The Precariat Are Still Mad!

How Should Investors Play the Next 4 Years? It Depends! – Part III

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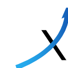
After President Trump won the 2024 election, market expectations of continued U.S. economic and financial exceptionalism went into hyper-drive. At the beginning of 2025, U.S. Stocks traded at 21.6x forward earnings that are projected to grow by 16% vs. 10% at the beginning of 2024. Most of the earnings acceleration is back-end loaded for H2, when promises of lighter tax and regulatory burdens are expected to turbocharge earnings. Bond investors have, however, been more circumspect and appear to be pricing in increased uncertainty over the long-run inflationary effects of the Trump policy platform. Though the Fed cut rates by 100 bps beginning last September, the 10-year Treasury yield rose by more than 100 bps by year end. By mid-December, these fears began to weigh on the stock market.

We acknowledge that "it depends" is an unsatisfactory answer. But as the shifting market narrative described above shows, national policy choices could lead to drastically different economic and market outcomes. Below is a summary of the scenarios, our beliefs on the most likely outcomes, and their economic and financial effects.

- Full implementation of the Trump platform would worsen the U.S.'s fiscal position, increase its debt burden and inflation; thus undermining U.S. financial exceptionalism. But...
- Trump's maximalist platform will likely be curbed by the following three factors:
  1. The U.S.' precarious fiscal and debt dynamics.
  2. The prospect of a "Liz Truss" like bond riot (previewed by the mid-December rise in bond yields) which would knee-cap stocks and other risk assets, and
  3. Voter sensitivity to inflation, which could stiffen the spines of an otherwise pliant U.S. Congress.
- A constrained Trump (our base case) would implement both mass deportation and tariffs at the lower end of policy estimates, and any tax cuts will be marginal. This version could extend the U.S.' current economic and financial exceptionalism.
- As in the past, the market is overestimating the long-term economic benefits of tax cuts. Neither the Bush or Trump's 2017 tax cuts led to a sustained improvement in business investment or economic growth. They also did little to improve the lot of the working class and thus are unlikely to address their disaffection with the four decades of neoliberal policies (perpetuated by both right and left leaning parties) that, as discussed in the Inset in Part 1 of this series, left them behind.



This piece is the third in a three-part series on the issues that led to 2024's anti-incumbent party backlash. The first two parts focused on the two issues that, according to exit polls, drove advanced economy voter preferences in 2024: Inflation (The Precariat Are Still Mad – An Analysis of 2024's Incumbent Party Shellacking,) and Immigration (The Precariat Are Still Mad! Real Talk on Immigration). Here, we evaluate the trade and other fiscal proposals put forward by the incoming Trump administration, as well as their investment implications. For a deeper dive on both their investment implications and proposed investment responses, we have hyperlinked the outlooks provided by our team of seasoned asset class experts in the U.S. equities, U.S. fixed income, and global markets.

"Tariff is the most beautiful word in the dictionary."

President Trump's vow to impose tariffs on "countries that have taken advantage of the U.S. for years," was a cornerstone of his campaign. When enumerated, though varying in size and scope from speech to tweet, the median outer limits of these tariff proposals were 20% on all imports, 25% on all products from Mexico and Canada and 60% on goods entering from China. It is important to note here that Trump's authority over tariff policy is nearly unfettered (see **Table 1**).

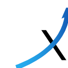
Table 1 | **Presidential Powers Over Tariffs Are Significant**

Trump can do whatever he wants... on trade policy. However, we also sense a pragmatic shift within the administration on tariffs. Specifically, **Trump has been focused on tariffing companies**, rather than countries. A significant shift.

Statute	Notable Provisions	Authorization	Presidential Powers	Constraint
U.S. Constitution	Art. I, Sec. 8; Art. II, Sec. 2	Executive orders, congressional acts, federal court rulings	Prerogative over foreign policy and national security	Weak
Trading with the Enemy Act of 1917	Section 5b	During time of war (incl. undeclared)	Regulate all commerce; freeze or seize foreign assets	Weak
Trade Expansion Act of 1962	Section 232b	Imports found to impact national security adversely	Impose tariffs or quotas to offset adverse impact	Medium
Trade Act of 1974	Sections 122, 301	Serious U.S. balance of payments deficit; foreign state's actions are unjustifiable, unreasonable, or discriminatory	Impose tariffs up to 15%, and/or import quotas, for 150 days against countries with large balance of payment surpluses	Medium
International Emergency Economic Powers Act of 1977	Section 1701, 1702	National emergency	Regulate all commerce; freeze foreign assets	Weak
NAFTA Implementation Act of 1993	Section 201; see also NAFTA Art. 2205	Maintain general level of reciprocal concessions	Proclaim return to Most Favored Nation level of tariffs; proclaim additional duties after consulting Congress	Weak

Source: Adapted from Marcus Noland et al, "Assessing Trade Agendas in the U.S. Presidential Campaign," Peterson Institute for International Economics 16-6 (September 2016).

Despite Trump's insistence that the costs of these tariffs would be borne by foreign companies and benefit U.S. consumers and manufacturers, an extensive survey of forecasters universally agree that the proposed tariffs would lower future U.S. GDP. To the extent that half of global trade is in intermediate goods, higher tariffs would effectively boost taxes on businesses and thus partially offset the earnings boost from lower taxes. Depending on various scenarios, including the retaliatory



response from other countries, the haircut to the U.S.'s GDP could range between a benign (-0.12%) to the substantial (-3.6%) (see Table 2).

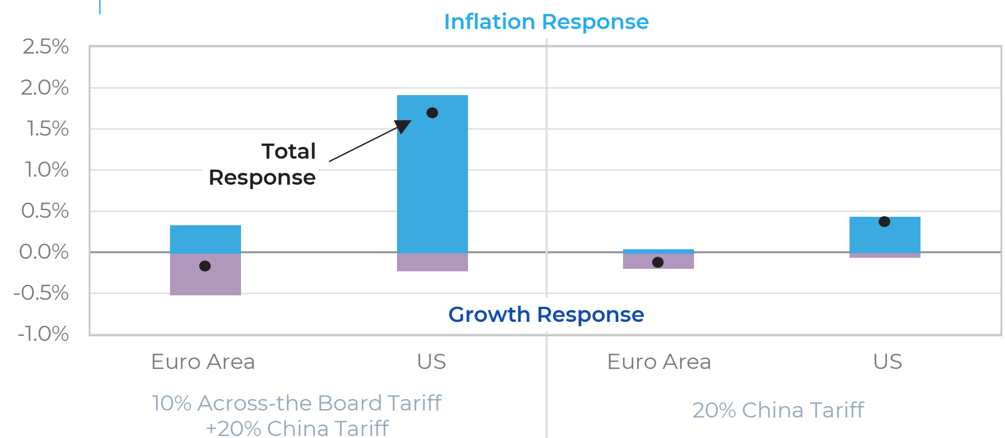
Table 2 **Leading Forecasters are Unanimous in their Assessment of the Negative Growth Effects of Trump's Tariff Proposals**

Estimator	Tariff Policy	Change in Real GDP
Tax Foundation	10% Universal	-0.5%
American Action Forum	10% Universal	-0.16% GDP; -0.31% with retaliation
UBS Wealth Management	10% Universal	Cumulative -1.0% to -1.5% over 3 years with retaliation
Peterson Institute for International Economics	10% Universal	10-year range, -0.36% (high) to -0.07% (final year); -0.88% to -0.24% with retaliation
Moody's	10% Universal	-1.04%, -2.8%, -3.45%, and -3.61% in 2025-2028, with simulated retaliation
Euromonitor	10% Universal	-0.5% in 2025, -0.9% in 2026, with retaliation (derived from growth rate projections)
IMF	10% Universal	-0.4% to -0.6%, persisting at -0.4% with retaliation
Peterson Institute for International Economics	60% China	10-year range, -0.19% (high) to -0.12% (final year); -0.43% to -0.21% with retaliation
Tax Foundation	10% Universal, 60% China	-0.8%, -1.2% with retaliation
Capital Economics	10% Universal, 60% China	Up to -1.5%
RBC	10% Universal, 60% China	-1.5% after 2 years
The Budget Lab	10% Universal, 60% China	-0.5%; -0.64% with retaliation
EY	10% Universal, 60% China	-1.18% in 2025 and -2.34% in 2026 with retaliation (derived from growth rate projections)
Tax Foundation	20% Universal, 60% China	-1.3%, -1.7% with partial retaliation
The Budget Lab	20% Universal, 60% China	-0.64%; -0.95% with retaliation
The Budget Lab	20% Universal, 60% China, Additional Mexico	-1.15%; -1.43% with retaliation
Fitch	Aggressive U.S. Tariff Scenario	-0.4% to -0.8%; up to -1.1% with retaliation

Source: Tax Foundation Review of Tom Lee, "Trump's Proposed 10 Percent Tariff: Considering the Impact"; Chief Investment Office GWM, "The Economic and Investment Implications of Higher Tariffs"; Warwick J. McKibbin, Megan, and Marcus Nolan, "The International Economic Implications of a Second Trump Presidency" Peterson Institute for International Economics; Mark Zandi, Brendan Lacerda, and Justin Begley, "The Macroeconomic Fallout of Trump's Tariff Proposals"; Aiste Bijune and Lan Ha, "US 2024 Election: Implications for the Global Economy"; International Monetary Fund, "World Economic Outlook, October 2024: A Rocky Recovery"; Paul Ashworth, "Trump's New Tariffs Would Accelerate Global Fracturing"; RBC Wealth Management, "The Economic Impacts of Non-Economic Policies"; The Budget Lab, "Fiscal, Macroeconomic, and Price Estimates of Tariffs Under Both Non-Retaliation and Retaliation Scenarios"; Lydia Boussour and Gregory Daco, "2025 and Beyond Trade Policy"; Fitch Ratings, "US-Led Tariff Hikes Under Renewed Trade War Would Reduce US/World Output."

Tariffs would inevitably lead to higher prices overall, with Goldman Sachs estimating as much as a 2% bump to inflation under the scenario of a 10% across-the-board tariff, a 20% tariff on Chinese goods, and full quid pro quo retaliation (see **Chart 1**). In both cases, European growth would be disproportionately penalized because of the continent's higher dependance on external trade with both China and the U.S. The U.S. exports less than it imports from other nations. Thus, tariffs would primarily transmit inflation through higher import costs.

Chart 1 **Estimated Effect of Tariffs on Growth and Inflation**
Effect of Higher Tariffs Rule-Implied Policy Rate Assuming Full Retaliation



Source: Goldman Sachs Global Investment Research

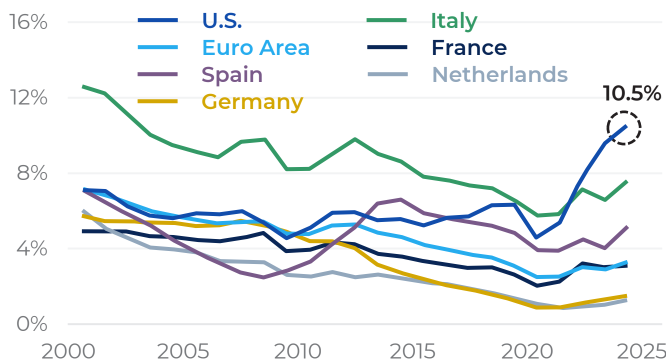
In effect, Trump's maximalist tariff strategy will ultimately be constrained by the reality of its' stagflationary impact on U.S. growth. We also believe that Trump's extreme rhetoric on tariffs is partially aimed at extracting (sometimes unrelated) concessions from trading partners. Stronger enforcement on border crosses or on reigning in Mexican cartels, for example, may fully or partially assuage the threat of tariffs on imports from Mexico. But in the interim, the U.S. economy is exposed enough to Mexico to see price rises if large tariffs are enacted both ways. The threat of tariffs on the Euro area may be assuaged by reforms to NATO and higher defense spending by European nations. But while the negotiation process plays out, elevated trade uncertainty is likely to tamp down business investment and transmit stagflation.

Deficits Are Beginning to Matter - Again

When Trump was first elected in 2016, net interest payments on federal government debt were 1.3% of GDP. By 2024, they were 3.1% of GDP. Current projections on interest payment on the U.S.'s federal debt – which unrealistically assumes the personal tax cuts in the Tax Cuts & Jobs Act (TCJA) or the "Trump tax cuts" of 2017, will be sunset at the end of 2025 – are projected to swell to 4.1% of GDP by 2034. Interest payments would thus absorb 23% of all government revenue, a level which exceeds the defense budget and is well above our European peer nations (see **Chart 2**).

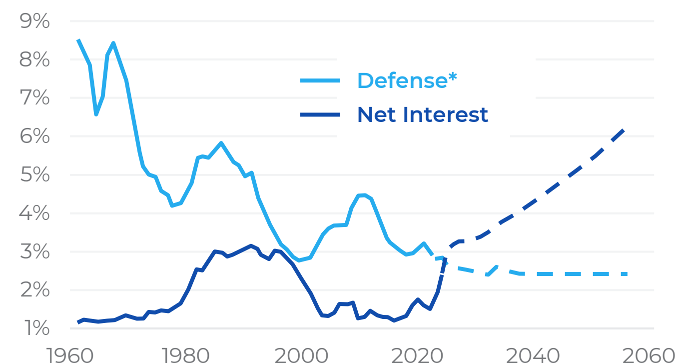
Chart 2 **U.S. Debt Expenses are Already Well Above Other Developed Economies**

General Government Net Interest Expense* as a % of Total Expenditure:



*Difference between primary budget balance and overall budget balance.
Note: Values for 2023 and 2024 are IMF forecasts.
Source: BCα Research 2024, IMF, Macrobond

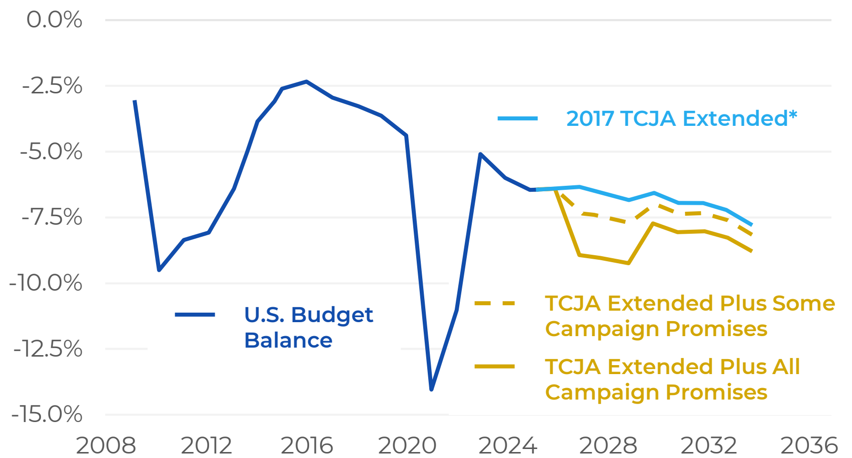
U.S. Spending as a % of GDP:



*After 2034, defense spending is assumed to be half of discretionary spending.
Note: Dotted line denotes CBO forecast.
Source: BCα Research 2024, Macrobond, Congressional Budget Office

Most reliable estimates, including those scenarios from the non-profit think tank Committee for a Responsible Federal Budget (CRFB) and the Congressional Budget Office (CBO) show all scenarios of Trump's policy plans as widening the U.S. deficit further (see Chart 3). The CRFB, which has been a non-partisan watchdog for government spending since the early 1980s, detailed the 10-year costs of various scenarios of Trump's spending and revenue raising plans (see Table 3). Clearly the most expensive of Trump's proposals would be the extension of the Tax Cut and Jobs Act (TCJA), which is set to expire at the end of 2025.Trump has said that he intends to not only extend the TCJA but end taxation on Social Security benefits and tips, as well as further lowering the corporate tax rate from 21% to 15% for domestic manufacturers.

Chart 3 **Bonds Will Act As a "Governor" On Trump's Fiscal Designs**
U.S. Budget Balance Projections as a % of GDP



*All provisions of 2017 Tax Cuts and Jobs Act Extended.
Source: BCα Research 2024, Congressional Budget Office

Table 3 **Trump's Proposed Fiscal Policies Would Increase The Budget Deficit**
Summary of Trump plan, savings/costs(-) (billions, 2026-2035)

Policy Proposals	Low	Central	High
Extend and Modify the Tax Cuts & Jobs Act (TCJA)	-$4,600	**-$5,350**	-$5,950
Exempt Overtime Income from Taxes	-$500	**-$2,000**	-$3,000
End Taxation of Social Security Benefits	-$1,200	**-$1,300**	-$1,450
Exempt Tip Income from Taxes	-$100	**-$300**	-$550
Lower Corporate Tax Rate to 15% for Domestic Manufacturers	-$150	**-$200**	-$600
Enact or Expand Other Individual and Small Business Tax Breaks	-$150	**-$200**	-$350
Strengthen and Modernize the Military	-$100	**-$400**	-$2,450
Secure the Border and Deport Unauthorized Immigrants	$0	**-$350**	-$1,000
Enact Housing Reforms, Including Credits for First-Time Homebuyers	-$100	**-$150**	-$350
Boost Support for Health Care, Long-Term Care, and Caregiving	-$50	**-$150**	-$300
Subtotal, Tax Cuts and Spending Increases	-$6,950	**-$10,400**	-$16,000
Establish a Universal Baseline Tariff and Additional Tariffs*	$4,300	**$2,700**	$2,000
Reverse Current Energy/Environment Policies and Expand Production	$750	**$700**	$550
Reduce Waste, Fraud, and Abuse	$250	**$100**	$0
End the Department of Education and Support School Choice	$200	**$200**	$0
Subtotal, Revenue Increases and Spending Reductions	$5,500	**$3,700**	$2,550
Net Interests	-$200	**-$1,050**	-$2,100
Total, Net Deficit Impact	-$1,650	**-$7,750**	-$15,550

NOTE: Figures rounded to the nearest $50 billion.
*The universal baseline tariff is assumed to be 20% in the low-cost estimate, and 10% in both the central and high-cost estimate. The Chinese tariff is assumed to be 60% in all scenarios, the high-cost estimate also incorporates revenue loss from potential dynamic effects, such as a reduction in GDP.
Source: Committee for a Responsible Federal Budget.

When confronted with the deficit widening impact of his fiscal proposals during the campaign, Trump contended that waste reduction, spending cuts, tariff revenues, and improved economic growth generated from tax cuts and cutting "red tape" would more than compensate for the additional outlays. But as discussed below, each of these claims either face serious constraints or have a decidedly mixed track record. This is again why we believe that the new administration will be hemmed in to policies that are at the low end of the spending range.

Waste Reduction – CRFB estimates on the potential savings from waste reduction put the total potential at about $250 billion at the high end (over 10-years). The largest acknowledged source of government "waste" is Medicare/Medicaid fraud, which the Government Accounting Office and Department of Health and Human Services both estimate at around $100 billion, per year.[1] But even if we (very) generously assume that the Trump Administration and its "DOGE" "committee," are successful in cutting that waste by half, that still would only offset about 10% of the costs of extending the TCJA alone.

Spending Cuts – Trump has promised to wind down the Department of Education (whose $238 billion budget largely consists of aiding low-income students), and "drain the swamp" of government excess in Washington. The Biden Administration's Inflation Reduction Act (IRA) is another likely target. Yet government non-defense discretionary spending is only 15% of the entire budget, out of which come many popular and difficult-to-cut expenditures such as veteran's benefits, the FBI, the FAA, and federal highways (see **Chart 4**). **Given that the TCJA extension alone is estimated to cost roughly $500 Billion per year, finding offsetting spending cuts just for that tax cut would necessitate a roughly 50% cut in all non-defense discretionary spending. Such draconian cuts would be politically challenging in any scenario but especially given the narrow majorities for Republicans in both houses of Congress.**

Chart 4 | Discretionary Outlays

Billion

$1.7 Trillion

Nondefense $917B

Defense $805B

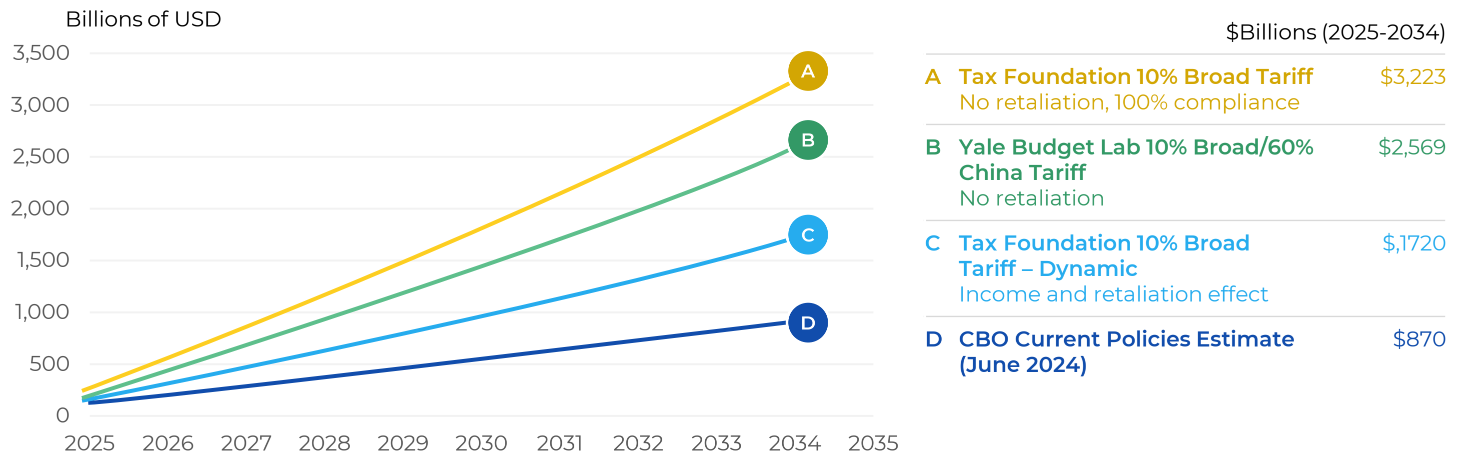
Billion	Category
$131	Certain Veterans' Benefits
$125	Education, Training, Employment, and Social Services
$115	Transportation
$100	Health
$100	Income Security
$83	International Affairs
$74	Administration of Justice
$48	Natural Resources and Environment
$41	Community and Regional Development
$41	General Science, Space, and Technology
$59	Other*

*Includes outlays for general government; administrative costs of Medicare and Social Security; agriculture; energy; and commerce and housing credit programs.

Source: Congressional Budget Office

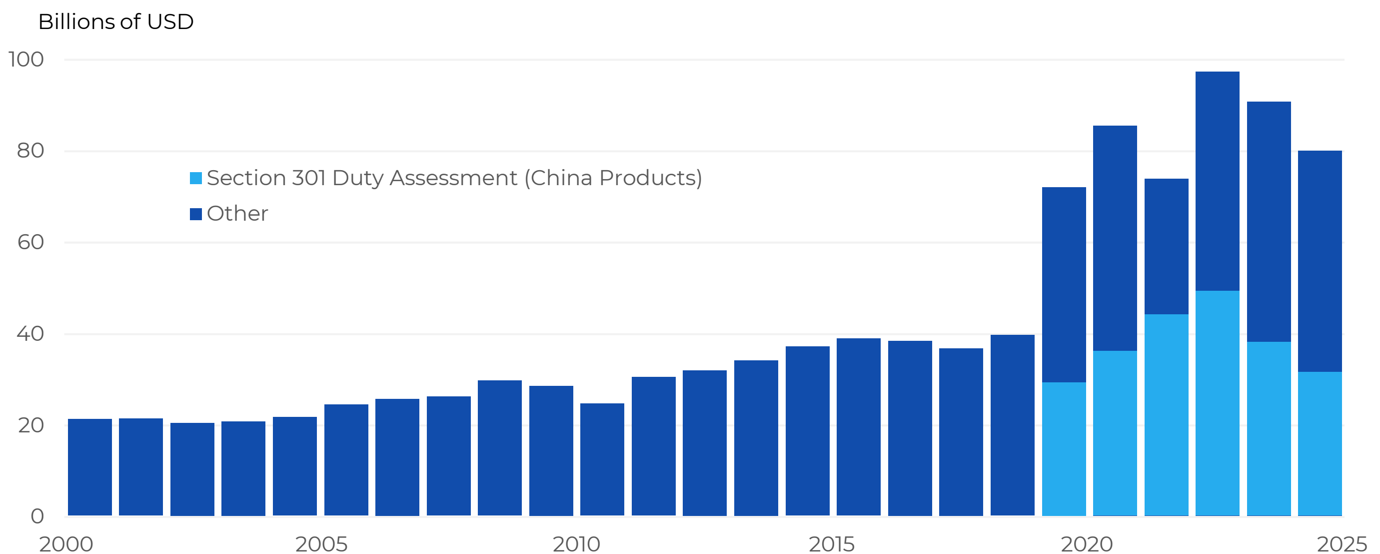
Tariff Revenues – Unlike spending efficiencies, tariffs can, on paper, go a long way to raising substantial revenues, especially given the levels of tariffs that Trump has proposed. But tariffs would only provide meaningful revenue gains if all nations and companies fully complied, and if the added tariffs do not reduce demand for imports. These robust revenue estimates also don't incorporate retaliation by affected nations or circumvention by shifting supply chains, neither of which is reasonable in today's globalized market. But one needn't speculate too much to see the marginal returns from tariffs. Additional tariff revenues from Trump's first trade war have already plateaued at a mere $40 billion per year (see **Charts 5a and 5b**), less than 10% of the projected costs of extending the TCJA.

Chart 5a | **Tariff Revenues Would be Sufficient to Cure the Fiscal Gap and Imports Adjust**
US: Cumulative Customs Duties in Various Tariff Scenarios, 2025-2034



Note: Based on fiscal year
Source: BCα Research, CBO, Tax Foundation, Yale Budget Lab

Chart 5b | **Tariff's From Trump's First Trade War Have Already Plateaued**
US Customs duties collected, 2000-2025



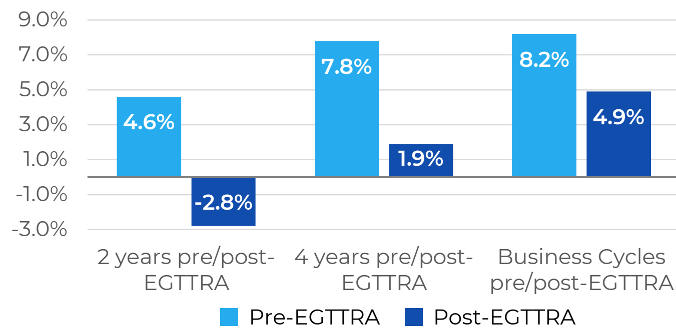
Note: Based on fiscal year
Source: BCα Research 2024, BEA, US Customs and Boarder Protection Trade statistics

Additional Tax Revenue, Due to Higher Growth from Tax Cuts

Trump has also asserted that extending the TCJA would boost growth and thus tax receipts. Without question, the years following the 2017 TCJA were good ones for the American economy in that unemployment was low and income growth was high. But correlation is not causation; and positive economic performance does not prima facie prove that supply-side tax cuts have succeeded. The post TCJA period, for example, also coincided with extraordinarily stimulative monetary policy (which resulted in low interest rates) and fiscal policy which boosted aggregate demand and consumption (as well the budget deficit) at the peak of the business cycle.

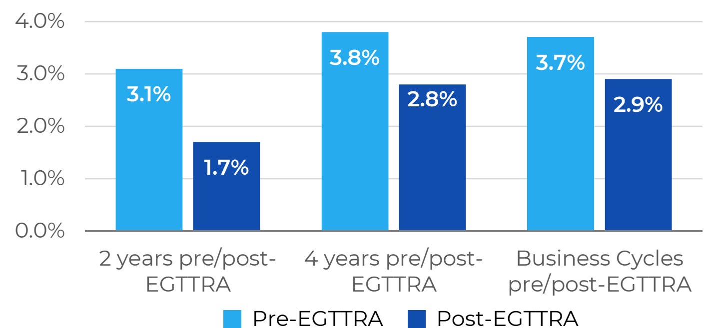
Supply-side tax cuts such as the Bush tax cuts of 2001 and 2003 and the TCJA are supposed to boost revenue-enhancing economic growth by improving incentives that in turn spur business investment. However, neither business investment nor GDP increased after the George W. Bush era tax cuts (see **Charts 6 and 7**). The pre-pandemic period that followed the TCJA also showed no sustained improvement in either GDP or business investment following its implementation in 2017-2018 (see **Charts 8, 9, and 10**). Additionally, any analysis of the TCJA's effects must separate the short-run effect of pulling forward investment from the long-run effect of raising the overall level of capital investment. For example, an analysis by American Compass showed that allowing corporations to expense the full cost of any investments made in Q4:2017 led to a 12.9% annualized growth that quarter, followed by a 7.3% growth rate in the first quarter of 2018. But what followed were two quarters of 0.7% and 0.0% growth. All told, the average growth rate in equipment investment for TCJA's first four quarters (5.2%) was little different from the prior four quarters (4.8%). In TCJA's second year, average growth in equipment investment fell to 1.7%. Had growth continued post-TCJA at the same rate as in the four quarters pre-TCJA, equipment investment at the end of 2019 would have stood at $1.30 trillion (annualized). With TCJA, it reached only $1.22 trillion.

Chart 6 | **Bush Tax Cuts and Growth in Business Investment** Avg. annual growth in gross private nonresidential fixed investment



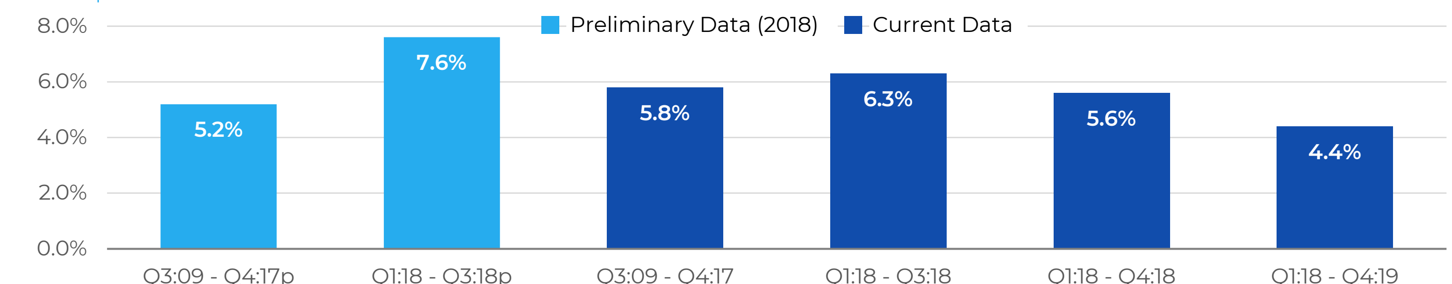
Source: Bureau of Economic Analysis
Note: Q3:2001 is the first post-EGTTRA quarter. Business cycles are Q2:1991-Q4:2000 and Q1:2002-Q3:2007.

Chart 7 | **Bush Tax Cuts and GDP Growth** Annual avg. growth rate in real GDP



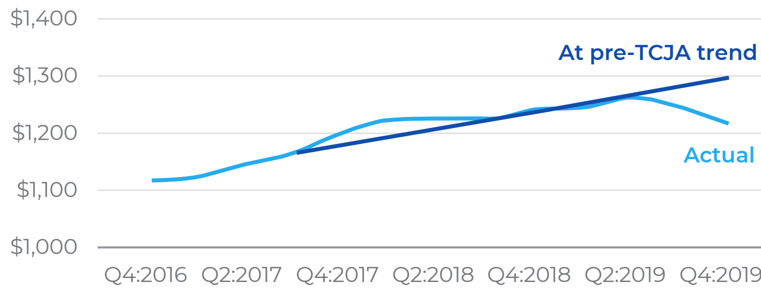
Source: Bureau of Economic Analysis
Note: Q3:2001 is the first post-EGTTRA quarter. Business cycles are Q2:1991-Q4:2000 and Q1:2002-Q3:2007.

Chart 8 | **Estimates of TCJA Impact on Business Investment** Avg. annual growth in gross private nonresidential fixed investment



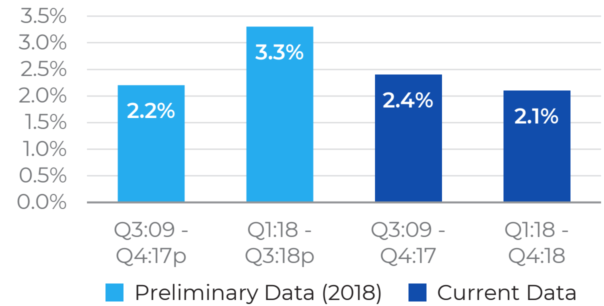
Source: Bureau of Economic Analysis; Federal Reserve Bank of St. Louis, Archival Economic Data (PNFIC1_20181221); White House Council of Economic Advisers

Chart 9 | **Long-Run Trend in Business Equipment Investment**
Gross private nonresidential fixed investment: Equipment (billions of chained 2017 dollars)



Source: Bureau of Economic Analysis; American Compass analysis
Note: Pre-TCJA trend is the average annual growth rate of 4.8% observed for Q4:2016-Q3:2017.

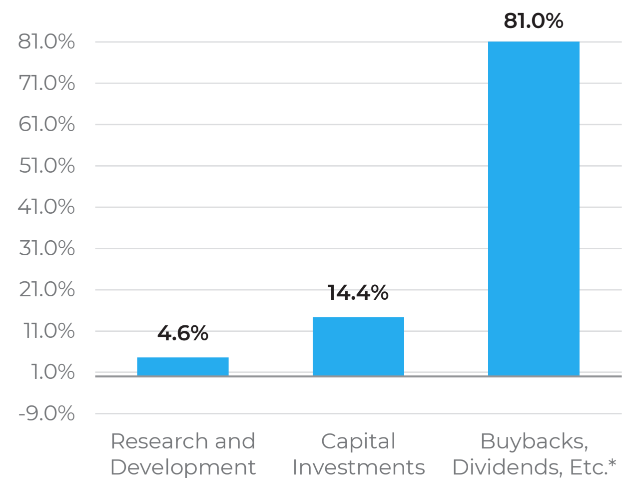
Chart 10 | **Updated Comparison of Pre- and Post-TCJA Economic Growth**
Annual avg. growth rate in real GDP



Source: Bureau of Economic Analysis; Federal Reserve Bank of St. Louis, Archival Economic Data (A191RL1Q225SBEA_20181221)

There are many reasons why business investments did not increase after the Bush and Trump tax cuts. For one, America's contemporary economic disease is different from the one that President Reagan addressed in the 1980s. The top marginal federal income tax rate is almost half the 70% rate that Reagan inherited. High-income households that pay most of the income tax roll, and thus along with corporations, disproportionately benefitted from both the Bush and Trump tax cuts, also have a low propensity to spend any windfall. For corporations, standard economic models suggest that firms will invest projects where the risk-adjusted return exceeds their cost of capital. Cutting the corporate tax rate effectively lowers the cost of capital or increases the expected return and should therefore cause more projects to go forward. But empirical data has shown that rather than investing in R&D or additional projects, many corporations have instead returned cash to shareholders through dividends and buybacks. Accordingly, as with the Bush Tax cuts, a study by the IMF found that most of the additional earnings from the TCJA went into share buybacks. Those buybacks boosted corporate earnings and turbocharged stock prices in the financial economy, but comparatively negligible expenditures on R&D or capital investment led to an equally negligible sustained boost to the real economy (see **Chart 11**).

Chart 11 | **Firms Invested Little of Extra Cash From 2017 Tax Cuts**
Firms Standard & Poor's 500 Index, 2018



*Share buybacks, dividend payouts, and other asset-liability planning and balance sheet adjustments.
Source: Emmanuel Kopp et al, "U.S. Investment Since the Taxt Cuts and Jobs Act of 2017," International Monetary Fund, May 31, 2019", CBPP.org

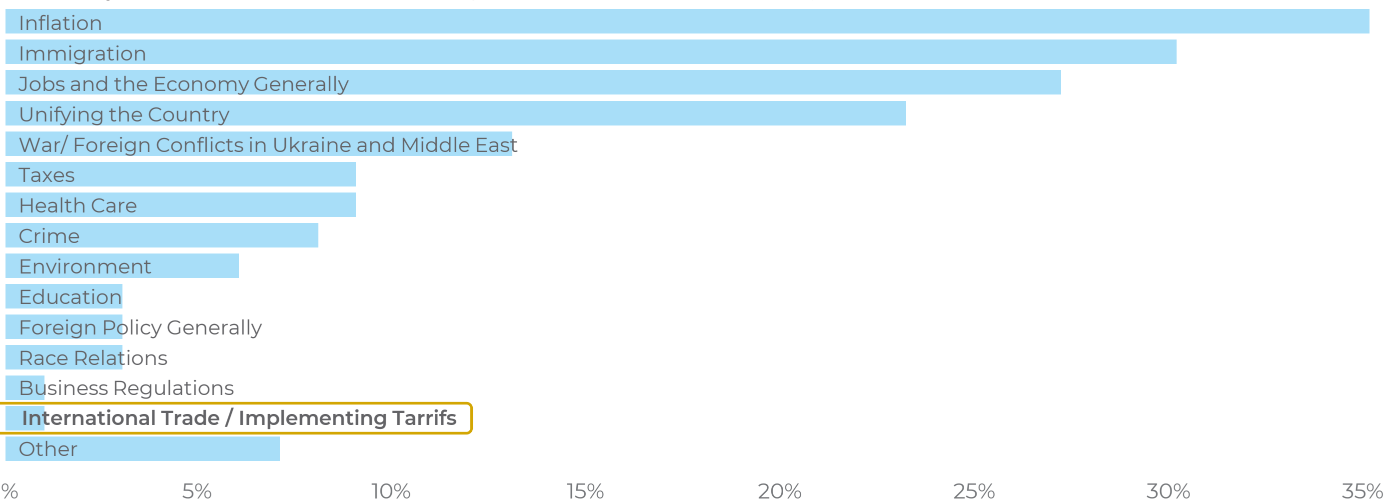
As the *Wall Street Journal's* Chief Economics commentator Greg Ip observed at the end of 2019:

> *The U.S. economy did enjoy a burst of 3% annualized growth after the tax cut first took effect at the start of 2018. But it has since slipped. It grew at a 1.9% annual rate in the third quarter. In the past 12 months, the economy grew 2%, about the same as it averaged from 2011 through 2017. This should not come as a surprise. The administration's claims rested on the belief that cutting the corporate tax rate to 21% from 35% and allowing companies to immediately write off the cost of new equipment would boost business investment and thus worker productivity and wages. Yet numerous other advanced countries had already cut their corporate rates in the prior two decades without experiencing anywhere near the growth boost the Trump administration promised. Many experienced no boost at all.*

Congress and the Bond Market Are Likely to Resist Runaway Deficit Spending

Without reliable offsets to tax cuts, Trump would need to woo an increasingly fiscally conservative Republican congress that has already shown its willingness to stand up to him (and Elon Musk) on budget issues. Though Trump may not feel so constrained by voter preferences, a still fragile congress will. Exit polls from the November election (**Chart 12**) put inflation as by far the number one issue on voters' minds. Taxes placed in the middle of their priority list, and trade/tariffs were dead last. Therefore, support for both tariffs and further reductions in corporate taxes could run afoul of the growing resistance to overreach by billionaire plutocrats from the populist wing of the MAGA base (see **Chart 13**). The prevailing mood of the electorate may thus stiffen resistance to the threat of being "primaried" by President Trump's formidable political machine.

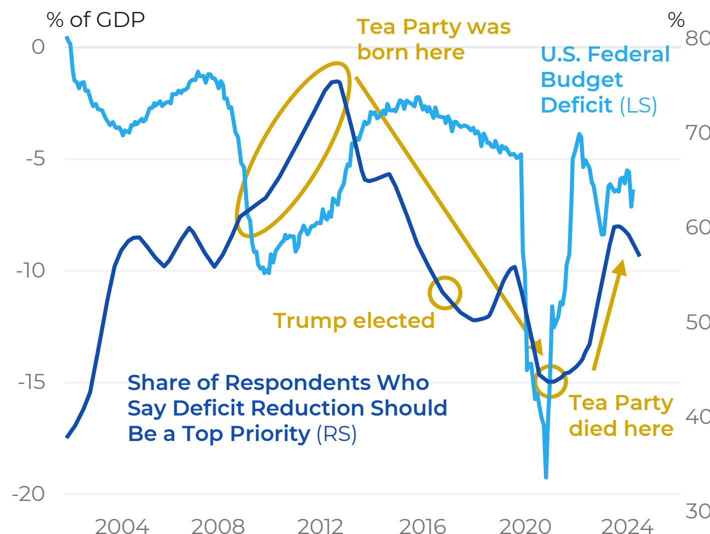
Chart 12 | **Runaway Deficit Spending May Be Reaching Its Political and Financial Limits**
What 2024 Voters Really Care About



Source: BCα Research, IPSOS Core Political Data, November 15-17, 2024

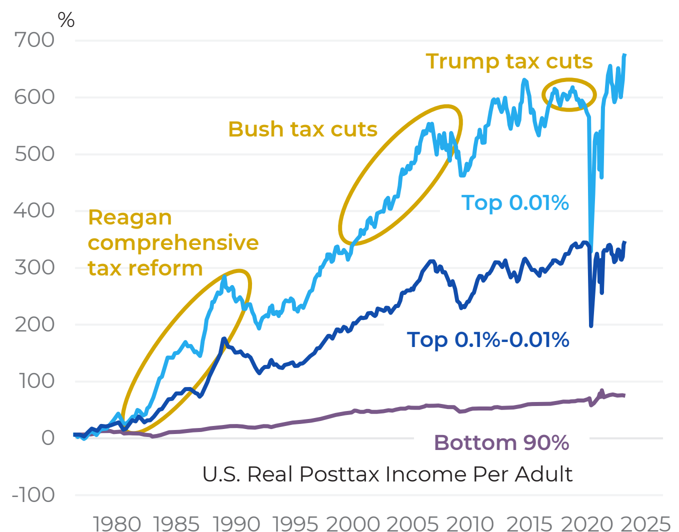
Chart 13 | **It Is Not Clear That The New Trump Coalition Will Be In Favor Of Further Corporate Tax Cuts**

Politics Can Shift... Quickly



Source: BCα Research 2024, Pew Research, BEA, U.S. Department of Treasury, Macrobond

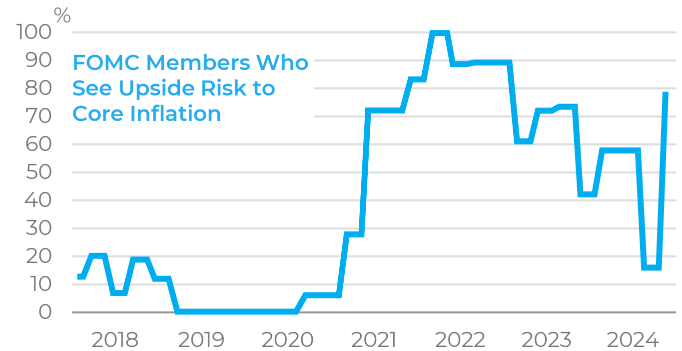
Trump's 2017 Tax Cuts Were Not as Plutocratic as Previous GOP Efforts, But Did Little to Boost Bottom 90% Income



Note: All series shown as cumulative growth from January 1976
Source: BCα Research 2024, Realtimeinequality.org

Even if Congress ignores voters' wishes and caves to Trump's maximalist fiscal platform, the bond market will not. When Trump first assumed the presidency in early 2017, the 10-year TIPS yield was close to zero and then fell into negative territory once the pandemic began. Consequently, the market simply did not care about large budget deficits. This is not the case anymore. **As previewed last December, bond investors are increasingly unwilling to underwrite further fiscal largesse without more compensation.** Thus, long-dated bond yields have moved sharply higher since the election in November, even as the Fed cut rates by 1% since September 2024, while debt delinquencies among high income households have surged. While Trump can perhaps afford to ignore such signals of stress, congressional Republicans cannot. Nor does it seem likely that a Wall Street veteran like Scott Bessent (Trump's nominee for Treasury Secretary) will run roughshod over a rioting bond market. Already, there is a sharp turn in inflation expectations at the Federal Reserve, where 80% of FOMC members now see meaningful upside risks to inflation as compared to just 20% before the election (see **Chart 14**). The double tightening of financial conditions via a falling stock market and rising bond yields will eventually weigh on economic activity. If this scenario bears out, bond yields would decline. Lower aggregate demand would prompt the Fed to cut rates more than is currently discounted (see **Chart 15**).

Chart 14 | **Fed Governors Now See Upside Risk to Inflation**

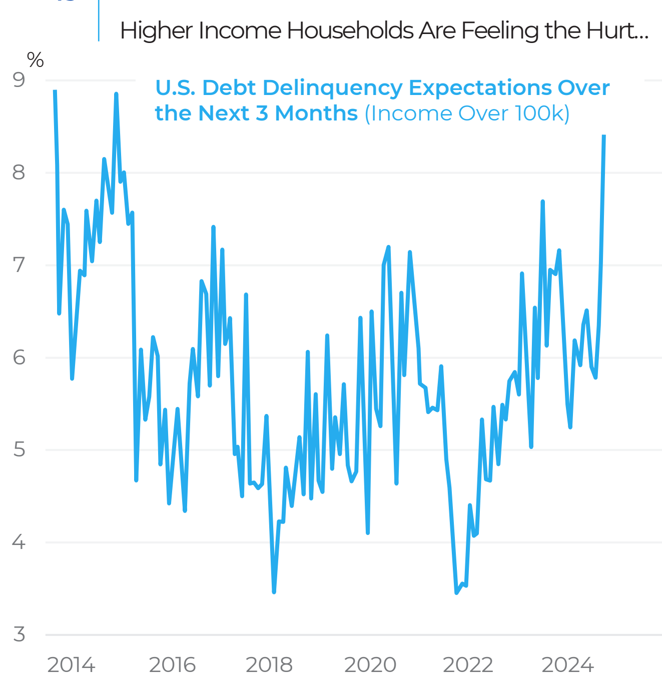


Calculated from the FOMC summary of economic projections, based on the percentage of FOMC members who expect unemployment to be higher or core PCE inflation to be lower than they are now in 12 months time.

Source: Board of Governors of the Federal Reserve System via Macrobond, ©BCαResearch 2025

Chart 15 | **Nobody Borrows at the Fed Funds Rate – High Borrowing Costs Will Eventually Cause Economic Pain**
As such, a rise in long-dated bond yields would negate all the dovish policy that the Fed has enacted.

Higher Income Households Are Feeling the Hurt...



Source: BCα Research 2024, Federal Reserve Bank of New York

...As Will the Overall Economy if Yields Don't Settle

Source: BCα Research 2024, Citi, U.S. Department of Treasury

Conclusion & Summary

Given the myriad of political, fiscal, and market constraints, our base case scenario is for a substantially watered down Trump agenda on the critical economic and fiscal issues of his campaign. His ability to deport migrants will be constrained by both fiscal and logistical realities, while tax cuts will be constrained by tepid political support from Congress and bond investors. Whereas Trump has the fewest constraints in levying tariffs, he also has the least support from voters and would eventually have to confront the reality that tariffs are inflationary for U.S. consumers. These findings underpin our forward-looking views which call for a mid-2025 slowdown caused by the combination of lower business investment due to trade policy uncertainty against the backdrop of a weakening labor market and retrenching state and local budgets (that account for 45% of government expenditures) due in part, to reduced federal transfer payments.

In 2025, we expect continued outperformance of the U.S. dollar (which historically outperforms when growth is slowing) and U.S. equities over European and Emerging Market equities. Japanese equities are less exposed to the U.S. market and unlike the U.S. Japan is one of the world's biggest creditor nations. The reason that Japan has run such large budget deficits in the past was not because the government was incapable or unwilling to raise revenue, but because every effort to tighten fiscal policy only served to worsen deflation. Moreover, the BOJ is the only developed market central bank which has not lowered interest rates, which could lead to a favorable interest rate differential during a global downturn.

Long bond yields will continue to trade in the 4% to 5% range unless a major default event or a bond market riot causes a significant risk-off event. At that point, long bond yields would return to a 3% to 4% range, credit spreads, that are already at the low end of their historical trading range, would widen, and the Fed would accelerate interest rate cuts. This would in turn provide a second wind to risk assets, such as corporate bonds, as well as small cap and value stocks.

Our asset class and sub-asset class views are summarized on **Table 4** (see pages 13 and 14). For a deeper dive on both their investment implications and proposed investment response, we have hyperlinked the outlooks provided by our team of seasoned asset class experts on the U.S. equities, U.S. fixed income, and global markets.

Table 4 | **Summary of Market Outlook Views**

Factor	Markets/Sectors and Commentary
U.S. Equities	• **Financials – Positive:** Trump's presidency will likely de-regulate the industry by watering Dodd-Frank and preventing the most stringent requirements of Basel III from materializing. Pro-growth policies and a steepening yield curve will benefit net income margins. Banks will profit from the higher receptivity to mergers and acquisitions and a resurgence of capital market activity. • **Industrials – Neutral:** The positive effects of Trump's protectionism and reshoring will benefit Industrials. However, these benefits may be offset by higher costs of materials. • **Energy – Neutral:** Energy production will be poised to grow. However, an increase in drilling will lead to lower energy prices, which will be detrimental to sector profits given the backdrop of weak global demand. • **Materials – Positive:** This sector will benefit from a push to reshoring US industry alongside the deregulation. • **Utilities – Positive:** This sector will benefit from the Republicans' deregulatory agenda that covers building out more power-generation capabilities to secure and advance the AI lead. Emergency powers can be invoked to waive a lot of environmental regulations to allow for the building of new nuclear and other electrical generation capacity to power the big data centers for advanced AI models. • **Technology/AI – Somewhat Positive:** Big Tech will benefit from the incoming administration's lighter touch on antitrust enforcement, which will spur a wave of acquisitions in the AI space. However, the Trump Administration is likely to impose new controls on chip exports to China, which would become a headwind for the entire industry. • **The Auto Industry – Neutral:** may benefit from Trump's protectionist policies; but this will be offset by higher input costs (tariffs on steel). Trump's tariffs will *hurt retailers* because of their import exposures and inability to pass on cost increases to customers.
Style	Value outperforms Growth when interest rates are rising or the yield curve is steepening, as long as that happens in anticipation of more economic growth. The value sector's composition is also favorable for benefiting from Trump's policies, as it is overweight Financials, Materials, and Industrials. However, if interest rates remain elevated for an extended period, this beneficial effect on Value will taper off.
Capitalization	Trump's pro-growth, domestically-oriented policies, tax cuts, and deregulation, will benefit mid-smid-small caps, offsetting some of the negative effects of higher interest rates. Trump's protectionism will benefit domestic industries (at least, initially), while other countries retaliatory policies will hurt US multinationals. The dominance of the Magnificent Seven is expected to decrease. Over a multi-year horizon, a trade war will likely weigh more heavily on large-cap stocks than on small caps, particularly in Europe and Japan where smaller companies are more domestically orientated. In the near term, heightened policy uncertainty, a stronger U.S. dollar, and supply chain realignments—along with postponed capital expenditures—could disproportionately hurt non-U.S. small-cap equities.
Developed Non-U.S. Equities	Uncertainty in European equities is already high given slowing growth and trade war fears. The most likely path for European equities is negative in the near-term. Longer term, Trump's "America First" foreign policy and increased tariffs could provide a domestic political foil for nascent attempts at productivity-enhancing reforms, which could be a positive for risk assets. In Germany, for example, the Bundesbank is calling for more investment in productive capacity. Japanese equities are less directly exposed to U.S. and exports in general than Europe. In addition, there remains long-term positive trends in Japan from reflation, corporate reform, and improved investor risk tolerances. Despite that, second order effects bear watching— increased interest rate volatility could disrupt the yen carry trade—prompting a sudden unwinding of these positions and exerting upward pressure on the yen and global risk taking.
Emerging Markets	Chinese equities have minimal exposure to exports to the U.S. and are far more levered to Chinese property and consumer demand, which remains caught in a liquidity trap. Encouragingly, the December Politburo has shifted its rhetoric to reaffirm Beijing's intention to prop up the economy further in 2025. China has already adjusted to a more hostile trade environment by off-shoring production to the U.S. allies. Thus, the threatened 100% tariff on cars imported from Mexico could affect EV car companies. Mexico, Taiwan, and Korea have much more exposure to U.S. imports, but Mexican risk assets have already traded down both from the summer's election results and again since Trump's election, with the equity market losing almost a third of its value in 2024, yet only 10% of revenues in the Mexican equity market emanate from the U.S. Other leading exporters to the U.S. in Korea and Taiwan are reliant on the chip trade, and semiconductor onshoring was a Biden-led initiative that so far has appeared politically uninteresting to Trump. Thus, there are few expected direct implications to EM equities from potential Trump policies.

Continued on next page.

Table 4 | **Summary of Market Outlook Views (cont.)**

Factor	Markets/Sectors and Commentary
U.S. Dollar	The U.S. Dollar is buoyed by relative rates and US Growth vs ROW. Policy uncertainty bedevils consensus on the interplay of tariffs and the U.S. Dollar. Tariffs would impair growth in Europe and China and would likely put a floor on rates. But a "maximalist" approach could weaken the U.S. dollar and hasten diversification into currency alternatives, though impaired growth in Europe and China in the short-term should continue to benefit the USD as a safe-haven currency.
Inflation	Our base case anticipates the lower end of Tariff/Mass Deportation estimates. More modest tariffs and deportation, paired with declining shelter inflation could steady inflations at around the 2.5% level. More aggressive tariffs and deportations could lift CPI back above 3%.
Interest Rates	Bond yields will be stuck in the 4-5% range but we could have a brief "Liz Truss" moment if Trump fully loads his fiscal platform and bond investors rebel. In the near-term, for example, a sharp and short-lived move higher could result from making the 2017 Tax Cuts and Jobs Act permanent. Longer-term, the impact of continued budget deficits along with the attendant increase in both debt/GDP and servicing the interest cost on this debt could cause the term premium to expand from the very low levels of the ZIRP era. Moreover, if tariffs and/or immigration policy ignite inflation, this could increase upward pressure on rates. Inflation protection remains valuable and real yields have room to fall. Thus, TIPs are appealing.
Curve	The long-term average for the differential between 10-year and 2-year treasury rates is roughly 38 basis points. During the Volcker era, it was inverted by as much as 200 basis points and was as steep as 280 bps in 2010 when investors expected a V-shaped recovery post Global Financial Crisis. The current level (less than 10bps) seems inadequate to compensate investors for the added risk of buying duration against a trifecta of factors that could conspire to dramatically change the rate regime and the shape of the curve.
Credit Spreads	Investment grade credit spreads are at the very low end of the historical trading range. The IG index constituents are dominated by large cap multinational companies, many of which stand to be hurt by a trade war. When we couple this with weakening credit metrics at the margin, the path for spreads is likely wider. High yield companies, by contrast, are largely mid-cap companies and have a distinctly domestic focus. From a business perspective, these are more insulated from a trade-war, but immigration constraints and increased input costs could hurt margins and thus credit metrics. Moreover, macroeconomic pressure stemming from economic policy could widen spreads across all corporate bonds.

[1] https://www.gao.gov/products/gao-24-107487#:~:text=The%20Department%20of%20Health%20and,programs%20in%20fiscal%20year%202023.

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