Investment Views

December 2024

BUTTERFIELD

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Trump's Currency Conundrum

- Policy by social media is back
- A strong US dollar has both benefits and drawbacks
- Trade-offs make for an uncertain policy environment in 2025

US equity markets responded positively to the re-election of Donald Trump to the White House, with the S&P 500 returning a healthy 5.9% in November. Markets outside of the US were mixed, with UK and Japanese equities seeing small positive returns in US dollar terms, while European and Emerging Market equities saw small losses. There was also wide dispersion between different market sectors, with Consumer Discretionary and Financials stocks outperforming, while Materials, Health Care and Utilities lagged. This dispersion at both the regional and sector level highlights the market's perception of the relative winners and losers under the new administration.

Sentiment indicators for both households and businesses have

jumped since the election. This is particularly the case for small businesses, owners of which typically favour Republican governments. The rally in US equity markets reflects the expectation that this jump in confidence will translate into higher consumer spending and business investment. Growth in the US has been solid in recent quarters, which has supported other countries through exports to the US. However, markets are concerned that potential tariffs and a more hostile environment for global trade will be a negative for regions like Europe and Emerging Markets. This combination has been positive for the US dollar, which has appreciated strongly since the start of October when markets began to price in a Trump victory.

Unpredictability will be a core feature of government under the Trump administration. This presents a challenge for investors, especially as policies may be announced without warning on social media. We have already had a taste of this with threats to impose tariffs against Mexico and Canada linked not to trade imbalances, but to immigration. Shortly thereafter, Trump effectively rescinded these threats and noted that he had productive talks with the leaders of Mexico and Canada.

This was followed by a social media post threatening any countries that attempt to move away from the US dollar. Trump posted: “we require a commitment from… countries that they will neither create a new… currency, nor back any other currency to replace the mighty US Dollar or, they will face 100% Tariffs”. There is a lot of debate around the role of the US dollar in the global economic system as it has both advantages and advantages for the US. On the one hand, being the issuer of the reserve currency allows the US to borrow in a currency that they control and it attracts capital from abroad. On the other hand, these capital inflows increase the value of the US dollar and this makes sectors like manufacturing less competitive versus other countries with weaker currencies.

100%

The percentage of tariffs that President Trump threatened any countries that attempt to move away from the US dollar

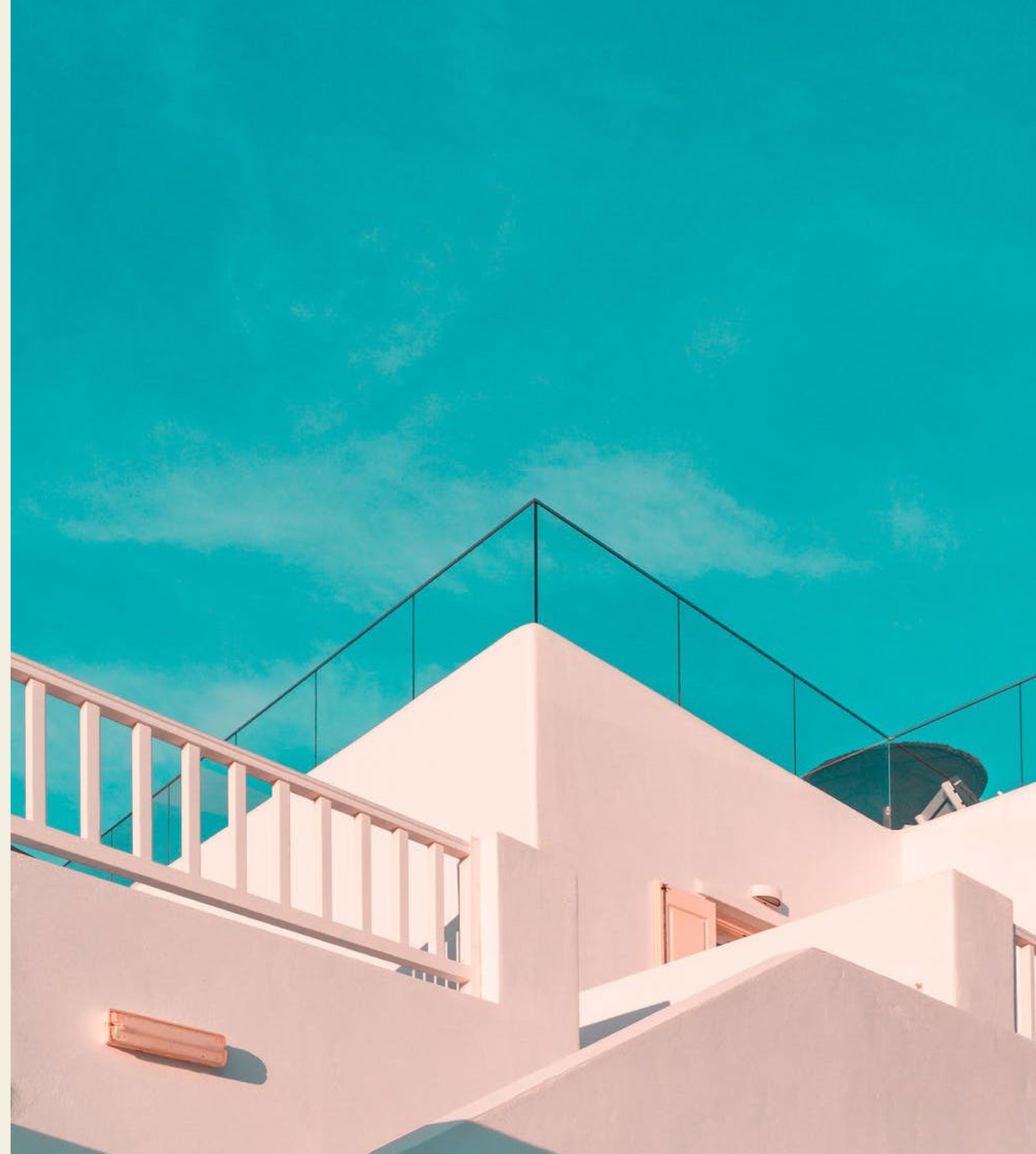
The US runs a very large trade deficit (their imports are much higher than their exports) and Trump has instinctively identified that there is an imbalance in the system. However, economists struggle to articulate the benefits and drawbacks of the role that the dollar plays as the reserve currency. This is an important debate that will help shape the outlook for next year as it will help determine whether tariffs are used as negotiating tactic or will be imposed in a meaningful way that hurts global growth.

Given the wide range of potential policy changes ahead, markets will likely be sensitive to the substance, severity, and sequencing of various policies out of Washington. While this is a challenge for investors, we know that Trump closely monitors financial markets and uses them as a barometer of success. Excessive fiscal policy will likely be met with a sell-off in bonds, and excessive use of tariffs will likely be met with a sell-off in equities. These two scenarios represent key risks heading into next year. If they do materialise, however, the market moves will likely feedback to policymakers and act as a moderating force on legislation.

Noise Fades, Policy Risks Persist

- Markets steady post-election, but the policy outlook remains unclear
- US inflation expectations ease, but UK stagflation risks grow.
- Bond volatility drops, dollar strengthens, credit spreads narrow

Despite the noise surrounding the US election, November market trends largely continued to follow the geopolitical and macroeconomic patterns observed at the end of October. This was primarily because the election outcome aligned with market expectations of a Trump victory. The initial market response saw US 10-year Treasury yields rise to 4.45%, reflecting early attempts to price in anticipated changes in tariffs, immigration, and corporate taxes. However, the appointment of Scott Bessent as Treasury Secretary helped to calm market nerves, leading to a decline in US government bond yields. Significant uncertainty persists regarding key policies and the distinction between campaign rhetoric and actionable policy. Until further clarity



emerges, our approach remains guided by the current trajectory of inflation and macroeconomic trends. A cautious, reflective, and nimble investment stance is appropriate at this juncture.

Long-term US inflation expectations ended the month lower as markets reassessed the path of monetary policy. Following the election, expectations of an overly accommodative rate-cutting trajectory were tempered, with the market converging on a 3.75% terminal rate and largely removing the prospect of significant cuts in 2025. In the UK, inflation data exceeded expectations, raising concerns of stagflation following the government's budget announcement. This heightens the risk that the Bank of England may delay lowering base rates, potentially exacerbating economic challenges. European fixed income markets outperformed their global peers, with German Bunds seeing sharp gains. German 10-year yields dropped 30 basis points to 2.09%, reflecting the country's struggle to return to growth. Political uncertainties in France and expectations of further rate cuts by the European Central Bank (ECB) provided additional tailwinds. By contrast, UK fixed income markets faced headwinds from weaker, more stagflationary (inflation but stagnant economic growth) macroeconomic data.

With the US election decided, the MOVE Index—a measure of bond market volatility—declined significantly by 30% to 95, indicating reduced expectations for bond market volatility. However, this was offset by increased currency volatility, driven by concerns over the potential impact of tariffs. Japanese government bonds were the only G10 bonds to post losses, amid expectations of further interest rate hikes despite mixed economic data. Average US high-yield credit spreads narrowed to 253 basis points over Treasuries, just 20 basis points away from 2007 lows. This narrowing reflects improved investor confidence despite broader concerns about economic slowdowns,

30%

The percentage that bond market volatility—declined indicating reduced expectations.

FIXED INCOME

as expectations for deregulation, corporate tax cuts, and solid corporate balance sheets encouraged risk-taking.

Macro indicators presented a mixed picture. In the US, positive economic surprises are fading, although the Atlanta Fed remains optimistic, projecting above-trend real GDP growth of 2.7% for Q4. Europe's growth outlook is also slowing, but at a more rapid pace in the UK, where the transition from being one of the fastest-growing developed economies in early 2024 to a recessionary environment is nearly complete. Currency markets were dominated by US dollar strength, with the dollar posting its strongest consecutive monthly gains in two years on a trade-weighted basis. This was driven by expectations of fiscal stimulus and tariffs under the Trump administration, as well as growth and real interest rate differentials. The euro and British pound weakened broadly, while the Japanese yen strengthened. However, the yen experienced high intermonth volatility, remaining sensitive to US rates and tariff developments.

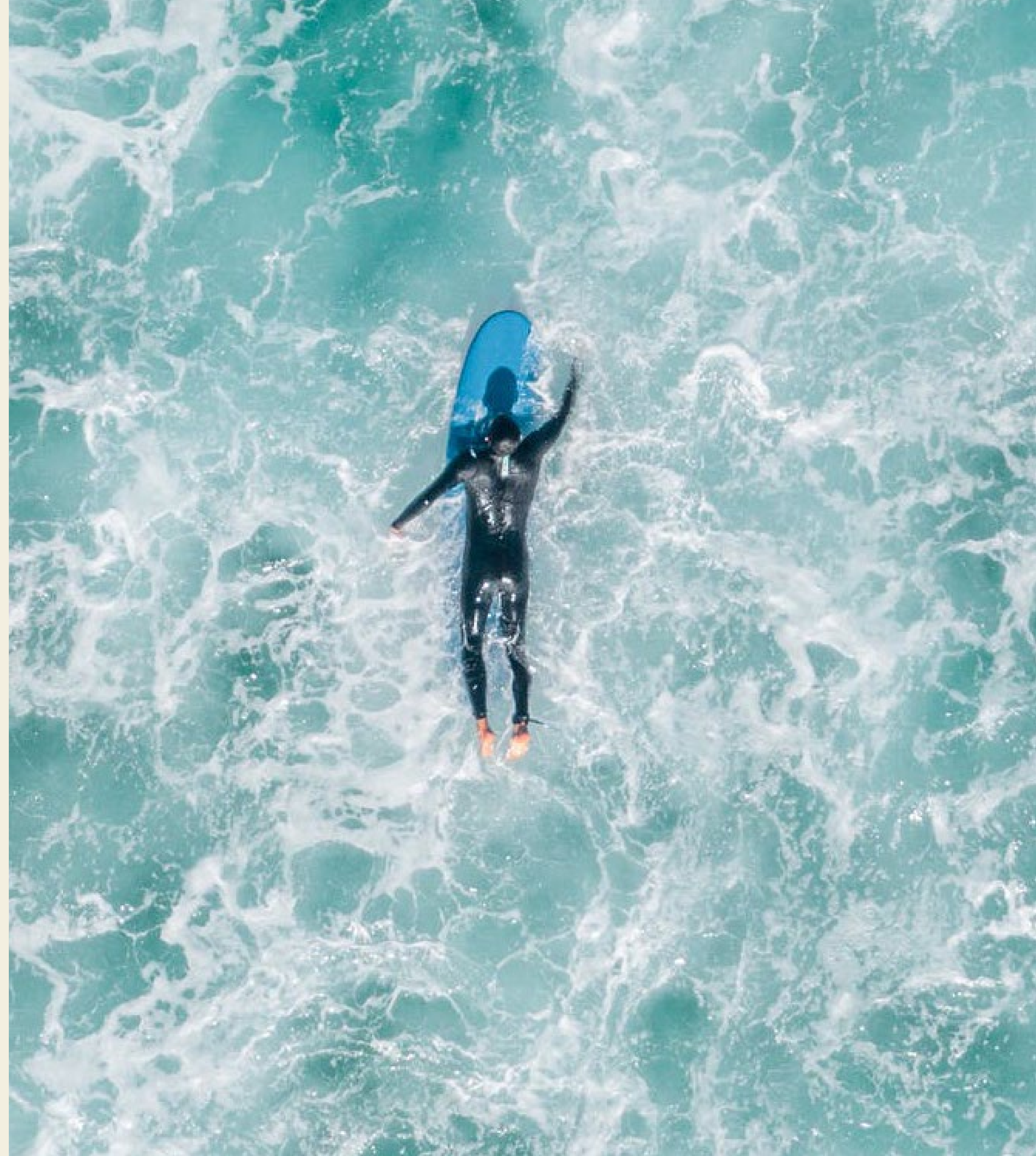
In our US dollar bond funds, we adjusted our US interest rate duration exposure back to neutral in November, having maintained an underweight position since mid-September. With US yields nearing 4.5%, we see them as offering good value, reflecting current inflation and macroeconomic dynamics fairly. We also reduced our inflation protection exposure, reallocating to nominal bonds while retaining a modest hedge. Corporate credit exposure remains stable and defensive. In currency markets, we have started to trim gains in the US dollar but continue to maintain an overweight position in the greenback. Financial conditions remain far too easy and fiscal deficit too large for the US economy, which raises the odds of a pause in the easing cycle. Risk assets will need to digest this in 2025.

Stellar Returns

- November the strongest month of the year for US Equities
- US election created winners and losers
- Equities are expensive, but earnings are delivering

The MSCI World Index had a stellar month returning 4.6% in US dollar terms, the best monthly performance this year. The combination of Trump winning the US election, the Federal Reserve cutting interest rates, and a robust third quarter earnings season, resulted in a risk-on environment. As we approach the end of the year, research providers are publishing outlooks for 2025, forecasting where the S&P 500 will be in a year's time. Bloomberg's top-down consensus numbers suggest a 2025 year-end target of 6,471 (7% return) and bottom-up aggregate numbers suggest a target of 6,597 (9% return). The consensus is positive on risk assets going into 2025.

Despite the bullish backdrop, equity valuations are near 10-year highs, with every additional dollar invested at an increasingly less



attractive risk/reward ratio. The S&P 500 is now trading at 22.4x blended forward earnings, a 22% premium to the 10-year average. These are levels not seen since 2020/2021 and prior to that, the dot-com bubble. However, a correction requires a catalyst, absent of this, the stretched valuations hold and the equity markets could achieve a near double-digit return next year.

38%

The percentage that Tesla rallied

As expected, Trump's election led to some winners and losers. Consumer Discretionary was the best performing sector in November, with heavyweights Tesla and Amazon leading the charge. Tesla rallied 38% as everything Elon Musk-related attracted investments with Musk himself benefitting handsomely from his sizeable contribution to Trump's campaign. Amazon rallied 12%, which was more in-line with the broader sector. The S&P 500 Consumer Discretionary sector rallied 8% highlighting that it wasn't only the largest names which performed well.

Financials was the second-best performing sector as potential deregulation from the Trump administration lifted large and regional banks. Insurance companies lagged but still put in a good performance. The worst performing sector was Materials, with Chemical companies and Metals and Mining companies underperforming. Healthcare, which is once again one of the weakest sectors this year, struggled with large market capitalisation pharmaceutical companies as well Biotechnology companies lagging.

The big winner this year clearly is the US stock market, with global investors wondering if there is any point investing in Europe. The US stock market is up 28% this year, significantly ahead of Europe (excluding UK) which is only up 3%. This is the largest divergence in performance seen in decades. Unlike the US market, which is trading on a lofty valuation, the European market is trading below its 10-year blended forward earnings average. The question we get from investors is, given the relative underperformance and attractive valuation, is now the time to invest in European stocks. With the European economy decoupling from the US economy from an inflation and interest rate perspective, and from a growth perspective, together with many of the major European economies facing political headwinds, the negative sentiment may continue. However, given the more attractive valuations, we are monitoring how the political landscape and growth story unfolds for any opportunities that may arise.

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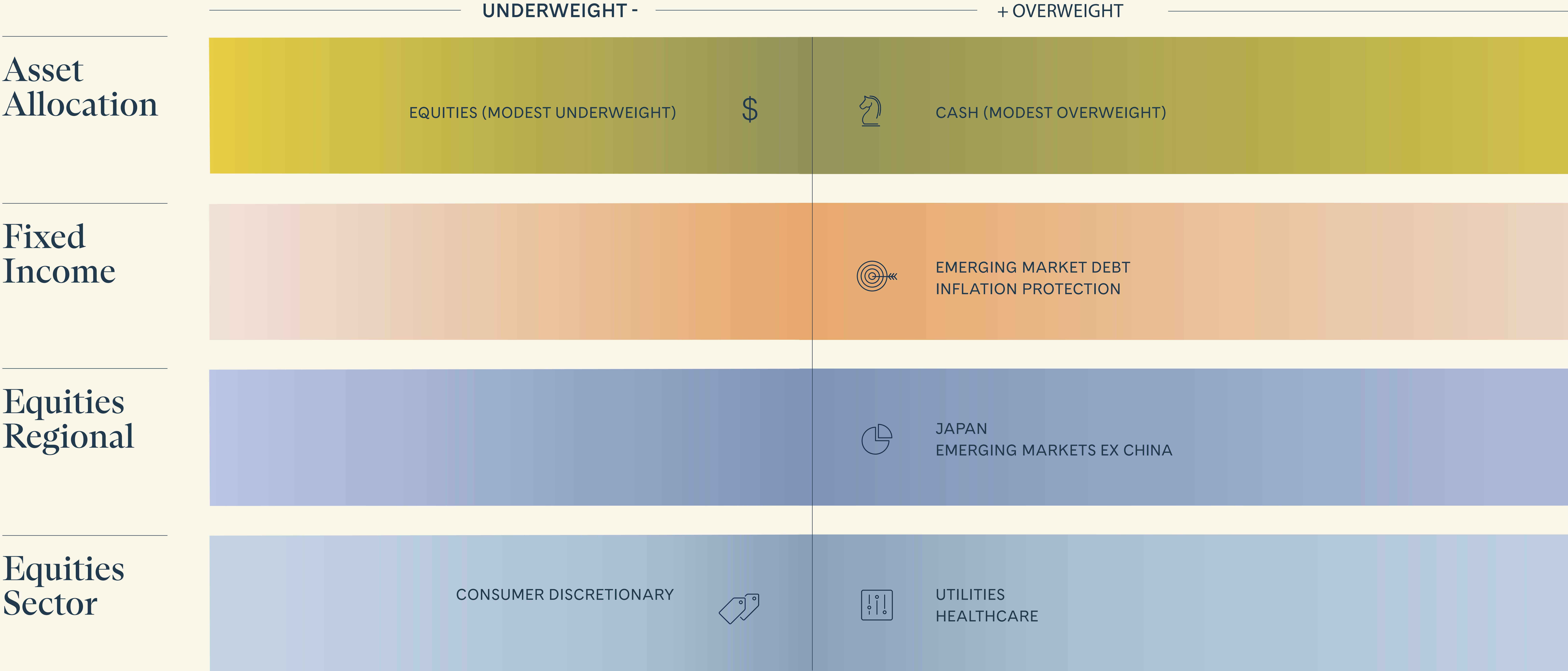
Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy



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