HYMANS ROBERTSON

Market Flash

US election reaction

November 2024

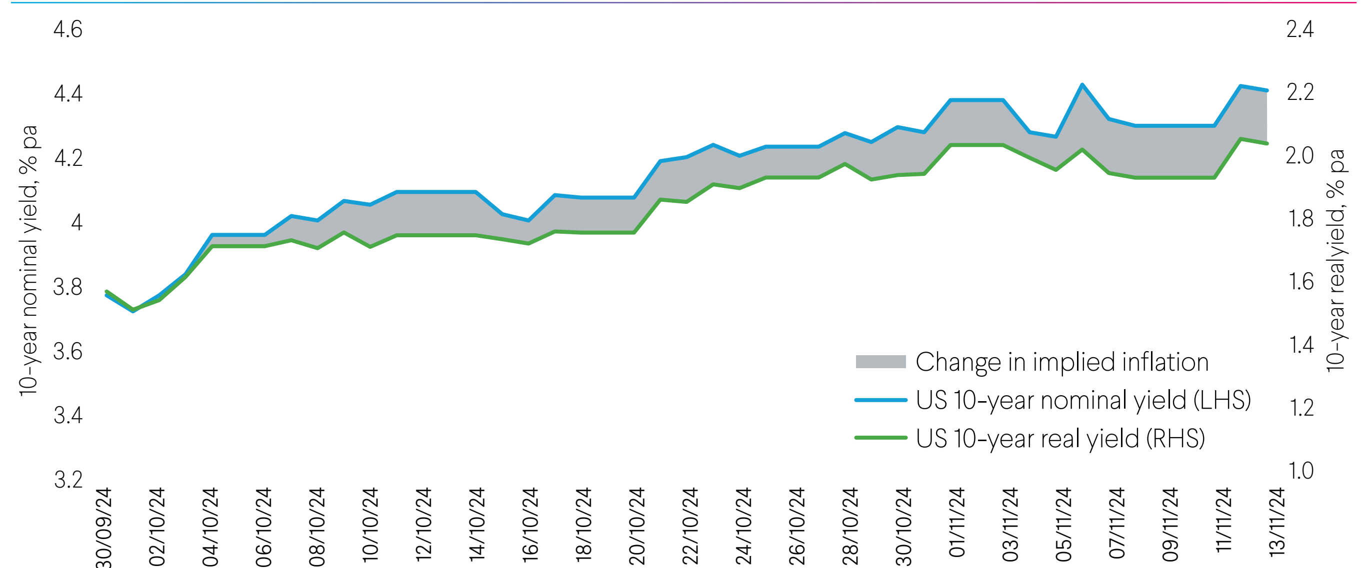
Donald Trump has claimed victory over Kamala Harris, becoming the first president in more than a century to return to the White House after losing it. Heading into the election, polls had Kamala Harris a notch ahead in the popular race, which she has lost, while Donald Trump was marginally in front across swing states. And it was these swing states that have carried him to victory.

However, the polls had underestimated both the margin of Trump's win and the potential for a clean sweep: Republicans have won the presidency and the Senate, and they're on course to retain control of the House of Representatives. Controlling all three will allow Trump a freer hand to implement his policy agenda.

Treasury yields rose across tenors, but long-end yields moved up faster than short-end yields – the so-called "bear steepening". The market reaction partly reflects stronger near-term growth expectations due to personal and business tax cuts and a lighter-touch approach to regulation, which are supportive of economic activity. However, this, and an expected widespread rise in tariffs and a crackdown on illegal migration are also expected to stoke inflationary pressures, through higher goods prices and upwards pressure on wages. Additionally, tax cuts will increase the already large budget deficit, or the rate at which government debt is being added to, increasing the likelihood of further treasury issuance in the future. This helps explain a larger rise in long-term yields, beyond that explained purely by an increase in interest-rate expectations. Some of the rise in yields, and the inflation risk premium, may also reflect lingering concerns that Trump may act to undermine the independence of the US Federal Reserve.

This initial reaction suggests that markets believe a Trump presidency will be good for US growth in the near term but will increase inflationary pressures. US 10-year nominal treasury yields jumped 0.2% pa as it became clear Trump was heading for victory. Nominal yields have since come down a little bit but remain up around 0.5% pa quarter-to-date. Real yields also rose but to a lesser extent. This meant that expected inflation, as implied by the difference in real and nominal 10-year yields, rose 0.2% pa to 2.4% pa quarter-to-date. Yields had risen throughout October as US jobs data surprised to upside and the odds of a Trump presidency increased.

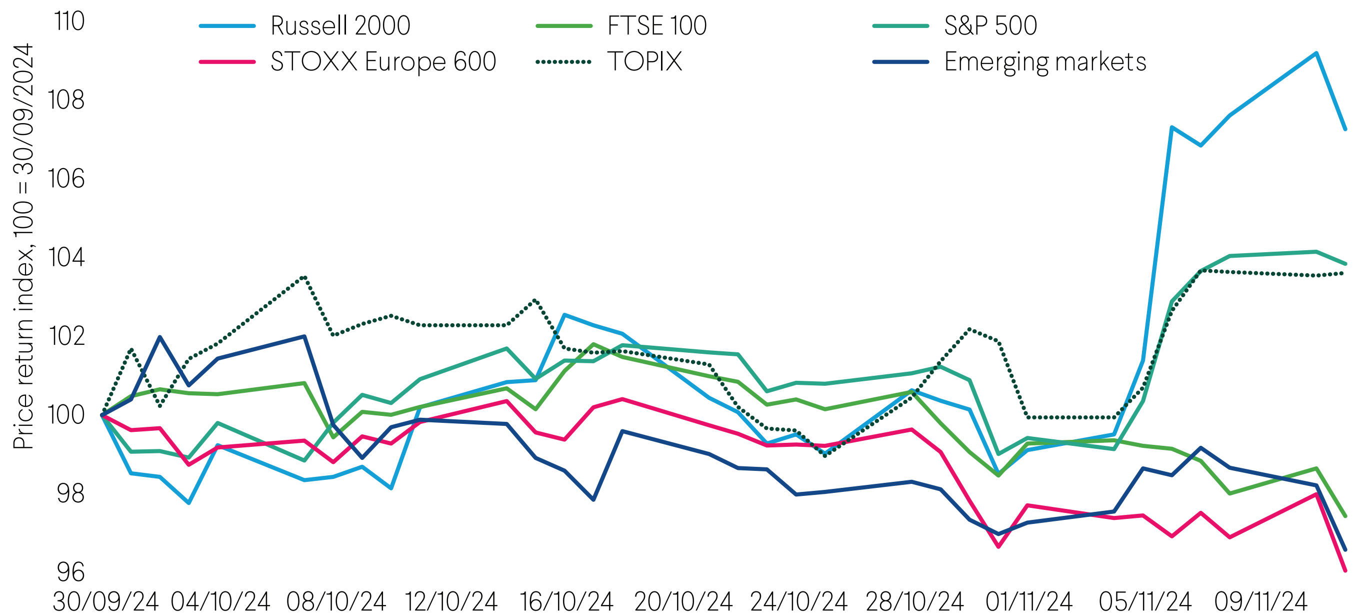
Chart 1: US yields have risen substantially QTD, and implied inflation has increased



US stock markets rose sharply in the immediate aftermath. The S&P 500 price index surged 2.5% as investor sentiment was buoyed by potential tax cuts and a lighter-touch approach to regulation under a Trump presidency (Chart 2). The Russell 2000 index of small-cap US stocks rose sharply, by 5.9%: domestically focused stocks are expected to see greater benefit from stronger domestic demand and tax cuts. Meanwhile, with smaller overseas revenues and local supply chains, they are less exposed to an escalation in tariffs and trade tensions.

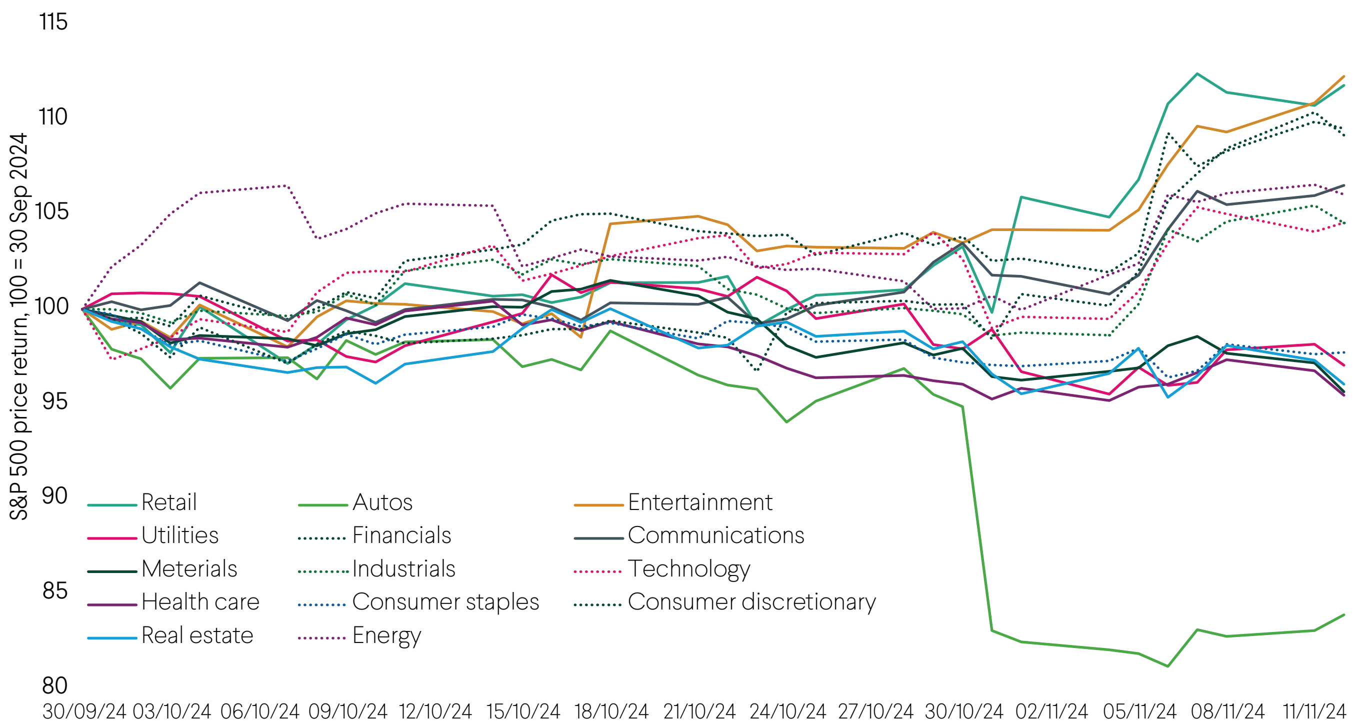
The US dollar appreciated versus major currencies like sterling, euro and the yen after the election result, on expectations that stronger growth and inflation will mean US interest rates remain higher for longer. The export-heavy Japanese equity market rose on the back of a weaker yen. Elsewhere, European equities weakened in anticipation of more difficult trading conditions ahead for some of the largest manufacturers, with German autos particularly exposed.

Chart 2: US equites outperformed in the immediate aftermath of Trump's win



US financials and energy stocks rose strongly in the immediate aftermath, up by 6.2% and 3.5%, respectively (Chart 3). This reflects market expectations of financial stocks being key beneficiaries of a lighter-touch approach to regulation, while higher-for-longer interest rates are also positive for their earnings through higher net interest margins. Markets also expect energy stocks, particularly extractive industries like oil and gas, to be key beneficiaries of Trump's win: he has vowed to give energy companies more freedom to drill for oil on federal land and is expected to lift a moratorium on the export of liquid natural gas. Autos, with their long and complex supply chains that are heavily exposed to an escalation in tariffs, were the main underperformers.

Chart 3: More cyclical sectors outperformed following the election result while defensives and autos underperformed



Our initial thoughts on potential impacts

It is early days, and it's difficult to judge the extent of Trump's policy agenda and how far he will go with regard to tax cuts, deregulation and higher tariffs. We expect that prior personal and business tax cuts will, at least, be extended; tariffs will be modestly increased; some post-GFC financial regulations will be rowed back; and oil & gas exploration, extraction on federal land and the export of LNG will increase. Against this backdrop, it's likely that global growth will rise initially. However, increasing trade tensions, higher US treasury yields and a stronger dollar are likely to weigh on global growth in the medium term.

We think stronger near-term growth and the positive impact on post-tax earnings via tax cuts is likely to support the US equity market in the short term, but we would make the following observations about the US equity market:

- The impact of tax cuts is likely to be less than back in 2017. US equity valuations are much more elevated now, and equity risk premiums lower, which tends to augur a period of more subdued returns.
- The so-called 'magnificent seven' stocks have been responsible for a disproportionate share of returns over recent years, significantly increasing market concentration. These stocks are highly exposed to a potential escalation of trade frictions, given their significant overseas revenues.
- Tax cuts and potential deregulation lend near-term support to the US equity market, but we might see market leadership broaden or change – cyclical stocks look better placed than defensives, while domestically focused stocks and small-caps look best placed to benefit from tax cuts and a potential reduction in foreign competition. The caveat here is that small-caps tend to have higher debt loads – if tax cuts, tariffs and a crackdown on immigration prove inflationary, and interest rates stay higher as a result, this would be a downside risk to these companies.
- Long-term real yields in the US and UK are bumping up against real potential growth forecasts – we believe this acts as a natural ceiling to real yields, as yields higher than this level would put debt on an unsustainable path, with some fiscal consolidation likely. So, with positive long-term real yields approaching what we see as a longer-term ceiling, we believe bonds can provide ballast and diversification in a downside growth scenario.
- We think Trump is unlikely to heavily interfere with the Fed's mandate – Trump and his team will be aware that high inflation was a major contributor to voter dissatisfaction with the Biden presidency. If inflation expectations were to rise due to interference with the Fed's mandate, we believe this would be likely to cause Trump to reverse course.

Summary

US growth exceptionalism is expected to remain intact in the near term, which will continue to lend support to earnings growth and the equity market. Furthermore, Trump looks set to extend personal and business tax cuts and adopt a lighter-touch approach to regulation. However, given elevated concentration and the headwinds and tailwinds mentioned above, perhaps now is a suitable time for investors to revisit exposure to US equities. Broader diversification within US equities (Russell 2000 vs S&P 500) or alternatives to market-cap-based exposures might be worthy of consideration.

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