NOVEMBER 2024

U.S. Election - Back to the Future?

Executive Summary

- The Republican sweep of the office of the President, House of Representatives, and the Senate gives the GOP significant latitude to implement its political agenda. For now, investors are working with the best available information—including assumptions based on policy proposals outlined on the campaign trail—and positioning portfolios ahead of 2025 on expectations of tax cuts, higher tariffs, deregulation, and a higher budget deficit.
- However, the 2017 playbook from President Trump's first term might not apply today. Economic and market conditions, as well as issues important to voters, differ substantially relative to eight years ago.
- In our view, many more details are required before having a clearer overview of how the economic fundamental picture could be impacted by federal government policies in 2025 and beyond. For now, we are focused on four agenda items and how the Fed could respond to their implementation, including trade tariffs, fiscal and monetary policy, immigration, and deregulation.
- The impacts on the U.S. and global economies will depend on what policies are prioritized and how they are implemented. If the policy mix doesn't result in higher nominal growth but instead leads to concerns about fiscal sustainability, inflation, and household consumption, global investors could ask for a higher risk premium to invest in U.S. assets, given that the compensation relative to non-U.S. assets is historically low.
- We expect the market narrative and investor sentiment to be sensitive to what measures are prioritized as the new administration takes shape, and will continue to assess the evolution of the fundamental picture and how the policy mix might affect it.
- Against this backdrop, we recommend staying invested and anchored in a long-term asset allocation, complemented by a prudent tactical allocation approach designed to provide flexibility and add value during periods of uncertainty and shifting fundamental dynamics.

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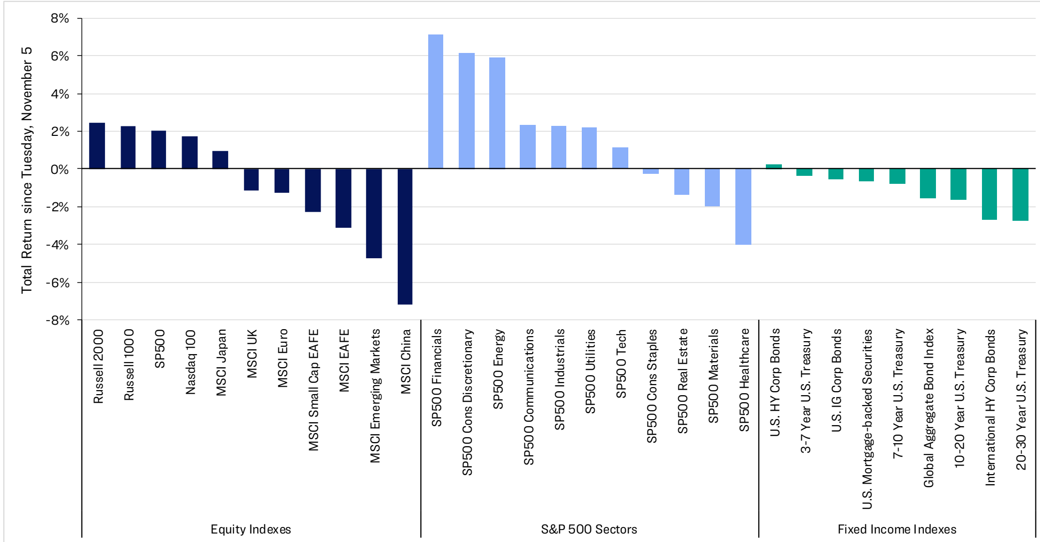
The highly anticipated U.S. presidential election on November 5 has concluded, and the dust continues to settle in the wake of what was a much cleaner and quicker outcome than what many market participants, political pundits, and polls anticipated. The Republican sweep of the office of the President, House of Representatives, and the Senate gives the GOP significant latitude to implement its political agenda.

As we discussed in our recent CIO Perspectives, "Electionomics," a unified government could be more likely to enact policies with the potential to materially alter market fundamentals. For now, investors are working with the best available information, including assumptions based on policy proposals outlined on the campaign trail (with little details about executability, implementation, and prioritization) as well as lessons learned during the first Trump administration. As a result, investors are positioning their portfolios ahead of 2025 on expectations of tax cuts (evident in the generally constructive U.S. equity sentiment), higher tariffs (evident in the outperformance of U.S. stocks relative to non-U.S. stocks), deregulation (evident in the strong performance of financial, energy, and small cap stocks), and a higher budget deficit (evident in the shift higher of the Treasury yield curve, resulting in negative fixed income returns) (Figure 1).

FIGURE 1

Market performance reflects investors' focus on taxes, tariffs, deregulation, and the budget deficit.



Source: Bloomberg, TIAA Wealth Chief Investment Office (data as of November 18).

However, the 2017 playbook might not apply today. Economic and market conditions, as well as issues important to voters, differ substantially relative to eight years ago (Figure 2).

When President-elect Trump was first voted into office, the economy was running around 1% below its growth potential[1] according to the International Monetary Fund (IMF). Today, the economy is running almost 1% above its growth potential, an environment where demand and supply remain unbalanced and therefore conducive to above-average inflation risks. Back in 2016, both the budget deficit and the federal debt were more reasonable as a percentage of Gross Domestic Product (GDP). In addition, financial markets were comparatively trading at much lower valuations back then, while today the price-to-earnings (P/E) multiple on the S&P 500 is currently at the higher end of its historical range. The 2016 environment was more fertile for significant fiscal stimulus, as the economy and markets were not at risk of overheating, and concerns about fiscal sustainability were still contained.

FIGURE 2

By the numbers: 2016 vs today.

	Year-End 2016	Latest
Nominal GDP Growth (3yr Annualized)	3.6%	7.1%
3yr Rise in Consumer Prices (CPI basket)	3.4%	14.9%
Household Spending (3yr Annualized)	3.9%	6.7%
Unemployment Rate (3yr Average)	5.5%	3.8%
Budget Deficit (% GDP, 3yr Average)	-2.7%	-6.6%
Federal Debt held by the Public (% GDP)	76%	99%
Price/Earnings Ratio (S&P500)	17.2	22.3
High Yield Spreads (basis points)	405	265

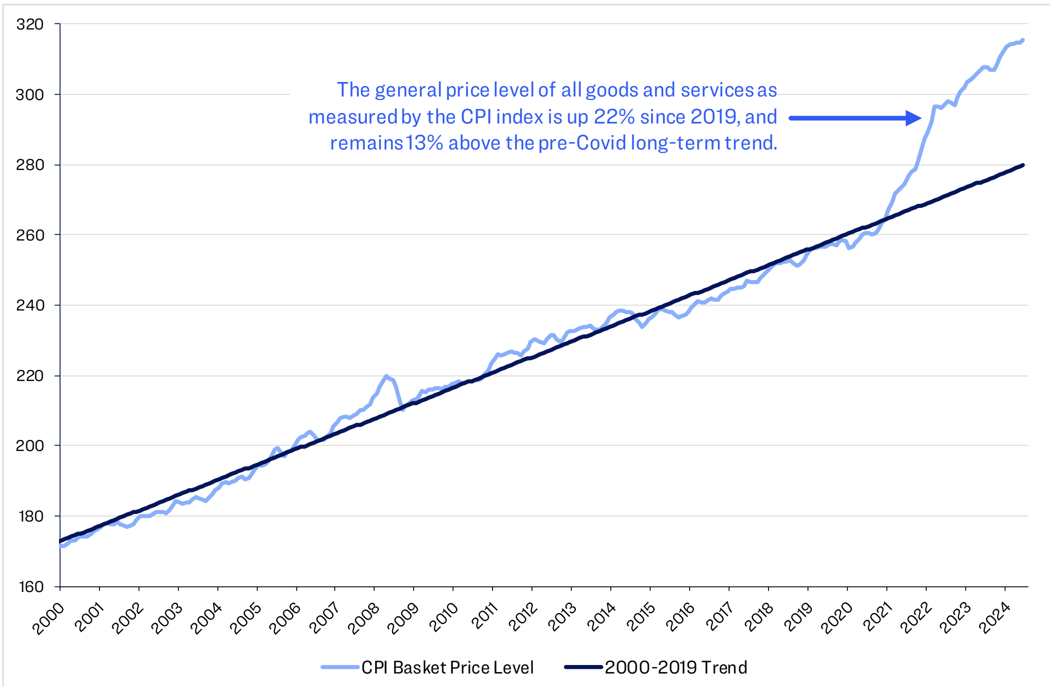
Source: Bloomberg, TIAA Wealth Chief Investment Office (data as of November 18).

[1] Potential Gross Domestic Product is an estimate of the level of output that the economy can sustain at full capacity utilization and full employment, without generating excessive inflation.

Leading up to the 2016 election, subdued economic growth was at the core of voters' concerns. Today, the overarching concern for voters relates to elevated price inflation. While the rate of change of price increases has moderated significantly since 2022, consumer prices (as measured by the Consumer Price Index [CPI] basket) have increased by 23% since the end of 2019 and are still 13% above the pre-Covid trend, with a drop in affordability in key categories like housing, healthcare, education, and groceries (Figure 3). That is a primary reason why the key mandate for the government looks different, and today it is much more rooted in the need to alleviate the cost-of-living burden that is affecting U.S. households. Thus, our view is that the next government will be sensitive to risks of overstimulating the economy and reigniting inflation, as both could have profound ramifications on households' purchasing power, consumer and business sentiment, monetary policy, borrowing costs, and consequently, equity and bond markets.

FIGURE 3

Consumer prices have deviated considerably from their long-term trend.



Source: Bureau of Labor Statistics, TIAA Wealth Chief Investment Office

Another difference that we are focused on is the nature of proposed tax cuts, then and now. While in the fall of 2017 the Trump administration passed large individual and corporate tax cuts as part of the Tax Cuts and Jobs Act (TCJA), the fulcrum of the current proposal hinges on the extension of the expiring individual provisions of the TCJA rather than on a fresh round of new tax cuts. Therefore, while the original version of the TCJA was projected by the Tax Foundation[2] to boost long-term economic growth by 3.5% and reduce budget revenue by $1.1 trillion, ideas President-elect Trump floated on the campaign trail to extend and expand the TCJA (including the "pay-fors" and the proposed reduction in the corporate tax rate from 21% to 15%) are projected to reduce budget revenue by $2.5 trillion while only boosting long-term growth by 0.8%.

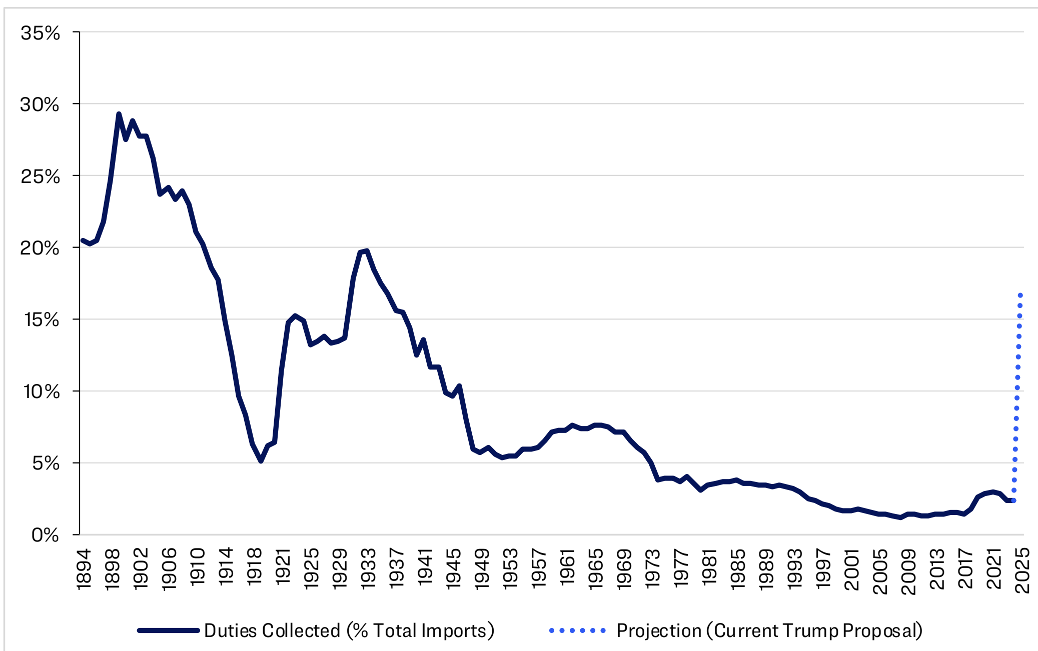
[2] The Tax Foundation is an international non-partisan research think tank based in Washington, D.C. that collects data and publishes research studies on U.S. tax policies at both the federal and state levels.

It is our view that many more details are required before having a clearer overview of how the economic fundamental picture could be impacted by federal government policies in 2025 and beyond. As outlined in the CIO Note "Election Update - The Day After," we are focused on four agenda items and how monetary policy could respond to their implementation:

- **Trade tariffs.** On the campaign trail, President Trump repeatedly pledged that, if elected, he would impose a 60% tariff rate on all Chinese goods imported into the United States, as well as a 10% blanket levy on all imported goods. During his first term and under the authority granted by Sections 232 and 301 of the Trade Expansion Act of 1962, President Trump imposed an average 19.3% tariff on $362 billion worth of imports from China without the need to obtain Congressional approval. And while a blanket tariff might require support from Congress, a unified government raises the probability that trade protectionism could extend well beyond China. A ramp up in trade tensions (Figure 4) could offset the positive impulse from further fiscal stimulus and induce volatility in both equity markets, where large cap stocks are global in nature and higher import prices would weigh on consumption trends, and fixed income markets that would likely need to contend with a short-term rise in inflation.

FIGURE 4

If implemented in their proposed form, trade tariffs could rise to the highest levels since before WWII.



Source: U.S. International Trade Commission, TIAA Wealth Chief Investment Office

- **Fiscal policy.** Most individual provisions contained in the TCJA of 2017 are set to expire at the end of 2025. In our view, a unified Republican government makes a full extension of tax cuts for individuals the base case though the revenue costs of doing this (estimated to be $4.6 trillion for a full ten-year extension of TCJA) will make this challenging and could engender significant interest rate volatility. A full extension of TCJA provisions would reduce the risk of a negative hit to household disposable income due to higher tax rates. However, the incremental benefits to economic growth may be much more muted than back in 2017, unless the tax cuts are also broadened and deepened, rather than just extended.

To this effect, a more recent focus of the Trump campaign has also centered on federal spending cuts, and a unified Republican government could embolden some of the fiscally conservative members of the GOP that are worried about excessive budget spending. We will be watching how this balance plays out, and how Treasury bond yields respond. In our view, a rise in interest rates that is not driven by stronger economic growth but by concerns about fiscal largesse could eventually dent equity markets.

- **Immigration.** A rise in immigration in 2022 and 2023 is believed to be a contributing reason for why inflation and the labor market have normalized without causing widespread economic pain. A draconian approach to immigration flows could halt or reverse this process, in turn reducing the short-term growth potential of the U.S. economy and risking a return of a tight labor market and higher services inflation.

- **Deregulation.** Deregulation was a central priority of the first Trump administration, and we expect deregulation efforts to continue over the next four years, lifting confidence in sectors of the economy with higher regulatory burdens like banks and small businesses.

- **Monetary policy.** The Fed's job will become more complicated in 2025. Tariffs would have the effect of raising price levels, but their direct impact would likely be one-off and short-term, and would also depend on how other countries respond. A sharp shift higher in prices would hit household disposable income, which in turn could be disinflationary over the medium-term. The Fed could therefore decide to look through the initial spike in inflation and focus on the hit to purchasing power. That being said, large tax cuts funded through higher tariffs and aimed at offsetting the hit to disposable income could extend the inflationary shock as consumer demand would be able to more easily adjust to higher prices. Given this uncertainty, the Fed is unlikely to incorporate these policies in its forecast until the effect becomes visible. At the same time, monetary policy will have to operate against the backdrop of higher starting federal deficits and the propensity for additional fiscal stimulus. As a result, the bond market may challenge the Fed's desired path toward further rate cuts and its notion of where the "neutral rate"[3] might be .

The impacts on the U.S. and global economies will depend on what policies are prioritized and how they are implemented. If the new government focuses on a prudent and pro-growth fiscal policy, deregulation, and targeted yet not indiscriminate trade tariffs, our view is that stocks could continue to perform well, and fixed income volatility could gradually subside. Conversely, in a scenario in which immigration curbs and tariffs take precedence over tax cuts (especially if tax cuts are just extensions, as discussed above), and in which the rise in yields comes from a higher term premium rather than higher growth expectations, investors would have to face a different reality than what is being priced in right now through the initial market reaction, and 2025 could shape up to be more volatile for markets and the economy.

[3] The neutral rate is the Fed Funds rate at which monetary policy is neither restrictive nor stimulative.

If the policy mix doesn't result in higher nominal growth but instead leads to concerns about fiscal sustainability, inflation, and household consumption, global investors could ask for a higher risk premium to invest in U.S. assets (via a combination of higher yields, lower stock and credit valuations, and a weaker dollar), given that the compensation relative to non-U.S. assets is historically low (the S&P 500 trades at a ~60% valuation premium relative to global stocks, compared to the historical average of 22%).

Portfolio Strategy Considerations

- Given the strong focus on deregulation that also marked the first Trump administration, our view is that this policy area could continue to be a significant market driver throughout the next four years. In this case, several "value" sectors could benefit, including financials and energy, as well as small caps. However, the latter group is still facing a challenging combination of declining earnings expectations, falling profit margins, and high borrowing costs, while financials and energy won't be immune to shifts in the macroeconomic outlook, including consumption trends, oil prices, interest rates, and geopolitics. Therefore, we continue to stress the importance of analyzing policy dynamics within a broader fundamental context.

- The "growth" side of the equity market should continue to benefit from strong underlying trends like Artificial Intelligence (AI), cloud, data center investments, and the scarcity premium from lack of scalable businesses that can win in this space. However, Mega Caps could also face a few headwinds over the next few years. Both Trump and Vice President-elect JD Vance have at times discussed the need to increase competition in the tech sector to the benefit of smaller companies. Whether the Magnificent 7[4] (Mag 7) oligopolies will face threats of break-up as part of antitrust efforts remains unclear at this point, regulatory scrutiny might nonetheless be more intense for Big Tech over the next four years amid an otherwise deregulatory approach by the Trump administration. Moreover, Mag 7 companies have a large revenue exposure to China (11.9% of total revenue on average, compared to 4.3% for the equal-weight S&P 500 index), making them vulnerable to an escalation of trade tensions.

- The U.S. has been an incredible engine of global growth. The significant U.S. trade deficit (U.S. importing more than it exports) is the byproduct of the U.S. economy consuming more than what it produces domestically. Therefore, countries that have the opposite problem (insufficient domestic demand to consume 100% of the domestic productive capacity) rely on such strong U.S. consumption to absorb the excess capacity and generate domestic economic growth. U.S. imports have grown at an annualized rate of almost 11% since Q2 2020, compared to 3.5% on average between 2010 and 2019. This is a testament to the remarkable strength of the U.S. consumer, who is able to propel not just U.S. GDP growth but also support global GDP growth.

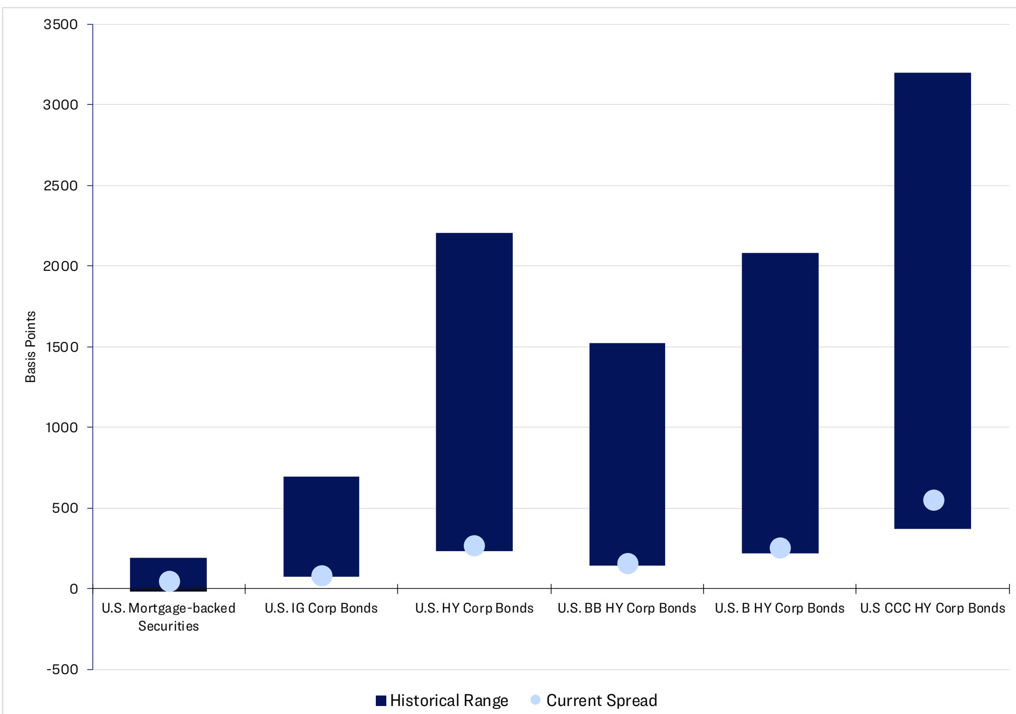
[4] Apple, Meta, Tesla, Alphabet, Amazon, Nvidia and Microsoft

Significant tariffs, especially if imposed broadly on all imports into the U.S., would likely hamper this dynamic and disrupt global trade flows, which could be a challenging development for export-oriented economies like China, Japan, European nations, and other developed and emerging markets. This could lead to continued underperformance of international stocks relative to U.S. stocks, although China in particular remains the wild card, as a decisive shift towards significant fiscal and monetary stimulus could offset the damaging impact of higher trade tariffs.

- On the fixed income side, given our view that the key mandate for this government is to alleviate cost-of-living burdens, the government could be particularly sensitive to higher rates. Therefore, fiscal policy could be calibrated in a way that seeks a better balance between tax cuts and spending cuts, with a less negative-than-expected impact on the trajectory of the national debt. In addition, the economy is dealing with some late-cycle dynamics, such as a softening labor market that looks more vulnerable than it did 12 months ago. These dynamics could accelerate if rates move above the level of nominal GDP growth, which has declined from above 7% (quarter-on-quarter annualized) in 2022 to below 5% in Q3 2024. In this scenario, many consumers and businesses could face interest expenses growing faster than personal income and business revenue, causing a slowdown in household spending and a decline in corporate profit margins. This is especially true if the rise in yields is not driven by higher growth expectations, but by concerns about inflation or fiscal sustainability. All this would make it incrementally difficult for yields to stabilize above nominal growth (projected to stabilize below 5% in 2025 and 2026). On that account, we think a further rise in rates could eventually present attractive opportunities to lock in higher Treasury yields, especially when compared to investment grade and high yield credit spreads trading at one of the tightest levels ever (Figure 5).

FIGURE 5

Credit spreads are trading at some of the tightest levels ever.



Source: Bloomberg, TIAA Wealth Chief Investment Office (data as of November 18)

Conclusions

We expect the market narrative and investor sentiment to be sensitive to what measures are prioritized as the new administration takes shape, and will continue to assess the evolution of the fundamental picture and how the policy mix might affect it. Against this backdrop, we recommend staying invested and anchored in a long-term asset allocation, complemented by a prudent tactical allocation approach designed to provide flexibility and add value during periods of uncertainty and shifting fundamental dynamics.

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4074894-0626 (11/24)