CITY OF LONDON
Investment Management Company Limited

The Art of Fading the Trump Trade

November 2024

Key Takeaways:

- *A Red Sweep and Donald Trump's return have raised expectations for further US equity outperformance and US dollar strength.*
- *As Trump 2.0 policies develop, we keep an open mind to the investment implications.*
- *Current evidence shows that 'Trump trades' mostly reversed course in his first term, and the hurdle for further 'US exceptionalism' is even higher for Trump 2.0, leaving richly priced US assets exposed to a period of underperformance.*
- *The strength and profitability of US corporates will continue to justify exposure to US equities in the long-term.*
- *However, non-US equities still provide compelling diversification and value for strategic asset allocation. Three prominent themes that favour exposure to non-US equities include advanced tech hardware demand, growing energy needs, and corporate governance reform.*

Trump 2.0

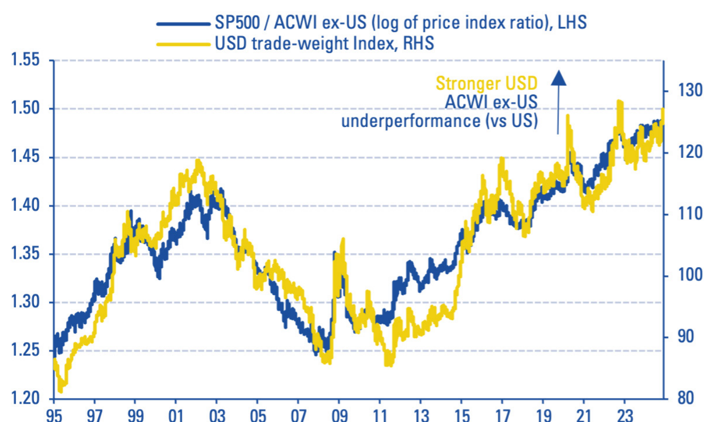
Donald Trump will be the 47th President of the United States on January 20th, 2025. Similar to 2016, 'Trump Trades' are already moving in anticipation of his return to office, and investors need to examine the durability of these trades for their asset allocation. There is a long list of relevant assets for this discussion (e.g., Bitcoin, fossil fuels vs clean energy, private equity, and Tesla stock). This note focuses on the implications for International (non-US) and Emerging Market (EM) equities relative to the US and the US dollar (USD), given its high correlation with the relative performance of International stock indices. The current consensus is leaning towards further USD appreciation and US equity strength relative to International equities. In other words, **the market is pricing a continuation of 'US exceptionalism' that has persisted since 2011 under Republican and Democrat Presidents (see Chart 1). These trends may extend, but the hurdle for further US outperformance is higher, and therefore, non-US equities still deserve a spot in a diversified portfolio.**

As an upfront caveat, Trump and his party's policies are still developing, and the sequencing of policies is still being debated. For example, will tax cuts be the main priority, or will immigration restrictions and tariffs be the first order of business? And if the latter, the details on tariff rates will have implications for US and global growth. Our views will adjust accordingly as new information is available. However, markets have already priced further US equity and USD strength (see Table 1). The initial market reaction is similar to the 2016-2017 performance, where assets responded positively to the prospect of tax cuts and deregulation. We are agnostic about whether Trump and the Republican-controlled Congress will prioritise their more growth-oriented policies. Markets may continue to trend in this direction leading up to the January inauguration. Still, our current assessment is the bar is higher to maintain 'US exceptionalism'. The US equity market and the US dollar are richer than in November 2016, and some factors driving US outperformance may fade or reverse under Trump 2.0. Given these risks, asset allocators may exploit this opportunity to add exposure to cheaply valued non-US equities.

Trump Trade: November 2016 Versus Now

Table 1 highlights how some assets reacted following Trump's recent election win compared to his November 2016 election victory and Biden's 2020 election win. The table also includes asset performance over Biden's current term, Trump's first term, and Obama's second term for reference. We focus on the last three Presidential terms because they capture the period since 2011, characterized by 'US exceptionalism', where the US equity market outperformed global equities.

Chart 1: US Equities (vs RoW) and the US Dollar



Source: Bloomberg

Table 1: Asset Performance Over Various Presidential Periods

	Period from election to inauguration			Recent Presidential Terms		
	2024 Trump Win Nov 2024 - Present	2020 Biden Win* Nov 2020 - Jan 2021	2016 Trump Win* Nov 2016 - Jan 2017	Biden's First Term Jan 2021 - Present	Trump's First Term Jan 2017 - Jan 2021	Obama's Second Term Jan 2013 - Jan 2017
MSCI USA Total Return (USD)	**2.7%**	15.7%	6.4%	56.4%	83.8%	61.6%
ACWI ex-US Total Return (vs USA, USD)	**-5.9%**	5.3%	-3.2%	-49.8%	-34.3%	-52.9%
MSCI EM Total Return (vs USA, USD)	**-7.1%**	9.6%	-7.1%	-70.8%	-11.8%	-70.2%
MSCI Eurozone Total Return (vs USA, USD)	**-8.3%**	2.7%	-1.5%	-42.0%	-35.9%	-46.9%
MSCI China Total Return (vs USA, USD)	**-8.6%**	1.8%	-7.6%	-98.5%	30.3%	-57.5%
UST 10y yield (bps)	**13.3**	18.1	61.2	332.4	-138.7	62.5
USD trade-weighted index (BBG DXY)	**2.3%**	-3.9%	4.5%	14.4%	-10.5%	26.5%
Gold	**-3.0%**	-2.0%	-5.1%	42.2%	54.7%	-28.4%
Brent	**-2.9%**	41.2%	20.5%	30.7%	1.1%	-50.3%
Bitcoin	**40.0%**	154.0%	26.8%	178.7%	3768.6%	5646.0%
Clean energy ETF (vs US energy ETF)	**-19.6%**	-12.5%	-20.0%	-168.3%	334.7%	37.9%

*Note: Red (green) colour indicates worst (best) performer between Biden's first term, Trump's first term, and Obama's second term. *Period from the election to inauguration.*

Source: Bloomberg. Prices as of November 21st, 2024.

At the time of writing, many major asset classes are tracking a similar trend to Trump's November 2016 win. US equities are beating their peers, the USD is appreciating, US Treasury yields are rising, Bitcoin is rallying, and clean energy stocks are falling relative to US Oil & Gas stocks. These trends appear to line up with consensus expectations for the incoming government. One exception is gold falling, which also occurred in 2016.

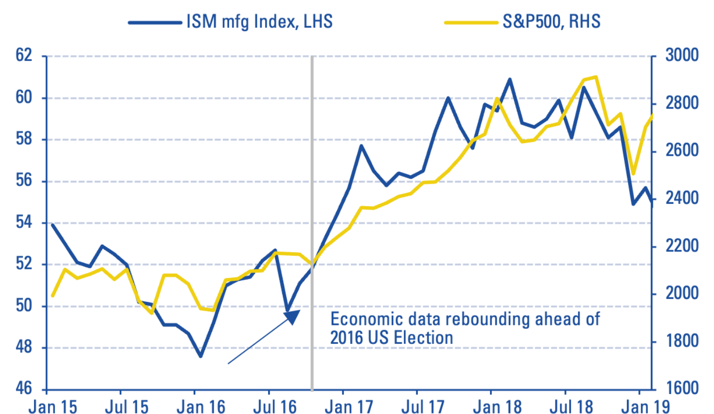
The remaining columns in Table 1 show asset performance over the past three Presidential terms. The red (green) colour highlights the worst (best) performer between Biden's first term, Trump's first term, and Obama's second term for each asset line. A few observations:

- Over Trump's entire first term, many asset prices moved opposite from the initial reaction between November 2016 and January 2017 (e.g. bonds, commodities, China equities, and clean energy stocks). Still, US equities outperformed International stocks as they have since 2011.
- Some initial price moves following the November 2020 election also reversed over the subsequent four years. Markets initially priced a better outlook for non-US equities and a weaker USD, which was not sustained.
- Compared to Obama/Biden, EM/China performed the best under Trump 1.0. Also, under Trump, the dollar fell, clean energy outperformed, and Treasury yields fell.

Asset performance under Trump 1.0 did not align with widely held expectations at the start of his first term. Similar to today, Trump was expected to accelerate 'US exceptionalism' with his America First policies. His first term is often remembered as a difficult period for EM and International stocks. However, the evidence shows that International and EM equities performed relatively better (in USD terms) under Trump 1.0 compared to the recent Democratic administrations. Despite his vocal support for the fossil fuel industry, clean energy stocks performed the best under Trump 1.0. The counterpoint to these observations is Covid, Fed policy, China's domestic policy, and broader macro trends varied under these three periods and explain the performance differentiation. However, this argument suggests that the US President is not the primary driver of macro and market fundamentals. If one accepts that view, investors should be fading 'Trump trades' that do not align with their pre-election fundamental framework.

Chart 2 is one illustration that suggests Trump 1.0 tax cuts and deregulation may not have been the primary driver of equities in the early part of his term. The chart shows the ISM manufacturing index, a commonly tracked indicator that positively correlates with equity prices, was rising ahead of the 2016 US election. Some may recall that Democratic candidate Hillary Clinton was favoured to win, and the surprise Trump win was briefly followed by a sharp market selloff (lasting hours). The selloff quickly reversed as markets found comfort in Trump's 'Presidential-like' victory speech. The narrative quickly shifted to tax cuts, deregulation, and the upside potential from a billionaire businessman running the country. The Republican Party's 2017 tax cuts contributed to US equity EPS growth. However, the chart indicates that macro momentum (starting pre-Trump) also played a significant role. Today, the ISM and other US activity indicators are decelerating following a period of strength, indicating potential cyclical headwinds for equities ahead of Trump 2.0.

Chart 2: Economic Data was Rebounding Ahead of the 2016 US Election



Source: Bloomberg.

Table 2: Key Indicators Today Versus November 2016

Metric	Nov 2016	Now	Comment
US Budget (%GDP)	-2.6	-6.9	US is more fiscally constrained.
US CPI (%yoy)	1.6	2.6	Inflation is higher.
BBG Recession 1Y Prob (%)	18	41	Recession risks are more elevated.
Fed Funds Rate	0.38	4.63	Monetary policy is more restrictive.
US 2y yield	0.84	4.30	
US 10y yield	1.83	4.40	The cost of debt is higher.
USD (BIS REER level)	97.4	110.0	USD is 13% richer.
SP500 (fwd PE)	18	25	US equities are more expensive relative to RoW.
MSCI EM (fwd PE)	14	13	
MSCI World ex-US (fwd PE)	16	15	

Current data as of Nov 21, 2024.

Source: Bloomberg

Table 2 further highlights that the macroeconomic and market backdrop is even more challenging for Trump 2.0 than eight years ago. Trump 2.0 will inherit a wider budget deficit, higher inflation, more restrictive monetary policy, and higher recession risks. Fiscal austerity and a US recession are arguably better policy options now, as Trump could then blame his predecessor while also taming inflation (the most important election issue). Market fundamental indicators (e.g., the forward P/E ratio) indicate a higher hurdle for further US equity and USD dollar strength. US earnings growth – which is already high - will need to accelerate, or multiples will need to expand further to sustain US outperformance. The bar was lower for previous administrations.

US Equity Drivers

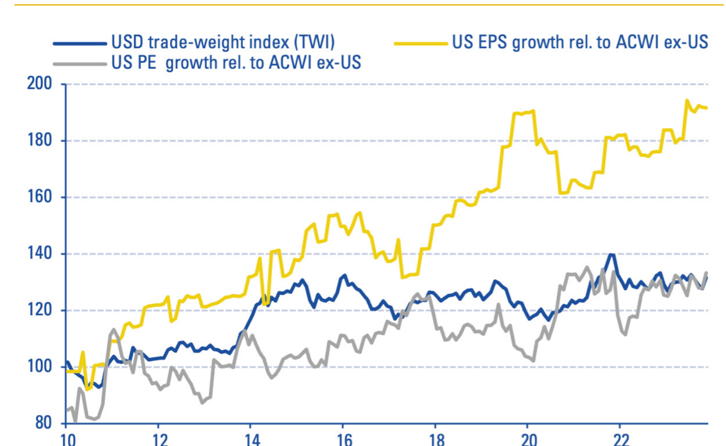
We do not think all price trends since the November 5th US election will reverse. Rather, we are highlighting that macro and market fundamentals may not align with the initial reaction from the US election outcome, and EM and International equities still deserve a place in a diversified portfolio. With that said, the US produces some of the best companies in the world, and the overall US market has consistently generated strong earnings growth and returns for investors. Global portfolios will continue to hold large exposure to US stocks over the foreseeable future. Looking beyond politics, one should consider the drivers of the persistent US outperformance since 2011 to determine if they want to reduce, maintain, or add to their existing US country allocation.

Since 2011, US outperformance has been attributed to a combination of 1) superior earnings growth, 2) multiple expansion, and 3) USD appreciation for unhedged global investors (see Chart 3). The policy environment and strength of US corporates have contributed to earnings. US equities (with a higher weighting to the Technology and Communication Services sectors) have seen revenue growth and margin expansion. Globalisation has allowed US firms to reduce costs with cheaper labour and inputs. The US also has a relatively low corporate tax. Trump 1.0 lowered corporate taxes, and Trump 2.0 is expected to extend these tax cuts. Large-caps were also able to lock in low interest rates with previous bond issuance, while their large cash reserves benefitted from recent rate rises. Loose US fiscal policy stimulated revenues (via excess pandemic savings) while wages have remained relatively tame – supporting earnings. Finally, strong corporate governance, share buybacks, and steady ETF inflows are also factors contributing to US strength.

Some of Trump 2.0's potential policies will help US companies, while others will hinder them. For example, Bank of America estimates that a corporate tax cut to 15% (from 21%) will lift S&P500 EPS by 4%. On a more cautious note, tariff threats may hinder multinational companies' supply-chain advantages, raising input costs and reducing margins. Potential immigration restrictions will also limit their ability to hire low-cost labour within the US. US monetary policy is expected to ease but to a lesser extent than pre-election. Fiscal thrust is expected to be supportive under Trump, but the bond market and Republican fiscal hawks may limit fiscal expansion. Should the budget deficit widen, higher inflation and a bond market revolt would likely negatively impact US corporates.

If Trump 2.0 leans more towards his growth-positive policies (e.g., tax cuts), US earnings strength may be maintained. Artificial Intelligence is also a separate theme that may further contribute to US earnings growth and productivity gains over the coming decade. Still, we reiterate that the higher US multiple has been the dominant driver of outperformance since 2020, and the US P/E ratio already reflects strong US earnings growth, leaving the US exposed to any disappointment. A growing concentration of mega-cap firms is also a risk for the US market. Chart 4 highlights that valuation metrics point to poor relative returns for the US over the long-term under the assumption of mean reversion in the US multiple.

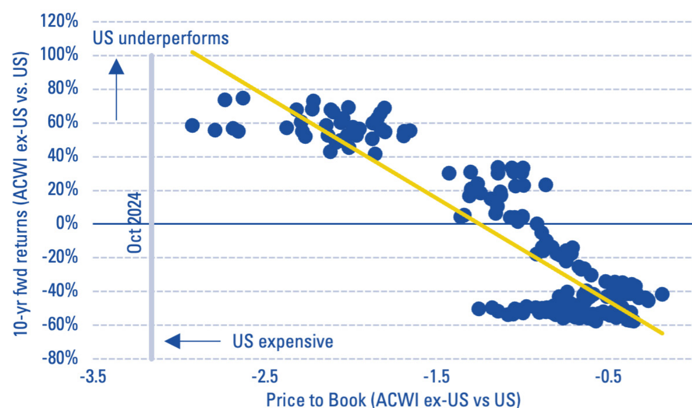
Chart 3: US Equity Drivers Since 2011



Note: Based to 100 in Oct. 2011. The chart shows MSCI USA EPS and PE growth relative to ACWI ex-US. USD Index is the BBG DXY.

Source: Bloomberg

Chart 4: ACWI ex-US Relative to US Price/Book Ratio and Subsequent 10-yr Returns



Source: Bloomberg

US Dollar

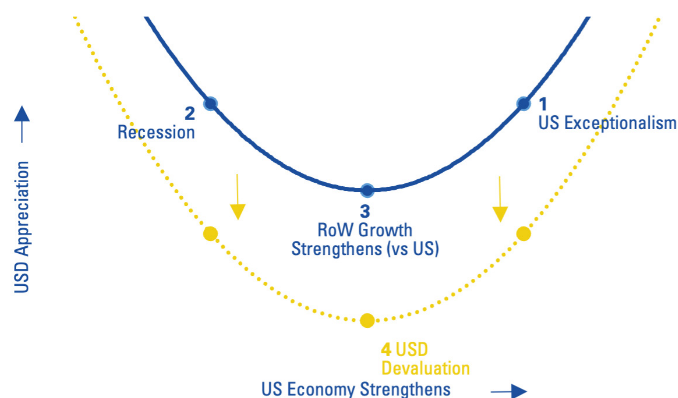
Markets have priced in a stronger USD in anticipation of Trump 2.0 policies. As highlighted in Chart 1, non-US equities historically have a negative relationship to the dollar and have underperformed following the election outcome. Unhedged global investors are directly exposed to FX risk, and International equites are sensitive to the dollar trend through various other channels (e.g., central bank policy, USD funding, and capital flows). If the dollar continues to appreciate, non-US equities (EM in particular) will likely underperform. However, we note that the dollar trend was weaker under Trump 1.0, and Trump has expressed a desire for a weaker USD to support US manufacturing competitiveness.

The market is currently voting for a stronger USD, but there appears to be a mix of views on the likely path in 2025. We would characterise the potential outcomes into four scenarios and reference how each links to the 'USD smile'. For background, the USD smile framework is commonly referred to by FX analysts. The theory (based on empirical evidence) suggests that the USD appreciates in periods of strong US growth (associated with US capital inflows) and in periods of global risk aversion (associated with safe-haven flows into the US). In between, the USD falls. The four scenarios are listed below and labelled in Chart 5:

1. **US economic growth may strengthen** where Trump 2.0 policies generate strong nominal GDP growth, while the rest-of-world (RoW) is weighed down by US tariffs. Europe and China will be particularly hard hit. US economic strength and higher rates will support USD strength (Point 1 in Chart 5)
2. A **US recession** may occur in 2025, as signalled by the weakening US labour market and dwindling US excess pandemic savings. Trump's immigration and tariff policies further reinforce the downside risks to growth. Historically, the USD has been countercyclical and will typically rally in a US recession (Point 2 in Chart 5). Note, though, that 2001 was an exception and the USD was expensive on valuation metrics at the time, similar to now (see Chart 6).
3. **US cyclical drivers may weaken relative to the RoW**. A wide US budget deficit limits fiscal support, US rates are on a lower path, and China is stimulating growth (Point 3 in Chart 5). Chart 7 indicates there are already some indications that weak RoW growth is bottoming, resulting in a headwind for further USD strength.
4. Trump may attempt a **USD devaluation**. A recent FT Alphaville article, "How to devalue the dollar (a guide for Trump)" (November 6th, 2024), provided a useful summary of potential policy options. These included 1) severe fiscal tightening, 2) direct adjustments to the current account, 3) changing the Fed, 4) another Plaza Accord, and 5) direct intervention. All the options have pros and cons but could be implemented. For brevity, we will not repeat the details from the article in this note.

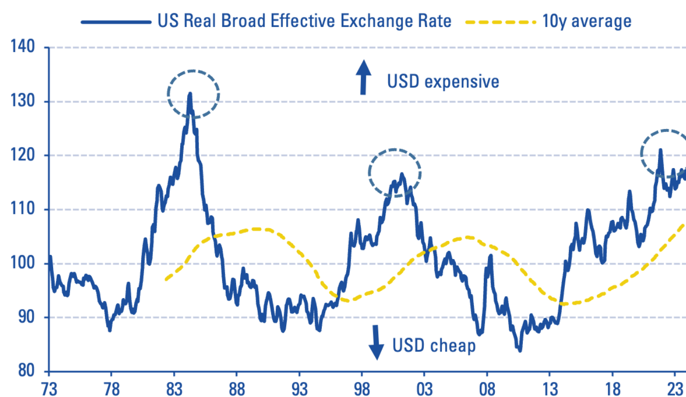
Currently, the market appears to be pricing scenario 1. Scenario 2 may be priced if recession fears grow again in 2025. We think scenarios 3 and 4 should be taken seriously and imply USD depreciation. Particularly given the current USD valuation, and evidence shows the USD weakened under Trump 1.0. Our macro indicators do not currently point to an imminent dollar reversal, but the risks are to the downside as one extends their time horizon.

Chart 5: 'USD Smile' Framework



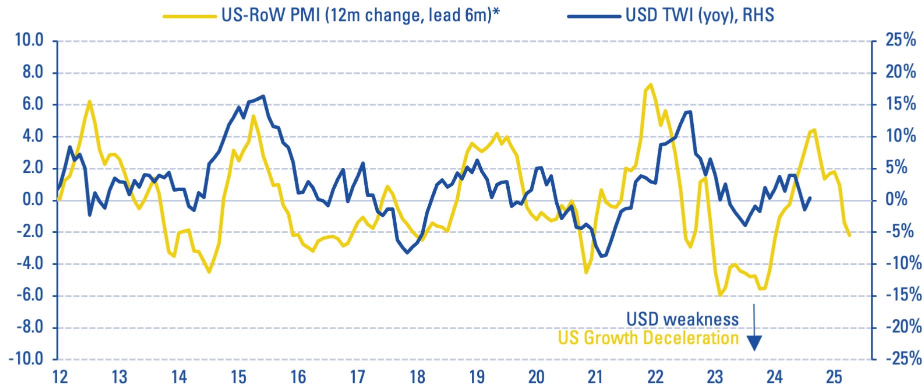
Source: CLIM. For illustration purposes only.

Chart 6: US Real Broad Effective Exchange Rate



Source: Bloomberg

Chart 7: RoW vs. US Growth Differentials and the USD



**3m moving average of US mfg. PMI relative to Eurozone, Japan, and China.*

Source: Bloomberg

Conclusion

US corporates continue to produce robust earnings growth, and its mega-cap firms are still at the forefront of innovation. Global investors will likely continue to hold considerable exposure to the US market before, during, and after Trump's second term. However, the US election outcome has started to motivate discussion about potential risks for non-US equities. For example, the November 2024 Bank of America Fund Manager Survey showed a downgrade to International 2025 expectations and an upgrade to the US. We cannot confidently say how Trump 2.0 policies will develop over the next four years. Some of his policies may benefit US assets, while others may serve as headwinds. Regardless, US equities will also be scrutinised once earnings growth moderates. International equities remain an alternative investment opportunity, and unlike the US, they offer compelling value for strategic investors. This note has focused on the US following Trump's re-election. Looking beyond the US, International and EM equities provide exciting growth opportunities.

Three prominent themes that will transcend current US politics are AI, growing global energy needs, and corporate governance reform. 2025-26 earnings forecasts for Taiwan, South Korea, and the Netherlands are expected to outpace the overall US market due to the indices' high weighting to advanced tech hardware. Linked to AI growth, a recent Goldman Sachs report estimated that data centres will consume 8% of US power by 2030 (vs. 3% in 2022). The MSCI USA Index weight to Energy is <4%, while the U.K. (12%), Canada (18%), and EM (5%) offer more exposure. Furthermore, if clean energy rebounds, similar to Trump's first term, growing energy needs support the Materials sector in Australia, Canada, UK, Switzerland, and EM. Lastly, many countries recognise the importance of improving corporate governance to attract capital and improve shareholder value. Japan has already made progress, while corporates in China and South Korea are making similar efforts. These are some examples of opportunities in non-US equities that we look to exploit, and we cover in more detail our regular asset allocation updates on the website Citlon.com.

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