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INVESTMENT SERVICES

# Weekly Relative Value


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## Trump 2.0

### THIS WEEK

- THE TRUMP AGENDA
- DON'T ASSUME!
- IT'S ALL ABOUT INFLATION
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"**For now,** investor sentiment is **pro-growth, pro-deregulation, and pro-markets**… There is also an assumption that merging or acquiring (M&A) activity will pick up and that **more tax cuts are coming, or the existing ones will be extended**. This creates **a strong backdrop for stocks."***
*— David Bahnsen, Chief Investment Officer, The Bahnsen Group*

We made it to November 6, barely, but we did. And regardless of the outcome, the sun still rose and life continued on. For those not happy with the result, every day from here on out moves them closer to 2028. For now, it is time to honor the collective will of our democracy.


I thought meteorologists and economists were bad at forecasting… time to add pollsters to that esteemed group. Indeed, so much for a nail-biting election that the pollsters had anticipated. Former President Donald Trump won the presidential election, and, frankly, it wasn't close. Trump won the electoral college securing 312 votes to 226 for Vice President Kamala Harris. In addition, Trump, surprised the pollsters by winning the popular vote. In fact, this was the first time a Republican has won the popular vote since George W. Bush in 2004.

No matter which way you voted, the good news for everyone, especially those that track the economy and markets, is that we will not have to endure weeks or months of a contentious and contested election and all the uncertainty that would have implied. That, in itself, is a sigh of relief.

### THE TRUMP AGENDA

Not only did Trump win the Oval Office decisively, but the GOP won the Senate and likely the House of Representatives. Thus, President-Elect Trump is likely to be able to govern without any resistance and enable a large part of his economic agenda to be implemented early in the new term.

So, while it's very early and much can change before Inauguration Day and beyond, below I will take a stab at reviewing and analyzing each of the four key pillars of **Trump 2.0** — tax cuts, tariffs, immigration restrictions and deregulation — and the potential implications on the economy, stock market, inflation, and interest rates.

**1. Tax Cuts**

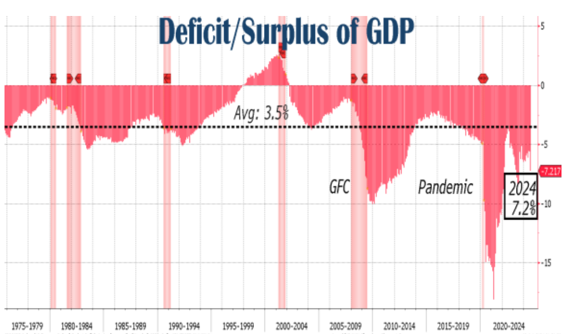
In 2018, congressional Republicans passed a sweeping Trump tax cut, including personal income taxes, which were set to expire at the end of 2025 alongside a permanent cut in the corporate tax rate to a flat 21%. At a minimum, the Trump campaign has committed to retaining the full Trump tax cut package that was passed in 2018. There is also strong support for a further cut, and Trump himself recently floated lowering the corporate rate further to 15%.

If Republicans do cut corporate taxes, do not expect it to be "revenue neutral." Defense spending is sacrosanct in the current geopolitical environment and the Republican platform explicitly rules out any adjustments to social spending. This in turn means more "deficit financing" to pay for the rate cuts.

Undoubtedly, lowering the corporate income taxes can stimulate economic growth, but the very large fly in the ointment is that tax cuts reduce government revenues. Per the non-partisan Committee for a Responsible Budget (CFRB), the cost of reducing corporate taxes to 15% would result in over $600 billion in foregone revenue between 2025 and 2034 thus increasing federal debt and deficit ratios, which are already at extremely high levels.

On the current course, according to the Congressional Budget Office (CBO), the federal debt will exceed 120% of gross domestic product (GDP) in the next few years. This is actually conservative due to a number of rosy assumptions. For one, this is "debt held by the public," which excludes the Social Security and Medicare trust funds. Not counting that debt is extraordinarily misleading. It will have to be funded. If any public company used the same accounting principles as the government, the SEC would justifiably call it criminally misleading, and they would be shut down.

Meanwhile, the latest CBO estimates show a fiscal year 2025 deficit of about $1.9 trillion (without including the Trump corporate taxes). It's actually well over $2 trillion because some spending is off-budget items, which is never talked about in the press. As shown below, the only time the U.S. budget deficit was higher was during the World Wars and the pandemic.

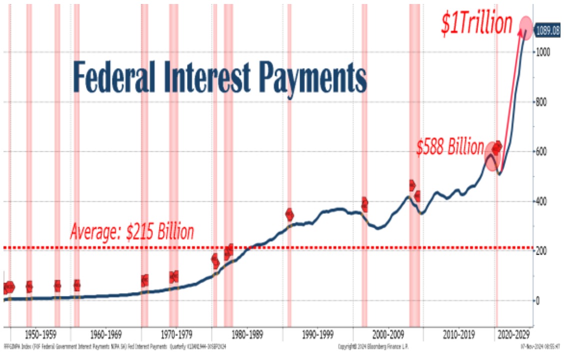



On the campaign trail, Trump also promised to quash taxes on tips, overtime and Social Security checks. According to the Tax Foundation, Trump's tax wish list totals $11 trillion and counting. If Trump delivers everything he promised, the debt ratio would rise to 150% of GDP in 2034.

The U.S. government has already a record $1.2 trillion on interest payments in 2024, the highest amount ever recorded. The interest cost has now exceeded the defense budgetary expense and is now the second largest budgetary expense behind Social Security. As the debt pile grows, the interest burden will continue to soar, especially if rates rise from here.

For some historical reference, in 2016, during Trump 1.0, debt-servicing costs accounted for just over 10% of the revenue pie. Today, the interest expense ratio is 20%. Even without the Trump tax cuts, this ratio is expected to spiral to over 30% within two or three years.

This debt and deficit dilemma is not on anyone's mind right now. But if the debt service ratio tops 30%, what could follow is a plunging dollar, failed Treasury auctions and credit rating downgrades. Simply put, this is a fiscal strait jacket that has the market bulls, yet again, salivating over prospective tax relief even though they may not be factoring in all the implications.




**Market Implications:** The fiscally conservative House is likely not going to play ball with a 15% top marginal corporate tax rate or the assortment of other election campaign goodies (including tax free tips, overtime pay and Social Security).

However, if Trump and the GOP were successful in lowering corporate tax rate via more deficit financing, it's quite possible the Fed would cut short its easing cycle and in the worst-case scenario be forced to hike rates again.

I also believe market forces – bond vigilantes – would intervene, if necessary, to check Trump's aggressive spending agenda. Indeed, on concerns about more fiscal excesses from the Trump administration the 30-year U.S. Treasury jumped by a massive 22 basis points in one session last week, the biggest spike since the COVID-19 crisis. Simply put, the bond market was overcome with fear. Fear of massive fiscal deficits. Fear of inflation. Fear the Fed will kybosh the easing cycle. I understand it.

As for the stock market, if Trump was to cut the marginal federal corporate tax rate by an additional 6%, this would deliver a large short-term stimulus, strong earnings and a bullish backdrop for stocks. This is why the S&P 500 climbed 2.6% – the best post-election rally on record and the best session in two years.

Indeed, the stock market is now absolutely giddy and overcome with greed. Upon the election results, throngs of retail investors plowed $20 billion into U.S. equity funds on the day after the election (the strongest flows into risk assets since 2016). The S&P 500 went up almost 5% for the week.

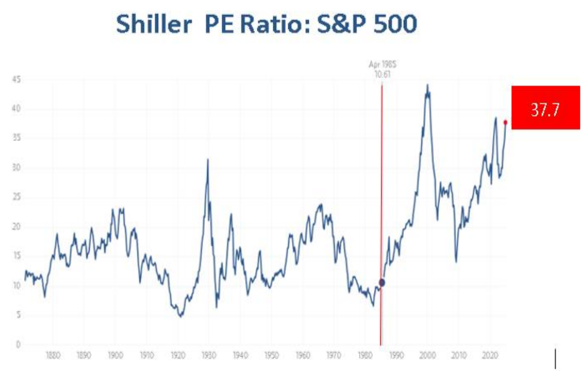
Median equity holdings have ballooned +70% in the past year to a record $250,000. Meanwhile, diversification has become a dirty word with 70% of the U.S. household balance sheet concentrated in equities, 21% in cash and only 9% in the fixed-income market.

But how long will this party last?

Generally, price is the single most important factor in the long-term performance of an investment. Unlike Trump 1.0 in 2016, equity valuations are at nosebleed levels today. Every valuation metric from price-to-earnings, price-to-sales, price-to-book, the Buffett Indicator (market cap-to-GDP) and the CAPE multiple (see below) are completely off the charts today.

Robert Shiller's CAPE (cyclically adjusted price/earnings) compares share prices to average inflation-adjusted earnings over the previous decade. On this basis, only one presidential election has previously taken place with the stock market so expensive, in 2000 when George W. Bush emerged victorious. On November 1, 2000, it was 38.78 and on the first of this month, it stood at 37.77. Anyone remember what happened shortly thereafter?

Yes, it's possible that Trump 2.0 will unleash a new paradigm and take equity valuations to previously unimagined heights. However, it's more likely that performance won't be great, for reasons that have nothing to do with his economic policies.




Source: Case Shiller

**2. Tariffs**

Like Trump 1.0, Trump 2.0 has talked repeatedly about raising tariffs. Trump has vowed to impose massive new tariffs, eyeing a duty of 20% on all foreign goods and 60% or higher on goods coming from China. On the campaign trail, he also dropped threats of even-higher rates on specific countries and products.

These taxes will be paid by U.S. buyers of imported goods. As these are passed down the supply chain, and even if retailers absorb some of the tariff cost, the end result would still be higher consumer prices.

It should be noted that tariffs generally apply to lower-frequency durable goods purchases (e.g., cars, appliances, furniture, etc.) In general, consumers are less aware of the price of these goods. Inflation perceptions are typically formed by hyper-awareness of the price of frequent purchases like food and fuel (less likely to be imported).

So, assuming the Trump Administration actually implements a 20% blanket tariff, import prices could jump by 20% in a single quarter and this price increase would pass through to core personal consumption expenditure (PCE) prices. The inflationary pressures following the implementation of the tariff program would certainly create some pain for the bond market.

**Implications:** Going back to the last Trump era, those widespread inflation fears at the beginning proved to be too extreme. The possibilities for tariff-induced inflation spikes were a common theme for Trump during his first term in office. Yet, inflation never exceeded 3% for even a single month in his presidency.

Moreover, inflation was a critical policy plank in this campaign. If Trump imposes massive across-the-board tariffs, and we get a huge spike in consumer prices, layoffs and supply chain debacles, millions of people will say “this isn’t what I voted for.” If the Republicans don’t deliver on lowering inflation, then brace yourself for political change in the other direction in the 2026 midterms.

Further, if large tariff increases are announced, assuming the economy is still on solid footing and inflation remains above target, the Fed could err on the side of caution, which could derail the Fed rate cutting cycle. Or frankly, be forced to hike rates again. In addition, the bond vigilantes could come out of the woodwork. Again, this would clearly not be a positive development for stocks or bonds.

*"We aren't [yet] calling for the 10-year Treasury yield to reach 5%, but the 'Bond Vigilantes' seem to be threatening to take it there… Investors often hear 'Don't fight the Fed,' but perhaps it's the Fed that shouldn't be fighting the 'Bond Vigilantes.' The bond market could easily nullify the impacts of another rate cut. These expectations are heightened by concerns about more fiscal excesses from the next administration.”*
*— Ed Yardeni, President, Yardeni Research*

If tariffs become too punitive, one would expect weaker trade volumes, which would likely negatively impact economic growth. And should other countries implement a tit-for-tat rise in tariffs, economic growth would be even more negatively impacted.

Nobody wins in a trade war!

**3. Immigration**

Trump has made immigration a cornerstone of his presidency and has promised to conduct “the largest deportation operation in American history.”

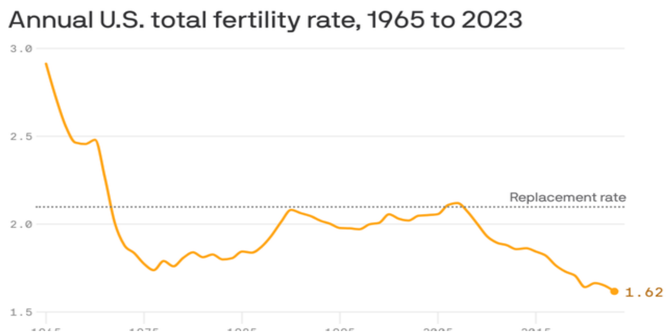
Despite the negative and toxic rhetoric surrounding immigration, it’s critical to acknowledge that immigration has been an important source of economic growth for the U.S. economy. Immigration has boosted aggregate demand and helped labor markets cool off post-pandemic.

In fact, the U.S. economy desperately needs immigrants. The fertility rate in the U.S. is now the lowest in history and way **BELOW** a replacement rate of 2.1. This means that the U.S. population is shrinking. This will cause lower GDP growth and higher public debt in the years ahead.

Yes, there are undoubtedly a few thousand criminals who have been released into the country but those can be targeted as a matter of heightened law enforcement. What is not needed, however, is the arrest and deportation of millions of economic migrants who are filling the wide gaps in America’s worker-hungry economy.

So, a misguided immigration policy would likely hammer tens of thousands of small businesses (e.g., construction, warehouses, chicken-slaughtering plants, fast food joints, landscaping operations, etc.) who employ an estimated 8.5 million illegal aliens and currently pay upwards of $100 billion per year in taxes. And they spend their wages on American goods and services.

Finally, a sweeping outbreak of litigation and congressional intervention would also ensue fostering bitter political polarization and legislative and judicial combat far more intense than what has already been seen.




Source: World Bank

**Market Implication:** Trump may not realize it yet, but he's facing an important tradeoff between delivering on his commitment to act tough on immigration and delivering stronger growth.

A draconian approach to immigration would likely be quite damaging to the U.S. economy. Businesses would suffer from losing the purchasing power of undocumented immigrants and would likely struggle to fill the job hole. Moreover, wages would likely rise, which would have an inflationary consequence. At the same time, the federal government would lose tens of billions of dollars annually in tax revenue from deported immigrants while the U.S. GDP would likely decline.

In other words, be careful about what you ask for.

**4. Deregulation**

Certainly, the most striking difference between the Biden Administration, and what probably would have been the Harris Administration, and the Trump in the regulatory area. The Biden Administration has imposed $1.7 trillion of costs on the private sector in less than four years. This is double what Obama did in eight years. During his four years as president, Trump imposed $40 billion in regulatory costs. It's just a night and day difference on the regulatory front. There's no reason to believe that it will be any different the next time around.

Deregulation would be a key theme, affecting sectors from energy to finance. This would clearly be beneficial to small and medium-sized corporations who are struggling under the burdensome cost of excessive regulations. Specifically, more shackles would be taken off the financials and there would be no big fight with Big Pharma. This is surely a confidence booster. Visions of a mega M&A cycle have equity investors salivating.

The tradeoff is that while this might spur short-term economic growth, it could also lead to environmental and financial instability. To wit: The rollback of regulations designed to mitigate climate change could have severe environmental consequences while less stringent financial oversight might increase the likelihood of market excesses and crises.

**Market Implications**: All things equal, the equity market is all about "deregulations" and is another big reason why the stock market performed so well post-election. Lowering regulations would lower inflation which would be a net positive for bonds.

**Trump 2.0 Summary:** The Trump economic agenda, if implemented as laid out, would likely stimulate economic growth and boost equity prices. It would also possibly lead to higher inflation and interest rates. That said, it's such an early stage and we don't know what the policies are. Once we know what they are, we won't have a sense of, you know, when they'll be implemented, or all those sorts of things.

There are simply too many variables for Trump 2.0 still at play to have a strong conviction as to what will happen to the economy, markets and inflation. So, stay tuned.

## DON'T ASSUME!

*"So let me say that in the near term the election will have no effects on our policy decisions [...] Here, we don't know what the timing and substance of any policy changes will be. We, therefore, don't know what the effects on the economy would be, specifically whether and to what extent those policies would matter for the achievement of our goal variables, maximum employment, and price stability. We don't guess, we don't speculate, and we don't assume."*
*— Jerome Powell, Federal Reserve Chair*

Unanimously, and as widely expected, the Fed cut interest rates by 25 basis points to take the federal funds rate target range to 4.50%-4.75%. The Fed has now cut rates -75 basis points from the peak, but the effect on the economy has fallen flat because of the jittery bond market and the impact on mortgage rates and the housing market.

The average 30-year mortgage rate since mid-September has soared +70 basis points to 6.8%. Talk about a paradox! This also constrains just how far Treasury yields can rise without creating even more recessionary pressure in the real estate market. To drive home this point, mortgage applications have now declined in each of the past six weeks!

In the press conference, Powell stated that while rates came down, the current policy was still restrictive working in terms of tame inflation. He was emphatic that there will be no policy response to any fiscal changes until they happen. He will not base decisions on speculation.

Powell took great pains to avoid answering any questions regarding Washington's fiscal future and punted on any rate predictions.

And when he was asked, "If Trump asked you to resign, would you?"

His response?

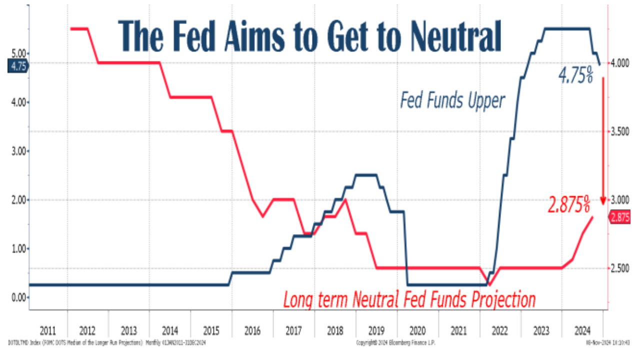
An ice cold, no B.S., "No."

He was then asked about the "legality" of president-elect Trump demoting or ousting governors in leadership positions, Powell replied with just five words.

"Not permitted under the law."

Powell stressed that while core PCE inflation has been stuck at +2.7% on a year-over-year basis, both the three- and six-month trends are in the low -2's. At the same time, he did state that the Fed intends to be patient in its easing approach, but the aim is to get to a more neutral rate, which is still at least 150 basis points away from where we are today.

Powell also mentioned the fact that the labor market had more spare capacity now than just prior to the pandemic in early 2020… when the policy rate was sitting at 1.75%!

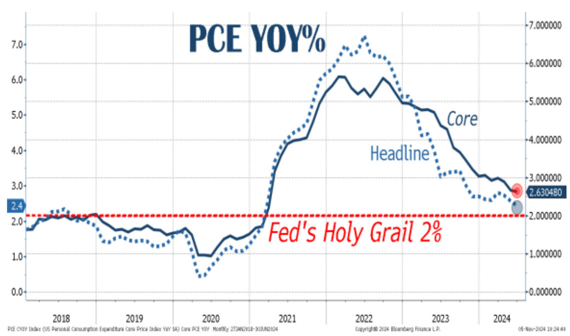



**Bottom line:** The Fed has previously acknowledged that we have an economy in balance and consistent with a near-3% terminal rate. Powell has stated that the aim is to get to a more neutral rate, which is still at least 150 basis points away from where we are today. There was nothing in the Fed's statement or press conference to suggest the Fed has changed its mind.

## IT'S ALL ABOUT INFLATION

*"The point is, we have gained confidence that we're on a sustainable path down to 2%. So that, I would tell you, is what that's really all about." — Jerome Powell, Federal Reserve Chair*

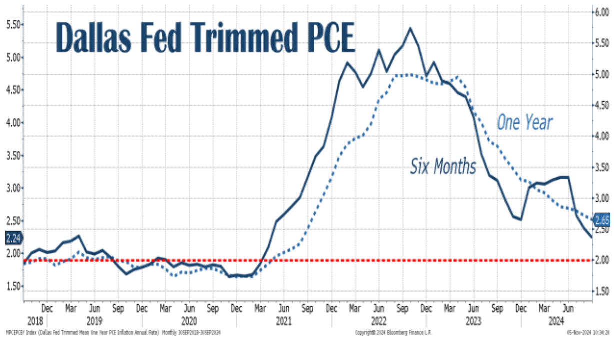
Despite the discussion above regarding the potential inflationary consequence of Trump 2.0, it's also important to recognize that inflation is currently well off its peak. But the consensus narrative is that the downtrend in inflation has stalled. As shown below, the year-over-year trend in headline PCE inflation has gone from +3.4% a year ago to +2.1% presently.



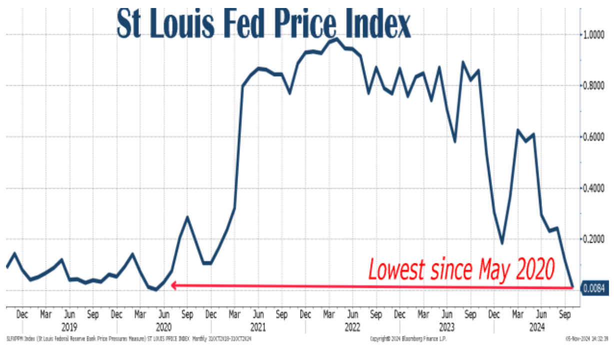

Further, the graphs below are very encouraging.

The annual change in the PCE price index —"headline" inflation — is the Fed's preferred measure of overall inflation. The Dallas Fed Trimmed Mean PCE is an alternative inflation. This index excludes the most extreme upside and downside price changes in each month's disaggregated inflation data. The rationale for the trimming is that extreme price changes are often due to one-off special factors not indicative of underlying inflation trends.

And the good news is that the Dallas Fed's Trimmed-Mean inflation rate has slowed from +3.8% this time last year to +2.7%, and the six-month trend has decelerated smartly to a +2.2% annual rate (right near the Fed's target) from +3.1% in September 2023.




As to the future trend in inflation, the Federal Reserve Bank of St. Louis has developed a measure called the price pressures measure (PPM). The PPM measures the probability that the expected inflation rate (12-month percent changes) over the next 12 months will exceed 2.5%. In September, the price pressure measure rang in at a measley +0.008, which is the weakest pulse since May 2020!




**Bottom line:** The bond market is all about inflation and the Federal Open Market Committee (FOMC) monetary policy. And so long as inflation trends are moving down, as they are, you don't need a recession to be constructive on Treasuries.

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"Longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets"*
*— Jerome Powell, Federal Reserve Chair*

Long before anything has happened, irrational inflation concerns have come to the fore and undermined the Treasury market. Trump hasn't lifted a finger yet, but if anything, the immediate response outside of the bond market has been the furthest thing from inflationary. To wit: West Texas Intermediate (WTI) oil is off -22% from where it was last April. Disinflationary. The Commodity Research Bureau (CRB) metals are down by more than -7% from the nearby mid-May peak… disinflationary. The DXY dollar index has moved inexorably upward to a five-month high. Again, disinflationary.

That said, and as well as was the case in 2016, the "conventional" wisdom says that that Trump's big sweep means big policies (e.g., tax cuts, tariffs and spending cuts) will lead to a budget busting inflationary boom**.**

And for now, the market has been going with the "conventional" wisdom as the 2-year inflation breakeven soared 100 basis points in the past eight weeks.


Further, because of heightened inflationary expectations, bond investors at this point are scared to add on any duration and are convinced that Donald Trump has a magic wand that will generate an inflationary economic boom. Since early October, the long end of the yield curve has sold off quite aggressively with the 10-year Treasury benchmark yield rising 3.62% to 4.30%.


Finally, let me end with this: In 2016, the Trump 1.0 playbook was the same as the Trump 2.0 playbook today. Both playbooks consisted of lower taxes, rising deficits, tariff hikes and immigration curbs. Yet, many Wall Street types see an economic boom under the Trump Administration. I think that the perception of a “boom” may be misplaced because during Trump 1.0 there was no economic boom even before the pandemic hit. Real GDP growth was growing a smidge better than Obama’s second term at around a +2.5% annualized pace. That isn’t bad, but it wasn’t a “boom.”

Further, after more than three years of a Trump tenure (pre-pandemic), inflation and Treasury yields were pinned around 2%. Ergo, the inflation hyperventilating after Trump was first elected proved to be not just excessive but plain wrong.

Will Trump 2.0 be any different than Trump 1.0?

We shall see, but I can hear Yogi Berra’s déjà vu all over again.

**Bottom line:** Until there is more clarity on the policy front, one should anticipate and expect higher volatility than normal over the next two to three months. And even though yields could rise from here on fear and speculation**,** the recent bond market sell-off looks way overdone.

If the disinflationary trend continues, Treasuries will do quite well whether or not there is a recession.

Maintain the course and continue to buy fixed income securities on periodic sell-offs.

Stay tuned and have a great week!

## MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (630) 276-2753.

As Alloya's Market Strategist, **Tom Slefinger** leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.