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MARKET COMMENTARY

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Trump 2.0: Implications for Emerging Markets

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While Donald Trump's election victory was far from a surprise, the strength of the mandate he won was impressive. Trump captured all seven of the pivotal swing states needed for Electoral College success, the Republicans flipped the Senate and are also poised to regain control of the House of Representatives. This means Trump has the political capital to implement his policies.

What is the political background for the stunning Trump victory, what does it mean for markets, and more importantly for Emerging Markets (EM)?

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It's inflation, stupid!

On headline metrics, the US economy has been strong under President Joe Biden. The economy has been at full employment, with an unemployment rate close to 4%, and with real gross domestic product (GDP) growth averaging 2.5% during his term. Since November 2020, the S&P 500 is up 55%, 12% per annum. However, for most 'working' Americans, the higher cost of living – not soaring stocks, low unemployment, or higher wages – has defined 'Bidenomics'. Inflation, alongside cultural matters and concerns over illegal immigration, were the reasons why Trump and the Republicans swept the country. This matters tremendously for policy.

'Trump unleashed'

In an economy at full employment (and services inflation above 4.0%), the full implementation of Trump's campaign promises of massively slowing or even reversing net migration, a 10% blanket import tariff and a 60% tariff on China, would lead to lower growth and higher prices. Further tax cuts expanding the fiscal deficit would demand much more debt issuance, likely to be destabilising. Wall Street is excited about de-regulation and slashing the size of the government, but those measures are unlikely to fully compensate for the inflation and fiscal damage from the other policies. Reversing some elements of the Inflation Reduction Act (IRA) is also on the cards.

Pricing in the possibility of this scenario, last Wednesday, the five-year US Treasury yield rose 14 basis points (bps) to 4.27%, fully driven by higher break-even inflation, which increased to 2.49%. This is 44bps higher than when the odds of Trump winning started rising on 24 September. In our view, the full front-loaded 'Trump unleashed' scenario would drive yields back to their highs and strengthen the dollar. This would ultimately start breaking the most levered corners of the economy, such as small businesses and private equity. In such a scenario, EM currencies should be expected to decline against the dollar and EM equities would sell off, albeit we do expect EM currencies to outperform ex-US developed market (DM) peers and EM stocks to outperform both US and DM in general.

However, Trump often speaks in hyperbole on policy, especially in campaign trails. In reality, the 'Trump unleashed' scenario is unlikely, especially in the short term. Trump's economic team is acutely aware of the need to take disinflationary measures first, giving the US Federal Reserve (Fed) room to ease monetary policy. Trump himself has said inflation is a "country buster". Thus, in terms of sequencing, we believe 2025 will see a significant effort to reduce the size of the government, and an unwind of spending plans linked to the IRA. Of the 3.2m increase in non-farm payrolls over the past 18 months, 0.7m came from the public sector. In October, the private payroll in the US shrunk. A slowdown of government payroll growth would now have a sizeable impact on the jobs market. On the IRA, Trump said he would" rescind all unspent funds under the misnamed IRA", which averages around USD 50bn per annum in expenditure until 2030. These measures are indeed disinflationary in the short term.

In 2026, the main agenda will be renewing the Tax Cuts and Jobs Act (TCJA) and cutting corporate tax further. While these policies have led many to assume a wider fiscal deficit, this will only happen in a manner consistent with bringing the fiscal deficit towards 3% by 2028, according to Scott Bessent, the hedge fund manager advising Trump's campaign and probably the next Treasury Secretary. The plan is not for tax revenues to fall faster than government spending. The threat of tariffs will happen in parallel, starting in 2025. Higher tariffs will add some extra revenue, but will be more targeted and less disruptive than many fear, in our view. Immigration curbs, also passionately promised, would be inflationary only in the medium term, through upwards pressure on wages.

Trade wars II

Tariffs would lead to higher inflation and lower GDP growth in the US, but would be disinflationary in EM. The extent of dollar strength depends on whether countries retaliate and other factors, but the anticipation of a 'grand deal' between the US and the surplus countries (China, Germany, Japan) could curb excessive dollar buying.

For EM investors, the current backdrop is more nuanced than the last time Trump was in office. Technically and fundamentally, EM is more attractive. Foreign investor exposure to EM has significantly declined and EM external balances are in much better shape. China's export volumes were little impacted by US tariffs during and after the first trade war, simply reorienting away from the US towards Europe, Japan, and mainly EM. This time round,

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China is also standing ready to counter trade pressures with further fiscal and monetary stimulus. Unlike in 2016, Mexico does not face the threat of being dumped out of the North American Free Trade Agreement (NAFTA) after it was replaced by the new USMCA agreement during the first Trump administration.

As with during the first trade war, we think tariffs will be implemented in a targeted and staggered manner. The initial focus will be on intermediated supply chain inputs with available substitutes, rather than inelastic intermediate and consumer goods. This will have the desired political effect, while minimising the inflationary impact. Tariffs will also likely start at a low level and be wrenched up slowly, to force China, Europe, and Japan into deals to rebalance their large trade surpluses with the US. In our view, at the negotiation table, Trump will ask for trade reciprocity, national security and currency strengthening commitments.

The mechanism to strengthen currencies varies. In Japan, higher interest rates would suffice. China manages its exchange rate, but boosting sentiment to local stocks, backstop local government's public finances, the real estate sector and consumption would structurally do the trick. In Europe, the implementation of Mario Draghi's plan would boost GDP growth and allow for structurally higher neutral policy rates, underpinning a stronger Euro. Ultimately these are steps that coincide with these countries' strategic self-interests. Stronger currencies would also boost their purchasing power, which should allow for more political stability.

An elegant rebalancing

The last trade war (2017-19) with China and Europe ultimately failed to resolve the persistent US trade deficit, which is rooted in structural issues. The US invests more than it saves, creating a need for foreign capital to fund the deficit. Additionally, as the issuer of the world's reserve currency, the US must run at least some level of external deficit to supply global liquidity.

If Trump genuinely aims to balance the trade deficit, he will need to fix America's balance sheet. Bessent's goal of reducing the deficit to 3.0% of GDP by 2028 could allow for a beautiful deleveraging and an elegant rebalancing. This gradual fiscal consolidation approach would ease inflation, allowing the Fed to cut rates as US Treasury yields decline and the dollar gradually weakens. This would support a natural rebalancing of trade, and other macro conditions, including lower debt/GDP levels.

This "elegant rebalancing" is the sweet spot for EM assets. Higher US growth and lower macro imbalances would lower global financial stability risks. A weaker dollar would allow for global savings to be reallocated from US assets to the rest of the world, supporting EM asset prices and GDP growth outperformance.

The Devil is in the detail

Cutting fiscal deficits while pursuing tax cuts is a tall order. Renewing the 2017 TCJA would add an estimated USD 5.3trn to the deficit over the next decade. Lowering the corporate tax rate by even a single percentage point, as Trump has proposed, would further reduce revenue by about USD 100bn annually. Thus, cutting taxes without widening deficits and re-kindling inflation would require deep government spending cuts as well as thoughtful deregulation. The details are yet to be announced, and the degree of credibility for this policy mix will be better understood during 2025. Another massive problem is the public pension plan system. The funds supporting pension payments are likely to be depleted within the Trump administration, demanding contributions from the budget could snowball.

In 2025, US GDP is likely to slow down due to the partial unwind of the IRA, the negative impact on investment and consumption from tariffs, and with lower immigration offsetting the economic benefits from deregulation. But the devil is in the detail. Make no mistake, markets will analyse US trade and fiscal policy announcements in microscopic detail in the coming months.

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