MONTHLY MARKET VIEWPOINT

DANCE WHILE THE MUSIC PLAYS

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- The reaction of equity markets to the sweeping victory of the Republican Party in the recent US elections is unsurprising: strong gains for US indices premised on fiscal stimulus, deregulation, and increased mergers and acquisition activity; non-US markets lagging due to worries about tariffs and relatively weaker growth. Though there are certainly risks ahead, our view is that this positive equity index performance, in particular that of the US, will continue for the time being.

- With ECB rate cuts now fully priced into eurozone government bond yields, we are neutral on the asset class. Eurozone investment-grade credit, by contrast, still looks attractive after a reasonably good earnings season and the ongoing search for yield by investors.

Many pre-election assumptions have had to be revised following the surprisingly convincing victory by the Republican party in the recent US elections. While prediction markets had pointed to a Trump win, the margin of victory and Republicans gaining control of both parts of Congress was largely unexpected. This configuration will enable Trump to implement more of his policies.

The initial reaction of equity markets was as expected: strong gains for US indices premised on fiscal stimulus, deregulation, and increased mergers and acquisition activity; non-US markets either rising less or falling due to worries about the imposition of tariffs and relatively weaker growth. Though there are certainly risks ahead, our view is that this positive equity index performance, in particular that of the US, will continue for the time being.

The main threats investors see to this outlook are tariffs, taxes, and immigration. While much was said during the campaign, we will have to wait until there is more detail on what the Trump administration actually wants and is able to implement before we are able to assess how significant the impact will be.

This uncertainty perhaps explains why the reaction of the fixed-income market has so far been rather muted, with US 10-year Treasury yields initially gaining just 15 basis points (bp) post-election and falling back below the 4 November 2024 level since. Inflation expectations for the next year have settled about 25bp higher, but for years further out they are largely unchanged. Initially, markets priced out one of the cuts foreseen in the fed funds rate in 2025, but that has since reversed.

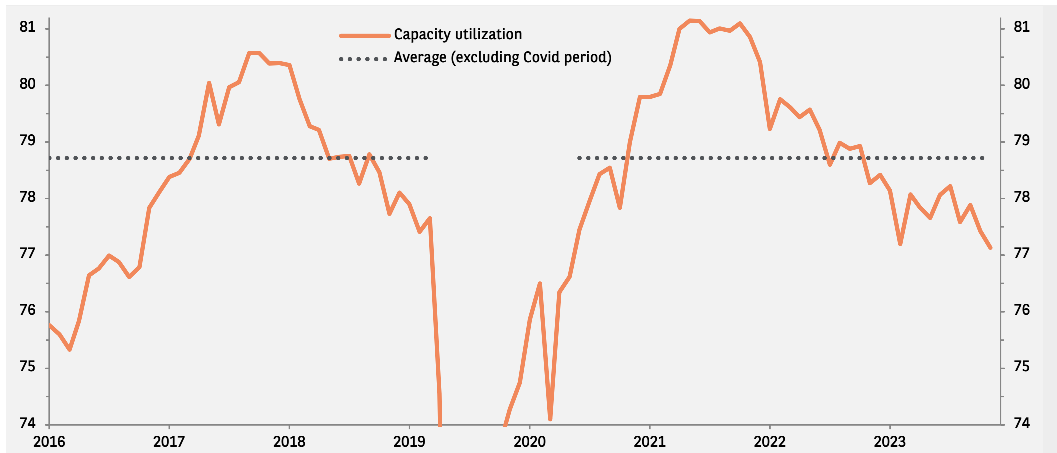
The US macroeconomic narrative has moved somewhat away from one of a 'soft landing' – where slowing growth and inflation allow the US Federal Reserve (Fed) to cut the policy rate several times next year – towards one of a 'no landing', where growth and inflation remain high and there are fewer cuts in the fed funds rate. Core personal consumption expenditures (PCE) inflation is currently 2.8%. Third quarter US GDP growth was also 2.8% (seasonally adjusted annual rate) and the fourth quarter GDPNow forecast from the Atlanta Fed is 3.3% (as at time of publication).

One of the few things investors can be certain about is that this combination of growth and inflation is unsustainable and both will have to fall. The question is how this transpires and when. One scenario is that Trump succeeds too well in his desire to spur growth in the US economy. Tax cuts would drive domestic demand from both households and businesses, while tariffs would further reorient that demand to domestic producers. The worry is that with growth already above potential, the increase in economic activity would simply drive inflation higher. The US unemployment rate is just 4.2% and restrictions on immigration and increased deportations would dampen labour supply.

Were inflation to rise, the Fed could increase policy rates – as happened after the first Trump tax cuts in 2017 – to put the brakes on growth and return inflation to target. By at least one measure, though, there may be scope for US activity to remain at current levels without pushing up inflation: capacity utilisation for the US economy is currently below average (see Exhibit 1).

Exhibit 1

The US economy may still have some spare capacity



Data as at 9 December 2024. Sources: St. Louis Federal Reserve, BNP Paribas Asset Management..

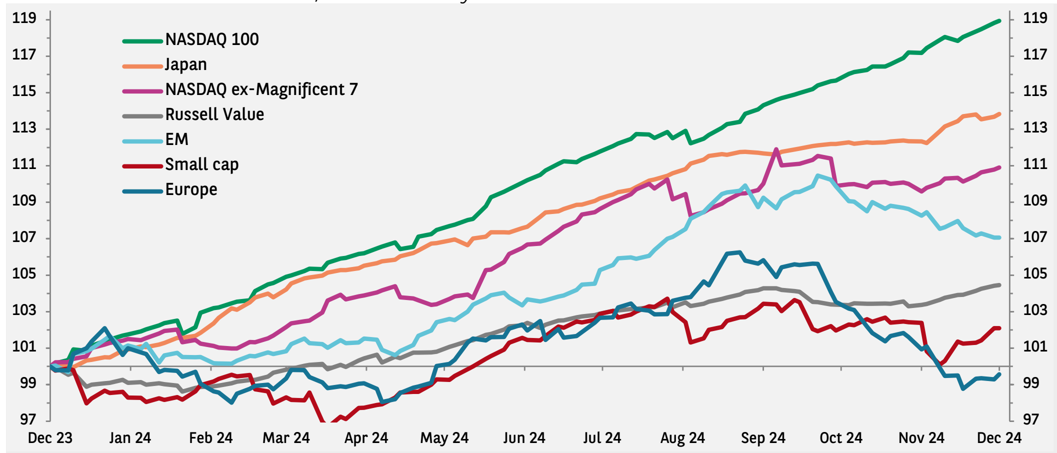
An alternative scenario is that the response of US trading partners to higher tariffs leads to a global trade war. Higher prices for imported goods would limit consumption, while US exports face tariffs from other countries. A slowdown in economic growth could come rather quickly in this scenario.

We will have to wait for Trump's inauguration on 20 January to be able to better assess which path the economy is likely to follow. For now at least, US equities are benefiting from the anticipated increase in nominal earnings stemming from economic growth and higher inflation, with few worries about the drag from tariffs. Earnings expectations had already been rising for the NADAQ 100 and have started to turn around for US small cap stocks (see Exhibit 2).

Exhibit 2

Postive earnings momentum for NASDAQ and US small cap

Next-twelve-month estimates, local currency terms



Data as at 9 December 2024. Sources: FactSet, BNP Paribas Asset Management

The fact that Treasury yields are lower now (at time of writing) than they were prior to the election has also boosted equity markets. But the modest sell-off in equities when Treasury

yields rose in November is a reminder of the risks ahead if growth accelerates and yields move back up again. Both the NASDAQ and Russell 2000 indices fell back sharply after yields rose, as one would expect given their sensitivity to interest rates, due to the 'long duration' of earnings for NASDAQ stocks, and because of higher debt levels for small caps.

A return to higher yields — bear in mind that the 10-year US Treasury was at 5% in October 2023 — would likely drag on US equity returns. Once the adjustment has taken place, however, the positive earnings outlook should reassert itself and lead to a renewed positive trend in the index level.

EUROPE

Prior to the US election, the outlook for the eurozone was already fairly gloomy. Purchasing managers' indices (PMIs) were either low (services) or sub-50 (manufacturing). Germany was anticipating a new election, making major policy decisions unlikely before next year.

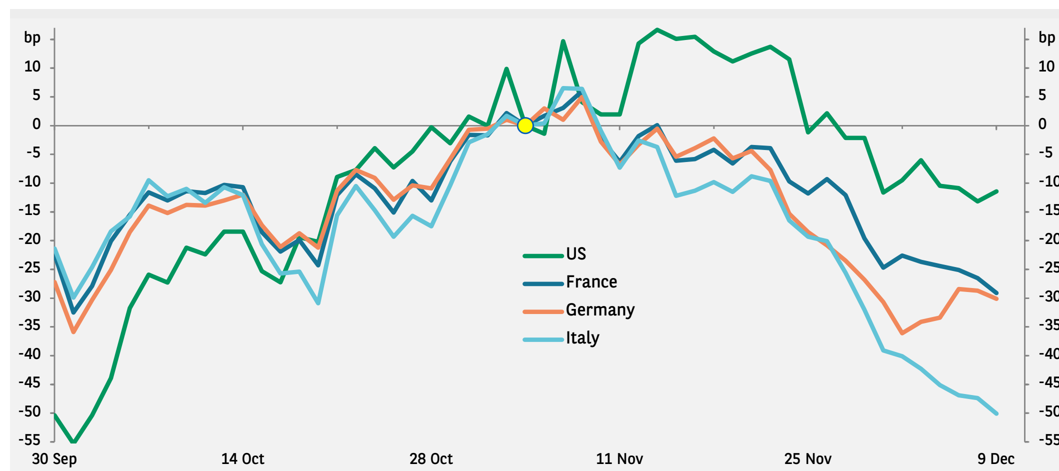
A bit more than a month on from the US elections, France is facing political turmoil and economic data points to a further deceleration in eurozone growth. November flash PMIs for both manufacturing and services were lower in every eurozone country, and in France and Italy they dropped from expansion to contraction territory.

The consequence of these developments has been a sharp rally in government bond yields (see Exhibit 3), while eurozone equities have lagged those in the US by six percentage points (MSCI USA vs. MSCI Europe at time of writing).

Exhibit 3

Negative outlook for the eurozone has been positive for the region's government bonds

Change in 10-year yield from 4 November 2024



Data as at 6 December 2024. Sources: Bloomberg, BNP Paribas Asset Management.

The greatest near-term threat to eurozone growth are US tariffs. Recent news, however, suggests that this may not come to pass, or at least not in its most extreme form. The discussions that President-elect Trump has had with Mexico and Canada suggest that he sees the threat of tariffs as a means to achieving other aims. If Europe is able to negotiate effectively with Trump, the negative impact of tariffs may be avoided, while the region's exporters would benefit from stronger US growth and a weaker euro.

MULTI ASSET CLASS VIEWS

- The Republican Party's clean sweep in the US elections came as a surprise versus market expectations, leading us to increase our exposure on US equities. They should be supported in the short to medium term by the positive impact of fiscal stimulus packages and deregulation on US growth. That said, questions are likely to emerge about the inflationary impact of these policies and their implications for the Fed's monetary policy. As valuations remain a concern, we chose to broaden our positions via additional positions on the S&P 500 Equal Weight Index, which offers a more balanced exposure to US large caps.
- Our position is neutral on euro sovereign bonds, ECB rate cuts being now fully priced into bond yields following the November rally. We maintain an overweight exposure on euro investment-grade credit after a decent European earnings season that confirmed companies' solid fundamentals. The search for yield should continue to be a support for the asset class.
- In a context of increased interest-rate volatility and a surging US dollar, we decided to take partial profit on precious metals after the strong performance year-to-date. Our positive conviction on this segment nonetheless remains intact given the medium-term outlook .