MARKET VIEW

Three Inconvenient Truths Confronting the Next Administration and the Markets

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The election victory of former President Donald Trump and the Republican Party ignited a broad-based market rally last week, with major U.S. indexes—the S&P 500, the Dow Jones Industrial Average and Nasdaq Composite—all hitting record highs. We believe there is more upside to the rally, with the prospect of lower tax rates and less regulation, combined with the dynamic and resilient DNA of the U.S. economy, supportive of a grind higher in U.S. Equities.

But that said, it's not all clear sailing for the markets. Why? Because an administration that favors higher tariffs, potentially, on friends and foes alike, appears to be prone to more deficit spending in the face of a massive federal budget deficit and is isolationist in nature is on a collision course with three inconvenient truths, outlined below.

Number one: Breaking up with China will be hard to do. Much has been made in the media about America's declining import share from China, with the percentage of total U.S. goods imports from China now at their lowest level since 2003. China's share of U.S. imports was just 13.3% in the first nine months of 2024, down from 13.9% in 2023 and a peak of 21.6% in 2017. Looking ahead, if President-elect Trump has his way, the share would only decline in the years ahead, with Trump pledging to sharply raise tariffs on Chinese goods to 60%.

Against this backdrop, tariffs on China imports have to be applied carefully because while America's import dependence on China for a range of basic and mundane products like apparel, footwear and toys has dropped precipitously over the past few years, U.S. dependence on China for critical mineral imports required to power America's manufacturing/industrial base remains quite high (Exhibits 2A and 2B, respectively). Indeed, for such key minerals like graphite, tungsten and rare earths, America's import dependence on China is higher today than when Trump first entered office in 2016.

Thus far, U.S.-China "decoupling" has been relatively painless for the U.S. economy and non-threatening to the capital markets because finding alternative suppliers for dolls, hoodies and sandals hasn't been that difficult or disruptive. But finding alternative sources for critical minerals supporting the U.S. semiconductor and defense sectors, for instance, isn't going to be easy or come cheap. The inconvenient truth is that the U.S. remains wedded—coupled—to the refining champion of the world: China. Boosting tariffs on China puts at risk U.S. access to key minerals and metals needed to power economic growth in America.

Number Two: Deficits will matter at some point. While U.S. deficits and debt have barely registered with the stock market, it's been different in the bond market. The bond vigilantes have become increasingly attuned to the fact that the U.S. fiscal stance is expected to remain expansionary for the foreseeable future, backing up Treasury yields and the cost of capital.

Where Treasury yields peak this cycle remains unknown—yet with the next administration likely to extend the 2017 Tax Cuts and Jobs Act, while cutting the corporate tax rate, the federal budget deficit is likely to remain large and therefore an ongoing concern to the capital markets. As Exhibit 2C makes clear, after accounting for spending on Medicare, Medicaid and Social Security, in addition to interest payments and defense spending, the share of federal spending on other programs is quite limiting.

The inconvenient truth is that there is little political will in Washington to rein in spending, nor the appetite to raise revenue. The upshot: outsized federal budget deficits over the medium term, coupled with rising debt financing needs, and the prospects of higher nominal long rates. That said, the more encouraging news is that America enjoys more financial space than most other nations because Washington's finances are backstopped by the most dynamic, innovation-led private sector in the world, which entails greater fiscal sustainability over the long run.

Investment Implications

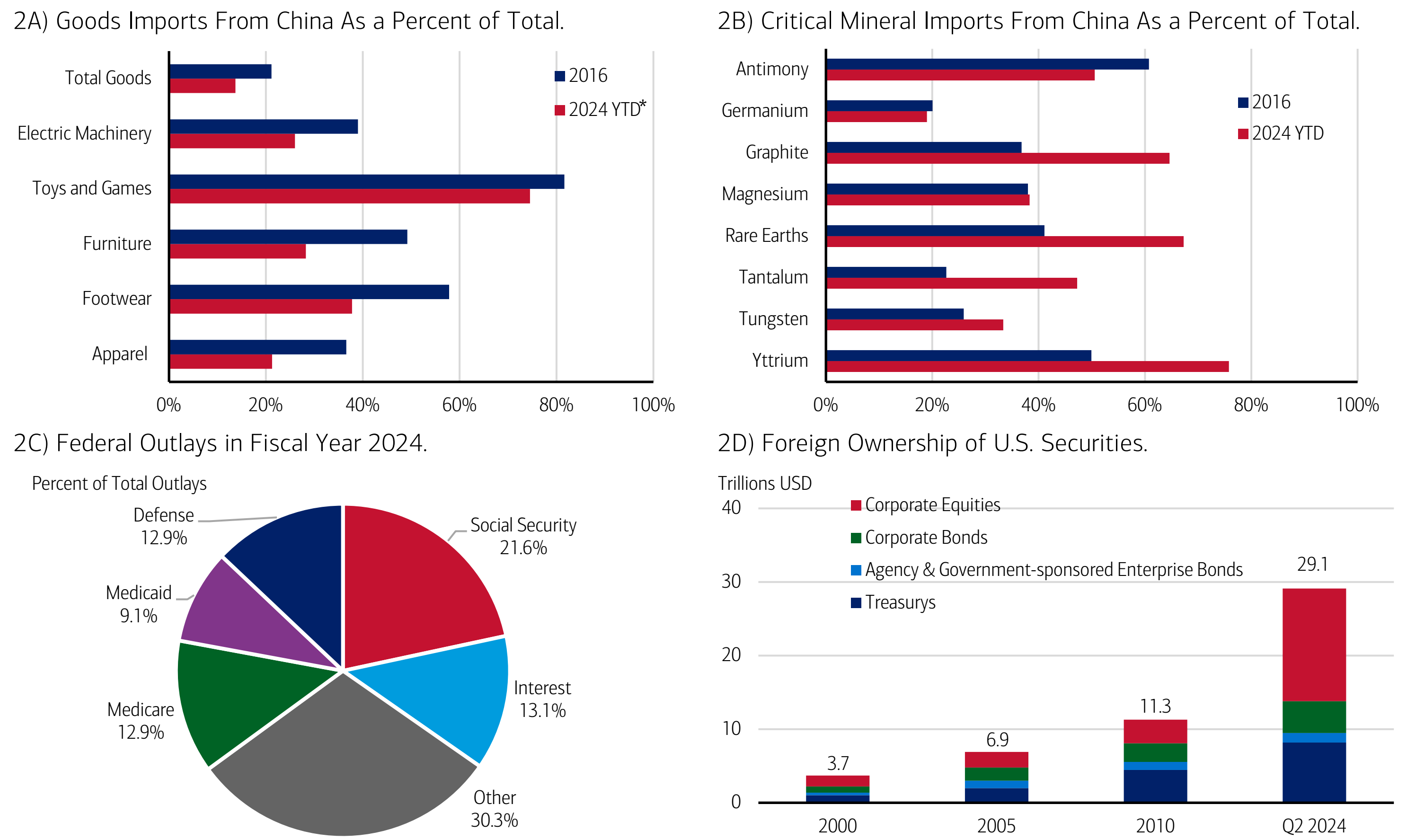
While market uncertainty has eased with post-election clarity, we believe that U.S. dependence on China for key materials, a federal budget deficit heading higher, and protectionist sentiment toward foreign creditors remain key issues to watch. We continue to emphasize broad diversification in portfolios with an emphasis on higher-quality U.S. assets.

Number three: Splendid isolationism could be harder to achieve than expected. There is little doubt that the pendulum is swinging away from internationalism (the U.S. being the nanny and caretaker to the world) toward isolationism ("America First" via more tariffs, anti-immigration, and deglobalization). This "go-it-alone" attitude of the U.S. has been building for some time and will likely only be amplified by Trump 2.0. The top priorities of the 47th President are domestic, not foreign. The rules-based, free market-led interdependent world led by the U.S. is of secondary importance, and emblematic of a U.S. strategically disengaging from the world.

But the inconvenient truth is that America's isolationist tilt isn't risk-free. Why? Because the U.S. is a large debtor nation, long dependent on foreign capital to plug its own savings shortfall. To wit, walking out on the rest of the world when you're in hock to foreign investors to the tune of nearly $30 trillion is going to be neither easy, nor prudent, for that matter. With massive amounts of Treasury supply about to hit the markets, the last thing the U.S. needs right now is a boycott of foreign buyers.

As Exhibit 2D highlights, foreign ownership of U.S. securities has jumped nearly tenfold since 2000, helping, in the process, to grease the financial wheels of the U.S. public and private sectors. As of the end of Q2 2024, foreign investors owned 30% of marketable U.S. Treasurys, 35% of marketable corporate bonds and 21% of U.S. Equities. That is another way of saying that foreign capital is a critical component of the U.S. capital markets, and that foreign investors have long had full faith and confidence in U.S. securities. This confidence, however, could be undermined by an administration wielding protectionist threats against its very own foreign creditors. The U.S. dollar surged immediately following the election results but could weaken or fade down the road as the U.S. turns more inward and insular.

Exhibit 2: Worth Watching: U.S.-Sino Trade, Federal Spending and Foreign Holdings of U.S. Securities.



*Year-to-Date. Exhibit 2A) YTD data through September. Source: U.S. Census Bureau. Data as of October 2024. Exhibit 2B) YTD data through August. Sources: U.S. International Trade Commission, U.S. Geological Survey Mineral Commodity Summaries. Data as of October 2024. Exhibit 2C) Sources: U.S. Treasury, Haver Analytics. Data as of October 2024. Exhibit 2D) Source: Federal Reserve Board. Data as of September 18, 2024.