Yardeni Research

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Morning Briefing

Trump 2.0, No Recession & Interest-Rate Cuts

Check out the accompanying chart collection.

Executive Summary: The policy priorities of Trump 2.0 would likely have mixed effects on inflation, the labor market, trade, and government borrowing—Eric sorts out the investment implications. … Also: The latest economic indicators still don't suggest a recession anytime soon, and there are signs of improvement in the slumping goods-producing sector. … And: The recent stock market volatility is not indicative of a broader risk-off move by investors.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Economy I: Assessing Policy Implications of Trump 2.0. On Sunday, President Joe Biden dropped out of the presidential race and endorsed Vice President Kamala Harris as the Democratic nominee.

Nevertheless, a second presidential term for former President Donald Trump still looks likely currently. Betting markets assigned a higher probability to Trump's beating President Biden in November after their debate, then upped the odds further following the assassination attempt on the former President. According to *PredictIt*, Trump has a greater than 60% chance of returning to White House (*Fig. 1*).

For now, the financial markets are uncertain how to prepare for Trump 2.0. The addition of Senator J.D. Vance to the Republican ticket further complicates the assessment of which policies are likely to prevail. Of course, much depends on whether the congressional races deliver a Republican sweep or continued Democrat control of the Senate, but much doesn't: Tariffs and regulations are areas that a Trump/Vance administration and conservative courts would be able to direct regardless of the outcome of the congressional elections, especially since the Chevron deference doctrine has been revoked.

With that said, let's deduce what we can about where policy may head under a second

Trump term, and what it means for financial markets and the economy:

(1) *Inflation*. Trump mentioned the word "inflation" a total of 14 times during his nomination acceptance speech at the Republic National Convention, and it seemed to be his primary focus. Inflation is also the subject of the GOP 2024 platform's first chapter.

Trump naturally focused his speech on the most salient issues for voters over the past few years. The PCED measure of consumer prices is up a cumulative 18.1% since March 2020 through May 2024, with much bigger increases in the costs of numerous essentials (*Fig. 2*). The core PCED inflation rate was 2.6% y/y in May—and we think it'll hit the Fed's 2.0% target by year-end (*Fig. 3*). However, most consumers aren't comparing the prices they pay now to those they paid a year ago (as economists do) but rather to those they remember paying at the start of the pandemic.

(2) *Energy*. The GOP's primary prescription for the inflation problem is to shift the energy supply curve to the right. "Drill, baby, drill," Trump said would be a Day 1 priority for his second term. Loosened oil and gas regulation will counterbalance inflationary pressures with cheaper energy prices, weaken the dollar, and boost economic growth. That said, it's questionable how much additional supply can come online with production and net exports of US energy already around record highs.

In any event, deregulation would widen the profit margins of US energy companies. The forward profit margin of the S&P 500 Energy sector is down from its November 25, 2022 peak of 12.8% to 10.6% as of the July 19 week (*Fig. 4*).

(3) *Immigration*. If inflation is priority number one for the GOP, immigration is certainly number two. There's no doubt that efforts to seal the US-Mexico border and deport illegal immigrants who are already in the country would require more federal spending and reduce labor force growth. Both are inflationary, while the latter is a negative for GDP. Of the 11.7 million workers who have joined the labor force since April 2020, about half, or 5.9 million, are foreign-born (*Fig. 5*).

That said, many former US officials doubt that a mass deportation would even be possible from a financial or manpower standpoint, as reported by the *NYT*. Still, assuming that immigration decreases substantially, companies would seek to address the undersupply of workers by investing in technologies like automation, robotics, and artificial intelligence. That would boost productivity, put downward pressure on inflation, and support real wage growth over the long run (*Fig. 6*).

(4) *Tariffs*. Will Trump institute a 10% tariff on all imports and 60% higher tariffs on imports from China? It seems plausible. He also has spouted intentions to impose a potential “100%-200%” tariff on cars manufactured in foreign auto plants, particularly in response to China’s use of plants in Mexico to circumvent tariffs.

Will new tariffs increase inflation? Well, the Biden administration has increased a range of existing tariffs on China, and import prices are still falling (*Fig. 7*). Onshoring and increased nonresidential investment are already underway under the current administration, limiting new inflationary pressures (*Fig. 8*).

(5) *Tax cuts & fiscal policy*. The federal budget is currently on an unsustainable path (*Fig. 9*). The GOP seems worried about this issue but has yet to propose material plans to solve it. In terms of federal revenues, Trump and the GOP suggest that higher tariffs will allow for lower domestic taxes, while deregulation will spur growth and therefore revenues.

Assuming that the 2017 tax cuts are extended past their 2025 expiration date, the Congressional Budget Office estimates that the government will need to finance an additional $4 trillion to $5 trillion of spending over the next decade. Of course, trillions of dollars’ worth of additional borrowing might jack up long-term US Treasury yields, possibly triggering a debt crisis that would have to be addressed with a structural solution requiring a higher long-term path for revenues and a lower long-term trajectory for spending.

Higher tariffs would probably reduce overall trade, potentially reducing import revenue for the US government (*Fig. 10*). Trump also spoke of a “No tax on tips” policy, which would further reduce federal tax revenues. Trump and the GOP will need to find ways to cut federal spending despite their promises not to cut Medicare or Social Security.

(6) *Regulation & Vance*. Both the *The Economist* and the *WSJ* have noted vice presidential candidate J.D. Vance’s stance on regulation. He is a big supporter of antitrust legislation and Lina Khan, Biden’s head of the Federal Trade Commission.

That could challenge the potential business gains from the end of Chevron deference and looser regulation. First order, it’s bad for dealmaking and the banks who rely on it for revenues. Second order, fewer mergers and acquisitions could mean fewer and smaller economies of scale, which hurts pricing power, productivity, and profit margins. We doubt that Vance’s affinity for stricter antitrust action would erode the GOP’s longstanding pro-business orientation, however.

US Economy II: No Recession Looming. A US recession remains a no-show in the latest economic data, and we're not expecting one soon. Some pockets of the economy that have been in a slump for the past couple of years are even starting to show signs of improvement. The recent soft patch in the Citigroup Economic Surprise Index might be ending (*Fig. 11*).

Let's review some of the recent data:

(1) *Record-high CEI*. The Conference Board's Index of Coincident Indicators (CEI) rose to yet another record high in June. The four components of the CEI include: nonfarm payrolls, real personal income less government transfers, real manufacturing and trade sales, and industrial production. Because profitable companies tend to expand their payrolls, the CEI is highly correlated with S&P 500 forward earnings (*Fig. 12*).

Rising employment boosts real wages, which leads to more retail sales and thus industrial production. So increasing payrolls forms the foundation of the CEI—the y/y change of which is highly correlated with real GDP growth (*Fig. 13*). As long as payrolls continue to increase, the CEI is likely to climb to new all-time highs and real GDP will trend higher.

The Index of Leading Economic Indicators (LEI), on the other hand, has been sinking since February 2022 (*Fig. 14*). Also compiled by The Conference Board, the LEI tends to be too oriented toward the goods-producing sector, which increasingly makes up a smaller portion of the US economy.

(2) *Nascent goods recovery?* The goods-producing sector is starting to show signs that it is exiting its rolling recession and entering a recovery. Expectations for Fed interest-rate cuts are starting to shore up the more rate-sensitive sectors like manufacturing and construction. Industrial production rose to its highest level since December 2018 in June as manufacturing hours worked continued to increase (*Fig. 15*).

The Philly Fed's regional manufacturing survey also massively improved in July, with new orders, shipments, and employment all jumping to their highest levels since 2022. The average of the Philly and New York Fed's regional M-PMIs—which rose to its highest level since April 2022—are correlated with the ISM's national M-PMI (*Fig. 16*). That suggests the ISM M-PMI may rise above 50.0 in July.

(3) *Historically low unemployment*. The rise in unemployment from 3.4% in April 2023 to 4.1% this June has many worried that a recession is near; that's because historically, small

rises in unemployment were preceded by spikes. We're not worried. The latest increase in unemployment is a function of both a growing labor force, largely thanks to record immigration, and a normalization from the pandemic shock.

Less than 1% of the labor force has transitioned from employment to unemployment, while more than 1% of unemployed workers represent new entrants to the labor force (*Fig. 17*). Both figures are historically low.

Strategy: Rate-Sensitive Rotation. Last week, the CBOE Volatility Index (VIX) popped above 16, its highest level since April. The selloff in S&P LargeCap 500 index and the concurrent rally in "SMidCaps" (i.e., the S&P MidCap 400 and S&P SmallCap 600) and interest-rate-sensitive sectors fostered higher stock market volatility. While the S&P 500 may have been overbought, we don't think this is the start of a bear market. Here's why:

(1) *Volatility*. The rise in volatility among large-cap stock indexes was unique in that both FX and Treasury volatility were subdued (*Fig. 18*). In fact, they've been mostly falling since the mini-regional banking crisis in March 2023. That suggests the broader market isn't in "risk-off" or panic mode. And it's worth noting that the VIX at 16 is well below its historical average of around 21.

(2) *Short covering.* Hedged investors who were long large-cap and short small-cap stocks or were short interest-rate-sensitive sectors—such as real estate, utilities, industrials, and materials—had to deleverage or pivot as the rotation went directly against their long-held positions (*Fig. 19*). The SG Trend Indicator showed Commodity Trading Advisers flipped its short small-cap position to net long on Friday.

(3) *Havens*. If a bear market were kicking off, we'd expect safe-haven investment inflows to boost the dollar. Meanwhile, the DXY is down 1.4% in the last month (*Fig. 20*).

Calendars

US: Tues: Existing Home Sales 4.00mu; Richmond Fed Manufacturing Index -7; API Weekly Crude Oil Inventories. **Wed:** New Home Sales 643k; MBA Mortgage Applications; Goods Trade Balance -$98.0b; Wholesale Inventories 0.5%; M-PMI & NM-PMI Flash Estimates 51.5/54.5; Atlanta Fed GDPNow 2.7%; Crude Oil Inventories & Gasoline Production; Logan; Bowman. (FXStreet estimates)

Global: **Tues:** Eurozone Consumer Confidence -13.2; Eurogroup Meetings; Lane. **Wed:** Eurozone, Germany, and France M-PMI Flash Estimates 46.0/44.1/45.7; Eurozone, Germany, and France NM-PMI Flash Estimates 52.9/53.3/49.7; Germany Gfk Consumer Climate -21.1; UK M-PMI & NM-PMI Flash Estimates 51.1/52.5; BoC Rate Decision 4.50%; Eurogroup Meetings; De Guindos. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in 12 of the past 14 weeks. LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 29 straight weeks and in 40 of the 45 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's rose 0.1% w/w and is just 2.1% below its record high in early June 2022. SmallCap's rose 0.2% w/w, but is still 9.8% below its mid-June 2022 record. Through the week ending July 19, LargeCap's forward earnings has soared 16.4% from its 54-week low during the week of February 1, 2023; MidCap's is 6.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.3% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.9%, 14.5%), MidCap (1.6, 17.4), and SmallCap (-5.4, 19.5).

S&P 500/400/600 Valuation (*link*): Valuations were mixed during the July 19 week for these three indexes, but remain near their recent two-year highs. LargeCap's forward P/E fell 0.5pt w/w to 20.9 from a 30-month high of 21.4, but is up 3.9pts from a seven-month low of 17.0 during the October 27 week. It's now up 5.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.1pt w/w to 15.4. That's down 0.6pts from a 27-month high of 16.0 at the end of March and up 3.1pts from a 12-month low of 12.3 at the end of October. It's now up 4.3pts from its 30-month low of 11.1 at the end of September 2022; these compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pts w/w to a 31-month high of 14.4. It's up 3.8pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November

2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 29% discount is up from a 24-year low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

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