Wise Investor

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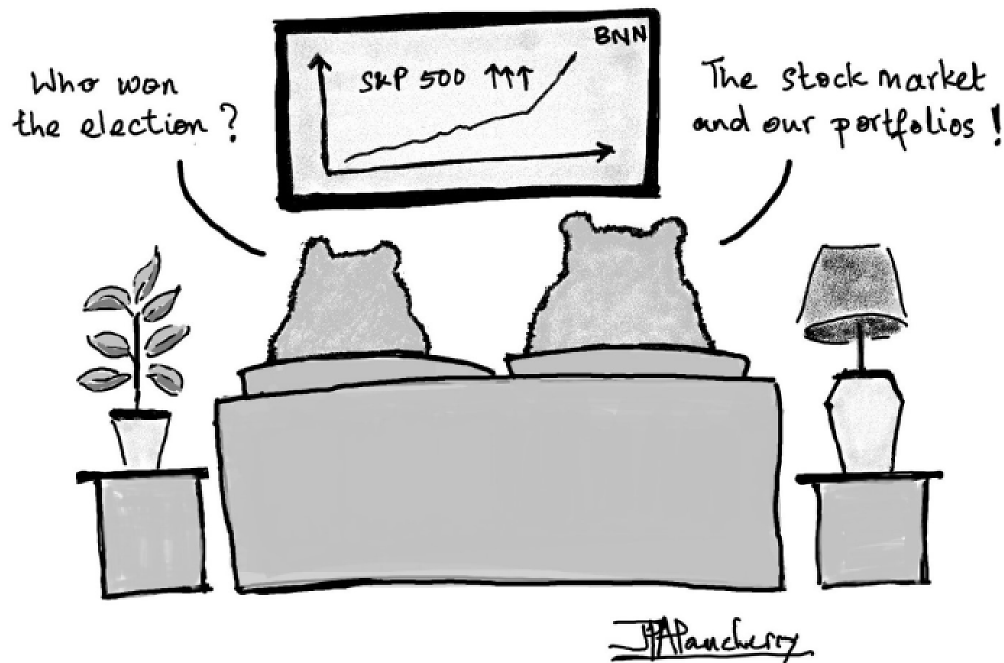


Wise Investor – Dec. 2024

Executive Summary

Well, here we go again, four more years. With the most recent birth of our 2nd child, I was quickly reminded of how chaotic things can get. Countless more loads of dirty laundry, the need to put up fences all over the house, constant crying and sleepless nights with dirty diapers at every corner. My life over the next four years could be a microcosm for the change in administration south of our border. We can expect a lot more airing of dirty laundry, added border walls, and probably some crying and sleepless nights. You can take the dirty diaper comparison however you like.

Regardless of your political views and opinions of the election result, the markets have so far met the Trump victory with jubilation. Much like my family life, it's safe to say that politics will certainly be a lot more entertaining than they were last year. In this month's publication, we will zoom out to take a look at the big Trump administration policies and their potential economic and investment implications.

Most Specifically, we'll discuss:

- **The most likely and impactful political police changes**
  1. **Higher tariffs**
  2. **Immigration constraints**
  3. **Lower taxes & less regulation**
- **Three reasons the 'Trump trade' could stumble**
- **How to position portfolios for the new regime**

Thus far the stock markets have been enjoying the election results, but I believe it's important to fully understand the complexities of the new administration and how that could impact the economy. Policy matters in the short-term, but the economy tends to matter a lot more in the longer-term.

Figure 1: Positive Post-Election Honeymoon

Index	1-year Forward Returns from Election						
	1996	2000	2004	2008	2012	2016	2020
S&P 500	32.1%	-24.9%	7.9%	14.3%	26.2%	23.6%	42.9%
Russell 2000	29.3%	-12.7%	10.1%	4.9%	36.3%	27.8%	50.8%
MSCI EAFE	5.1%	-24.6%	17.3%	11.8%	27.6%	24.1%	34.9%

Source: Bloomberg Finance, TD Asset Management. Data as of Nov 11, 2024

What's Happened Lately

'History does not repeat itself, but it rhymes'

- Mark Twain

Once again, pre-election polls and the media got it wrong as the general public was braced for a tight and contested, 'uncertain' election outcome. Instead, President-elect Trump had a clean sweep with the biggest surprise of them all, winning the Popular Vote. The decisive victory removed the uncertainty of policy direction and cleared the way for the U.S. markets to reach new highs. This gives us near-team optimism, but also sparks some longer-term concerns. As Mark Twain so aptly quoted above, the last seven elections from election day to a year forward have had returns above average with the exception of the tech wreck of 2000 (figure 1). If you believe we are not in some sort of a tech bubble, our belief, then the investment environment could remain robust for a little longer. With that said, since the end of WWII, on average markets are up double digits but we must also remember that -20% drawdowns, and a recession, are common in every presidential term.

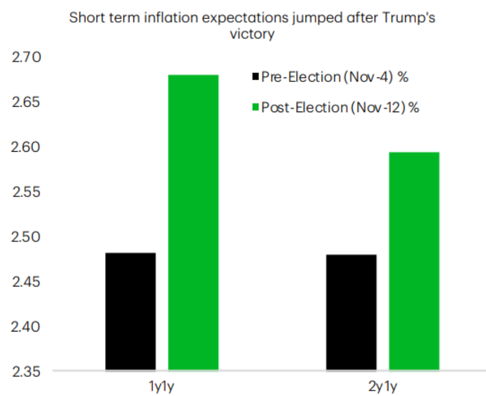
The Trump economic agenda of higher tariffs, lower taxes and less regulation are far more likely to happen now that the Republicans control all three branches of government. Trump promised to support U.S. manufacturers by imposing strict trade tariffs, threatening 10% across the board globally and as high as 60% for China. Most important for us Canadian's, he's suggested a 25% tax for Canada and Mexico. Whether Trump can deport millions of illegal workers or not is one thing, but we can be assured the borders will be tighter to immigration which likely results in wage pressures for corporations. On the other side of the coin, corporate tax cuts and deregulation could be seen as very pro-growth. Much of Trump's rhetoric focused on blue-collar issues, restoring the U.S. manufacturing sector to its former glory. Reading between the lines one will wonder if the new administration neglects the darlings of the tech sector that now dominate the U.S economy. Lastly, the famous 'drill, baby, drill' call in support of oil and gas production could provide some strength to an unloved sector.

With elections over, we can now objectively analyze the economic data today, and in our opinion, the risk of an immediate recession in the U.S. is low. There's a strong possibility that some of the Trump policies could eventually tip the scales to a more substantial slowdown, but we would recommend waiting for the data to corroborate it before doing anything drastic. Some investors may be tempted to double down on the pro-business policies while others may fear the worst and want to run for the exits. Straying from long-term objectives to make a bold prediction can be worse than getting it wrong. I would argue that excessive enthusiasm is back, making the markets vulnerable to a short-term correction but backdrop remains positive. In the following pages I will explain that while we are not rushing to add more equity to the mix, we are also not harvesting gains to hide in cash at this time. Let me discuss.

Why Should We Care

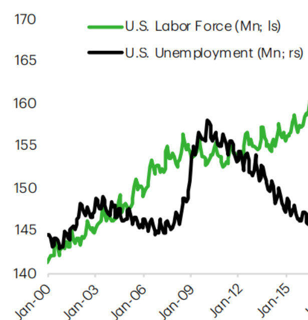
Higher Tariffs, less workers in the workforce and tax cuts, all things being equal, should result in higher prices which could throw a wrench in the Fed's path to combatting inflation. TD Economics has cited estimates of a 50-to-100bp rise in inflation relative to the current trajectory (figure 2). The real question is how the Fed will respond, as 2022 is fresh in our minds where interest rate increases sent the investment world into a spiral. We think that the answer to that question is, probably not at all. Central banks are used to looking past short-lived news cycles. We would need to see inflation bottom and then start to increase again before being really concerned. The Fed likely still cuts rates in December and again in January but may then be on more of a 'cut-pause-cut' pace through 2025 resulting in a much less restrictive interest rate stance but taking a little longer to get there.

Figure 2: Inflation expectations rise post-election



Source: Bloomberg Finance L.P. *based on U.S. forward inflation swap
1y1y : The 1-year inflation market expects one year from now.
2y1y: The 1-year inflation market expects two years from now.

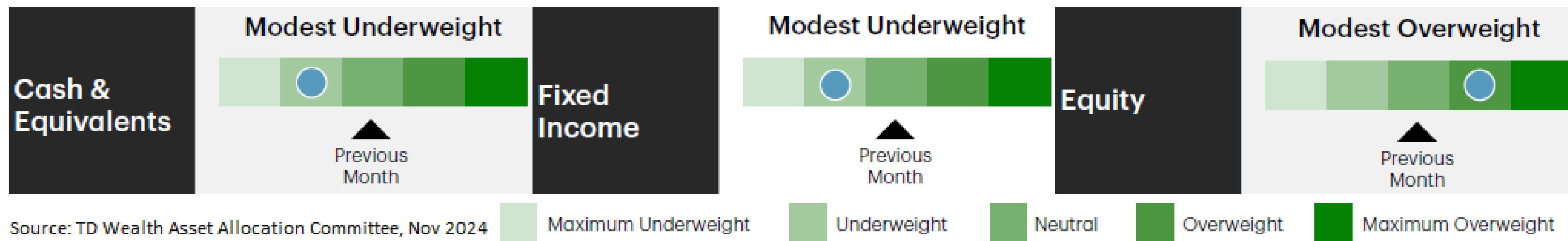
Figure 3: Fewer workers could spur wage inflation



Source: Macrobond and Wealth Investment Office, as of November 15, 2024

In a worst-case scenario that Trump actually delivered egregious tariffs of 60%, 25% and 10% across China, Canada/Mexico and the rest of the world respectively, there would be significantly economic damage. The deportation of 10-15 million migrants would directly impair the U.S. economy as the shrunken labour pool would increase wages and prices resulting in higher inflation (figure 3). But we should keep in mind that previously, Trump declined to follow through on his most controversial campaign promises. The pro-growth policies, tax cuts and deregulation will provide relief and stimulus for corporate America, even greater for smaller companies that have been burdened by higher debt loads.

With the markets having rallied on the back of the Trump trade, there's 3 things we should consider before chasing these trends. Firstly, U.S. stock valuations/prices, are broadly looking stretched. Stickier inflation and the resulting higher rates could be a constraint to corporate profitability, while also making future earnings look less attractive as companies borrowing costs increase. Secondly, Corporate earnings targets for the next 12 months look a little lofty. This is not synonymous across all of the market as sectors like energy and financials may actually see estimates rise on increased regulatory clarity however multinational corporations may see their products and services more expensive abroad given the ongoing strength of the USD. Lastly, the timing of policy will influence how this all plays out. The negative impacts of tariffs and immigration curbs need to be offset by the pro-business policies and if implementation on the former comes significantly ahead of the latter there could be negative implications. Again, using history as a gauge, we may see increased volatility and short-term sell-offs followed by recoveries as rhetoric takes to action when Trump takes office in January. We need to understand the complexities of the coming changes and monitor them as the wheels hit the road, adjusting course as needed.

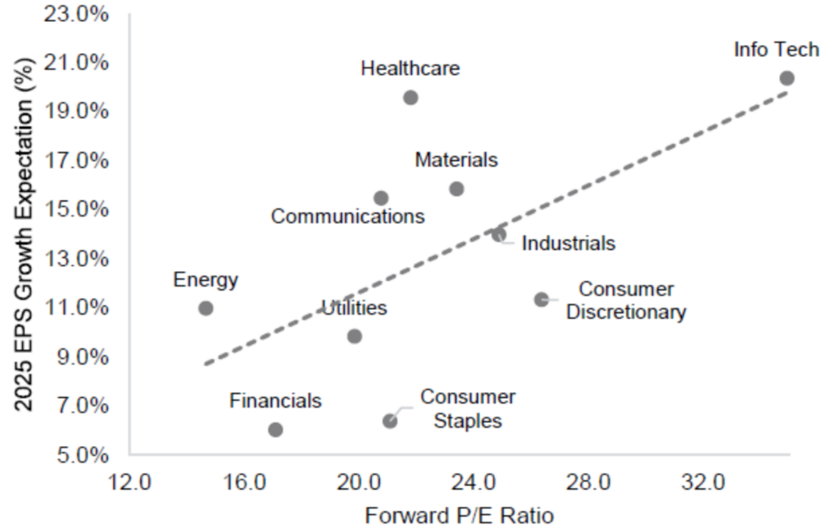


What Should We Do

With the rate cutting cycle kicking off in 2024, bonds have delivered attractive returns on the back of strong price appreciation. This has resulted in good after-tax returns for our fixed income component. Although there's probably a little more upside to be realized with further cuts, we've shifted our fixed income position to a modest underweight. We still expect reasonable returns given current yields with bonds continuing to provide the benefits of capital preservation at the same time reducing overall portfolio volatility. With the downgrade, we've upgraded equities modestly, most specifically in the U.S., as the risk of a more severe economic slowdown has declined.

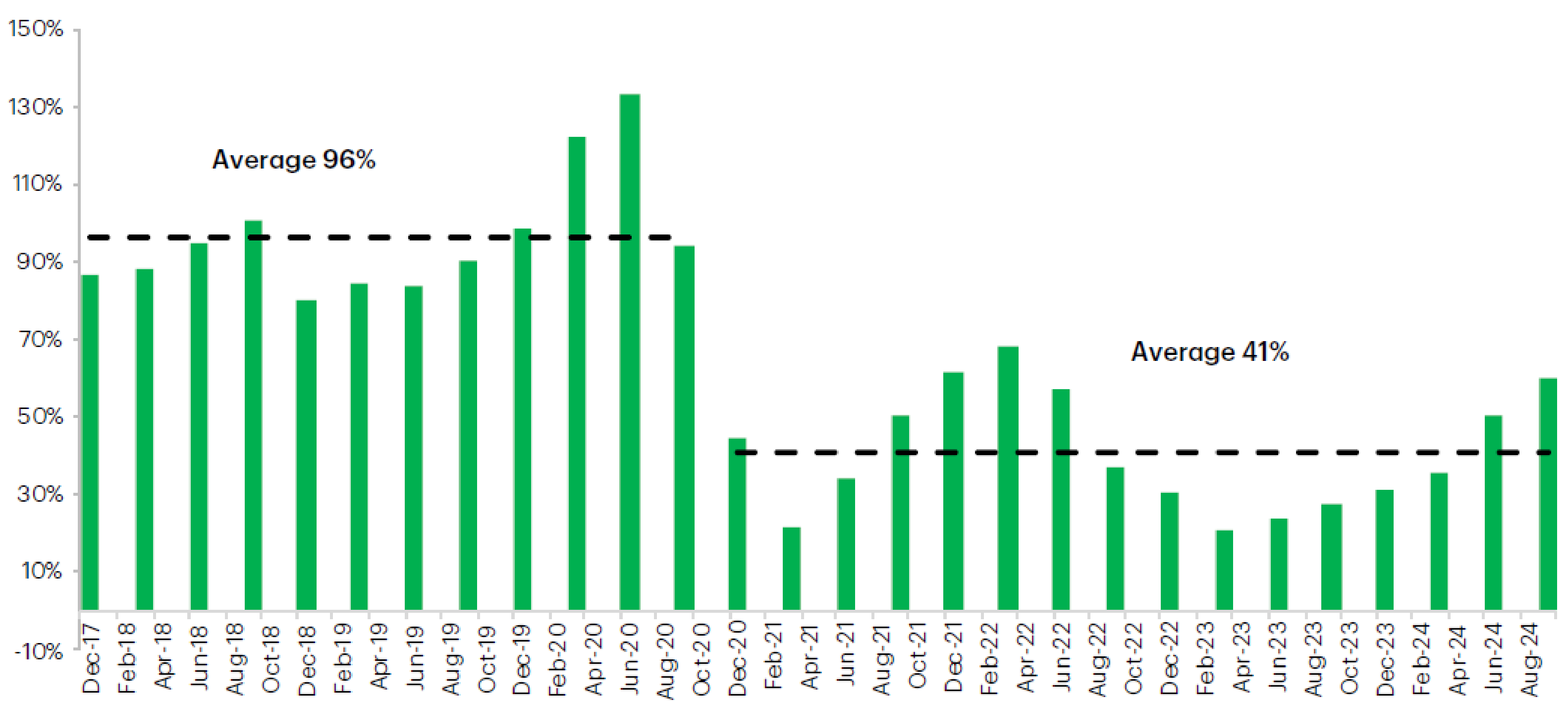
There's been a broadening out in equity markets and some of the best performers can now be found outside of the expensive, magnificent seven tech stocks. The chart below shows a ratio of future price expectations against earnings expectations broken down by sector. Although the tech sector continues to trade at the highest prices, the sector is still expected to deliver the highest earnings. The regulatory environment may drive tech valuations even higher as the removal of the Biden administration's antitrust rules may open up larger M&A and remove the fear of a big tech sector breakup. Drilling down to the AI-related subsector, we have to be warry of an eventual oversupply where demand peaks can lead to corrections. The market expects these AI companies to not just meet expectations but exceed them. Current valuations are not as extreme as the dot-com bubble, but the most popular names need to be monitored closely as the law of numbers would suggest that growth eventually wains.

Figure 4: Price vs Earnings Expectations



Source: Macrobond, Wealth Investment Office as of November, 2024

On the opposite end of the spectrum, energy and financials could see an outsized benefit from deregulation. A Trump White House will likely favour oil and gas production and rollback climate initiatives leaving these companies with more profits in the coffers. Also, oil is a natural inflation hedge which could provide a tailwind as the new administration's policies come into practice. Uncertainty around capital requirements under Biden drove the banks to hold excess capital, which came at the expense of stock repurchases vs Trump's previous term (figure 5). The ability to return more capital to shareholders should allow banks to be more capital efficient and could lead to higher valuations/prices and solid returns.



Ultimately, we have seen an outsized positive reaction in investments, likely due to the 'positive surprise' of avoiding prolonged uncertainty. However, it does feel to me like the euphoria for U.S. stocks is somewhat overdone and some retracing of recent gains could take place, just like we saw in 2016. We continue to recommend a barbell approach having some exposure to the expensive but growthy tech sector but an equal weight to some of the more reasonably priced sectors that could see outsized returns from here. The good news for now is that inflation is improving, and the economy is doing well. Come January, when headlines start to fly, we would not be surprised by a little more choppiness but historically, markets have provided positive returns in the two years following a decisive victory and we recommend staying the course.

Personal Note

As we approach the holiday season, I find myself reflecting on the chaos of our current political and financial landscape. Whether it's managing a toddler's meltdown at home or interpreting volatile market trends, life is full of challenges—but also opportunities to adapt and grow. Both demand patience, perspective, and a steady hand to focus on what truly matters.

In the spirit of the season, I encourage you to take a step back from the noise and cherish the people who make your life meaningful. Markets will fluctuate, and political debates will continue, but the moments spent with family and loved ones are irreplaceable. As we celebrate the holidays, let's take time to connect, laugh, and build memories that remind us of the bigger picture.

Wishing you and your family peace, joy, and moments of gratitude this holiday season

Marley

TD Wealth

"Wealth is not his that has, but his that enjoys it."

Benjamin Franklin

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