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12/31/24 Focal Point: Political Volatility Can be Managed with Diversification

**Benjamin B. Wallace, CFA – Portfolio
Manager, Research Director**

The main driver of recent Federal Reserve policy has been squeezing out the COVID inflation from 2020–2022. This surge in inflation stemmed from three major factors. First, there was an acute labor shortage due to limited labor mobility in 2020–2021, accelerated retirements of baby boomers in 2020, and rolling market re-openings from 2021 to 2022 that restricted global labor flexibility. The second major driver was the shock to the supply chain as, factories were first forced to shut due to COVID restrictions, and then demand surged for goods, as spending on services (such as restaurants, travel and leisure) was limited. Finally, this supply shortage was met with a surge in demand, as the US and other governments employed various forms of fiscal stimulus to keep economies stable through periods of shutdowns.

Combining all three factors produced the images of backed up container ships off the coast of US ports and empty car dealer lots, as stimulus and stay-at-home spending caused a demand surge amidst a supply shortage. Add in the surge from oil prices in 2022, and the result was high inflation, peaking in mid-2022.

Subsequently the goods-based inflation surge has faded (goods inflation is about 0% right now), and wage growth has eased as the labor market has normalized. The recent uptick in the unemployment rate was a key deciding factor in the Fed starting rate cuts in 2024.

Why the history lesson? Because voter anger over the inflation surge, though it had passed by 2024, was a key factor in the recent election. Yet two of the major economic planks of the Trump platform run the risk of disrupting the two supply side factors mentioned above. Tariffs run the risk of disrupting the global supply chain by increasing costs of imports and/or forcing businesses to shift trading partners. Tighter restrictions on immigration, and especially deportations, would limit labor force growth and could cause wage pressures to return. Added to this are an array of fiscal stimulus proposals including tax cuts that would maintain the demand boost.

In short, a candidate elected due to voter unhappiness with inflation has policies that could re-ignite the ebbing of inflation that has been key to 2023 and 2024's soft landing. This is on both the market's and the Fed's mind entering 2025.

This is why the term "bond vigilantes" has returned to the financial press. This refers to the bond market sending a signal to lenders (in this case, the US government) that policy may need to change. Using the framework that the 10yr Tsy yield should approximate growth plus inflation, it is easy to see the 2% inflation plus 2% growth equals 4% target turn into 4.5% or even 5%, should inflation and/or growth head towards 2.5%. Or, from a simpler theoretical standpoint, if the expectation is policy will push growth and inflation higher than the market had assumed, then interest rates should rise.

Importantly, a 50 or even 100 bps shift in that expectation is manageable. Rather than trading at the low end of the recent 4.00% – 5.00% range, the 10yr might trade closer to the top. The key is the mix between growth and inflation. If the story is rising growth, with a little extra inflation, that will be manageable. Equity can manage as profit growth would balance valuation pressure from higher interest rates, while credit sensitive Fixed Income would benefit, as higher income would offset minor duration losses and credit losses would not be a concern.

On the other hand, if the cause for rising rates is driven by inflation instead of growth, stocks and credit sensitive Fixed Income would be more negatively impacted as they would experience the duration impact of higher rates and could see growth concerns pressure spreads and raise the risk of credit losses. These issues have caught the attention of bond traders, already on edge from the recent interest rate increase.

HOWEVER, as we always caution, political rhetoric is not policy. And policy is only one factor that impacts economies. The inflationary political talking points above are yet to turn into actual policy. Tariff threats made towards Canada and Mexico (accounting for 30% of US trade) are tied to border security issues and may not be enacted, even for a brief period. This would echo threats around 2018 negotiations by the first Trump administration, when NAFTA withdrawal was threatened, until the trade pact was mostly renewed as the US Mexico Canada Agreement (USMCA). On the immigration front, while deportation numbers ranging from 5 million to 20 million have been thrown around, totals in the 1 to 2 million range are more likely. And it's even conceivable that immigration reform legislation on par with proposals scuttled in 2024 could be enacted. Fiscal policy where tax cuts are balanced by lower spending and less regulation could prove beneficial, as well.

While the more extreme rhetorical scenarios present risks, more moderate outcomes are less disruptive. Until the transition from political rhetoric to policy is known, markets will be swayed by the headlines and even the Fed will have these potential impacts in the back of their mind.

Shifting expectations and uncertain outcomes create volatility in financial markets. Yet constraints, like budget deficits, the legislative process and practical limits on policy implementation limit the impact. And it remains the case that

population growth, labor force productivity, technology, and other underlying factors outside the control of policy will be the main drivers of the economy. And the economy is but one driver of the markets. That is why it is important to remember that while political uncertainty may impact volatility in 2025, the underlying trend is more stable, and thus historic market returns and economic growth across political administrations have been similar.

Looking at the markets entering 2025, fiscal policy is biased to higher rates (whether higher growth or higher inflation), reinforcing the already higher levels as interest rates seem to be normalizing. Equity valuations, especially in the concentrated S&P 500, are above normal. Both higher rates and higher uncertainty are more of a risk when equity valuations are high.

Fortunately, *Political Volatility can be Managed with Diversification*: higher interest rates allow Fixed Income to hold up its side of the portfolio, and Equity exposure beyond the recent market winners (via SmallCap, equal weight S&P 500, or value exposures) offers lower valuations while maintaining exposure to potential economic growth benefits.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barclays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and

rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund univers