Trump 2.0: Time to Curb Your Enthusiasm?

US exceptionalism will remain a focus for markets, but the big question is how long it can last.

Key Points

- **The Republican sweep in the US election turbocharges the already positive direction of US fundamentals.** While there are many policy unknowns with the incoming administration, we're aligned with the recent momentum in equities, despite rich valuations, and continue to favor global equities over bonds.
- **We favor US over European equities and European rates relative to US rates.** We've increased our view on Chinese equities to neutral, given cheap valuations and our belief that recent stimulus, while not entirely adequate, has at least put a floor under the market.
- **We've reduced our credit view to neutral** given record tight spreads[1] and compression between CCC and BB bonds. We think rich valuations on high yield offset the good supply/demand technicals and carry.[2]
- **We remain wary of higher US fiscal deficits** and think US rates and the embedded term premium[3] are the best reflection of the market's view. On the other hand, the Federal Reserve (Fed) remains on an easing path, even if rate cuts might be shallower than expected a few months ago. Thus, we remain neutral on duration.[4]
- **We think gold has upside based on central banks' continued desire to diversify** their foreign-exchange holdings and as a hedge against geopolitical and stagflation[5] risk.
- **Downside risks** to our views include a spike in US interest rates spurred by inflation concerns (from fiscal policy and/or tariffs) and dimming hopes of Fed easing. A flare-up in geopolitical risk could also weaken our base case. **Upside risks** include a jump in US productivity that increases US growth potential without higher inflation and meaningful fiscal stimulus from China that catalyzes a strong rally there as well as in emerging-market (EM) economies linked to China.

Insight from sub-adviser Wellington Management

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Risk markets have been ecstatic over the US election results, with US equities climbing to record levels and credit spreads tightening. US exceptionalism is the running theme based on expectations of deregulation and lower taxes, and that has meant US outperformance over pretty much everything else. The big question is how long it can last.

The crystal ball is pretty cloudy right now. How does an allocator navigate markets when so much about the policy landscape is unknown, and the details, once they emerge, could have major implications for sectors, companies, and regions?

First, focus on what we do know (at least as of this writing in early December). We expect the new administration to act on the four pillars of its campaign: lower taxes, more restrictive trade, deregulation, and less immigration. But changes in trade and regulation may be implemented sooner than tax or immigration policies, which could require congressional approval. We also have deeper knowledge of fundamentals than politics, and we know current valuations.

Second, take a scenario-based approach to what we don't know. For instance, what's the likely impact of different growth/inflation mixes on interest rates? Third, consider using policy uncertainty and associated volatility to increase or decrease exposure when markets' knee-jerk reactions put valuations out of sync with fundamentals.

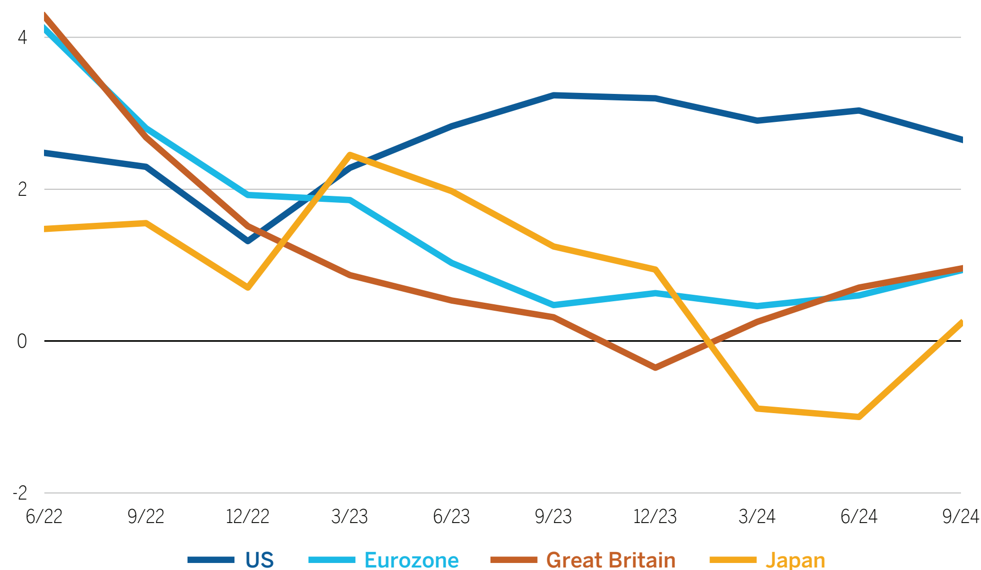
With that in mind, we're leaning into the good fundamental picture in the US—a better growth/inflation balance, stronger earnings than the rest of the world, and supportive Fed policy—with a moderately overweight view on US equities. What keeps us from having a larger overweight view? Valuations are at the rich end of the historical range, though we acknowledge that any reversion could take years, not months.

We expect the Trump administration to put tariffs on European goods, which, in combination with weaker growth, could hurt Europe relative to the US. We express that in our overweight view on US equities and on European duration relative to the US. Japanese equities have had a good run since we initiated our overweight view on the market in late 2022, but we've now moved to a neutral view given that the weak yen and uncertain political situation could offset the positives, including improving corporate governance and supportive valuations.

FIGURE 1

US Exceptionalism Is the Running Theme

Real GDP (Year-Over-Year %)



Quarterly real GDP data from Refinitiv, 6/30/22-9/30/24. Data Sources: Wellington Management and Refinitiv.

In fixed income, we've reduced our high-yield view to neutral. With spreads close to the zero percentile, the risk/reward has shifted negatively—though we recognize that attractive US yields, low default rates, and limited net supply could keep spreads tight for a while. We note that interest-rate volatility has been running higher than equity volatility, creating potential opportunities for allocators to take advantage of pricing anomalies in government bonds.

We remain positive on gold. De-dollarization continues to be a goal for many central banks concerned about US sanctions on US-dollar reserve assets. We see limits to the rise in yields, which hurt gold prices recently, and think the precious metal will again be valued for its hedging role amid geopolitical and inflation risks.

While US political uncertainty will be a feature of the coming year, several guardrails could rein in the tail risks. First, the Senate confirmation process should mean that more extreme picks for key policymaker roles won't be a shoo-in. Second, existing laws and regulations should limit the implementation of more radical policies. Third, the stock and bond markets will be "voting" on the economic implications of new policies. If either market tanks, the president is likely to respond.

Equities: Broadly Bullish but Weighing Regional Pros and Cons

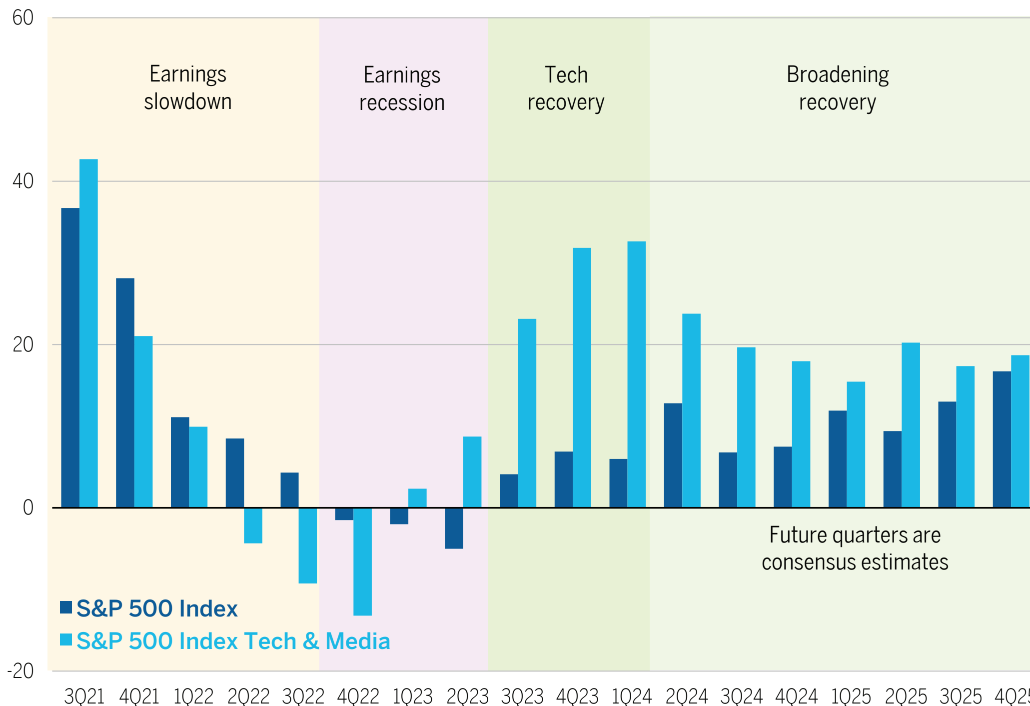
We maintain a modestly positive stance on global equities. Overall, economic growth remains on a steady positive trajectory, and the disinflationary path is intact, although bumpier than before in some regions. Broadly speaking, market sentiment is bullish but not overextended, in our view; however, divergences remain. In the US, we think companies may be well positioned to achieve robust earnings growth, but valuations are a challenge. In other markets, such as Europe and Japan, earnings breadth is a concern, but valuations are supportive. We think the biggest threat to global equities is the potential reemergence of inflationary pressures, which could lead to a disorderly move upward in yields and create valuation headwinds. While these risks aren't our base case, they give us reason to maintain some caution and keep us from moving to a full overweight view on global equities.

Turning to our regional perspectives, we've moved from a neutral to a moderately overweight view on the US. The economy displays continued resilience, with a renewed pickup in macroeconomic leads, such as consumer confidence. Earnings surprised on the upside in the third quarter, and we estimate they could grow by 14% over the next 12 months. The latest earnings show a picture of margin expansion, and a pickup in productivity has supported companies' bottom lines. Evidence of a more balanced advance in earnings thus far is mixed, as tech and related sectors still dominated cyclicals and energy in the third-quarter earnings season. However, the market advance turned more broad-based following the US election. And looking forward, expectations are for earnings growth in companies outside tech and mega-caps to close the gap with the leaders (**FIGURE 2**). When it comes to election impacts, markets face a balancing act between growth-boosting policies, including deregulation and the extension or addition of tax cuts, and the disruptive effects of tariffs and curbs on immigration. Still, we believe that the potential policy mix disproportionately favors the US over other regions.

FIGURE 2

Earnings Growth Expected to Broaden

% Earnings-Per-Share Growth Year-Over-Year



As of 11/11/24. Data represents year-over-year change in earnings-per-share for S&P 500 Index and the technology and media industries within the S&P 500 Index. Earnings per share is the projected growth rate in earnings per share for the next five years. S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks. Indices are unmanaged and not available for direct investment. Data Sources: Wellington Management and Bloomberg.

We maintain a moderately underweight view on Europe, where earnings growth remains muted, and earnings revisions are more negative. Germany's sluggish economy and France's political uncertainty have further clouded the economic outlook. European equities are cheap relative to earnings in both absolute and sector-adjusted terms, but they lack a compelling catalyst for outperformance vs. other regions, particularly in light of potential US tariffs. We'll keep a watchful eye for a change in trend given low valuations.

We've moved from our long-term overweight view on Japan to a neutral view. We think the market faces a few potential stumbling blocks in the coming quarters. As with Europe, we think Japan faces uncertainty about whether potential trade frictions will stymie companies' ability to capitalize on any improvement in the global demand picture. We've noted that earnings expectations are falling, and revisions breadth is weak. Japan also faces some domestic policy uncertainty following its election this past fall, which has yielded an unstable coalition. Volatility in the exchange rate may also cause price-to-earnings[6] compression and lead to margin uncertainty for exporters. We remain constructive on Japan structurally though, as improvements in corporate governance, buybacks,[7] and domestic demand growth continue apace.

We've moved from a small underweight view on China to neutral. While recent fiscal stimulus hasn't sufficiently addressed weak private-sector confidence, we believe it puts a floor under the equity downside. Policymakers may have preserved dry powder for fiscal interventions in case tensions escalate. Looking at company fundamentals, we see room for modest optimism, as buybacks are increasing, and short-term earnings expectations are moving slightly higher. We remain neutral, however, because we expect valuation expansion may continue to be limited by a weak and uncertain long-term earnings growth picture and a lack of visibility on the sequencing of a policy response to serious growth challenges.

Within sectors, we're positive on financials and utilities, given favorable valuations and macro signals, and more negative on consumer staples and telecoms. Utilities appear to be in a good position to capitalize on strong projected electricity demand growth and the resulting pricing power. We think financials could benefit from the steeper yield curve,[8] a recovery in private credit, and deregulation. Small caps in the US seem likely to benefit in relative terms from a deregulatory impulse and a pickup in mergers and acquisitions. They may also benefit from low starting valuations and are less exposed to an expansion in tariffs and supply-chain frictions than many large caps.

Government Bonds: We Expect Divergence Ahead

Most central banks are easing monetary policy, but President-elect Donald Trump's election victory inserts new risks into the outlook that could induce greater divergence between countries' bond markets. Our highest-conviction view is that the combination of fundamentals and politics could drive the gap between US and European yields wider.

On the fundamental side, the difference between US and European growth is stark (**FIGURE 3**). The US has surprised on the upside, with 2.7% GDP growth expected for 2024, and should benefit from the Trump administration's pro-growth agenda. Europe, on the other hand, is struggling with weakness in Germany, political uncertainty there and in France, and the threat of a negative growth shock from US-imposed tariffs. In fact, we think the market may price more rate cuts for the European Central Bank. In our probability-weighted excess-return scenarios, we see the greatest potential upside for European bonds and the greatest potential downside for US bonds.

On the political side, we think inflation is the main risk in the US given Trump's campaign promises to extend tax cuts, impose stiff tariffs, and deport immigrants. Interest-rate volatility, as proxied by the MOVE Index,[9] has been

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	—
Developed market (DM) govt. bonds	Neutral	—
Credit spreads	Neutral	⬇
Commodities	Moderately OW	—
Cash	Moderately UW	⬆
Within Asset Classes		
Global Equities		
US	Moderately OW	⬆
Europe	Moderately UW	—
Japan	Neutral	⬇
China	Neutral	⬆
EM ex China	Neutral	—
DM Government bonds		
US government	Moderately UW	⬇
Europe government	Moderately OW	⬆
Japan government	Neutral	—
Credit Spreads		
US high yield	Neutral	—
Europe high yield	Neutral	—
Global investment grade	Neutral	—
EM debt	Neutral	—
Bank loans	Neutral	—
Securitized assets	Moderately OW	—

OW = overweight, UW = underweight

Source: Wellington Management | Views expressed have a 12-month horizon and are those of the authors and the Investment Strategy & Solutions Group. Views are as of November 2024, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This is not to be construed as investment advice or a recommendation to buy or sell any specific security.

running much higher than equity volatility, as proxied by the VIX.[10] The market has cut easing expectations from 200 basis points (bps)[11] in September to around 90 bps today, and 10-year yields are 60 bps higher, driven mostly by real yields.

Of course, the bond market's reaction to higher inflation would depend on whether it was driven by strong growth (deregulation), a supply shock (fewer workers or less trade), or fiscal profligacy (an end to Social Security taxes, for example). The risk is that the term premium spikes in response to "bad" inflation. That said, the policies that are actually implemented may be milder than campaign rhetoric. We expect the feedback between higher US yields and the economy to cap the rise in yields and think allocators can potentially take advantage of high volatility and may want to consider positioning tactically in a range of 3.75% to 5.25% on the 10-year Treasury.

On balance, the combination of winners and losers in an era of deglobalization makes us neutral on overall duration.

> The bond market's reaction to higher inflation would depend on its cause, and the policies that will actually be implemented may be milder than campaign rhetoric.

FIGURE 3

European Weakness Suggests Lower Yields Relative to the US

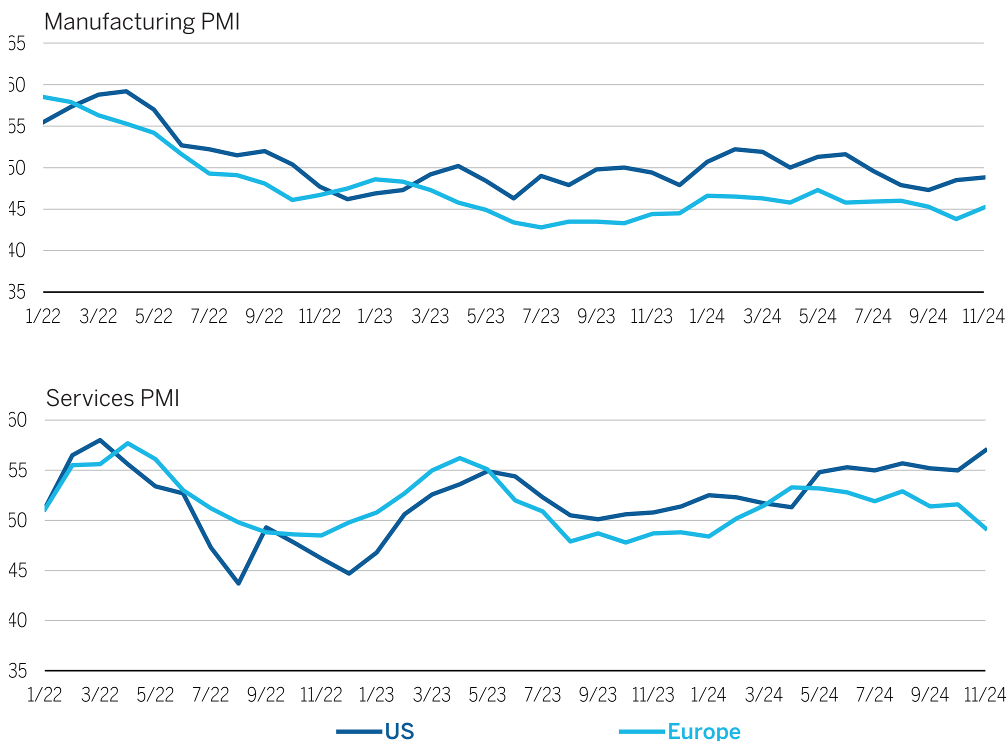


Chart data as of 1/31/22-11/30/24. The Purchasing Managers' Index (PMI) is a monthly indicator of the prevailing direction of economic trends in the manufacturing and service sectors. Data Sources: Wellington Management and Refinitiv.

Credit: Upside Is Limited, but Not Enough for an Underweight View

Having had an overweight view on high-yield credit spreads since the start of 2024, we've now moved to a neutral view. We think the macro and fundamental backdrop remains supportive for credit—central-bank rate cuts are underway, economic growth is strong, earnings and balance sheets are healthy, and high-yield default rates globally continue to trend down. However, the upside for credit is now limited by the fact that spreads are extremely tight relative to history. Last quarter, there was at least some value remaining in the riskiest parts of the credit markets, but that gap has closed, and we see very tight spreads across the entire quality spectrum. This means the upside potential of the asset class, compared to equities, for example, is more limited.

Having said that, we opted for a neutral rather than underweight view because we think spreads could remain at current levels for some time. We don't see any immediate catalysts for widening (especially now that the US election is behind us). Technical support also remains for credit markets, with yield-sensitive buyers continuing to flow into the asset class in search of attractive yields and seemingly agnostic about slim spread levels. We expect this to continue into the new year. Regionally, we remain neutral, seeing limited forward-return differentials between different credit markets.

Gold has had an incredible run in 2024, and we see reasons for it to continue into 2025.

Commodities: As Good as Gold

We maintain our moderately overweight stance on commodities, driven by positive views on gold. Gold has had an incredible run in 2024, and we see reasons for it to continue into 2025. Our base case is that central-bank buying, ETF demand, and interest-rate cuts could be supportive for prices going forward. We've stuck with a moderate rather than full overweight view because there are risks—particularly the possibility that central-bank buying fades or real yields increase with sticky or rising inflation. But for now, the status quo remains supportive for the asset class.

Within oil, we've moved to a neutral view after previously being positive. While we continue to think economic growth will be supportive for prices, there's a growing risk (particularly coming out of the US election) that supply will increase and hurt prices in the new year. A positive roll yield,[12] which reflects the lower cost of longer-dated futures, continues to support the asset class, in our view.

Risks to Our Views

Downside risks include:

- A scenario in which core inflation reaccelerates or spikes, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking
- A jump in fiscal risk that pushes long-term rates higher in a disorderly fashion
- A big reversal in one or more of the mega-cap stocks, which could threaten the market's current sharp upward momentum
- A spike in geopolitical risk that pushes up oil prices and increases macro uncertainty
- Punitive US tariffs on China and/or the rest of the world
- The risk that capital flows to China are constrained by political maneuvers

Upside risks include:

- A breakthrough in US/China relations that results in lower-than-expected tariffs or no tariffs
- More widespread diffusion of growth globally and inflation moving closer to target, giving central banks room to cut more than is currently priced in
- Meaningful fiscal stimulus in China, targeted to the consumer and private-sector companies
- A broad resolution to the Middle East conflict
- Lower oil prices, suppressing inflation fears

Investment Implications

- **Prepare for US exceptionalism to potentially dominate in equities** — We think the optimistic mood in risk assets[13] could continue as pro-growth policies dominate the narrative over the coming months. Rich valuations make the decision to be long equities less straightforward, as does the risk of inflation down the road. To express this balance, we prefer a slight overweight view on global equities and a regional equity view favoring the US over Europe.
- **Expect further broadening in the equity rally** — With better growth prospects, we expect earnings improvement to expand beyond the mega-cap tech sector. We think this could benefit value, small cap, and some cyclicals. Among sectors, we favor financials and utilities and are more negative on consumer staples and telecoms.
- **Consider seeking relative value in fixed income** — We think the positive backdrop for credit, including strong technicals and falling default rates, is fully priced in and that a neutral view on credit is appropriate. We also have a neutral view on duration on the basis of central-bank easing continuing, albeit at a slower pace. We favor securitized credit over other credit sectors and favor European duration over US duration.
- **Consider a small allocation to gold** — Central-bank buying continues to be a positive demand technical for gold as countries look to diversify their currency reserves and avoid the risk of US sanctions. A more muscular approach to foreign policy from the new US administration could insert more geopolitical uncertainty into the landscape.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[2] Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

[3] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

[4] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[5] Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation.

[6] The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock.

[7] A buyback is a company's purchase of its outstanding stock shares. Buybacks reduce the number of shares available on the open market.

[8] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[9] The MOVE Index, short for the Merrill Lynch Option Volatility Estimate Index, is a measure of expected volatility in the U.S. Treasury bond market. It is a gauge the level of uncertainty or risk in the bond market, which can sometimes signal potential volatility in the broader financial market.

[10] VIX, commonly referred to as the "Fear Index," is the ticker symbol for the Chicago Board Options Exchange (Cboe) Volatility Index and measures the market's expectation of 30-day volatility. VIX levels below 20 reflect complacency, while levels of 40 or higher reflect extremely high levels of volatility.

[11] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[12] Roll yield is the amount of return generated in the futures market after an investor rolls a short-term contract into a longer-term contract and profits from the convergence of the futures price toward a higher spot or cash price.

[13] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets such as China. • Small-cap securities can have greater risks, including liquidity risk, and volatility than large-cap securities.• Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject the investors to greater volatility than traditional investments. The value of such instruments may be volatile and fluctuate widely based on a variety of factors. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Different investment styles may go in and out of favor, which may cause underperformance to the broader stock market.

Diversification does not ensure a profit or protect against a loss in a declining market.

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