Research @ Citi Podcast, Episode 14: Trump 2.0 and the Markets

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Guests: Scott Chronert, Head of U.S. Equity and ETF Strategy, Citi, and Dan Tobon, Head of G10 FX Strategy, Citi

Transcript:

Lucy Baldwin (00:02)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

My name is Rob Rowe. I am the U.S. Regional Director of Research at Citi, and my guest today is Scott Chronert, our Head of Equity Macro Strategy and Head of ETF Strategy here at Citi, and we will also have Dan Tobon on, who is our G10 FX Strategist, to discuss the elections. Well, Scott, “What a difference a day makes,” is the only way I can think about the U.S. elections. But Scott, tell us a bit about how, how the equity markets have reacted to the election, maybe prior to the election, to the election, and then how do you see things going forward? Because I know there's a lot of moving parts in the U.S. equity market.

Scott Chronert (01:03)

Yeah. So let's just kind of set this up. So over the past month, over the course of October, let's say, we began to see the election probabilities shift in favor of Trump, even though the polling was still very tight. And so what you saw was this reflected in certain asset classes, such as rates, to a certain degree currencies, which Dan will reflect on, and other asset classes such as gold. Interestingly, though, equities traded sideways over the course of October. And so while you had this shifting sentiment under the surface, it wasn't specifically manifested in U.S. equities. So you get the election outcome. You can consider a surprise or not, but what it did was then trigger, in our view, sort of a catch-up move in equities that was an alleviation of this uncertainty that took us down a risk-on path. A lot of the Trump-related trades that we've been talking about actually came to fruition the day after and even so today. So I think where we are is that to a certain degree, equities are playing a little bit of catch-up to some of the positioning that we saw in other asset classes.

Rob Rowe (02:10)

And what did we think some of those trades were — you mentioned they came to fruition, but what were they?

Scott Chronert (02:15)

Yeah, so as an example, since mid-summer we've been talking about the banks as a preferred Trump trade, if you will, just because of the emphasis on deregulation but in a sector that already had, we thought, some fundamental tailwinds. More recently, over the past month or two, we've been talking about U.S. small capp as an intriguing sort of secondary Trump beneficiary. And you look at yesterday's price action, and both of those saw pretty significant outperformance. So those are the two that we've been most visible on.

It's interesting — most of the client discussions, though, have been on areas such as tariffs, such as where you actually see the regulatory effect and tax rates. Those have been a little bit more difficult to model. So they've been easy to talk about, but much more difficult to model. So I think the more traditional responses are more or less what we would have expected from an industry group or sector or even size perspective, Rob.

Rob Rowe (03:11)

So let me ask you two other things, Scott. One is, I think you've termed the phrase that we're going "from election uncertainty to policy uncertainty." I think you had just highlighted that a little bit with tariffs. Can you expand on that a little bit about what other policy uncertainty is out there that the equity market would be sensitive to?

Scott Chronert (03:29)

Yeah. So again, my starting point here was that we think the equity markets are fairly fully valued and they're discounting a soft landing sentiment shift and probably to some degree paying forward for next year's expected earnings growth around this soft landing narrative, which is its own question mark. Now, going into the election, the two main topics were Trump and tariffs versus Harris and taxes. And now with the outcome behind us, what we now need to get more granular on is what the potential impact is of a push down the tariff path. At the same time, how do you really begin to assess what deregulatory effects actually mean? And then even in a Trump platform, there's been ongoing discussions about how to think about tax rates and we've gone from an approach where you look to potentially slash overall corporate tax rates, which was an early platform, to something more recent that's a bit more nuanced, that perhaps is targeted, focuses on domestic production, and maybe uses tax incentives in addition to just lower tax rates. So all of those, those three components now is where we are shifting our focus and still waiting for a little bit of policy direction that has more precision to it so that we can, with more confidence, really begin to pencil out what some of the impacts of this might be.

Rob Rowe (04:46)

And in terms of valuations, where are equity valuations now? I mean, I know we're— you can remind me where we are in terms of the earnings cycle right now, but where are valuations and how do you see those playing in effect here? Are they anchoring the prices somewhere close and how do you see that?

Scott Chronert (05:05)

Yeah. Okay, here this is where it gets really interesting. So the S&P at the index level is about 24 times trailing, maybe a little bit higher off of yesterday's action. On a forward basis, you're just under 22 times. Both of those are sort of top decile versus history. Now here's where it gets interesting. Some will say, "Well, Scott, isn't that just a function of the Mag Seven being more highly valued?" And it certainly is, but at the same time, the other 493 are actually more expensive versus their history than is the Mag Seven. So again, what that falls back into is this narrative where, hey, to a certain degree, the equity price performance we've seen in the back half of this year is paying forward some next year's expected earnings growth. Now, this takes to the next point. This is where the policy uncertainty part comes in, because we suspect that our initial work on tariffs is that at some level here, they're going to be detrimental to different companies' fundamentals — almost akin to supply chain constraints that we were dealing with coming out of the pandemic. And so at the next step for us, or next phase for us, is to get a little bit more clarity on more specific tariff design so that we can go back and assess what that might actually mean to company-specific fundamentals. Again, starting point, soft landing positive sentiment, paying forward for next year's earnings. So what we're suggesting is that there's probably going to be some risk dynamic as we go into the first part of next year, or we're going to have to be looking at our out-year earnings expectations being a bit on the aggressive side.

Rob Rowe (06:39)

Got it. And Scott, some of these things play out, I mean in the beginning of the year, there was a big story about U.S. exceptionalism. It seemed like the U.S. stock market was the place to be internationally, you know, seemed like there weren't as higher expected returns globally as there were in the U.S. If certain changes happen like that, could we see an allocation more into say Europe or Japan, in terms of equities instead of the U.S., or do you think that this just reinforces U.S. exceptionalism?

Scott Chronert (07:12)

It's timeframes, Rob, so I think longer longer term, you can't project the Trump trade to perform too strongly, but it may actually have a very positive longer-term implication. I'm more concerned in this intermediate term where there's going to be some disruption to expectations. But the way I would think about this is that coming off back-to-back years of 20%-plus S&P 500 gains, the complacency thing kicks in: “Oh, I’ve got to be in U.S. equities because they always give us this degree of performance,” and I think we have to be prepared that that's not going to persist. It just— the law of numbers works against you on that. So, but what I would say, though, is that I still think within the U.S. equity complex, up and down the market cap spectrum, the stock selection opportunity is going to be really, really intriguing over the next several months as we migrate through a lot of these policy transitions. Now, at the same time as you then compare the U.S. to the rest of the world, I don't think you can be solely in one market or the other, but I do think that we're going to see opportunistic setups unfold globally. But hey, I'm the U.S. guy, and I think from what we're seeing, there's plenty to do in the U.S. from a stock selection / alpha generation perspective to keep us busy for a while.

Rob Rowe (08:27)

Great. Thanks very much, Scott. Appreciate the comments and the insight. And now we have Dan Tobon, our Head of G10 FX Strategy, here on the podcast. The reason why I wanted to also speak to Dan is because he's not only our G10 FX Strategist, but he's also been one of our chief strategists following the U.S. elections and how markets have been reacting to U.S. elections. And I said to Scott just a minute ago, you know, what a difference a day makes in terms of how these markets have played out. But in terms of FX and rates, how have you seen these markets play before during and after the election?

Dan Tobon (09:07)

Yeah. So it's been interesting for sure. One of the things that we've been talking about really since January is that we would expect the market to price in some Trump premium ahead of the event itself. And so we started recommending to clients even back in September, that look this looks like a close race, the market isn't really pricing anything for Trump, and they should, because he's got a really good chance of winning, and so we would expect to see Trump trades could start performing into the election. And in fact, that's what happened. It is important to disaggregate a little bit, some of that was the macro backdrop. U.S. data was starting to get better. And so as a result, we saw U.S. fixed income selling off, Fed expectations turning a little bit more hawkish, relatively speaking, and the dollar rallying. But even beyond just the macro, we clearly saw that some of that was also becoming Trump trades into the election itself. And as a result, we actually had a bit of long dollar positioning, short fixed income positioning, as we went into the event.

The real question now is, okay, we've got this outcome that's a clear mandate for Trump. Technically, we don't have the results for the House yet. We would say it's very likely that he will get the House, even if it's by a small margin. What should clients do now? It's tricky. And the reason we say it's tricky is that again, going back to the beginning of the year, we were saying you typically get these “sell the news” dynamics into these elections. And so there was a chance the dollar would peak into the election and yields would peak into the election and then reverse even if Trump won. We started shying away from that a bit, though, and I think there might still be some room for these trades to work, but it's a lot choppier now, for sure, because we— really because of the idea that when the policies come into play is really next year. Do people want to be positioning too much for those potential policies now? Probably not. And so it still really feels like a trading environment. How much are we trading the news versus policy trades? Those might be more of a next year story.

Rob Rowe (11:11)

So in terms of trading the news, I mean, we don't know the results of the House yet in terms of whether there's a red sweep. And obviously, I guess a red sweep would imply carte blanche in terms of policy impact for Trump. So I guess it would have the greatest policy impact. Do you think that that piece of news, though, would significantly move the markets one way or the other?

Dan Tobon (11:37)

Maybe not significantly, but certainly will have an impact, because it will change the possibility of what the policies look like. For FX, there's less sensitivity to it because you don't need congressional support for tariffs. They can be done through the trade representative using Sections 301 and 232, and that's actually what we saw under Trump's first administration. It wasn't done through Congress. And that's also why we've been saying FX might be a little bit more sensitive to pro-Trump trades because it doesn't require the full red sweep. That being said, the full red sweep would then actually make it easier to do these broader tariffs. There you do need some congressional support, and obviously for a lot of the other policy adjustments that Trump wants to do, it helps if he’s got full control of Congress. I do think that there's an element of if we get this news, if it is a red sweep, we probably have a bit more now to go on this trade, but it might just be a trade. Then we might have to reduce sizing and then it becomes more episodic as we get to the policies next year.

Rob Rowe (12:40)

And Dan, in terms of the U.S. dollar, I know that there were some so-called Trump trades that were also good trades from a valuation perspective. How are valuations influencing this? And then are there certain trades like going long the U.S. dollar which in effect is, has other reasons for that recommendation other than a Trump trade?

Dan Tobon (13:04)

Yeah. I think valuations are starting to look a bit more fair. So let's say Euro/dollar, for example, we use a couple of factors. If we're off, that's actually how we've been figuring out what's priced in for Trump versus what's macro. We take the residual of our models and basically make some assumptions that this is largely what's political. If we look at where Euro/dollar is right now, it's probably about 1% lower than where it would be on just trip typical macro, and we're calling that 1%–2% weakness the “Trump residual.” That Trump residual moved to 5% back in 2016. And in 2020, when Biden won, but the market had been thinking Trump could win, we unwound a residual of more around 4%. So 4%–5% to us feels like the fair premium that should be put in for Trump — and again, it's only about 2% now — and that's why we think it could be a little bit more on that side.

But to answer your question on the other factors, this is probably good for U.S. growth, bottom line. It's probably bad for Europe, bottom line. So is that fully reflected already in Fed pricing, ECB pricing? No, probably not, right? Especially on the European side, the downside risks are bigger. Not necessarily saying that the base case has changed, but certainly the downside risk increases, especially at a time where you're already seeing a lot of structural issues, especially around trade and manufacturing in Europe, already taking hold. So we think that it certainly increases the risk that Euro/dollar lower into next year will be a good trade. Will that play out over the next couple of months? It's much tougher to say, but structurally, that does look like a Euro-weaker story.

Rob Rowe (14:48)

And how do you think, in terms of both rates and FX, we're sort of peacefully moving along in a Fed cycle, and we do have the Fed decision coming up. How is that, given that we've seen a lot of election gyrations in the markets, how do you think the Fed's looking at that? Is the market continually to fully price in various cuts with the Fed while this is going on? I worry that the Fed may be worried about long-end rates being higher than they should be.

Dan Tobon (15:22)

So there's a lot of moving parts to this. And so I guess here's the way that we're thinking about the short term and the long term for it. One is, we have a Fed meeting today, we expect them to cut 25 basis points, probably by the time that listeners hear this, we'll already have been past it. But certainly when we hear historically how the Fed responds to potential policy and future policy, they really downplay the effects of that into their own process because they really want to set policy based on what they know is going to be— they certainly know this policy will be implemented because it's already gone through Congress and it has passed. I think the Fed responding to what policy may come, I think the market is overestimating that. But the risk is that inflation expectations start moving higher. We've already seen inflation expectations move up pretty rapidly, both leading into the election and since the election. And so at some point, the Fed may have to address that aspect of it. Probably too early to expect that today. But that will be something that if inflation expectations continue to stay as elevated as they are, that does have to come in to how they are considering what their policy is going to be. But the markets probably ahead of themselves on actually expecting some kind of immediate pivot from Powell simply because of the election results.

Rob Rowe (16:49)

You know, it seems to me that when I heard Trump said on his speech, "Promises made, promises kept." And I think that was in reference to— obviously, I think one of the ways in which President Trump won the election was that he really complained about the high cost of living, right? So inflation is something I would imagine he would want to keep down. But some of his policies, potential future policies, could actually ignite inflation. How do you think that's going to play out, not only in rates markets, but do you think that that will anchor his decisions on certain things in order to sort of prevent inflation from going higher?

Dan Tobon (17:36)

Well, the two channels for inflation would be one, tariffs, and second, through any fiscal expansion. On tariffs, one thing that we found during the first administration was that you have some offsetting factors that actually downplay the effect of inflation through tariffs — the most obvious one being the FX channel, actually. This is why we say tariffs are dollar-positive and that's what we saw in the first administration as well while when tariffs actually became a policy dynamic. So I think there, there's concern for sure. It will really depend on just how big the tariff package ends up becoming. If it's unilaterally focused on China with— more as a tool in order to get some trade deals done, then it's probably not going to be a big deal. If you do get the more extreme side of it, 60% tariffs on China and blanket tariffs across the world, you'll probably have a bit more of an impact, and then it'll probably be enough to actually have consequences for the Fed.

The thing about tariffs, at least in Fed research — this isn’t us saying this, but this is the way the Fed is probably thinking about it — what they found in manufacturing during the tariffs that were implemented in the first administration was that the net effect was actually a little bit soft— soft for manufacturing because even though it's a plus that the domestic manufacturing is building up, there are some negative aspects to it. One is retaliatory tariffs because there's always some kind of retaliation, and two is increased input costs. And so the net actually washes out a bit. So it's not as positive for manufacturing as one would think because there are some consequences, too. So I don't think that the Fed from a growth side would view this dynamic as necessarily being an issue. So the real issue is fiscal: How much will tax cuts or any new spending impact inflation? That's harder to say, but that's really a late-2025 issue in terms of getting the policy through and then economic impact is 2026. And that's why we say the Fed's probably going to be more patient on looking to see how those effects actually come through because they're not something immediate.

Rob Rowe (19:50)

Got it. Dan, thanks so much for being on. Always glad to hear your insights. Thanks everyone for participating on our podcast today. We'll be back at you shortly with other topics. Thanks very much.

Lucy Baldwin (20:02)

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