U.S. ELECTION SPECIAL

MARKET INSIGHTS

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AMERICAN SYSTEM 2.0:

A Trump Victory—Propelling the U.S. into a New Gilded Age

As the Roman philosopher and statesman Lucius Annaeus Seneca once said: "Yield not to adversity; trust not to prosperity; keep before your eyes the full scope of Fortune's power, as if she would surely do whatever is in her power to do." This sentiment resonates as we examine the current economic landscape shaped by Donald Trump's victory in the 2024 U.S. presidential election.

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> "Let us be brave in the face of hazards. Let us not fear wrongs, or wounds, or bonds, or poverty."
>
> - Lucius Annaeus Seneca

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The New Economic Vision

We stand at a pivotal juncture as we transition from a wartime to peacetime economy. The U.S. Federal Reserve's shift towards a more proactive monetary policy aligns with the new Trump administration, introducing uncertainties that could profoundly impact risk assets. The longstanding strategy of interest rate cuts and increasing liquidity, prevalent since the late 1980s, is now under scrutiny as we enter this new era.

In the wake of Donald Trump's 2024 election victory, his team—featuring notable figures like Robert F. Kennedy Jr. and Elon Musk—aims to implement a transformative economic agenda reminiscent of the late 1800s. Dubbed "American System 2.0," this modern iteration of the historical economic framework emphasizes protectionism, government efficiency, deregulation, and tax reform, encapsulated in Trump's "America First" policies. The objective is to propel the U.S. economy into a new Gilded Age, fostering a renaissance that sets the stage for decades of economic growth and rebirth.

Supporters believe these measures will unlock economic potential and create jobs. However, critics caution that with global debt levels reaching unprecedented highs, there is considerable risk of a fiscal crisis in 2025 if unsustainable spending isn't addressed. Yet, Wall Street seems unable to recognize that a balanced approach to deregulation and deficit reduction could be the key to resolving the current fiscal crisis.

Urgency for Reform

The current debt-to-gross domestic product (GDP) ratio in the U.S. stands at 125 per cent, with a projected fiscal deficit growth of 25 per cent in 2024, underscoring the urgency for reform. Despite ongoing debates about the effectiveness of Trump’s policies, evidence suggests his prior tax cuts positively impacted various income groups. Americans earning under US$100,000 benefited from an average tax cut of 16 per cent due to the *Tax Cuts & Jobs Act*. The Congressional Budget Office noted an increased tax contribution from the top one per cent, while lower earners experienced reduced burdens. However, the potential expiration of these tax cuts in 2025 could impose an additional US$1,500 in annual taxes on families earning US$75,000, while the Child Tax Credit may be halved, significantly affecting working parents. Advocates argue that this expiration would raise middle-class taxes amidst enduring inflation, whereas critics caution about the long-term deficit implications.

The Musk Factor: Efficiency and Innovation in Government

In a bold initiative, Trump has announced plans to establish a government efficiency commission led by billionaire entrepreneur Elon Musk. This initiative aims to audit federal spending and propose reforms to eliminate waste, potentially aiding deficit reduction. Musk's appointment is noteworthy due to his leadership at innovative companies like Tesla and SpaceX, bringing a private sector mindset to government operations. Trump's reference to Musk's workforce reductions at X (formerly Twitter) highlights his ability to streamline processes and cut costs. As we enter the "age of efficiency," restructuring governments for greater efficiency becomes a key aspect of our evolutionary journey. The implications for deficit reduction are significant, promising profound changes in how we manage public resources.

The commission would be tasked with the ambitious goal of saving "trillions of dollars" by identifying and eliminating fraud and improper payments within six months of its formation. Trump has highlighted that fraud and improper payments cost taxpayers hundreds of billions of dollars in 2022 alone. This focus on efficiency aligns with Trump’s broader economic strategy, which emphasizes reducing regulations and lowering corporate taxes. Musk has expressed his willingness to undertake this role, stating on his social media platform X, "I look forward to serving America if the opportunity arises. No pay, no title, no recognition is needed." This altruistic stance resonates with Trump supporters, who view it as a commitment to public service.

The alliance between Trump and Musk could herald innovative solutions to longstanding governmental inefficiencies and address pressing concerns surrounding the deficit.

Global Economic Challenges and Policy Responses

The Federal Reserve faces the complex challenge of anticipating economic shifts while managing the long lags associated with monetary policy. Trump's victory may exert pressure on the central bank's independence, reminiscent of the dynamics between former President Ronald Reagan and former Federal Reserve Chair Paul Volcker. The president-elect's critiques of recent Federal Reserve policies and calls for aggressive rate cuts could create tensions between the administration's growth objectives and the central bank's mandate for price stability.

The experiences of Japan and China serve as cautionary tales, illustrating the limitations of monetary policy. Despite high debt ratios and near-zero interest rates, both countries have struggled with low inflation and sluggish growth, challenging the notion that loose monetary policies are a cure-all.

Trump's proposed tariffs, including a 60 per cent levy on Chinese goods and a 10 per cent universal tariff on all imports, promise to reshape global trade dynamics. While Japan may gain short-term advantages, the long-term outlook is less rosy, as Chinese firms may relocate production, potentially undermining Japan's benefits.

The question remains whether Trump's second term will live up to its promises. Economic studies suggest that his proposed tariffs could reduce long-run GDP by at least 0.8% and result in the loss of approximately 684,000 full-time equivalent jobs in the U.S. However, the actual implementation of these tariffs may diverge from campaign promises, and economic realities could temper their overall impact.

Trump's victory also signals a revival of his first-term energy policies, focusing on domestic oil production. His "Drill Baby Drill" approach may boost supply and potentially lower oil prices, with some analysts forecasting West Texas Intermediate (WTI) crude could fall to US$50 per barrel by 2025. This bearish outlook is driven by anticipated oversupply across the Americas, combined with sluggish demand growth, especially from China.

The Path to Pre-GFC Interest Rates: A Post-Election Perspective

Deregulation and the Banking Sector

Achieving interest rates reminiscent of the pre-Global Financial Crisis (GFC) era hinges on one critical factor: deregulation. Under a Trump administration, the prospect of rolling back post-GFC regulations—such as raising the asset threshold for "systemically important" institutions and easing capital requirements—could empower banks to expand their lending activities and engage in more risk-taking. This shift would not just be beneficial; it is a necessary and sufficient condition for restoring the operational flexibility that characterized the pre-GFC environment. Remember my nuanced point of view—in normal times banks create money and credit, not central banks.

Implications for Monetary Policy

To transition back to pre-GFC interest rates, a transformation of the current regulatory framework is essential. The existing constraints on banks' ability to create credit must be lifted. A more permissive regulatory environment would enable banks to respond more effectively to changes in interest rates, thereby enhancing the transmission of monetary policy. By fostering greater risk-taking and financial innovation, deregulation would support higher interest rates and more dynamic market conditions. As investors position themselves for these potential changes, the emphasis on deregulation underscores its critical role in revitalizing the banking sector and achieving the desired interest rate regime.

What Should Investors Do?

The anticipation of a Trump victory sparked a rally in U.S. equities, even during the traditionally weak October period. I project that the S&P 500 could reach 6,000 by year-end, with a potential to hit 7,000 by late 2025 or early 2026, provided favourable conditions arise. Risk assets, such as gold, appear attractive, with breadth expected to expand into late 2024 before contracting in mid to late 2025.

Transitioning to a peacetime economy under Trump's economic policies presents both challenges and opportunities for investors. While the S&P 500 may achieve new highs, investors should prepare for potential volatility and shifts in market leadership. Alternative assets like gold and bitcoin may offer promising avenues, while the energy sector could face challenges from oversupply and technological advancements.

Developments in artificial intelligence (AI) have the potential to bolster the U.S. economy, possibly helping it narrowly avoid recession, although this optimism does not extend globally. With slowing growth worldwide and Saudi Arabia's efforts to defend market share affecting oil prices, investors should remain cautious regarding international exposure. Banks would likely benefit from deregulation under a Trump administration, with the potential to fix the ineffective monetary policy transmission mechanism and introduce a new interest rate regime like in the pre-GFC era. Investors should prepare now.

While Wall Street focuses on current performance, discerning investors look 18 months ahead, recognizing that global liquidity—not just corporate performance—drives market dynamics. As we enter an era of global reflation, risk assets are likely to benefit.

The pressing question remains: when will investors acknowledge the fragility of private sector growth and the uncertainty surrounding a soft landing? With inflation at target and a balanced labour market, the federal funds rate should align with a natural rate of 2.75 per cent. Given the 18-month lag in monetary policy and the prospect of fiscal austerity, a hard landing in the U.S., while not my base case, remains plausible, with interest rates potentially dipping below two per cent by mid-2026.

As we look to 2025 and beyond, investors must stay vigilant and adaptable. The intersection of a peacetime economy and Trump's economic policies creates a complex financial landscape. Success will depend on a nuanced understanding of global economic forces, monetary policy, and structural reforms. As Seneca reminds us, we must be prepared to seize the opportunities ahead. The coming years will test the resilience of our financial systems and the effectiveness of our economic strategies, rewarding those who navigate these challenges adeptly.

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