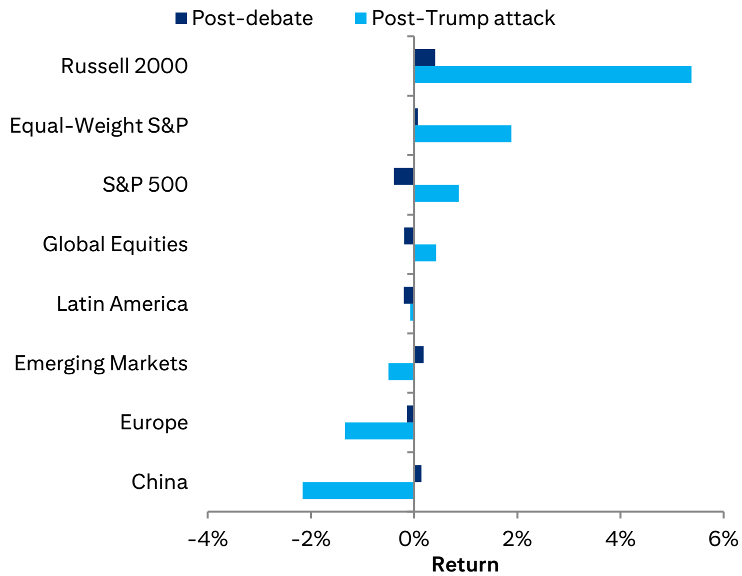
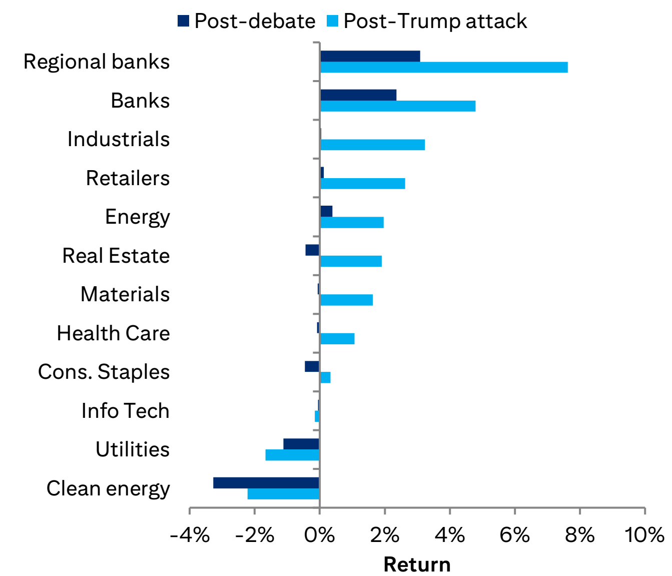


FIGURE 3: Sector performance around moments of rising Trump victory odds



Source: Bloomberg as of July 16, 2024. Regional equities are using their respective MSCI indices as proxy. Sectors are using their respective S&P 500 indices as proxy. Date of the debate was June 27, 2024 and the Trump attack was July 12, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

What the Republican platform means for the US economy

The Republican Party's agenda may include very broad shifts in policy that could also potentially impact the fixed income market.

First, domestic economic policy is likely to be viewed as highly "protectionist" and potentially inflationary in multiple ways, assuming it largely conforms to the platform adopted this week at the Republican convention, and that Republicans win both houses of Congress.

Trump has proposed in the past implementing "baseline" tariffs imposed on all global trade partners by 10% with Chinese imports by as much as 60%. The exact mix of these tariffs is not specified, and there likely will be loopholes to limit retaliatory action on politically important exports (agriculture products, for example).

The tariff collections of 2018 had remarkably little impact on final consumer prices and even domestic wholesale costs and imports (see **FIGURE 4**). The US dollar increased, some trade substitution reduced impact and importer margins absorbed costs. However, the size of the tariffs proposed is now much larger and recent experience with price increases during the pandemic may make it easier for firms to try to pass these costs on to consumers in the future.

In addition, Trump has vowed to reverse immigration via deportation, which may reduce the supply of labor. The growth of US employment appears strongly boosted by immigration which waned during the pandemic and bounced back. In the short run, worker shortages could boost prices, but it would likely result in a lower speed limit of the US economy as labor force growth is one of the key pillars of economic growth. The economic doldrums of Japan and to a lesser extent Europe can be blamed in no small part on resistance to immigration amid shrinking and aging domestic populations. Despite making up only 19% of the workforce, foreign born workers have accounted for 57% of the labor force growth in the past ten years (see **FIGURE 5**).

FIGURE 4: CPI and tariff collection

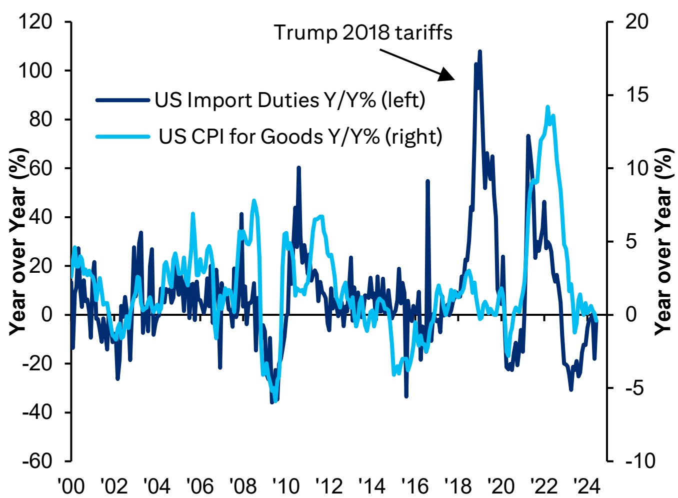
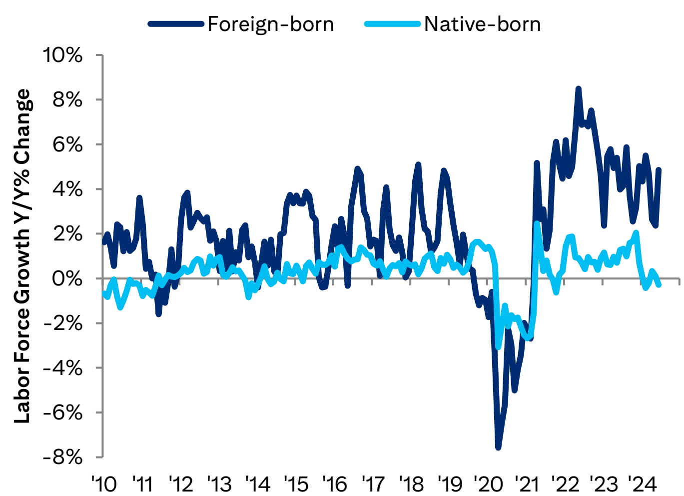


FIGURE 5: Native born vs foreign born US labor force growth



Source: Haver Analytics as of July 9, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Importantly, tax cuts enacted in 2017 are set to expire at end 2025. The Congressional Budget Office has estimated that a permanent extension of the lower Federal Income tax rates and other measures would add over $4 trillion to budget deficit estimates over the next decade, more than a 10% increase over current debt levels. Candidate Trump wants further tax cuts and other measures (e.g., no taxes on “tips”).

Another policy push may be that the new Administration tries to actively weaken the dollar. While there are too many hypothetical policy shifts in this respect to analyze (for example, a tax on financial flows into the US), the broad thrust of this policy mix would be to encourage reshoring of manufacturing and increase American exports.

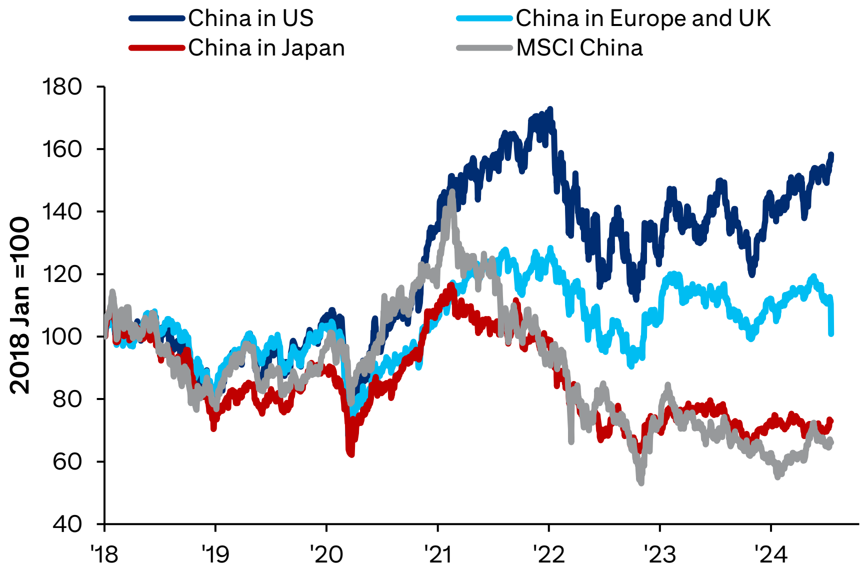
Self-styled tariff man

While at a first pass, the overall market has rallied on rising Trump odds, but we should note several caveats.

First, we are still about four months away from election day. A building “consensus” for Trump victory leaves the market vulnerable to surprises in the Democrats’ favor. The House in particular remains very much in play, and a Democratic victory in the lower house of Congress could foil Republicans’ most ambitious policy plans. How could this play out differently than markets surmise? Trump may raise tariffs (an act that collects Federal Revenue and reduces borrowing) while Congress may fail to pass offsetting tax cuts. This is a particular risk given that some degree of Democrat cooperation will be needed simply to avoid tax increases that are current laws at year-end 2025.

Second, beyond the knee-jerk move to sell Chinese equities, it remains highly uncertain how Trump's actual trade policy will play out. It is also difficult to game out to what extent trade partners will retaliate against American firms. This leaves some US multinationals at potential risk in the event of an escalating trade war (see **FIGURE 6**).

FIGURE 6: Equities of US firms operating in China vs other regions



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While we can take cues from the market during decisive moments of the campaign, investing through the next four years won't be as simple as chasing the initial gut reaction of the past month. Follow our Road to the White House series with much more analysis to come as we approach November 5.

Moving western energy producers off Top Potential Opportunities list for now

There are many ways politics and policy can be confounding for investors. One is the observation that deregulation and freedom of investment can result in lower returns on capital in some cases. Greater investment and competition are good for consumers, but can reduce capital returns.

For commodities in particular, product gluts can be painful, with 2015 being a particularly bad year for oil producers as the US shale sector boomed with hundreds of new producers. OPEC followed this with large output increases of its own, collapsing the oil price and bankrupting marginal producers.

The drivers of returns in the energy sector are a complex conglomeration of "bottom up" factors playing out in a global scope. Some macro factors are large and decisive. As we noted in our Wealth Outlook 2024, OPEC's decision to restrain production last year and give up market share has helped to stabilize the oil price. In practice, it's allowed US producers to raise their output sharply at a higher and more profitable price level (see **FIGURE 7**).

FIGURE 7: US crude oil production as % of world output

Source: Haver Analytics as of July 16, 2024.

Brent crude has averaged $84 per barrel in 2024 and $82 in 2023 versus $101 in 2022 amid global market adjustments and the higher non-OPEC+ production including the US. In June, OPEC+ announced it would begin lifting its production limits by October.

The Hamas-Israel conflict did raise oil prices last October but only briefly as actual supplies in the region have not been disrupted.

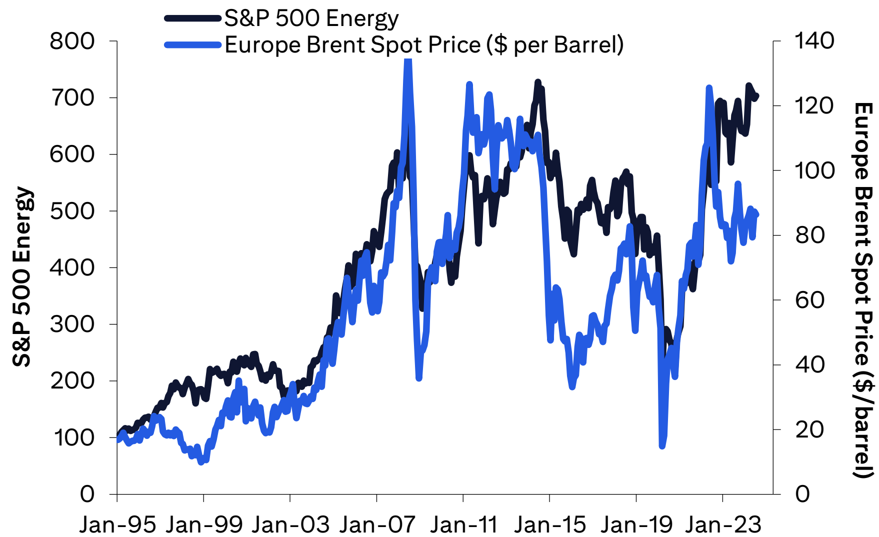
According to the latest IEA Oil Market Report (OMR)[1], world oil demand in 2Q24 increased by the lowest amount since 4Q22 as Chinese petroleum consumption contracted. Looking ahead, the IEA thinks modest global economic growth, efficiency gains, and deeper electric vehicle penetration could act as headwinds to oil demand growth. Meanwhile, supply is poised to increase, led by the US, Canada, Guyana, and Brazil. While there are a wide range of security risks and other factors, Citi Research analysts see crude oil trading in the $60s range in 2025 as inventories build.

Oil prices have historically been a primary driver of Energy sector equity market performance (see **FIGURE 8**). As we have expected, the gains in output for western producers at the expense of OPEC has helped boost their share performance beyond what might be expected from the oil price alone.

The S&P 500 Energy sector is reasonably valued at just 12 times expected year-ahead earnings, but earnings growth could face challenges if oil prices materially retreat. As a result, we've decided to move this opportunistic investment idea to the sidelines after a 17.8% gain, as we monitor unfolding events. As described in Wealth Outlook 2024, these opportunities are meant to be areas of high confidence in our view. If oil prices drop or circumstances change, we might revisit this idea again.

[1] IEA (2024), Oil Market Report - July 2024, IEA, Paris https://www.iea.org/reports/oil-market-report-july-2024

FIGURE 8: Energy sector performance vs oil prices



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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

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Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

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