

Trump 2.0: What's at Stake and How to Position Portfolios

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- **But there are still many known unknowns.**
- The focus has now shifted toward the bigger issue of fiscal policy. What's at stake? \$2.5 trillion in fiscal policy stemming from Trump 1.0, Biden and COVID spending packages that are set to expire by the end of 2025.
- If nothing is done, \$2.5 trillion will then fall out of the budget and represent a **large fiscal tightening**, ultimately unfriendly to markets.
- Predictably, this debate about the budget, fiscal policy, taxes, tariffs, spending cuts and the "pay-fors" will dominate the market narrative for the next 14 months.
- This will undoubtedly impact markets as these fiscal and monetary policy debates heat up, so let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Trump 2.0: What's at stake and how to position portfolios. Now that the presidential election results are in many of the known unknowns are now known. We have therefore crossed peak uncertainty and volatility has declined in equity markets. But there are still many known unknowns. The focus has now shifted toward the bigger issue of fiscal policy. What's at stake? \$2.5 trillion in prior fiscal policy stemming from Trump 1.0, Biden and COVID-related spending packages. These are all set to expire by the end of 2025. If nothing is done, \$2.5 trillion will fall away from the budget, and that represents a large fiscal tightening which would be unfriendly to markets. Predictably, this debate about the budget, fiscal policy taxes, tariffs, spending cuts and the "pay-fors" will dominate the market narrative for the next 14 months. Undoubtedly, this will impact markets as these policy debates, fiscal and monetary, heat up. Let's get into it.

Let's start with monetary policy. Despite all the talk on tariffs and expansion that may increase the deficit under a Trump 2.0, no policy has been enacted yet and the Fed will not speculate on it and not alter their course to lowering policy rates. As we see it, the Fed is on a mission to lowering policy rates to 4% and will reevaluate when they get there. Notice I said lowering policy rates, not easing them. As we learned from the press conference at last week's Fed meeting, the Fed believes policy rates are still in restrictive territory. Thus, they are lowering interest rates until they reach an estimated neutral policy rate. If they further reduce rates from there, then they would start a process of easing. This nuance is important. The problem is that it is unknown exactly where neutral is. So we need to estimate it in real time. Currently, I think it's closer to about 4%, maybe a little lower. This is why I say the Fed is on a mission to cut rates to 4%. So what does this mean for the bond market? Effectively it means 10-year

bond yields may have difficulty rising above 4.5% unless the Fed changes its policy stance. This is largely supportive for bonds. As long as we have a soft landing, then it's all then it's also supportive for credit markets. Now, what does it mean for equities? Well, again, it's largely supportive. It should help sustain what seems to be fully-valued multiples around 22 times or at least above 20.

But monetary policy is not the only game in town. What about fiscal policy? Well, there are certainly a lot of fiscal policy uncertainties. There are many concerns that a Trump 2.0 might lead to a higher deficit, which is ultimately inflationary and could lead to higher yields. This is a risk consideration in markets and is the reason bond yields rose after Trump won the race. To understand this risk we must ask ourselves how likely this becomes reality. Although Trump won the presidential race, the Republicans took control of the Senate and possibly Congress - and even won the popular vote - we think he falls short of having a mandate and is limited to how he can enact fiscal policies. Why? Because the deficit is already very high, nearly 7% of GDP. If Trump's goals are to reduce inflation, then greatly expanding the deficit is a major headwind to achieving that. Additionally, many members of his own party are self-proclaimed deficit hawks. It's not yet clear that Trump can cut taxes and spend as he wishes because a margin is still very narrow in Congress to get full support. But this doesn't mean he will not try to spend on items that are important to him. The difference this time from Trump 1.0 is that he will also need to reduce outlays or spending in other areas simultaneously. To be sure budget math can be tricky and it's scored by the congressional budget office (CBO) over a 10-year period.

From an equity market perspective, we should think about where Trump may be spending and where he may be cutting. This has sectoral implications across the market. It would seem that certain cyclical components and factors in the market such as Materials, Industrials and Energy may benefit. Additionally, mid-cap companies and the equal weighted S&P 500 could reflect the benefits. Technology, which represented the beta in the market, is less clear. Said differently, when we consider the PE ratio for equities, perhaps more focus needs to be placed on the E than the P. This is a common late-cycle dynamic for investors to consider. As a result, we think beta sources of return may represent lower quality than alpha sources. Essentially, this means that the technology sector, which represented more beta and momentum, may attribute less to returns in 2025. Structurally, this is how we're thinking about repositioning portfolios post election.

The lines will be blurred between the simplified way of thinking about markets as Growth versus Value or large cap versus small cap. One may need to discern where earnings growth is mispriced and where it may rotate away from and towards. This is a shift in how we think about market performance and where the performance may be derived from.

Lastly, there is another surprise factor to consider which is that the US may enact more fiscal discipline as it sets its budget projections for 2025. Not because it wants to but because it may have to because the deficit is already very large but could this budget reallocation trigger a shift in spending that leads to robust non-inflationary growth. Well, that would be the plan and that would be an ideal outcome if it does equities can rally much further if it doesn't, well, then the opposite. This is what we'll be watching and deciding upon in terms of portfolio positions in a Trump 2.0. Stay tuned.

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