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Tough Talk and Maximum Pressure: From Tariffs to Pensions

The verdict is in. In a year of global elections the incumbents have been ditched. Despite evidence of economic growth, even in the UK and Europe, and confirmation that inflation was in retreat, years of cumulative inflation took their toll – especially on the US voter. The comeback and re-election of President Donald Trump was the result of a quixotic coalition of billionaires and the working class and he was elected promising an agenda of mass deportations, tough tariffs, America first, government downsizing (DOGE) and a raft of further tax cuts. This America first agenda is boosting US markets and causing some handwringing among its trading partners.

Meanwhile, geopolitical fires continue to burn, but at the time of writing a ceasefire between Israel and Hamas had been floated. The conflict in Russia and Ukraine continues to intensify with the use of long-range US supplied missiles within Russia and dialed up nuclear sabre-rattling. In the UK the post budget analysis became eclipsed by pending pensions reform, and an accelerated response period and desire for bold action has created a scramble to respond among Pools and Administering Authorities alike. While equities globally remain sanguine, bonds have shown more volatility, and the beginning of the interest rate cut cycle has injected some support into markets that clearly needed a boost – particularly in Europe and the UK. As we round out the year, we are preparing for a new-ish world order as we watch the impact of Trump 2.0.

Key Developments since the last quarterly update:

- **Inflation stays in check, but fears remain.** UK and European inflation continued to stay range bound in recent months although the US number ticked up slightly at the last reading to 2.6%. While in the US food and energy stayed stable, there was a slight tick up in services inflation and the cost of labour . . this leads to some concern that the stickiest part is still remaining and, indeed, that the "last mile" of conquering inflation will be the hardest. This will especially be the case in the UK and Europe where energy costs are likely to rise going into the winter – this is less of a threat in the US which is now broadly energy independent.

- **Rates are coming down but where will they settle?** All three of the Bank of England, the ECB and the US Fed have now instituted a double set of rate cuts citing data dependency, confidence in the state of inflation and, in the case of the US Fed, a sense that a soft landing has been achieved. While the telegraphing from the institutions has been coolly executed and without surprises, bond markets have responded in a somewhat schizophrenic fashion. In the US, bonds initially rallied as rates were expected to fall steadily, while signs of economic strength led to a sell off and yields returned to a relatively high level. In the UK, similar volatility in UK Gilts was caused by a lack of confidence in government policy and post-budget wobbles. So far, the bond market has been a lot more volatile than equity markets, which could be a sign of cracks in the seemingly resilient economic state.
- **Testing the Limits of the Trump Trade.** Despite a nail-biting finish in the US Presidential election, President Trump executed his political comeback in a convincing fashion. This led to most of the Trump trade (see below on page 6) playing out as expected, and even the most destructive tactics, namely sizeable tariffs on imports, were shrugged off by markets at this stage. Market exuberance translated into a very strong run for US equity markets in the fourth quarter so far, with world markets also strong, albeit trailing.
- **Geopolitics heats up.** It has been a year of geopolitical turmoil and maybe because geopolitical developments seem to have lost their ability to really stop the wheels of commerce and shock markets, protagonists are upping the ante. As we write above, both conflicts in Russia and the Middle East were intensifying in recent weeks, while one may be closer to a resolution than the other.

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Current Macro Snapshot

Modest growth but markets demand more

The UK budget in October set the stage for a very measured recovery in economic growth – projecting 1.1% in 2024, 2.0% in 2025, 1.8% in 2026, 1.5% in 2027, 1.5% in 2028, and 1.6% in 2029. CPI inflation was forecast to average 2.5% this year, 2.6% in 2025, then 2.3% in 2026, 2.1% in 2027, 2.1% in 2028 and 2.0% in 2029. While last quarter we noted that Sterling hit a two year high against the USD, the “downcast” budget in terms of taxes and rates did not inspire confidence and the currency lost ground. The budget was designed to boost long-term growth, with a mantra of “invest, invest, invest” and set out a “modern industrial strategy" to set out the sectors with the "biggest growth potential" such as aerospace and automotive sectors as well as life sciences. Other investments were announced around green hydrogen and carbon capture in a program designed to restore stability and rebuild Britain.

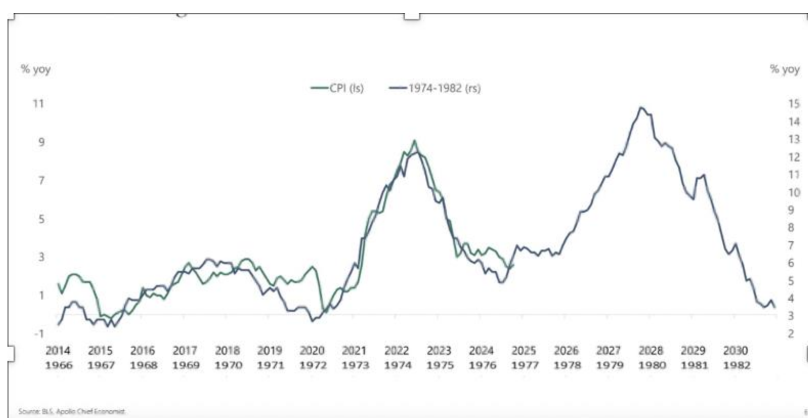
Despite this ambitious language, the increase in taxes and business rates led markets to be unconvinced and UK Gilt yields rose indicating ongoing lack of confidence in the Britain's desired economic recovery.

Outside the UK economic growth remained anaemic in Europe (Spain being a notable exception) and was at modest levels in the US. This gave faith to the notion that the US economy at least could grow its way out of some of its problems (like its growing federal budget deficit). The resilience of the US consumer continues to be a phenomenon, and as the chart below shows, spending remains robust as we enter the festive spending season.

Inflation – looking back to look forward

All of the signals suggest that inflation is largely yesterday's problem, and now the devil is in the detail of conquering it in its last mile. Policy makers exude confidence (c.f. the budget projections issued in the UK above) and clearly are prepared to risk re-igniting it through interest rate cuts, shifting their focus to employment and economic activity. This chart mapping the inflation pattern in the US to that of the 1970s gives some pause though. While the drivers of inflation then (which included the oil crisis) and the drivers of the recent spikes (Covid dislocations followed by massive stimulus) were different, it is sobering to witness how inflation can behave.

The green line reflects current CPI in the US, while the blue line shows the shape of 1970s inflation.



Monetary easing is unleashed, but will it work?

The US Fed delivered according to expectations with two rate cuts – one of 50 bps in September and one of 25 bps in November, while the Bank of England delivered two consecutive 25 bps rate cuts bringing the base rate to 4.75% and the ECB did the same, bringing its base rate to 3.25%. It is worth pausing here to ask whether monetary easing will have the effect we think it will have?

We know that during the rate rise cycle the "transmission effect" was delayed as fewer consumers that expected were actually affected by rate rises, and some delayed remortgaging while some corporates had locked in favourable borrowing rates of their own and could delay refinancing. Lower rates will stimulate borrowing and may make business models make sense again, in places such as infrastructure, but can it change structural impediments to growth, particularly in Europe? Some of these include demographic changes, higher regulation and taxation, and a sluggish institutional investor base. This month former "lions" of Europe have come under the microscope with a slump in industrial profits in Germany – especially the auto industry, which has seen profits slump (WV 64%, Audi 91%, BMW 84% and Mercedes Benz 54%), and a crisis of confidence in France due to its political paralysis.

The European economy has failed to follow the trajectory of the US one over the past 15 years and as noted before the current set of rate cuts is expected to be a shallow set of cuts.

Talking Tariffs and Cabinet Picks

No stranger to "shock and awe" tactics, the incoming President Trump announced a catalogue of bold and disruptive cabinet picks, as well as forecasting sizeable (25%/35%) tariffs on imported goods from Mexico, Canada and China tied in certain cases to commitments re. immigration reform. It was staggering that these announcements did not have a stronger effect on markets given their obvious inflationary nature – perhaps markets were less focused on rhetoric and more on action, and certainly some sectors – such as financials, which are not dependent on imported goods – were relatively strong.

Outside trade policy, certain cabinet picks such as the known anti-vaccine advocate Robert F Kennedy Jr. for Health and Human Services Secretary did rock sectors such as pharma, but otherwise markets have been relatively sanguine.

Turning to digital assets, Trump ran on a campaign of aggressive deregulation and downsizing and the pending departure of SEC Commissioner and Bitcoin hawk Gary Gensler drove the price of Bitcoin to close to $100,000. In addition, many of the "picks and shovels" or supporting infrastructure stocks such as digital asset exchanges performed strongly.

It is exceptionally difficult to classify newer and emerging classes such as Bitcoin and other digital assets as it is impossible know how they will behave throughout market cycles. However, the current ascent of those assets indicates just how pro-cyclical they are but similarly could also represent a desire to hold an alternative asset to fiat currency if a debasement of that currency is expected. Debasements of currency can occur when confidence falters – c.f. the fall of Sterling after Brexit, the Gilt Crisis of late 2022 and again after this year's budget, and also when the government debt burden grows. So Bitcoin prices could be sending us a signal of a flight to safety in progress – this and the persistent strength in the price of gold:

Trump's fiscal policies are estimated to add over $7 trillion to the Federal Budget deficit, as revenue cuts stemming from tax and government spending cuts are offset by tariff revenue, but markets seen poised to ignore this – as they often do. Because growth is persistent – at least in the US, the consumer is strong and spending remains supported, a growing budget deficit recedes in its near-term impact. The problem with such a stance is when growth comes in short – as it has been doing in Europe and the UK.

The Trump Trade

While this chart is not new (from May 2024), it is worth revisiting the expected Trump trades from over six months ago, if only to validate them as they have largely played out exactly as expected.

Winners	**Losers**
Traditional energy	Renewable Energy/Solar
Gold	USD?
Bitcoin/Crypto Currency	Chip stocks?
Industrials	EV manufacturers
Deregulation	DEI
Inflation	Environmental Regulation
Tax cuts?	Big tech?
	Nato, Europe, Ukraine, Asian exporters
	Economic Growth
	US Fed independence
	China – now in contraction territory

Finally, we read this month that global private credit has now hit $3 trillion reflecting its affirmative move out of "shadow banking" and into the main stream. It remains relatively conservative at this juncture too – as leverage levels within funds are consistent at between 0.1x to 1.5x debt to equity while 31% of funds are unlevered. This suggests that the maturing asset class is in no way overstretched and is well established in the short to medium term.

Individual Asset Class Performance.

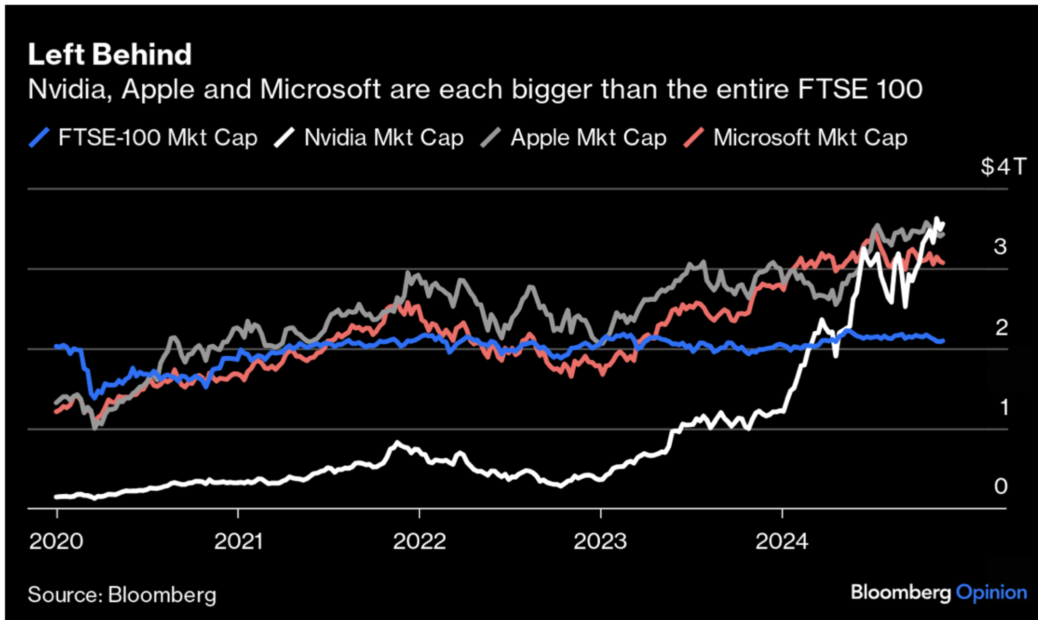
- Equities
- Fixed income
- Real Estate
- UK Pensions as outliers

The chart below shows recent performance in main equity indices (at November 28, 2024):

Equity Index	**Last 12 months**	**Year to date (November 28, 2024)**
FTSE 100	9.92%	7.02%
S&P 500	25.76%	31.82%
Nasdaq	26.97%	33.68%
Dax (Europe)	18.45%	15.94%
Hang Seng	13.94%	15.41%
Shanghai Comp	11.82%	9.72%
Nikkei 225	14.18%	14.29%

It can be seen that all global equity indices have had decent positive performance – in line with expected average equity returns - on a year-to-date basis albeit with marked dispersion between the tech-dominant Nasdaq and the more old-economy oriented FTSE 100.

The breakaway nature of certain stocks and the relative lag of European markets is indicated by the chart below, which illustrates how each of the three companies Nvidia, Apple and Microsoft is alone bigger than the entire FTSE 100.



As noted above, renewable energy stocks were particularly unpopular after President Trump's victory, and this manifested in sharp sell-offs as shown below.

Last quarter we showed a chart reflecting a broadening of market strength into sectors beyond tech, and in the last few months this breadth extended to include small and mid-cap sectors – typically sectors less affected by imports and a strong dollar and beneficiaries of an America First approach to purchasing.

Fixed Income: Where worry finds a home?

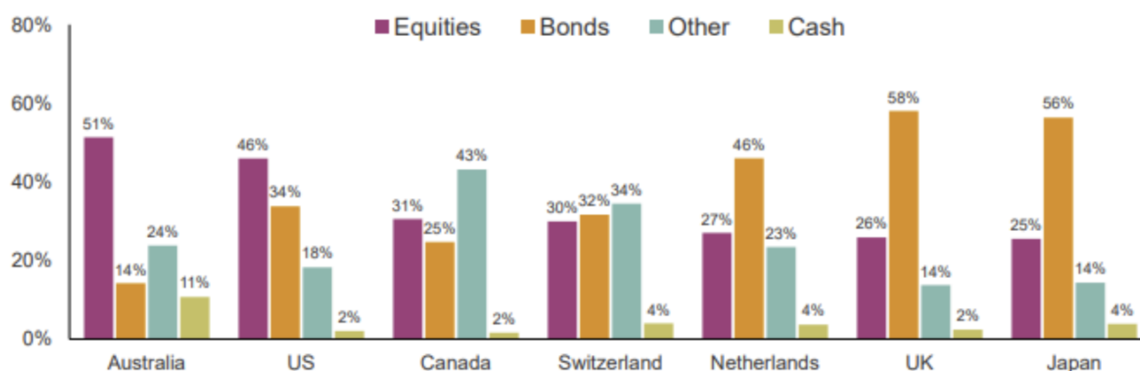
Bonds continue to display more volatility than equities at present, and, despite one jumbo rate cut and another of 25 bps fixed income yields in the US performed a full "round trip" – with bonds initially rallying in the expectation of more rate cuts, then essentially going right back to their starting position of 18 months earlier as it looked like the economy was stronger than thought. While this means that short term risk-free bonds – as well as cash – still produce decent returns, they will pale in comparison to the equity returns shown above, and any portfolio positioned for growth cannot have too much of an overweight there (c.f. the discussion on UK pension weightings below).

Real Estate

Green shoots are appearing in real estate – as mortgage rates finally start to reflect the start of a rate easing cycle and home sales have received a bit of a positive nudge. On an institutional level there is broad optimism regarding sectors such as residential, industrial and, for the first time in some time, retail, as experiential and premier mall sites enjoy heavy footfall from a resilient consumer and as falling rates look to boost transaction volumes and returns. In the UK one manager estimated a total return of 8.5% over the next 5 years, a very favourable one relative to recent history.

UK pensions in the cross-hairs

As the UK government consults on harnessing pension fund assets to inject growth into the UK market, an interesting study by Towers Watson's Thinking Ahead Institute revealed a major divergence between UK institutions and those in the rest of the world, particularly around the use of bonds. As the charts below show, UK institutions are an outlier in the high percentage owned in bonds - only Japan comes close – while other alternatives such as real estate and real assets also trail their global peers.



Thinking Ahead Institute

This is an intriguing difference in approach, which may be traced to the position of The Pensions Regulator, who has encouraged a resolute focus on funding level and a derisking with a glide path to buyout as pensions mature. There has been little appetite for the funding level volatility that a riskier

asset allocation might entail and indeed the use of LDI and leveraged LDI products which has become pervasive among the DB pension community precluded much exposure to risk assets. Added to this, the recent Gilts crisis in the UK further undermined the use of risk assets by UK pension funds as their asset base shrank and their existing private allocations were found to be overweight and likely to remain so.

We might suggest that despite the government's current good intentions it could take decades to unwind a firm allocation bias which has taken root over the last 15-20 years, and the encouragement to invest "at home" may need to be accompanied by a lighter regulatory touch and more freedom of self-determination.

Outlook

In previous newsletters this year we spoke about economies and markets "in transition" – from high inflation to moderate, from high interest rates to falling ones, from incumbent governments to newly elected ones and from Covid excesses to the post Covid new normal. It seems that we should have finished that transition now. It seems that we have a new reality even if markets haven't yet figured out how to deal with it.

That reality is a world economy where a leader has pulled far, far in front, and is lapping some of the laggards, seemingly getting stronger at every lap. That growth surge is minimizing other factors – rising government debt, rising inequality, an affordability crisis – although those other factors continue to roil the other racers. All of the attention is on the leader – the elite runner – which means that policies that dominate there – downplaying sustainability factors and the energy transition, deregulation and low taxes – get disproportionate attention, and drown out alternative approaches.

With populations falling and growth stuck in a vice Europe will struggle to recover global attention and investor interest, while Emerging Markets are hardly visible under the pile of towels that have been thrown at them.

The incoming US administration promises to be as fascinating as it is impactful, and its policies – whether or not enacted – are likely to attract extensive media attention. For investment portfolios we will be watching in particular:

- **Equity markets beyond the US – how much do they matter?** Because the US has dominated equity market returns and now represents 75% of the MSCI World Index, it is tempted to think

that non-US markets no longer are as relevant for portfolio construction. This is a rebuttable presumption – we will see if the months ahead rebut it.

- **Digital Assets – will we all want a piece of the action?** The increased attention on digital assets such as Bitcoin during the US election and now in its aftermath are likely to attract more and more institutional attention as equity markets seem to touch frothy levels and bonds fail to excite. A wave of deregulation will bring some casualties but it is worth watching how this industry continues to define its value proposition and mature.
- **The target and pace of rate cuts:** Now that the rate cut cycle has kicked off there is plenty of capacity to ease – although central banks are likely to be highly alert to the potential for overheating their economies as none could stomach the spectre of inflation in high single digits any time soon. We will be interested in this as a lever to propel growth but also to examine how effective monetary policy can be these days – a controversial topic.
- **The divergence between saying and doing.** President Trump and his team have been saying a lot, once inauguration day passes we can see what he actually "does". Already geopolitical alliances have been kickstarted by much of the strong rhetoric while markets seem to wait for the "proof of work". The quarter to come will allow that work to see the light of day.

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With best wishes for Christmas and the festive season and I wish you a Happy New Year 2025.

November 29, 2024