"Seismic"

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"We are at the precipice of great transformation within our culture and government."
- Zachary Quinto

It is sometimes said that elections don't matter for financial markets, that outcomes are accorded a passing nod before investors return to the more pressing issues of growth, inflation, interest rates, company earnings and their impact on bond and stock markets. Not this year. The US election results handed a more decisive victory to Mr Donald Trump than opinion polling had thought possible prior to the event and in so doing rounded off a year in which 80% of world stock market capitalisation, 60% of world economic activity and 40% of the global population went to the polls. In anticipation of each, incumbent administrations loosened fiscal policy while central banks cut interest rates (153 times the world over including in the UK, China, Euro Area and Canada, but not Japan) in an effort to maintain full employment and maintain the status quo. Policies have boosted many of the Western world's stock markets and seen precious metal prices surge, but they failed to achieve their political objectives. The Financial Times confirms that in each case the ruling administration lost share of the vote and in many cases, including both the UK and United States, power too, as electorates, angered by persistent inflation and the rising cost of living, punished policymakers in favour of populists.

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Mr Trump's victory, coupled with confirmation that the Congressional legislature will be under Republican Party control, has had far-reaching consequences as investors have been forced to assess the potential implications of a seismic shift in likely policy priorities. Just as in 2016 when Mr Trump won his first term in the White House, the reaction has been strongest in the currency markets. The US dollar has surged on the foreign exchanges in anticipation both of policies aimed at putting America first (tax cuts and a reduction in business-related red tape) and in anticipation of the expected imposition of trade tariffs on goods imported from overseas.

Unlike the 2016 experience, this time round the Chinese yuan and euro have been hit the hardest as investors have been quick to try and assess the adverse impact of policy on those countries with substantial trade links with the US. Sterling has escaped comparatively unscathed, a slight weakening against the dollar reflecting the assumption that the imposition of a 10% trade tariff would impact only on those sectors (mainly pharmaceuticals, automotives and power generation) in which the UK trades heavily with the US. Goods exports to the US account for just 2.3% of UK GDP, notably lower than those of Germany and Italy, but services exports are around twice the size and thought likely to be exempted.

Despite this, might the Labour administration decide to retaliate by imposing increased tariffs of its own, as the European Union is thought likely to do? Bear in mind that back in 2018 and 2019 the UK was still legally obliged to replicate Brussels' position. But once the Brexit transition period concluded in December 2020 the UK was, and is now, free to choose whether it wishes to follow the EU or forge its own agreement with the US administration. Westminster has made little secret of its desire to build a closer relationship with the EU, both in terms of economic ties and with regard to a common stance on the escalating conflict between Russia and

Ukraine. So, a tit-for-tat retaliation against the US is possible but highly selectively and likely avoiding oil and gas which collectively amount to 32% of total US imports.

Uncertainty surrounding future economic policy is just one factor, albeit an important one, lying behind the sharp drop in gilt-edged prices (and rising yields). This is a trend in place since mid-September, the result of financial markets' fears regarding the rekindling of inflationary pressures. This is in part due to the pre-announced rise in utility prices and in part in anticipation (now realised) of the inflationary consequences of measures confirmed in Chancellor Ms Rachel Reeves' Budget. Since the 30th October set-piece, inflation expectations have jumped while the markets' degree of conviction in a sharply lower base rate has diminished. While senior officials at the Bank of England have been cagey regarding the chances of a further rate cut next month, market pricing points to a still high degree of confidence that rate-setters will be able to keep upward price pressures in check over time. Also that the base rate should still fall as 2025 progresses but on a more gradual trajectory than had previously been thought likely.

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The rise in government bond yields is far from unique to the UK. The distinct shift away from the easy fiscal, tight monetary policy of the past to the easy fiscal and easy monetary policy of the present has caused stock markets to soar particularly, but not exclusively, in the US. There was no global recession this year, as some had feared, a soft landing evolving as the dominant macroeconomic narrative. Investors have had no cause to abandon their hesitation towards the government bond market given a widespread deterioration in public finances. They've also seen no reason to rotate away from stocks and corporate credit, the beneficiaries of policy aimed at delivering economic reflation going forward.

If investors have been wary of government bond markets it is nothing compared to the strong anywhere but China theme apparent throughout the year and still going strong despite Beijing's periodic, but still piecemeal, efforts to galvanise domestic demand. The annual National People's Congress concluded without the bazooka stimulus that financial markets had hoped for. Undaunted, investors continue to place their faith in jam tomorrow policy easing sufficient to address the weak household consumption and solvency concerns plaguing the country's sprawling real estate and financial sectors, as well as offsetting the imposition of a possible 60% tariff on goods exported to the US.

For all the uncertainty that November has brought, investors can take comfort from the fact that the decoupling in stock market valuation and government bond yields can be explained by increasing confidence in future growth. This confidence is further reflected in notable outperformance from the more economically sensitive stock market sectors over defensive counterparts. Despite the latter's underperformance in price terms, reliable cash flows and income-generating characteristics will likely always find favour with investors seeking to reduce risk through a broadly diversified portfolio of financial assets.