# MARKET PERSPECTIVE

**JANUARY, 2025**

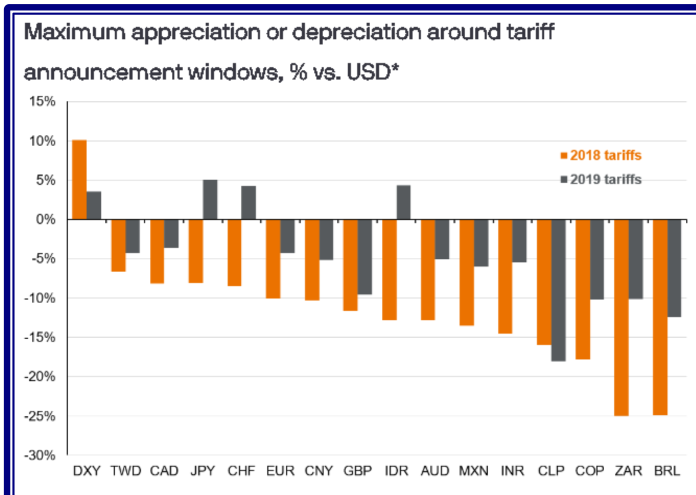
## IN FOCUS:

**The risk-on trade continues on the backs of strong economic data and a solid corporate earnings season, despite the uncertainty surrounding policies of a new administration.** The promise of sweeping tax cuts and a reduction of regulatory hurdles that comes with a Republican-controlled congress are supporting investor confidence. But some of the policies, such as wide spread tariffs and crackdowns on immigration could run counter-productive to the goal of future growth and prosperity. A trade war following decades of globalization puts many U.S. corporations at risk of a profits squeeze. Another example is the intention to use tariff revenues to fund massive tax cuts. The administration is also pushing for lower interest rates and a weaker dollar which is inflationary in that it makes imports more expensive. Not unlike his first term, Trump is very intent on raising equity prices, so any pull back in the markets in direct response to policy moves would likely limit follow-through. Keep in mind, the economy is different today than it was during Trump 1.0 when there was slack in the economy to absorb growth without it overheating. The bond market is now more sensitive to a growing budget deficit - and yields could move higher given the new spending policy agenda. Inflationary pressures are relatively higher as well.

**The U.S. dollar rose sharply off September lows, sparked by better-than-expected economic data and a Republican election victory.** It has since retreated to $106 from its January high of $109.9 on rising budget deficit concerns and sticky inflation data. Our outlook for the U.S. dollar is for continued volatility given the uncertain direction and pace of both inflation and interest rate levels. Additionally, several of Trump's policy promises that will most likely impact on the dollar significantly have yet to be fully defined, creating uncertainty. While he has made his appeal to the Fed to lower interest rates, the independent Fed hit *pause* on lowering its key rate given sticky inflation and job market strength. Uncertainty with regards to trade policy tends to strengthen the dollar, as we witnessed during his first administration. A trade war ensued and the dollar appreciated 10%. This past week 10% tariffs were imposed on targeted exports from China. They were met with retaliatory levies targeted at goods imported from the U.S. However, a quick look back at Trump 1.0 shows us that a weaker dollar from tariffs is not guaranteed.

**President Trump has long advocated for a weaker dollar**. The current administration's view is that a weaker dollar makes the price of imported goods into the U.S. more expensive and lowers the cost of its exports, making them more competitive globally. It can be argued that the U.S. dollar is overvalued at current levels - but there are other forces at play here. Interest rates are relatively high as the Fed is yet to unwind its restrictive policy. Another factor supporting a higher dollar is the fact that it remains the world's preferred reserve currency.

**Foreign Exchange Performance During 2018 and 2019 Tariff Announcements**

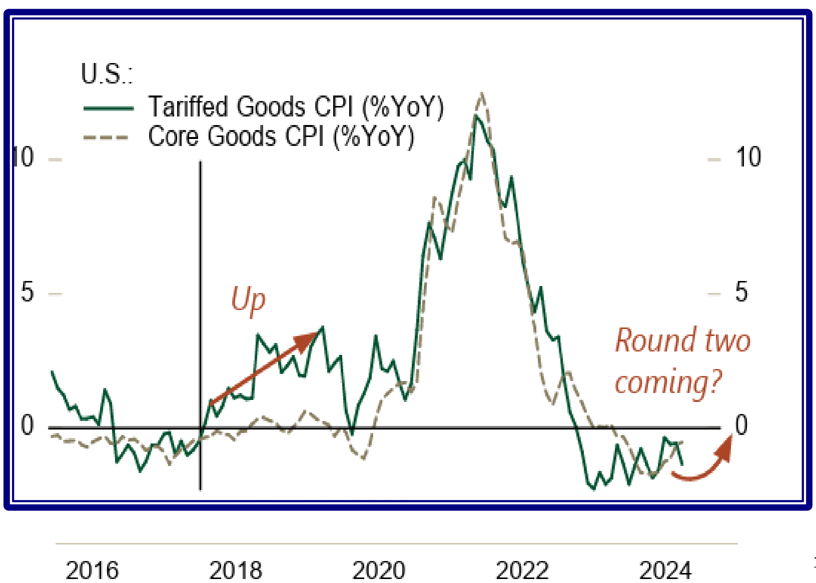



Source: FactSet, J.P. Morgan Asset Management. *Excluding DXY index which compares the USD vs. currencies of major U.S. trading partners. The columns show maximum appreciation from trough to peak or depreciation from peak to trough during the tariff announcement windows. The dates used for the tariff announcement windows are January 22, 2018 to December 1, 2018 and May 10, 2019 to December 13, 2019.

**A $4 trillion dollar tax cut agenda is adding to already existing concern over the nation's growing budget deficit.** Tax cuts when considered in isolation could boost growth by putting more money in consumer pockets. However, weakening public finances created by a subsequent swelling budget deficit puts downward pressure on the dollar. The potential for inflation to stay higher for longer alongside bloated deficits is bearish for the dollar.

**There is much debate surrounding the potential impact on inflation from higher tariffs.** Recent tariff pressures, have varied widely, from universal tariffs to country specific threats. The level of tariffs on each has also been a moving target. It is true that 25% tariffs on Mexico and Cananda have been paused for 30 days, but they are not off the table. *Capital Economics* equates the size of the tariffs on these 2 countries, which account for one third of U.S. imports, to a 10% universal tariff. They go on further to suggest that the inflationary impact from this round of tariffs as compared to ones imposed during his first term would be greater. This is because wage and inflationary pressures are greater now than they were in the late 2010s. In fact, in his first term, U.S. output was operating at a level lower than its full capacity due to weak demand which is deflationary. The market appears to be pricing in a softer version of his potential tariff rhetoric. Consumers are already dissatisfied with the current level of prices, so this leaves Trump with less room to maneuver in pursuit of his campaign promise of higher tariffs.

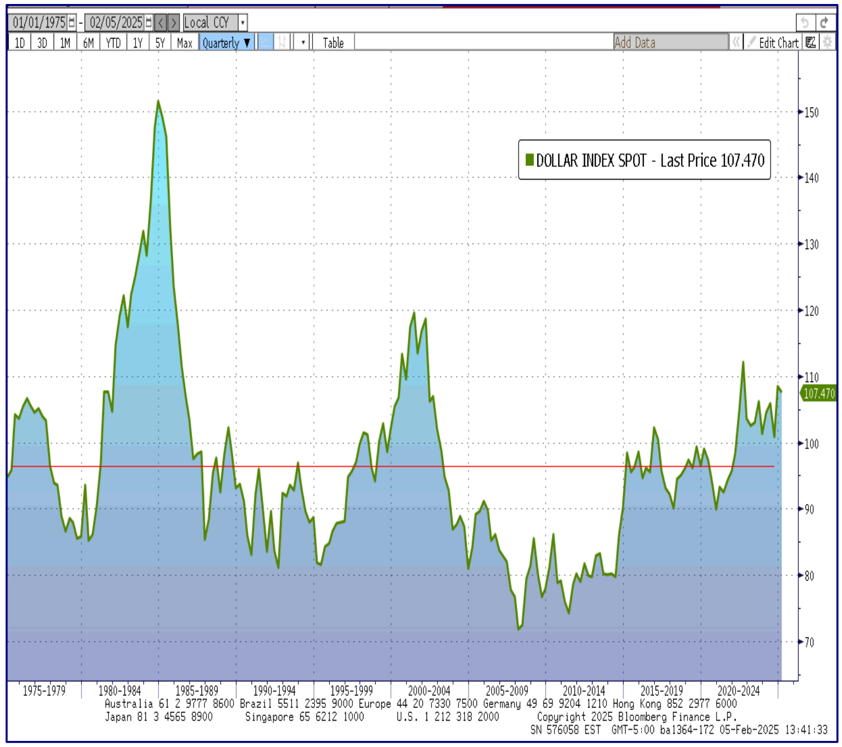
**Tariffs Triggered Inflation in Targeted U.S. Goods**




* Rebased to Feb 2018 = 100; sources: U.S. Bureau Of Labor Statistics, MRB Calculations
** Core excludes food & energy; source: U.S. Bureau of Labor Statistics
*** Current GDP relative to potential GDP; source: Congressional Budget Office
Note: Vertical line denotes tariff implementation

**The politics surrounding tariffs however are often more consequential than the actual tariffs which may only be a tool for negotiations.** They are often met with retaliation by the targeted country and can develop into a trade war. In fact, Canada, China, Europe, and Mexico are all on record stating their intensions to do just that. The wide scope of these proposed tariffs could cause broad-based supply chain disruptions as businesses scramble to find new suppliers. One doesn't have to go back very far in history to remember the havoc supply chain disruptions can run on price levels. The argument that tariffs encourage more domestic manufacturing and promote job growth applies more genuinely to targeted tariffs. Broader based tariffs would require an enormous amount of infrastructure build and sourcing to relocate manufacturing back into the U.S. As our trading partners retaliate, the U.S. economy is at risk of weakening growth and higher inflation. The Federal Reserve may further delay additional interest rate cuts. Without a credible strategy to reduce the Federal government deficit, investors may reconsider the outlook for the greenback in coming months.

**The Dollar is Elevated**




**The cost and benefit of undocumented immigration has long been debated.** Target deportations are already underway. The current position of the America First policy has broad implications on the cost side. This includes concerns over spending levels required for undocumented workers' healthcare, education, and public services. However, a study by Harvard University economic policy professor, Jason Fermen highlights the flip side that is the value these same undocumented immigrants provide in the way of labor contributions to agriculture and construction industries, unremunerated payments into social security, and stimulus to the economy. He goes on to reference preliminary findings from the National Academy of Sciences that suggest that "immigrants, including undocumented ones, he says, tend to pay more in taxes than they receive in benefits. While state and local impacts might be more mixed, the immigrants' overall federal fiscal contribution is positive."

**An additional consideration often neglected is that the composition of our labor force is not solely based upon immigration, but other factors such as an aging population and a declining birthrate.** Immigration has helped fill these gaps by absorbing jobs and paying taxes. This has worked to alleviate inflationary labor crunch pressures. The aforementioned issues can have a profound impact on our economy for decades to come. Erratic policy changes in any direction on these sensitive issues will likely exacerbate uncertainty within the economy and markets. A more measured and analytical approach to immigration policy that takes into consideration all causes and effects on our economy might be a more effective approach in managing our ever-evolving population and labor force.

**Data releases as a whole continue to support economic growth and therefore bode well for continued market strength.** U.S. economic sentiment has been much weaker than actual economic activity since the pandemic, leading to misplaced bearishness about the economic cycle among analysts. However, sentiment has improved meaningfully and is now better aligned with economic reality according to many economists compared to recent years. *Yardeni Research* highlights this point citing select sentiment gauges, which include business surveys, that show a revival in animal spirits, which, if sustained, should contribute positively to growth. To date, the Fed has been successful in harnessing inflation without causing a recession. We expect this to continue, barring any extreme policy initiatives. To reiterate a comment we made earlier, stock market strength is very important to this administration, and sharp reactions in the marketplace may limit follow-through of some initiatives.

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