VOLATILE POLITICS… RESILIENT MARKETS

Political news has come thick and fast since November 5. The day after Republicans swept to victory in US elections, the German coalition government collapsed. As Ukraine this week marked 1000 days since Russia's invasion, President Biden gave permission for the use of long range weapons into Russian territory. Shortly afterwards, President Putin amended Russia's nuclear doctrine.

In the meantime, President-elect Trump moved swiftly to roll out names for key positions in his new Administration. Some were unsurprising, a number are controversial, and all are allies likely to prove loyal to him and to his election promises. Of interest, the President-elect has not yet settled on the candidate for Treasury Secretary – traditionally the most important economic post.

Despite the rush of political change – or maybe reflecting it – US financial markets remain resilient. The so-called Trump trade lost some ground after the early post-election surge. But heading into the Thanksgiving break, equities are up 3.3% since the election, the dollar is up 4.0% and corporate bond spreads remain compressed. Investor confidence in the US remains strong.

ALL CHANGE IN THE US

The President-elect is set to hit the ground running, with an Administration that looks very different from the outgoing one. In the economic sphere, the important position of Commerce Secretary – where details of tariff policy and export controls are decided and implemented – has gone to Howard Lutnick, CEO of Cantor Fitzgerald. He has spoken favorably of tariffs. Change is also coming to the SEC, of importance to market participants and investors. Current chair, Gary Gensler, this week announced his resignation as of January.

As we wrote just after the election, the overall economic impact of the President-elect's policy will depend on the balance between its different elements. Higher tariffs and mass deportations will raise prices over time, directly and indirectly through reducing productivity and labor supply. Tax cuts may also put pressure on inflation and lead to higher interest rates than otherwise, as the bond market has anticipated. In the near-term, however, any inflationary impact is likely to be muted. And a boost to growth from lower taxes and deregulatory moves, in particular in the energy sphere, may come at an opportune time. The Federal Reserve has managed a soft landing and has begun to cut interest rates. But policy is still restrictive, and the economy is slowing gradually from its post-pandemic spurt.

FED STILL ON TRACK?

After last week's 25 basis point cut in rates, the Federal Reserve has time to assess economic data before it next meets on December 17/18. That is lucky. After the central bank shifted its focus towards the employment side of its dual mandate, the jobs picture became murky in October due to the impact of floods and strikes. And inflation ticked up slightly above expectations. Next week's data for the Fed's preferred PCE measure of inflation may clarify the inflation picture.

The labor market is showing signs of cooling. Although unemployment remains low – employers are reluctant to let workers go – hiring is also slowing. One indication is that quit rates have come down, suggesting that those with jobs are also reluctant to leave. If the November labor reports, due just after Thanksgiving, confirm that picture, the Fed would have a green light to continue cutting, provided that November consumer price inflation is on track. But Chair Jerome Powell and colleagues may decide to hold fire, given the policy uncertainties ahead. Market pricing has moved down from 80% likelihood of a December 25 bp cut to 30/40%.

WATCHING AND WAITING

As much as Americans are wondering how the President-elect will govern and to what extent he will carry out his election promises, the rest of the world is also watching.

China has been the focus of bipartisan American criticism. China hawks look set to dominate the new Administration's foreign policy, led by the likely Secretary of State, Marco Rubio. It is China's economic and trade policy that has fueled American opposition. Here, the President-elect has laid out a clear policy – 60% across the board tariffs. Some still believe that this is an opening bid, not a likely outcome.

China remains dependent for its growth on exports, where China's share of global exports has reached to over 14%. While US imports from China have halved in the last 8 years, imports from ASEAN, Mexico, Taiwan, South Korea, India and Europe have steadily increased. This shift is partially driven by Chinese companies reorienting their production chains. China's overall trade surplus has risen significantly since the pandemic. Exports reported this week showed a significant boost in October, with total export rising by 12.7% from a year earlier. Beijing appears to be doubling down on the government's aim to become self-sufficient on key technologies and products, while also looking to encourage foreign investment and, most likely, hoping that the business interests of American firms – and individuals such as Elon Musk – will soften America's trade policy.

Stimulus announcements have so far disappointed. As RockCreek anticipated, President Xi is not willing to make the far reaching policy changes needed to shift China from export-dependence to a consumption model that could fuel domestic-led growth. Instead, China will look to strike deals with the US to head off tariff threat. This week China's Ministry of Industry and Information Technology (MIIT) has urged solar companies to prioritize sustainable growth over unnecessary expansion. This announcement follows the Ministry of Finance's recent decision to reduce the tax rebate for exports, which could represent a preemptive show of good faith for trade negotiations. China may have some success in its trade negotiation with the US. With 14% of US imports coming from China, tariffs of that kind could cost American consumers and businesses as much as $300 billion, as noted economist Olivier Blanchard pointed out this week. China will also seek to divide European import policy from that in the US.

In Europe, also an exporting region overall, there is concern that longstanding alliances and friendships will not count for much in Washington. On both defense and trade, Europeans are vulnerable. Defense and security analysts discussing the outlook this week fear that Europe cannot – and will not – shoulder the burden of defending Ukraine should the incoming President oppose further US aid. So far, US funding exceeds that of all of Europe.

On broader defense issues, the first Trump administration was often described as a "wake up call" to NATO allies that Europe must spend to provide its own security umbrella. But, as one European bemoaned, we stayed asleep. Yes, European countries have boosted defense spending. But they are nowhere near agreeing a common approach. On procurement, where an offer to spend on American-made goods may in the end soften the incoming Administration's threat to NATO, defense ministries typically prefer to spend on weapons made in their own countries. That is no way to build a unified force, as discussed at the recent Prague summit of the International Institute of Strategic Studies (IISS).

Economic as well as political concerns loom large in the defense debate, notably in Germany. The government fell because of a difference over adherence to strict spending and debt limits. A constitutional change is needed to loosen the “debt brake” put in under Angela Merkel’s finance chief, Wolfgang Schauble. Economists broadly agree that the brake is too constricting – slowing growth as well as inhibiting needed defense spending. But it is politically popular. Ahead of elections now set for February and a likely long period of coalition building thereafter, Europe’s largest economy remains unable to lead and mired in recession. Responsibility for EU trade policy lies in Brussels. Europeans fear that a new Administration in America may try to pick off countries with bilateral deals to avoid tariffs in exchange, for example, for promises to boost purchases from America.

WEAKENING CONSENSUS

Two global meetings this month have demonstrated how fractured the world has become in the approach to global problems.

In Azerbaijan, climate negotiators have battled to preserve past gains in pushing back on fossil fuel production. As RockCreek CEO Afsaneh Beschloss and Senior Advisor John Lipsky discussed this week, Baku has so far been a failure. The G20 summit a few days earlier failed to preserve this commitment or to advance climate goals more broadly. The negotiators no doubt bore in mind that the incoming US Administration would take a different approach to the energy transition. Climate skeptic and oil and gas executive Chris Wright has been selected to run the Energy Department. Looking ahead, the most important issue for US energy policy may be about how to produce and distribute sufficient electricity to power today’s rapidly increasing needs, including for AI.

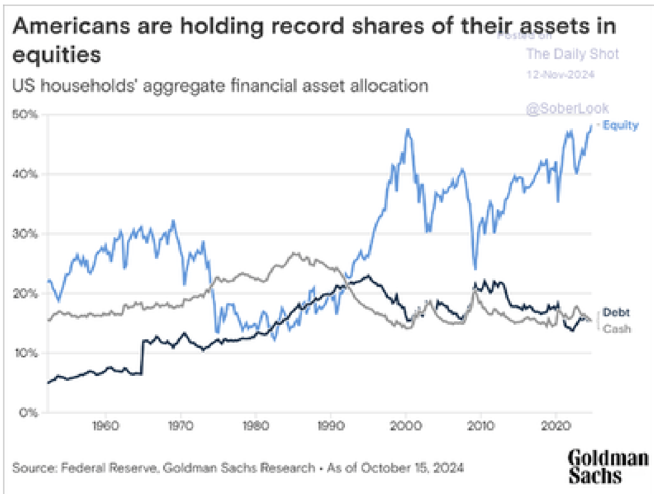
And, in another blow to Ukraine, the G20 leaders removed a sentence that had implicitly condemned Russia’s invasion.

EQUITIES

The US equity market has been on fire with the S&P 500 on track for its biggest election year gain in 88 years, up over 25%. This has been driven by a confluence of factors, but none greater than the revolutionary potential of AI and US companies’ central part in that. Nvidia’s Wednesday earnings release was perhaps the most widely anticipated event of this past week. After-hours trading immediately following the release hinted at some disappointment among investors with the highest of expectations, though Nvidia still recorded another record quarter with its profit more than doubling and reported “staggering” demand for its latest AI chip, Blackwell, which is set to debut in the coming months. With Nvidia’s stock having gained nearly 200% this year and now treading water post-earnings, it looks as though expectations may have finally caught up with the company’s foreseeable growth potential. This may be true across much of the AI ecosystem, in which case investors will want to start looking elsewhere for value.

A compelling story receiving less attention is Walmart’s impressive results and its striking contrast with Target. While the job market, inflation, tariffs, and overall health of the US consumer are all important macro topics, the dichotomy between these major retailers is a good reminder of the power of underlying fundamentals and the rich environment for active managers who do their homework. It is also a lesson outside of AI on the fruits of innovation in an evolving competitive landscape. Walmart’s 5.3% comparable sales growth for the three months ending October 25th handily beat both consensus expectations and Target’s paltry 0.3% growth rate while also raising guidance. How did it accomplish this? Walmart’s value and convenience has helped it retain its core customer base while newer initiatives like its bettergoods private-label brand have helped it attract more higher-income consumers. Meanwhile, Walmart has invested heavily to improve its e-commerce business, which grew 22% last quarter and sped up delivery times. Additional emerging growth drivers are the expanding membership of Walmart+ and the Walmart Connect advertising program which capitalizes on its expansive customer reach. Target's inability to keep pace has led to its shares falling 9.6% this year versus Walmart's impressive 73.8% rise.

It is both incredible - and worrying - how the US's dynamism is overshadowing the rest of the world. Judging by MSCI, the US is outpacing the rest of the world this year by close to 20 percentage points. Investor preference and concentration in US stocks relative to the rest of the world has perhaps never been higher. As a result, the market is very expensive, but this can remain the case for a long time. It is difficult to be outright bearish when there is so much working in the US's favor, but it is doubly as important to be disciplined, rebalance, and maintain diversification. This chart from Goldman Sachs highlights the extent to which American households have bought into equities. Such highs in 2000 and 2008 resulted in painful corrections. Whether the current momentum lasts into 2025 and beyond is anyone's guess.



DIGITAL ASSETS

One of the best performing assets following the US election has been Bitcoin. The digital token has risen more than 40% this month, bringing its YTD return to more than 130%. While some have pointed to the possibility that the cryptocurrency is reprising its role as "digital gold" to protect against a potentially inflationary environment over the next few years, Bitcoin is only one of many digital tokens experiencing record-breaking runs. This would suggest that crypto optimism is resurgent as potential clarity around regulation could reinvigorate the wider blockchain ecosystem. There is potentially good reason to be optimistic. In the most recent congressional elections, pro-crypto PAC Fairshake participated in more than sixty elections, achieving victory in over fifty of those races. This outcome, along with the passage of the FIT21 Act by the US House earlier this year, sends positive signals for potential regulatory clarity – which will hopefully enable projects to operate with more certainty. The potential applications for blockchain and digital tokens remains widespread with high-profile projects covering everything from decentralized WiFi hotspots and smart grid applications to reward programs for restaurants.

FIXED INCOME

The fixed income has held on to its post-election moves. US 10yr rates backed up by nearly 20 basis-points immediately following the election results and, despite some volatility over the last few weeks, are trading near their post-election highs of 4.45%. The same is true across the curve except for the very front-end, which has repriced following the Fed's 25 basis point cut on November 7th. This price action would suggest, particularly in contrast to the ground given up by other markets, that bond traders are taking the inflationary risks of the incoming administration's proposed policies seriously.

This concern has also led markets to reprice the likelihood of additional easing from the Federal Reserve for both the upcoming meeting and through the end of 2025. When polls closed on November 5th, short term interest rate markets were pricing an eighty percent probability that the Fed would cut rates in December – that is now less than a sixty percent chance. In addition, the year-end 2025 market-based forecast for the Fed Fund's rate is now 3.9%, up from 3.6% on the 5th. This is about 50 basis points, or two entire cuts, above the Fed's year-end 2025 median projection from the last Dot plot. Traders will be watching the newest Summary of Economic Projections closely at the Fed's December 18th meeting.

This repricing of interest rates has, as one would expect, pushed bond prices lower, with the Bloomberg US Agg falling 0.5% since the election. Broadly speaking the major subcomponents - Treasuries, Mortgage-Backed Securities, and Investment Grade Credit (IG) - have fallen in-line with each other over this period. Within IG, however, there has been a significant amount of dispersion, with the highest rated issues falling the most (-1.4%) and the lowest rated BBB's outperforming AAA by approximately one percentage point. What's more, the performance of high-yield bonds (not included in the US Agg) have generated positive returns over the same period. Indeed, some of this performance discrepancy is attributable to higher quality names tending to be longer duration in nature, but interest rate sensitivity doesn't tell the whole story. Spreads have continued to tighten on corporate credit, with the lowest quality names seeing the most contraction. CCC issues tightened by 26 basis points, while high yield tightened by almost 20 basis points on average. That compares with less than five basis points for any IG quality rating. It would seem that market optimism around the corporate operating environment and a desire to seek out the best all-in yield are pushing investors out the risk curve amid the ongoing central bank easing cycle.

CURRENCIES

The US Dollar has continued to gain ground against most other developed market currencies. Against a backdrop of stronger economic growth and somewhat stickier inflation, the greenback has broadly appreciated against major currencies such as the euro, British pound, and Australian dollar. Other currencies, particularly the Canadian dollar and Japanese Yen, have experienced even more volatility as a result of idiosyncratic domestic factors. The Bank of Canada is expected to continue aggressively cutting interest rates, potentially cutting by 50 basis points at each of the next two meetings, which may weigh on the Loonie. The Yen has recently become more of a mixed bag. While rate differentials between the US and Japan have widened on the back of the sell-off in longer dated Treasuries, the Yen has proven resilient as a safe-haven amid escalating tensions in Ukraine.

The theme of broad dollar strength largely extends to emerging market currencies as well. East Asian FX – particularly for export-oriented economies – may see the most continued pressure. Currencies such as the Singaporean dollar, Taiwanese dollar, Thai baht, and Chinese yuan look particularly vulnerable.

COMMODITIES

Recently, Russia imposed restrictions on uranium exports to the United States, however the exact details of how this ban will be implemented remain to be seen. Nevertheless, bipartisan support for the expansion of nuclear power in the US to fuel surging demand from data centers and the creation of small modular reactors (SMRs) amidst such a potential supply disruption may create a temporary price floor for the metal.

Oil has been range bound over the last few weeks. The market seems to be having trouble digesting multiple incoming data points affecting the global supply/demand balance. Will US oil production increase under the incoming administration? If so, will that be enough to offset the effects of more stringent Iranian sanctions, which could reduce global supply by one million barrels - according to some estimates. Then there are the escalating tensions between Russia and Ukraine discussed elsewhere in this letter. It is an unclear picture at the moment for sure, but one to keep an eye on given its importance to economic growth and inflation.