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WHAT THE POLITICS OF 2024 TELLS US ABOUT 2025

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Table of Contents

EXECUTIVE SUMMARY

We would like to offer a different kind of "year ahead" analysis. What does the political and economic landscape of 2024 mean for investors in 2025?

Current political polls have consistently shown that President Joe Biden trails the Republican frontrunner, Donald Trump. This is occurring against a backdrop of improvements in growth, inflation and personal income, which should be positive for the incumbent.

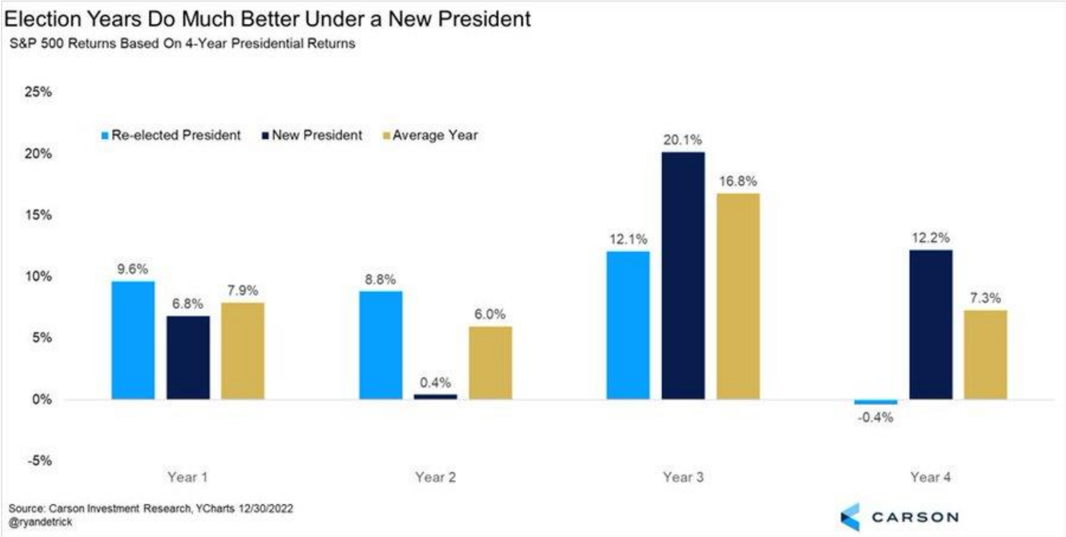
Here is a preliminary look at what 2025 might look like under a Biden administration and a Trump administration. A Biden White House is more predictable using conventional economic analysis, so let's start there. Much depends on whether the Fed can achieve a soft landing of the economy. Assuming there is no recession, the economy will likely continue to expand in 2025, which should be bullish for stock prices. The effects of a Trump White House will be more difficult to predict. The only certain investment bet under a Trump administration may be to buy volatility.

A Different Kind of "Year Ahead"

We are not fond of the ritual of "year ahead" forecasts. Street strategists' forecasts are far more dispersed compared to past years. The 2024 year-end target for the S&P 500 varies from 4200 to 5200.

So let's make this brief. Analysis from Ryan Detrick of Carson Group shows that the S&P 500 rises an average of 12.2% in an election under a new president. That sounds about right in light of the recent Zweig Breadth Thrust buy signal from early November.

Exhibit 1: S&P 500 Returns by Year



Source: Carson Group

Instead, we would like to offer a different kind of "year ahead" analysis. What does the political and economic landscape of 2024 mean for investors in 2025?

The Fed's Balancing Act

One of the key questions for investors in 2024 is the direction of monetary policy. The Fed has already signaled that it plans to pause rate hikes, but when does it cut?

The market became very excited with Fed Governor Christopher Waller's dovish pivot when he addressed the question of rate cuts: "If you see this [lower] inflation continuing for several more months, I don't know how long that might be—three months? four months? five months? You could then start lowering the policy rate because inflation's lower."

Waller's remarks shouldn't have been a surprise. Fed Chair Jerome Powell said the same thing at the July post-FOMC press conference [emphasis added]:

> *So if we see inflation coming down credibly, sustainably, then we don't need to be at a restrictive level anymore. We can, you know, we can move back to a—to a neutral level and then below a neutral level at a certain point. I think we would, you know, we would—we, of course, would be very careful about that. We'd really want to be sure that inflation is coming down in a sustainable level. And it's hard to make—I'm not going to try to make a numerical assessment of when and where that would be. But that's the way I would think about it, is you'd start—**you'd stop raising long before you got to 2 percent inflation, and you'd start cutting before you got to 2 percent inflation**, too, because we don't see ourselves getting to 2 percent inflation until—you know, all the way back to 2—until 2025 or so.*

There was some confusion after the December FOMC meeting. The Summary of Economic Projections, or "dot plot", projected three quarter-point rate cuts in 2024 and Powell mentioned the Committee talked about rate cuts. On the other hand, New York Fed President John Williams appeared to walk back market expectations in a CNBC interview the following week by stating, "We aren't really talking about rate cuts right now."

Here's the real story. First, Powell said during the press conference that policy is restrictive, "Our actions have moved our policy rate well into restrictive territory." However, the FOMC was only discussing rate cuts in an informal and preliminary way. Rate cut decisions were not on the active formal agenda:

> *So it comes up in this way today. Everybody wrote down an SEP forecast. So many people mentioned what their rate forecast was, and there was no back and forth, no attempt to sort of reach agreement, like this is what I wrote down, this is what I think, that kind of thing. And a preliminary kind of discussion like that, not everybody did that, but many people did. And then, and I would say there's a general expectation that this will be a topic for us looking ahead. That's really what happened in today's meeting.*

Regardless of whether there was any formal discussion of rate cuts, it is becoming evident that disinflation is gaining the upper hand. As inflation decelerates, the Fed will need to lower nominal rates so that real rates stay steady. As monetary policy operates with a lag, Fed officials will also have to pre-emptively ease policy as inflation approaches its 2% target in order to avoid excessive tightness that plunges the economy into recession.

As a consequence, the market is therefore discounting a series of rate cuts that begin in March.

Exhibit 2: Fed Funds Expectations

CME FEDWATCH TOOL - MEETING PROBABILITIES

MEETING DATE	300-325	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
1/31/2024					0.0%	0.0%	0.0%	0.0%	16.5%	83.5%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	14.2%	74.1%	11.7%
5/1/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	13.7%	71.9%	14.0%	0.4%
6/12/2024	0.0%	0.0%	0.0%	0.0%	0.9%	17.7%	67.9%	13.1%	0.4%	0.0%
7/31/2024	0.0%	0.0%	0.0%	0.8%	15.5%	61.3%	20.3%	2.1%	0.1%	0.0%
9/18/2024	0.0%	0.0%	0.8%	14.3%	57.6%	23.6%	3.5%	0.2%	0.0%	0.0%
11/7/2024	0.0%	0.5%	9.0%	40.8%	36.8%	11.3%	1.5%	0.1%	0.0%	0.0%
12/18/2024	0.4%	7.7%	35.7%	37.4%	15.4%	3.1%	0.3%	0.0%	0.0%	0.0%

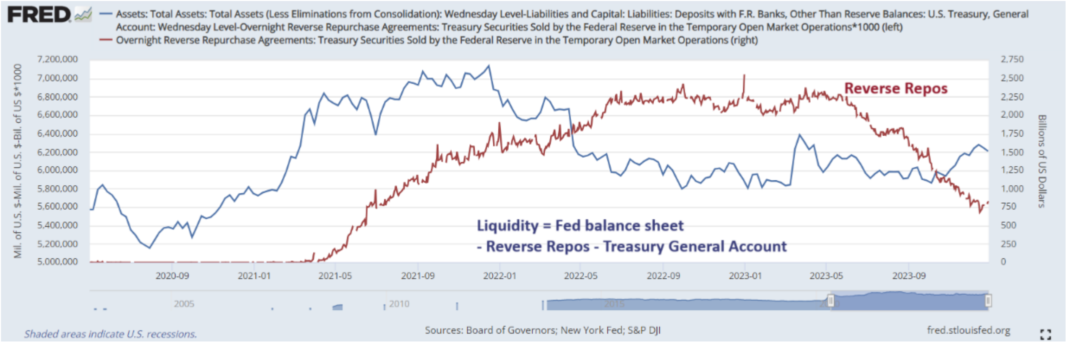
Source: CME FedWatch Tool

We think that such an aggressive schedule of rate cuts is an unrealistic expectation. We differ from the consensus with the timing of the initial rate cuts as we believe it would be reasonable for the Fed to begin cutting in Q1 or Q2. We just don't believe the Fed will cut in the second half of 2024, which is an election year.

Fed officials don't want to be seen as partisan in an election year. If a case for cuts can be made because of rising real rates, the cuts will have to occur in the first half. In a crisis, the Fed can take other steps to support the economy, which translates into the return of a Fed Put.

As an example, the reverse repo account (RRP) has been steadily shrinking and has been providing liquidity to the financial system. Should a crisis erupt and RRP levels are too low, which threaten the level of banking reserves, the Fed could inject liquidity into the system by halting the shrinkage of its balance sheet (QT).

Exhibit 3: Liquidity and RRP



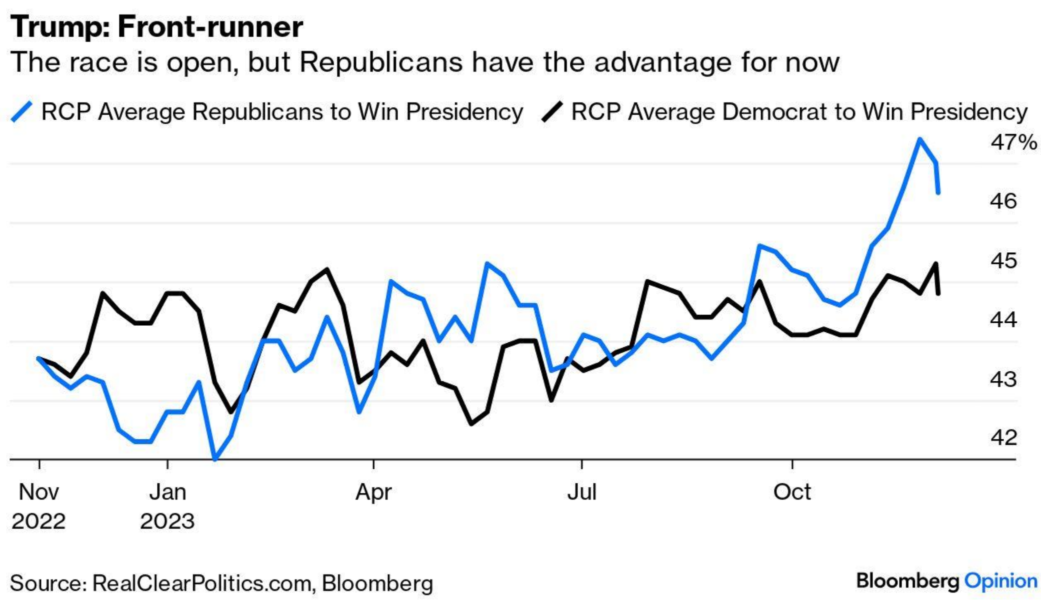
Source: FRED, Federal Reserve Bank of St. Louis

In summary, the Fed has to walk a fine line between its dual mandate of price stability and full employment, as well as its unspoken mandate of financial stability and its political neutrality.

Biden's Polling Problem

Here is where the economic rubber meets the political road in 2024. Political polls have consistently shown that President Joe Biden trails the Republican frontrunner, Donald Trump.

Exhibit 4: Trump Leads Biden in Polls



Source: Real Clear Politics, Bloomberg

Second-term elections are usually a referendum on the incumbent's performance. In effect, voters are asking the question that Ronald Reagan asked in 1984 in his re-election campaign, "Are you better off than you were four years ago?" If so, let's have more of the same.

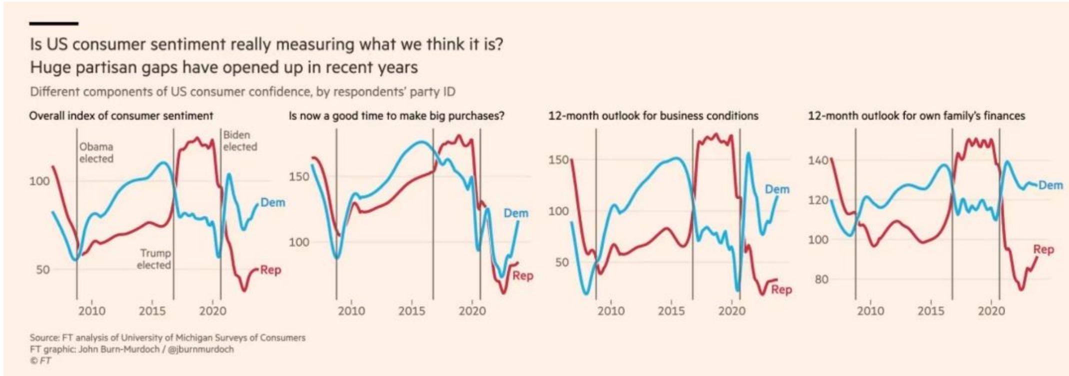
Even as the hard data shows that the economy is improving, soft sentiment data is weak, which spells trouble for the incumbent. The U.S. is unique among other advanced economies in this divergence.

Exhibit 5: A Significant Divergence Between Hard and Soft Data

Source: Financial Times

When questioned about the specifics of consumer sentiment, a partisan divide in opinion becomes very evident.

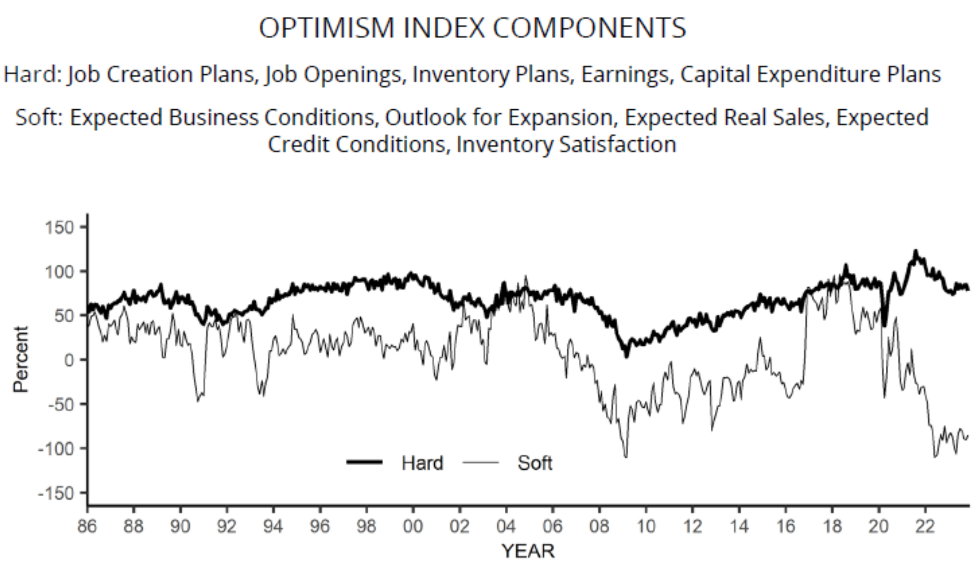
Exhibit 6: A Partisan Divide in Consumer Sentiment



Source: Financial Times

A similar divide can also be seen in the opinion of small business owners, who lean small-c conservative. But that's not the entire story.

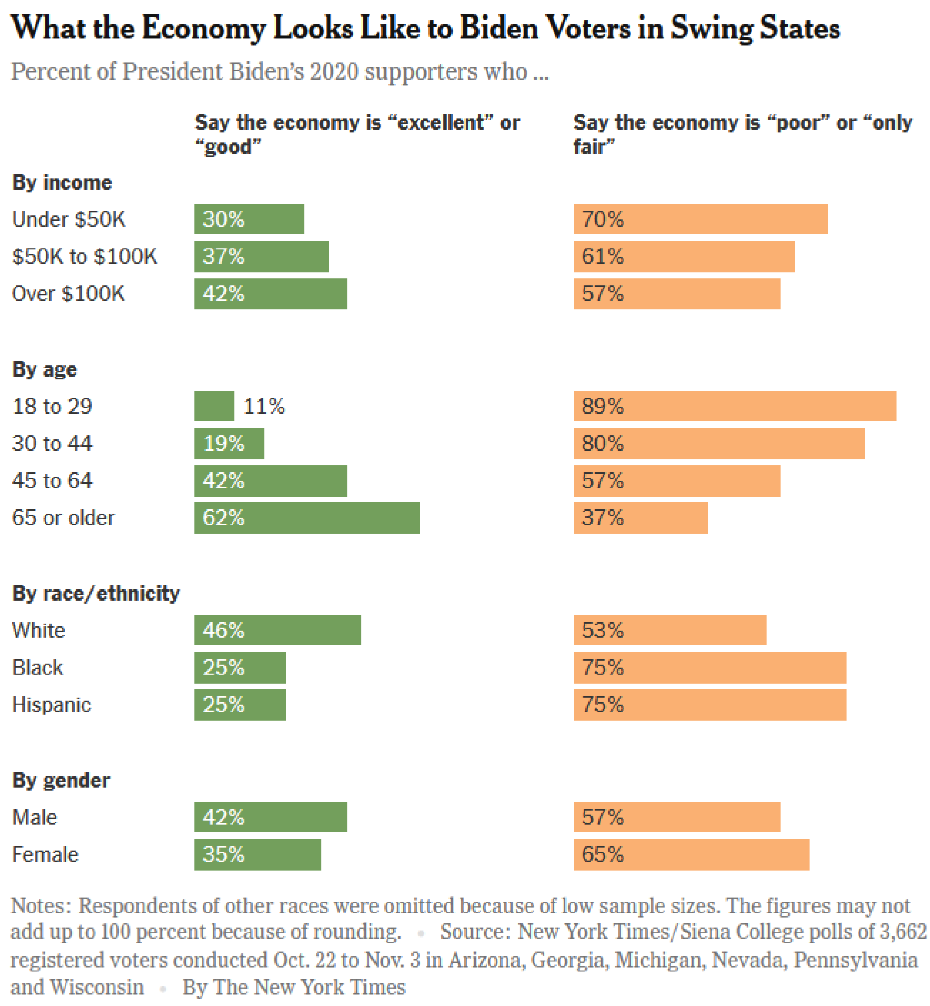
Exhibit 7: An Enormous Gap Between Hard and Soft Data Confidence



Source: National Federation of Independent Business

A New York Times poll of swing state voters shows widespread economic dissatisfaction among Biden supporters.

Exhibit 8: Widespread Economic Dissatisfaction Among Biden Supporters

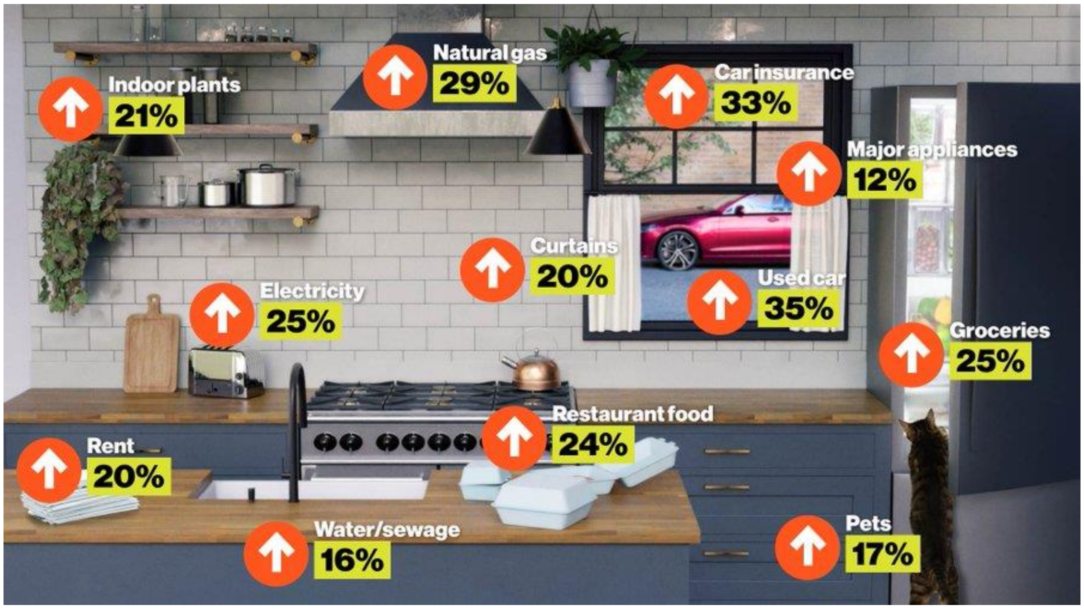


Source: New York Times

The question is why, and the answer could determine the results of the election in November.

The answer is a combination of inflation and the pandemic. Even though inflation has been decelerating, the inhabitants of Main Street aren't the economic nerds on Wall Street. Bloomberg recently documented how much different price categories have risen since 2020, from energy, housing, groceries and other major household costs. Is it any wonder why the electorate is dissatisfied?

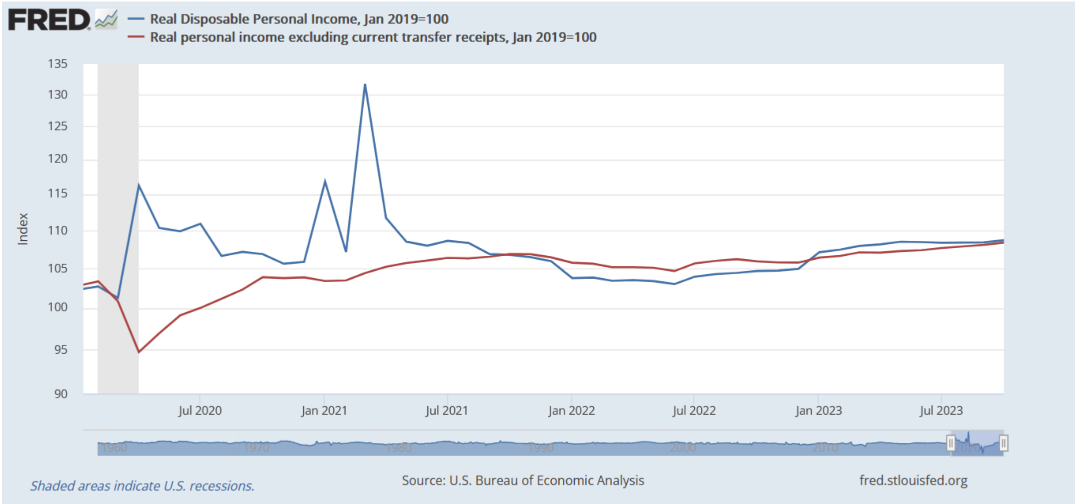
Exhibit 9: Inflation Since 2020



Source: Bloomberg

To be sure, incomes have kept pace with inflation, but perceptions have also suffered from households anchoring on the recent past. The accompanying graph shows the progress of real incomes, normalized to January 2019 at 100 (red line), which has been rising unevenly since Biden took office. However, real income with government transfers (blue line), which include all the COVID stimulus, spiked in 2021 when Biden took office but it's fallen since then. The expiry of those payments, along with the additional burden of student loan payments, has made many householders feel poorer.

Exhibit 10: A Tale of Two Real Incomes

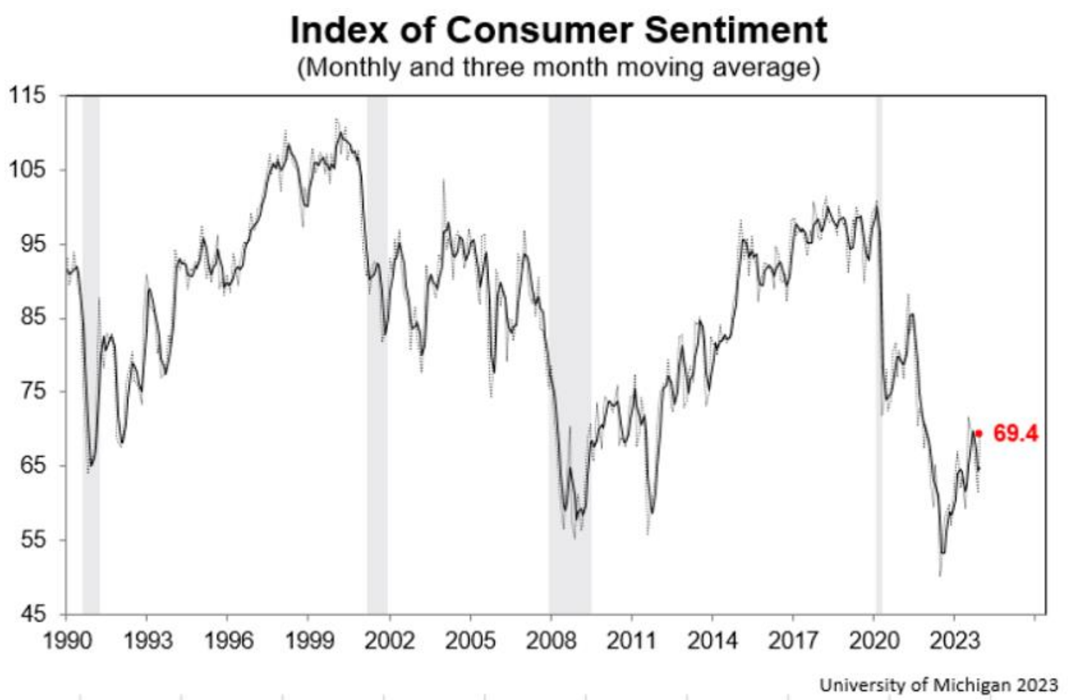


Source: FRED, Federal Reserve Bank of St. Louis

In summary, New Deal democrat discussed Biden's political problem in a blog post on November 13, 2023. He concluded, "History shows that voters generally focus on the economy for the last 6 to 9 months before the election…If we get better news on inflation and interest rates next year, Biden will be in much better shape." Much will depend on whether the Powell Fed achieves a soft landing of the economy in 2024.

In the end, all this hand wringing over consumer sentiment might be nothing. The University of Michigan Consumer Sentiment Index has begun to recover. Similarly, the Conference Board's December Consumer Confidence showed a similar level of recovery.

Exhibit 11: A Recovery in Consumer Sentiment



Source: University of Michigan

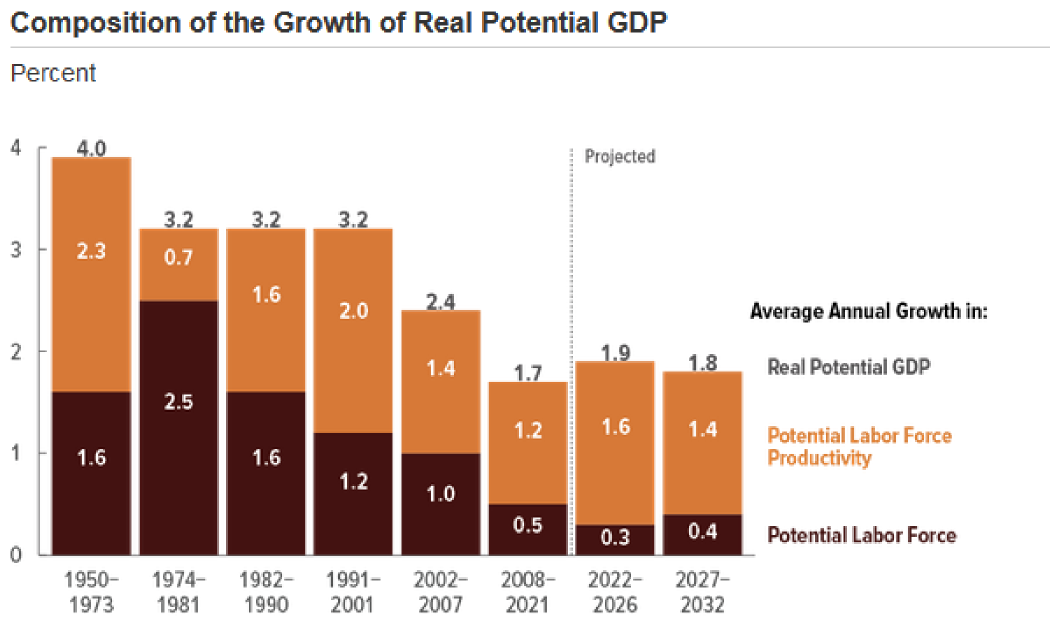
Peering into 2025

What happens after the election? As much can happen between now and the election, here is a preliminary look at what 2025 might look like under a Biden administration and a Trump administration.

A Biden White House is more predictable using conventional economic analysis, so let's start there. Much depends on whether the Fed can achieve a soft landing of the economy. Assuming there is no recession, the economy should continue to expand in 2025, which should be positive for stock prices.

The non-partisan Congressional Budget Office estimated that the economy can grow at 2.6% between 2022 and 2026. One driver of growth is growth in the labour force, which will be a function of the hot-button issue of immigration.

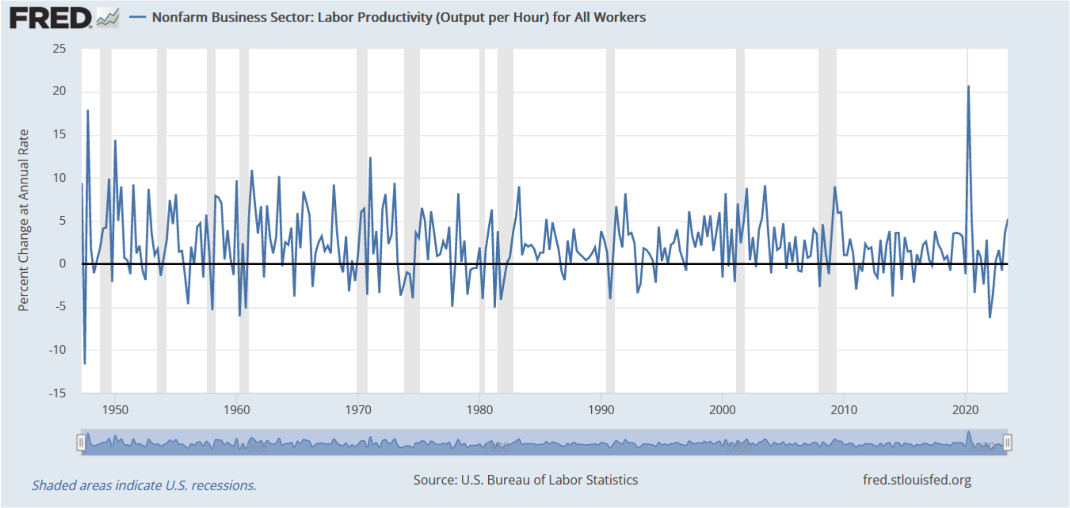
Exhibit 12: An Estimate of Economic Growth Potential



Source: Congressional Budget Office

But most of the growth will be a function of productivity improvement. The CBO estimate is 1.6% and the recent surge in labour productivity is promising. In addition, the CBO estimate did not include any productivity gains from the implementation of AI, which has the potential to be a productivity game-changer.

Exhibit 13: Labour Market Productivity



Source: FRED, Federal Reserve Bank of St. Louis

The effects of a Trump administration are more difficult to forecast. Here are the bull and bear cases.

Let's start with the bear case. The Trump team is known to be assembling an extensive list of potential hires in order to implement its policies so that a second Trump term would not be as chaotic as the first one. During his first term, it was felt that many of Trump's initiatives were being stonewalled by the civil service, otherwise known as the Deep State, and a more committed group of adherents would affect Trump's plans without interference. The Heritage Foundation's Project 2025 is one of the most intensive screens of potential personnel based on ideological beliefs. While Wall Street is likely to be agnostic about changes in government personnel, it might not be rattled if Trump were to extend his reach into the Federal Reserve.

However, the biggest risks for asset returns under a Trump administration will be the effects of foreign policy.

- **Trade War**: Trump has proposed an across-the-board tariff of 10% on all imports. Global trade would collapse under such a scenario. Any re-shoring initiatives will be slow (see TSMC in Arizona). More importantly, re-shoring will be hampered by the disappearance of local supply chains.
- **Ukraine:** Trump has shown himself to be highly transactional in his foreign policy dealings. He has shown antipathy to NATO and he is unlikely to continue to support Ukraine in its war (see NY Times article). A Russian victory would create a refugee crisis in Europe as Ukrainians flee into the EU that collapses the European economy (see Bloomberg article outlining U.S. allies' fears). In addition, the growing power of anti-EU and pro-Russia elements in Europe, such as Geert Wilders of PVV in the Netherlands, Marine LePen in France, AfD in Germany, Viktor Orbán in Hungary,

and the new pro-Moscow government in Slovakia, have the potential to unravel the European Project.

- **The End of Pax Americana:** Trump's transactional approach to foreign policy will mean the end of Pax Americana and U.S. leadership. Devoid of the protection of the U.S. nuclear umbrella, Trump's approach incentivizes G7 allies like Germany, Italy, Japan, as well as countries like South Korea and Saudi Arabia to consider the acquisition of nuclear weapons. The world will become far more multi-polar and unstable.
- **Invasion of Mexico:** Trump, along with a number of other Republicans, have proposed an invasion of Mexico to deal with the drug cartels in the past. The U.S. military hasn't had a strong counterinsurgency track record and an invasion has the potential to create a Vietnam-style quagmire on America's doorstep. It would be an enormous drain on the federal budget and a shock to Wall Street.

Here is the bull case for asset prices under Trump:

- **Tax Cuts**: Trump is a Republican, and Republicans enact tax cuts. All else being equal, tax cuts are bullish for stock prices.
- **An Everything Bubble**: The potential for a significant decline in the USD is very real. But a collapse in the USD could spark an Everything Bubble like 2020–2021 that turbocharges tax receipts and asset prices.

In short, the effects of a Trump White House will be more difficult to predict. The only certain investment bet under a Trump administration may be to buy volatility.

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