Investments - Flash

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TRUMP'S AGENDA WORRIES AND DISRUPTS THE MARKETS

Risks of imported inflation, rate increases, threats to growth, return of uncertainty to start 2025

US presidential election upsets market risk assessment

The last quarter of 2024 was marked by the US elections and by major changes in the perception of political and economic risks that extended beyond the US alone.

Donald Trump's return to the White House in January 2025 triggered major changes in people's assessments of possible developments in terms of economic growth, fiscal and budgetary policies, and inflationary risks, linked in particular to his clearly stated intention to raise customs barriers through higher tariffs applicable rapidly to China, Mexico and Canada, three countries accounting for 45% of US imports.

The first visible reactions in the financial markets were linked to the positive consequences for US equities of a lower tax rate on corporate profits. Earnings forecasts for 2025 were buoyed by this anticipation, enabling the equity markets to continue their upward trend of the first nine months, with the S&P500 adding a modest +2.39% in Q4 to end the year on a +25% note.

Inflation fears drive interest rates up

At the same time, fears of inflationary effects due to higher tariffs rapidly affected expectations of Fed rate cuts, which were abruptly reduced from six expected cuts of 0.25% to just two before June 2025.

The Fed Chairman made no secret of his concern about the significant risks to inflation from Trump's program, suggesting that caution and pause were called for before further rate cuts. Trump's protectionist policy, perceived as inflationary, pushed June 2025 Fed Funds rates up from 3.1% to 4.1% and 10-year Treasury rates from 3.6% to 4.6% in the space of a few weeks.

US bond markets plummeted, dragging other Western markets with them for no reason, wiping out the positive performance of the first part of the year. Faced with the sharp rise in interest rates, securitized real estate indexes failed to resist and also fell.

Indirect risks to economic growth

While Trump's policies are often described as "pro-business", in particular because of his lowering of corporate tax rates and his desire to reduce burdensome regulations, it is no longer certain that their implementation will be conducive to American growth.

The latter had already had to withstand the sharpest rate hike in its recent history over the past three years, before the Federal Reserve decided that the risks of an economic slowdown far outweighed the risks of a rebound in inflation, and finally began a phase of monetary easing in September 2024.

At that point, it judged the risks of a slowdown to be sufficiently great to lower its key rate significantly by 0.5%. This decision paved the way for a positive cycle of rate cuts, which was to reduce key rates from 5.5% to 3% in 2025, in a context where inflation had already fallen from +9.1% (June 2022) to +2.4% (September 2024) and was approaching the +2% target.

DOGE threatens employment, household confidence and consumption

Job creation was at its lowest in recent years in September, as was consumer confidence. Uncertainties were on the rise, once again threatening the equilibrium of financial markets. Since then, however, the creation of the Department of Government Efficiency (DOGE) has raised fears of more severe shocks to the US economy and labor market.

Elon Musk and Vivek Ramaswamy, who will head the DOGE, announced that $2 trillion in budget cuts would be necessary, suggesting that federal agencies be reduced from 400 to 100, and that up to 75% of federal employees be laid off by July 4, 2026. Such a drastic reduction will probably never be carried out, but the direction is clearly suggested and could well be followed by a Republican party largely wedded to the cause.

Beyond the potential positive long-term impact on the budget and the possibility of debt reduction relative to GDP, these consequences would be potentially catastrophic for employment and household and business confidence.

The Trump program pushes back key rate cuts

The year 2024 thus ended with the potentially worrying prospect of a rapid implementation of Trump's program, which would therefore logically have major repercussions on household confidence, consumption and business investment in the short term.

Consequently, this program has other implications that should be considered more important from an economic point of view in assessing the next evolution of the Fed's monetary policy than just the inflationary risks evoked by J. Powell.

If the markets now consider that imported inflation will be high enough for the Fed to change its policy and refrain from lowering its key rates, the possible consequence for growth could be very damaging.

New York Fed growth estimates plunge to +1.8%.

If the economy was already showing sufficient signs of weakness in September 2024 to motivate the Fed to reverse its monetary policy, the loss of household confidence in the face of these uncertainties will only further weaken economic momentum.

The New York Fed's growth forecast for Q4 2024 has fallen from +3% to +1.8%, and stands at an eighteen-month low. The rise in mortgage rates above 7% is already taking its toll on mortgage applications, which are down for the fourth week running.

More generally, the sharp rise in financing costs seen in December seems unsustainable for many economic agents, suggesting a likely rise in defaults and bankruptcies.

The threat of imported inflation must be carefully considered

Donald Trump's political and economic program comes as no real surprise, in that it is largely a continuation of the action already declared during the campaign and partly already implemented during his first term in office.

However, it was not until the run-up to the elections that the spectre of the inflationary effects of Donald Trump's protectionist policy suddenly resurfaced. And yet, while no one really knows how the principle of higher taxes on US imports will be applied, the general perception in the markets is that a serious inflationary impact will be the consequence.

While it is true that, in principle, an increase in customs duties will, all other things being equal, raise import costs and potentially production costs, and then consumer prices, it is difficult to measure the likely impact today.

To date, the roadmap is not known, either as regards the final list of countries and products, or the scale of the increases concerned.

What lessons can be learned from 2017-2018?

If historical analysis can be a guide, let's remember that during his first term in office, the rate hikes decided upon were gradually introduced and did not affect all countries and all products, but rather a specific selection.

Moreover, the CPI index actually remained relatively stable centered around +2% between 2017 and 2020 before falling at the start of the Covid. Even more astonishingly, the import price index, already at +3% (YOY) at the start of 2017, gradually declined to move into negative territory in 2019 before the Covid and fall to -7% in 2020.

Economic growth was then positive in 2017 before falling from +4.6% to +0.6% at the end of 2018 after the introduction of higher tariffs.

During the 1st Trump presidency the dollar actually fell in its first year by -10%, which should have contributed to a sharper rise in imported inflation. The logic was therefore not so simple in 2017 and 2018.

Long rates had initially fallen to land on the level of annual inflation between before rising again to 3% and supporting a dollar that was losing momentum in 2017.

Are the risks of imported inflation real or exaggerated?

So what are we to make of this main source of uncertainty, which is the expectation of a return to inflation sufficiently high to call into question the Fed's monetary easing policy of just three months ago?

Is it really reasonable and justified to consider that imported inflation could cause such a disruption to prices that the Federal Reserve would have to pause its policy?

Over the past three months, the financial markets have decided to scare themselves by anticipating the worst for inflation, forgetting to take into account the fact that current rates are already much higher (200bp) than annual inflation.

U.S. imports represent 14% of GDP, and while the three main countries mentioned (China, Mexico and Canada) account for almost half of this, it is premature to assume that all of them will be hit by price rises.

Finally, it should not be forgotten that a rise in imported prices can also be offset by an appreciation of the dollar, as well as by an improvement in corporate productivity or a reduction in margins.

Consequently, we believe that current fears, while not totally unjustified, are potentially excessive, while the 2017-2018 period, which could be a proxy for the next two years, does not show a massive rise in imported inflation and consumer prices justifying a massive rate hike. Inflationary fears seem excessive to us and will have to be reasoned with.

Overreaction in bond markets

Overall, therefore, interest rates in most countries underwent adjustments greater than would have been justified by recent year-end price trends in their respective countries.

The influence of US rate dynamics was thus decisive in the adjustment of investor expectations, and exacerbated tensions in other countries.

The correlation between interest-rate markets is not a new phenomenon, even if it does lead to temporary disconnections between the specific economic reality of certain countries and their interest-rate levels.

Over the coming months, we expect inflation to improve again in the vast majority of these countries, supporting a downward adjustment in yields.

In the case of the United States, in our view it was not the +0.3% rebound in inflation that triggered the 100 bp rise in long yields, but rather the anticipation of the potential inflationary effects of higher tariffs.

The next few months should enable us to reassess these risks and reduce current fears and excessive expectations. Against this backdrop, US ten-year yields should fall once again, bringing with them further adjustments in other bond markets.

The Fed's cautious stance is the main factor behind rate increases

The U.S. central bank had embarked on a new program of rate easing, lowering its key rates for the first time since 2022 in September 2024. By international standards, this move came relatively late, with a further postponement of the decision at the June 2024 meeting, only to be followed by a sharper 50-bp cut in September.

At that point, the Bank was no doubt convinced that inflation had fallen sufficiently to allow it to loosen its grip on key interest rates, while continuing its policy of reducing the size of its balance sheet.

Over the last few months, it had undoubtedly indirectly contributed to tensions in the government bond market by not renewing positions held in maturing Treasury bonds and by withdrawing more than 100 billion. of liquidity per month. Its Quantitative Tightening program enabled it to reduce its balance sheet by 25% in two years, bringing it back to its April 2020 level.

Yet in the space of a few weeks, the Federal Reserve has significantly altered its assessment of the potential evolution of the US economy in the face of numerous policy pronouncements by Trump and his entourage, notably on tariffs and the risks of a resurgence in inflation.

By noting that uncertainties were high and that this was enough to justify a cautious approach to rate cuts, the Fed certainly encouraged financial markets to consider that it would pause in its rate-cutting strategy. This was all it took for expectations to adjust, erasing four expected program cuts.

Six-month forecasts for key rates are excessive

In our view, the 100 bp rebound in Fed Funds is certainly excessive and not based on sound fundamentals, as is the rise in long rates. The Fed should quickly realize that the market expectations of recent weeks are weighing on household and business confidence.

After a brief phase of post-election euphoria, we can clearly see a rise in uncertainty and already negative reactions from economic agents to rising rates. The Federal Reserve should observe these factors and perhaps realize that the risks of imported inflation are not so high.

By adopting a cautious stance, it is nevertheless allowing a feeling of uncertainty to develop, which could well have a more negative impact on consumption from the start of the year than expected.

The central bank has put itself in a difficult position by trying to ensure sufficient room for manoeuvre in the face of the risks posed by Trump's policies. It has de facto provoked an excessive shift in market expectations, which are now even more concretely endangering the economy's growth path.

In our view, the risks of a slowdown have risen sharply and need to be quickly contained by the Fed adopting a more committed stance. In our view, the best way out would be for the Fed to announce the end of its QT at its next meeting on January 29.

Trump's extreme stances prior to his inauguration provoke uncertainty and stupefaction

La In our view, the deterioration in the investment climate at the end of 2024 is exclusively the result of the sharp rise in uncertainties caused by the positions taken by the future President of the United States prior to his inauguration.

Indeed, Donald Trump has not waited until January 20, 2025 to announce new, often extremist political projects on an almost daily basis, the most recent of which have already provoked strong reactions from Canada, Denmark and Panama, which have no intention of allowing themselves to be annexed under various economic or military pressures.

Each time, his highly publicized stances surprise observers, who obviously find it difficult to determine their concrete reality and possible effects. It was against this highly uncertain backdrop, in the absence of any concrete evidence of the effects of higher customs duties, that interest rates rose excessively in the 4th quarter and penalized most financial assets at the end of the year.

An improvement in the investment climate will depend on Trump's political clarifications and an easing of interest rates

Trump's inauguration should provide the first clarifications of his political intentions, as well as more concrete elements enabling a more accurate assessment of their impact on the economy, inflation, purchasing power and the confidence of economic agents.

We believe that the next few weeks should already provide an opportunity to assess the real risks of inflation and a slowdown in economic momentum. An improvement in the investment climate will necessarily require a clearer vision of the duality of these factors.

Considering that the immediate inflationary effects are currently overestimated by the markets, and that the risks of a slowdown are underestimated, the forthcoming readjustment of expectations should have a positive impact on interest rates.

The US Federal Reserve is expected to announce the end of its QT and continue its program of rate cuts to counter the risks of an economic slowdown before consumer confidence collapses and plunges the economy into recession.

A rapidly more favorable interest-rate environment would have direct positive consequences for bond markets, and indirectly for other asset classes.

Central scenario

Inflationary fears are likely to normalize, allowing central banks to renew their willingness to ease monetary policies. Financial markets would reassess the trajectories of key rate cuts, thereby supporting a global adjustment of the yield curves.

If these developments were to take place quickly enough, the risks of an economic slowdown would also be reassessed downwards. At current yield levels, bond markets would then be seen as very attractive, allowing downward trends in interest rates to continue.

The context would also be favorable for securitized real estate markets and, of course, for equity markets.

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