FULL DISCRETION

Extra Credit

Initial US Presidential Election Thoughts from the Full Discretion Team

Former President Donald Trump Will Once Again Serve as the President

Donald Trump has been elected as the 47th president of the United States and Republicans have retaken control of the Senate. While the House of Representatives has yet to be decided, we believe it is likely that Republicans could maintain a narrow majority based on how current polling has evolved. The initial market reaction has been in line with Trump's expected policies on tariffs, taxes, deregulation, immigration and government borrowing, which has led to a move higher in Treasury rates, in our view. Stocks have rallied, likely driven by the belief that Trump will implement pro-growth policies while also being supported in the short-term by the removal of uncertainty around the election outcome.

Our Initial Thoughts: Trump Administration Policies Light on Details and Timing

Given the lack of policy details today, we are unsure of exactly what direction this administration could go, and how far and quickly they will push their agenda. As much as the yield curve has initially been repriced, there could be more pain ahead given our expectations for the growth in the deficit and subsequent necessary Treasury issuance. The question that can only be answered with time is whether higher yields, a re-acceleration of inflation or a global trade war will halt economic activity or will Trump be able to stimulate enough growth to push the economy back into an expansionary environment (supportive of risk assets and current valuations). The initial market reaction suggests the latter; however, we expect the market is still digesting the potential outcomes of a Trump victory.

Our base case scenario heading into the election was for a resilient economy with unstable inflation, and we attributed a low probability to a mild recession. We have not changed our view and continue to believe that growth will be positive, supported by the consumer and stable corporate fundamentals. The mid-to-upper consumer, which drives much of the US economy, is supported by low unemployment and healthy financial markets (i.e., strong equity performance and real estate appreciation through COVID). In our opinion, corporate fundamentals are stable and also supportive of the economy as earnings growth has been positive and our credit loss expectations remain low.

Our Secular Themes are Unchanged: Expect Unstable Inflation and a Higher Deficit

We have been advocating that inflation may remain unstable and potentially experience higher lows due to secular themes, such as the fiscal deficit, trade protectionism, deglobalization, decarbonization and aging demographics. The incoming administration does not change those perspectives and may serve to accelerate the risk of unstable inflation and growth in the US deficit.

We believe Trump's immediate course of action could be imposing tariffs that the administration thinks will help benefit US manufacturing and create jobs. This is likely to speed up the theme of deglobalization and the development of regional trading alliances, in our view. In addition to the potential impact of driving costs and prices higher, security is becoming increasingly more important, in our view, and, as a result, could push defense spending (and the deficit) higher. Lastly, while a change in president does not impact the characteristics of an aging population, we believe immigration policies of the Trump administration could have a negative impact on both wage costs and economic growth (i.e., shrinking workforce).

Key Themes We'll Be Watching

Trump Administration Appointments – We will be closely monitoring Trump appointments for his cabinet, such as Attorney General and Secretary of the Treasury, to gain insight into the future policies of the administration. In addition, Trump's relationship with Federal Reserve (Fed) Chair Jerome Powell, whose term expires in May 2026, will also be an important gauge in terms of overall market stability, in our opinion.

Fed Policy – We have been advocating for a shallow and more prolonged interest rate cutting cycle from the Fed ahead of the election and Trump's policies are supportive of this stance. We believe there is a risk that the market could back out and/or defer rate cuts that are currently priced into the forward curve. The Fed might be forced to lean against stimulative fiscal spending and inflationary tariff hikes. We are not expecting the market to go so far as to add policy rate hikes, but it is conceivable that all the rate cuts could be priced out.

Treasury Rates – We believe the prospect of higher deficits could send yields at the longer end of the curve higher as suggested by the initial move after the Trump victory. We have been calling for long-term fair value of the 10-year US Treasury of approximately 4.25-4.50%, based on a 1.50-2.00% real rate and 2.25-2.50% breakeven rate. With Trump's election, this could push the fair value target slightly higher, in our view.

Corporate Spreads – We believe a jump in yields and the potential for tariffs could upend the risk trade to a certain degree. It is tough to say for sure because there are a number of crosswinds that cut both positively and negatively. For example, tax cuts would be stimulative and help profits. On the other hand, big tariffs could raise prices and hurt demand. The current health of corporate profitability is stable, which we believe is encouraging for the future performance of corporate bonds. The corporate default environment continues to remain fairly benign, although we are mindful of the impact of higher borrowing costs on highly levered credits as they look to access markets to refinance existing obligations.

Emerging Markets – We see that higher risk-free rates in the US could have the effect of "crowding out" weaker borrowers. This set-up may not be good for fragile sovereign borrowers, which will put an emphasis on country and security selection.

US Dollar – We do not see a clear path for the US dollar. Trump has historically sought to weaken the US dollar to improve competitiveness, however, his policies may prove the opposite.

It's Too Early to Call: We Believe Striking a Balance Will Be Prudent

We have seen the initial positive reaction in risk markets has thus far been driven by many investors being underweight risk coming into the election due to the uncertain outcome. This has been further supported by the potential for pro-growth policies (e.g., tax cuts and deregulation) and the decisive outcome of the election. We are mindful of the risks going forward and that spreads have moved to the tightest levels of this cycle. We believe markets will continue to digest the ramifications for the next four years over the coming weeks and we should start to get more clarity as we move towards the January 20th inauguration. Fundamentals are stable with the potential for losses to remain benign, and buyers are showing up with an almost insatiable demand. We feel that carry will be an important component of fixed income returns, particularly if interest rates remain range-bound or are pressured higher. We believe it is prudent to maintain a balanced risk profile between interest rate and spread risk going forward.

Please see Important Disclosure on following page, an integral part of this document.

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