STRATOS
INVESTMENT MANAGEMENT

ELECTION RESULTS AND POTENTIAL IMPACT

COMMENTARY

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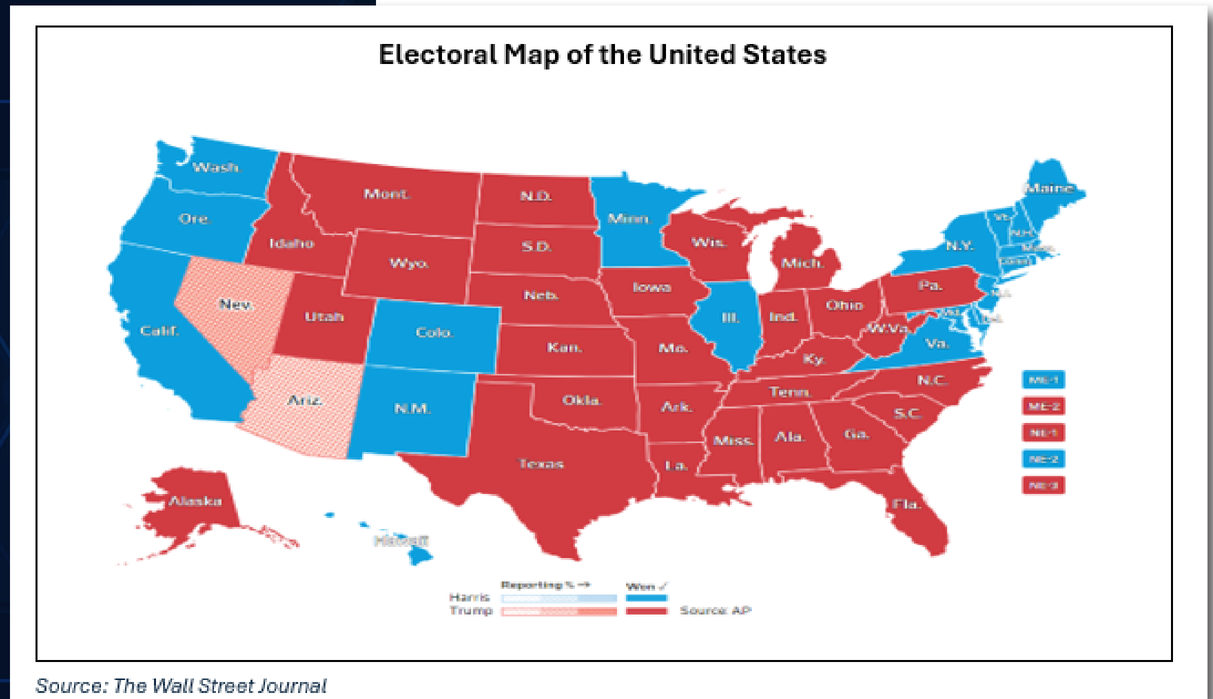
Former President Donald Trump is now President-elect Trump. The first person since Grover Cleveland to win a split term at the highest office in the land. What was surprising to many was the completeness and margin of victory as well as the broadness of his coattails.



Source: The Wall Street Journal

As this is being written, Donald Trump has 295 electoral votes to 226 for Vice President Kamala Harris, and assuming Arizona (11 electoral votes) and Nevada (6 electoral votes) hold for the former President, he will end with 322 electoral votes.

That he won seemed to be news enough, what seemed more impressive is that his coattails

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helped flip Ohio, Montana and Pennsylvania to the Republicans, giving them (so far) a very solid 53-45 advantage in the Senate with two races still too close to call. While Democrats had hoped to be able to flip enough House seats to regain their majority in the lower chamber, it appears that not many are switching hands and that the Republicans may be able to hang on in that chamber as well.

So, what does that mean for the domestic economy and economic policy?

While it is early, and President-elect Trump is finalizing his administration, here is what we are thinking:

Tax Policy – We believe that the first order of business will be to extend the tax cuts due to expire after 2025. This will include continuing the lower income tax rates established under the Tax Cuts and Jobs Act (TCJA). It should also mean maintaining the higher standard deductions, and that Congress may, at a minimum, maintain the current estate tax exemptions established under the TCJA, potentially indexing them for inflation.

More problematic (at least from a fiscal standpoint) would be getting rid of the cap on the State and Local Tax (SALT) deduction. This primarily impacts high(er) income filers who reside in high tax locales like New York and California as filers are currently limited in how much state and local taxes they can deduct against their federal income tax.

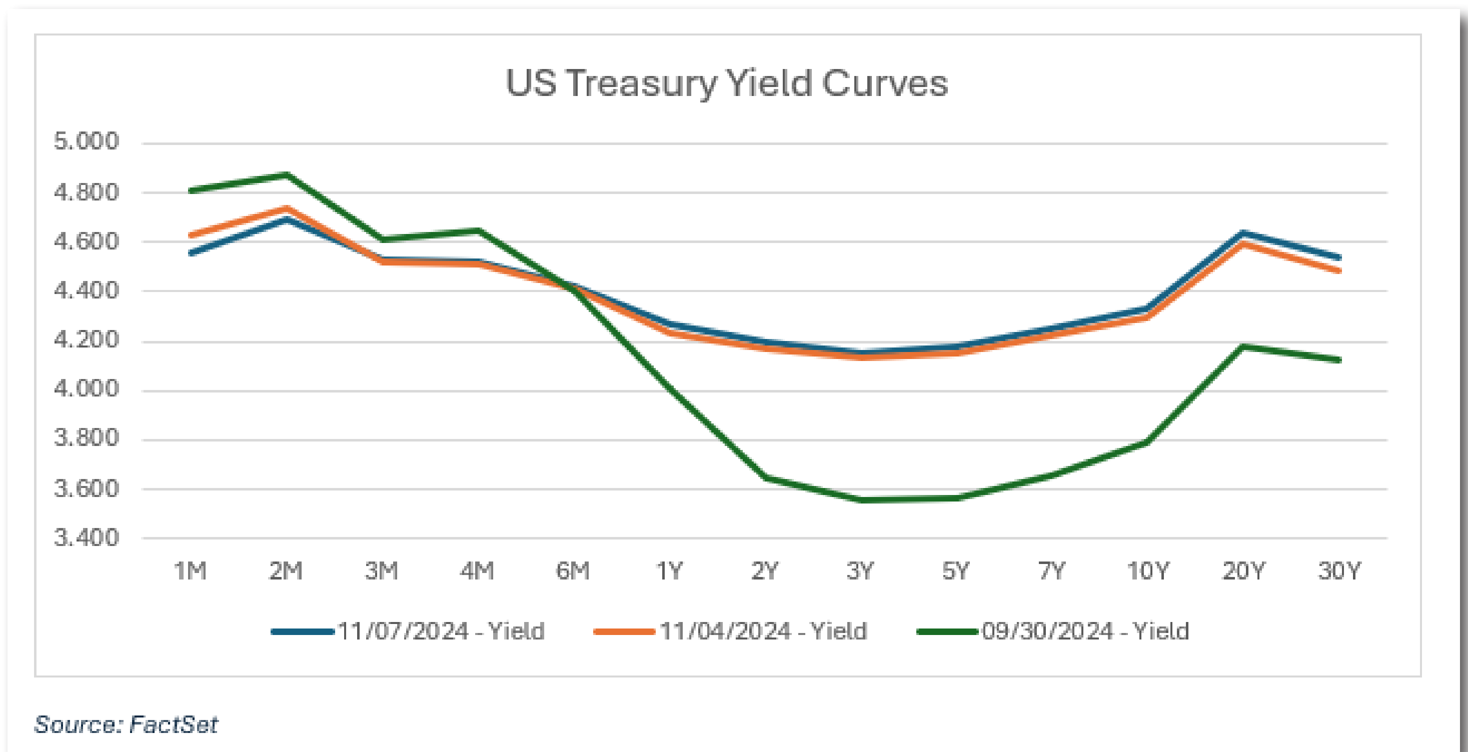
President-Elect Trump has also talked about exempting social security income, tips and overtime pay from income taxes. While they are popular ideas for certain segments of the population, these proposals create a bit of a revenue hole for a federal budget already in significant (and growing) deficit.

Tariffs are the other major tax proposal likely to happen. While he has proposed 60% tariffs on Chinese imports and as much as 20% tariffs on imports from the rest of the world, we believe that the headline number(s) are likely a bargaining chip and that rates (if enacted) may likely be lower.

We believe The dangers from the tariff proposals are two-fold. First, if we assume a 10% tariff on all non-Chinese imports, it is estimated that the core PCE deflator (Personal Consumption Expenditures – The Fed's preferred inflation gauge) would rise by 0.8%. Based on current inflation rates, this would increase core inflation to close to 3%. Secondly, and potentially the biggest danger, would be that increasing tariffs globally could kick off a global tariff war that could significantly harm global economic growth as happened prior to the Great Depression with the Smoot-Hawley tariffs. While we view that likelihood as remote, it is something to keep in mind.

Interest Rates - The Federal Reserve began the process of bringing down short-term rates at their September meeting, cutting rates by half a percentage point (50 basis points), and continued the process by cutting an additional quarter percent at its November meeting. We had discussed in a recent piece (Against the Grain: What if the Fed Doesn't Do As Much?) the potential that the Fed might not need to cut rates as much as their September Dot-Plot indicated. If tariffs get implemented causing the core PCE deflator to rise close to 3%, then the Fed might be forced to stop cutting earlier than they would (seem to) want.

We think that it is instructive to look at the change in the US Treasury yield curve from the end of the third quarter and just prior to the election. As you can see from the yield curves below, while shorter-term rates have moved down, longer-term rates have risen.



Source: FactSet

While we have been expecting the yield curve to normalize, this scenario has been one of our concerns as we believe higher longer rates have two implications for investors: 1) poor to negative returns for bond investors and 2) the potential that the Fed may feel the need to significantly slow cuts or reverse course. We believe that this could have a continued negative reaction from more than the bond market. This is because as rates rise, the discount rate for equities would rise putting downward pressure on equity values.

The economy – Equity markets initially cheered the result of the presidential election as the potential for loosening up the regulatory environment could mean increased M&A activity and, in the case of the banking industry, loosen up capital for increased lending. Indeed, if the incoming Trump administration is able to reduce the regulatory burden on businesses it could spur investment across the board. Add to that the potential for increased scrutiny on government waste and you could see government's portion of GDP go down as businesses' increases. That said, the consumer still represents more than two-thirds of economic activity and here is where things could get "interesting".

President elect Trump's proposals (outlined above) to exempt tips, overtime pay and Social Security from income tax would certainly give the consumer more income with which to spend. We believe that this has two impacts. First, exempting those sources of income from taxation would widen the federal deficit, increasing the need for the Treasury Department to issue additional debt continuing a crowding out effect that would drive up interest rates. Second, the additional income should increase consumer spending which should increase GDP growth. To the extent that GDP growth rose above its long

term “potential”, it could spur inflation which would ultimately put pressure on the Fed to increase short-term rates.

Ultimately, much of what could happen is dependent on Congress passing the incoming administration’s proposals. While Republicans have gained control of the Senate and (while the jury’s still out on the final outcome) could maintain its hold on the House, passing legislation is often far more difficult than the administration might like.
We believe that investors should approach the coming transition as they should any change. Don’t get out over your skis. In other words, don’t start investing without understanding the risks and don’t reach for performance. Hippocrates had it right: First do no harm.

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