What Trump's win means for markets and portfolios

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Allison Nathan: The markets are reacting forcefully to Donald Trump's victory in the U. S. presidential election. U.S. stocks, bond yields, and the U.S. dollar are all rising sharply in Wednesday trading, but will these moves have legs? And what medium- and longer-term market implications could this election outcome have?

I'm Allison Nathan and this is Goldman Sachs Exchanges.

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Today I'm sitting down with Christian Mueller-Glissmann, head of asset allocation research in Goldman Sachs Research, and Brian Garrett, who oversees equity execution on our cross asset sales desk in Goldman Sachs Global Banking and Markets.

Christian, Brian, welcome to the program.

Brian Garrett: Thank you very much. Glad to be here.

Allison Nathan: Yes. And Brian, you've been up since the wee hours of the morning. Christian, you were in London, so you had the benefit of the time change, but we've all been up, a lot overnight watching these markets, which as I've just said, are reacting quite strongly to Donald Trump's victory. We've seen these so-called Trump trades that we've been talking about for a long time now really taking off. So, Brian, talk us through the flows that you are seeing today and how much further you think these trades can run because they've already run quite a lot.

Brian Garrett: I think coming into today, clients were underweight risk on where they wanted to be, especially in the event of kind of the Trump potential red sweep. If we were to handicap it, clients were probably running at a five out of 10 in terms of positioning. We've seen clients engage on trades that worked following the 2016 election, which were long banks, long technology, long energy stocks. And if you look at 2016 as a playbook, the market rallied 2 percent the day after the election. And between mid-November and mid December in 2016, we rallied another 3.5%. Which, given where S&P is right now, would put us right around 6,100.

Allison Nathan: But is the 2016 playbook the right playbook because it feels very different this time around. In 2016, Trump was a big surprise, but markets were largely expecting this result if you look at prediction markets and other gauges. So, is that the right playbook because things have already been priced in to some extent?

Brian Garrett: I think to some extent is the right way to frame it. You're seeing the 10-year interest rate up 20 basis points today, roughly. And so, I agree that we're coming into 2024 at a different rate environment and equities are obviously at a different multiple. But I think that the idea of continuation of tax cuts, the idea of more beneficial M&A environment, and the idea of, you know, kind of less regulation on banks, a lot of these themes will work in 2024.

Allison Nathan: Is there anything unexpected you've seen today about the price action?

Brian Garrett: So, I mean, definitely a surprise in the renewable energy space. You've got some of these names that are down 15 to 20 percent just on the fact that we could see changes to the IRA, which would have an impact on their earnings per share and their ability to generate revenue. One of the other things that I think was pretty

surprising is the move in the VIX. The market had started to build in- this like you have election day and then you maybe have two or three days of discovery where you, you don't know the, the outcome of the election. I don't think many people had it in their playbook that we would know the next president by 11 a.m. on Wednesday. And so, you're seeing a very sharp repricing in market volatility. The two-day change in the VIX is one of the largest moves of the last decade. And so, you're seeing that extra volatility come out of the marketplace very quickly.

Allison Nathan: And Christian, if you're listening to everything that Brian's saying right now, is that what you are generally observing from your seat across the pond?

Christian Mueller-Glissmann: Yeah. I think as Brian was mentioning, the VIX decline was definitely faster anticipated. Generally, this pattern into the election's outcome, the VIX picks up a bit and then in the days after it comes time it came down much faster. And the very interesting setup as a result of that is you started a global risk on where actually European equities initially were up and then throughout the day, they started to properly diverge. And that was definitely something interesting, which in our client conversation throughout the day, people did the analysis focused on the potential impacts on growth, on tariffs on risks. And that started to take a bit longer for markets to realize. I think the other thing that's

interesting is that the price behavior has been somewhat reflationary you mentioned the 2016 episode as well. So you had like equities up, bonds down. Normally in that type of backdrop you would see global equities value a lot of those areas do better but because of the additional dimension of tariffs, geopolitical uncertainty, that didn't play out at all and related to that, normally you would see commodities do better. So you would actually see oil and possibly even copper benefit from that type of price behavior. But this time around because of the strong dollar most likely but also the linkages maybe to China, you have actually seen commodities broadly being down. So there are a few disconnects compared to the traditional reflation template.

Allison Nathan: I want to spend one more minute on the decline in the VIX that both of you all just mentioned. We've seen a sharp decline. But if we think back to Trump's first administration, of course, a key feature of it was uncertainty. We never knew what was going to happen next. And if you think about the advisors and the cabinet that Trump is likely to have around him this time around, it seems like uncertainty is going to remain a big feature of this administration. But that's not being reflected in volatility. So, why isn't that being more reflected by the markets?

Brian Garrett: So, I think the first thing is that the market remembers what the first year of the Trump presidency was post the 2016 election, every bank out there was saying that 2017 was going to be a year of volatility, similar to what you're talking about. But 2017 actually was one of the lowest realized vol calendar years in the last 60 years. What ends up happening is you have different uh agendas that go through, which creates a lot of dispersion at the index level where you can have banks and technology higher and you can have REITs and utilities lower.

So you get a lot of under the surface movement where the index can stay relatively stable. Two other things that, that I would add to it. Number one, investors are under positioned, and so one thing that creates at least a bid to volatility is when people are looking to hedge, and I don't think anybody's looking to hedge right now I actually think people are looking to add risk. And number two, there's a dynamic in the US volatility market that creates a lot of pressure on the VIX and on implied option prices in the S&P. And so I think you’re seeing a little bit of that get reflected in the market as well.

Allison Nathan: And, Christian, are we seeing those same patterns in vol in other assets and in the more macro assets, not just equities?

Christian Mueller-Glissmann: I think it's definitely been the biggest move in equities and there's been a huge amount of relief. I think equities did bake in uncertainty via skew, via vol. If you actually look at the put-call ratio It spiked into the election. So people were kind of seemingly hedging for the event and to your question. It seems like we're still having a lot of uncertainty, like the VIX is a one month type contract. So it's really the very shorter-term uncertainty that the market is pricing here, so from that perspective, I think this kind of vol reset in equities is kind of making sense. Equities have been a core asset class and focus.

What's interesting is rates volatility. I think we've seen some very large moves. Brian mentioned that in the back-end yields we've seen a steepening of a curve. Also, FX volatility, we've seen some pretty large moves. In both cases into the event, volatility actually picked up. The move index, which is the rates equivalent index of the VIX. That was actually quite elevated. It was at a year to date high going into the elections and it's coming down, but it's coming down a bit slower. And you could argue that, this kind of reflation that we're currently seeing, which to some extent for equities has been a positive story in a lot of regards. In rates markets, there's still a bit more lingering nervousness that you can see in the vol. The FX vol has also come down, but again, not as sharply as, as for the VIX, which again, reflects maybe risk on trade tariffs,

details you might get. So I think FX and rates seemingly are, seeing less of a clear reset in vol right now.

Allison Nathan: But is your view that FX and rates vol will continue to move lower into year end?

Christian Mueller-Glissmann: I think so. I think generally we're leaning towards rates volatility and having some potential to normalize the are opportunities related to that. But I can understand to your point with the uncertainty on policy being high with the appointments not being out yet, that the market will really struggle to kind off sell rates volatility, sell off FX volatility in especially the areas that are directly exposed to US policy. So I could imagine it being quite sticky, but I would also argue that there's probably a carry opportunity over the next few months to lean a bit against the rates volatility being so high. We've seen this before, I think in the last two, three years. As we know, uh, bonds have become a very difficult part of the portfolio to manage and rates volatility was unusually high, so there's a bit of a echo probably still going through people's minds and, and it might reflect positioning as well. We've seen people actually rotate into bonds quite a bit over the last few months. So we've seen significant inflows into bonds in anticipation of rate cuts. so it feels like there's a lot of reasons why you might have more hedging demand kind of keeping vol a bit elevated.

Allison Nathan: But Brian, on the equity side, you think volatility is setting up to remain low and the overall backdrop is risk on?

Brian Garrett: Totally. I think one of the things that actually will create a pickup in volatility is a rally. Given the fact that, that clients are, are underexposed, you know, what, what tends to happen, especially when you, when you start to see, you know, increases in risk like we're seeing today in the market is you start to see clients start to chase call options. And so, as the market rallies, you can actually get this kind of spot up, vol up dynamic that happens. And so, yeah, I think all else equal, you know, a grinding type rally market will be vol suppressive. But I do think that if we start to see a pickup to the upside, we'll see a chase for options.

Allison Nathan: Right. So people are going to try to capture more of that upside through optionality.

Brian Garrett: 100%.

Allison Nathan: But ultimately, if we hear what Christian just said, there is nervousness on the bond market side. Many of the economic policies that Trump intends to pursue, seems to want to pursue, are likely going to be inflationary. At least that's our economists' assessment and

many economists' assessment. And so, more concern about higher bond yields. Christian, any thoughts about, you know, concerns about what could dent the risk on and the enthusiasm in the equity market right now?

Christian Mueller-Glissmann: Yeah, I think there is a risk of some reflation frustration, some back and forth, and it comes down always, we say to the level of bond yields. So from which level you're increasing, the speed of the move and the source. And I think part of the reason why the market has taken the bond yield increases in its stride, especially small mid caps that have like floating rate debt, that are more levered, and the Mag Seven as well, I think, have, have performed reasonably well. Some people have often said that they are a bit more rate sensitive. I think the reason why that happened is really the source. I think the source of the bond yield move is related to reflation, better growth, and better drivers of growth - deregulation, taxes. So from that perspective, right now the market looks at the growth inflation policy mix and actually sees the overall mix as favorable.

I think there's two things how this can become a bit more problematic. the first one is speed. So what we found is if over a three month horizon, the U.S. 10 year yield goes up by more than two standard deviations from its trough, that usually drives some indigestion. So we've got to be a bit careful about that. And the other thing to consider is the

level. And, um, you want to think about in particular the level of real yields. We've done some new work that actually shows that if the real yield goes up too much relative to the long run trend growth expectations that people have in their minds, that eventually can then also weigh on equities, and that is very closely linked to Fed policy.

Allison Nathan: And so we also have a Fed meeting as if we needed another major event this week. Goldman Sachs Research is expecting the Fed to cut by 25 basis points tomorrow. But Christian, will any of this influence the Fed path ahead?

Christian Mueller-Glissmann: I think our economists have not really changed their forecast at this junction in a big way. I think markets have been backpedaling on the Fed cuts, for some time now. That really has kind of happened as the odds for Trump have picked up before because we have to be completely clear while this reflationary shift today has been extreme and large. I think it's been going on for a few weeks and then you had a bit of a setback. So I think like the market has been backpedaling a bit on how much the Fed cuts. Not because of the elections, but because of the growth. I think the US growth picture has generally been better than expected. Macro surprises have turned positive and that can already explain some, of the Fed cuts having been taken out.

So I think that process is in motion with the kind of recent, you could say reflation acceleration, if you like. And, and I think to, to some extent, it's somewhat in line with what we're discussing here. You have some inflationary policies. You have some potential impacts on growth via deregulation and via taxes. But I think the reason why our economists have not been, um, making those changes in part is because there are some offsetting factors. There can be negative impacts on growth from the tariffs as well. In particular, outside of the U.S. of course, but it can kind of, create feedback loops via financial conditions. You could argue about all kinds of interaction effects, with the market, like right now, for example, financial conditions are easing. So that, that could also make the Fed want to be a bit less dovish. So I think to, some extent that makes it incredibly difficult. The direction of travel though seems to be less Fed cuts. And, and I think the market has already reflected quite a bit of that.

Allison Nathan: Right. Brian, do you agree with that?

Biran Garrett: Yeah, you know, I think 25 basis points for tomorrow is pretty much a done deal. You know, market expectations are now that about a half a cut has been taken out of the future's pricing for next year, just as of this morning. So to Christian's point, like you are starting to see the reflation theme play out in kind of like longer term Fed expectations.

Allison Nathan: Right. But let's be clear the market expectations for the Fed path has been extremely volatile over the last, let's call it, year.

Brian Garrett: Correct.

Allison Nathan: So we'll see what the future brings. Christian, let's take a little bit of a longer-term look. When you think as an investor about your portfolio right now, does anything that happened over the course of the last 24 hours with this election outcome that is looking like a Republican sweep, although not confirmed at the time of this recording, but does any of that impact the way that investors should be thinking about asset allocation in their portfolios?

Christian Mueller-Glissmann: Yeah, I think generally our allocation has been shifting in a more late cycle direction. It always sounds quite scary when you hear late cycle, but what we've been arguing is that we're in a very stable early late cycle backdrop. So we don't expect a recession at all, but there are certain elements of the economy, and you mentioned that that's different to 2016, certain elements of the economy appear late cycle. So unemployment rates are very low. Profit margins are high. Output gaps are positive. If you look at the equity risk premium, it's very low, credit

spreads are tight. So I think from that perspective, you want to put your late cycle kind of asset allocation together. Generally what we say is if you're not expecting a recession late cycle, the right allocation is overweight equity, underweight credit, neutral duration and the idea is that credit is often in a late cycle backdrop more constrained in terms of the type of returns it can deliver because spreads are tight and you get paid the spread, and maybe you even suffer a bit on your kind of duration part of the fixed income portfolio. So we generally like to be underweight credit. And there's also more negative convexity in case something goes wrong and you do actually get a recession and credit can be quite illiquid and react very fast.

Whereas if you look at equities in a late cycle backdrop, there is much more optionality. You have optionality that the cycle reaccelerates. And that's exactly, I think what the market is betting on right now that you get via tax cuts, via deregulation, certain laggards of the economy start to drive equity returns, you get a broadening out of equity returns. And I think you also can see valuations expand. I think that's the very interesting thing about late cycle periods.

Often you have equities overshoot on valuations. You might argue we've already seen a bit of that and that's fair. I think equities have actually been driven by valuations quite a bit in the last 18 months because of the very favorable macro

and to some extent the optimism around the Mag Seven. But that doesn't mean that it cannot go further, especially if there's optimism. So I think like generally we want to protect such an equity overweight as long as possible. And this will be the next stage. So unless there's a significant shift with regards to growth, it will be about hedging and protecting that equity overweight. And that will be the challenge in the next six to 12 months, because there will be setbacks, there will be setbacks like we discussed, like reflation frustration, there will be setbacks with regards to geopolitical events, policy uncertainty. And, I think, um, in this type of late cycle backdrop, we want to protect the equity overweight as long as possible until you actually really have a reason to worry, which is mainly a recession.

Allison Nathan: And given some of the comments you made earlier about the different reactions across different equity markets around the world, when you say equity overweight, do you mean overweight U.S equities, or how do you feel about diversification internationally in the equity market at this point?

Christian Mueller-Glissmann: I think normally, as I mentioned, the reflation template in a late cycle acceleration would be going a bit in the direction of laggards and outside of the U.S is where a lot of laggards are. But we have to be careful because the policy uncertainty, is unusually high with regards to the rest of

the world. So our current asset allocation, we are overweight U.S equities and we are overweight Asia. The reason why we've been overweight Asia, and this is the allocation we had before the election outcome, is to some extent to diversify because, you know, it wasn't a hundred percent clear that we would get a such a Republican sweep type outcome as it looks right now. So we wanted to diversify, but also we have to consider that Asia is not only very depressed from a valuation and positioning point of view but there's also the fiscal stimulus that our team has seen quite favorable. So from that perspective, you have kind of this overweight in U.S and Asia. And at the margin, of course, with the outcome now out you have headwinds for Asia, no doubt. And I think we've been neutral on Japan. Japan turned out to be a very good diversifier for this event because of the strength of the dollar. I think Japanese equities actually performed very well. But I think I would say that Asia, both Asia ex-Japan and Japan, I think that sounds like more of a neutral.

I think the more interesting area is, of course Europe. And I think seemingly both in terms of price action, but also in terms of first takes from our economists, Europe could be quite badly impacted. And so we are underweight, Europe on the equity side. We also underweight Europe on the credit side in European high yield. We're overweight U.S, underweight European high yield. And we overweight duration in Europe, which is again bearish view where we do think that trade tariffs could hurt growth, but even

without the kind of setup that we're facing potential Europe was already doing quite poorly economically. So I think we're currently quite underweight Europe. So you have to be selective in terms of diversification and broadening out.

Allison Nathan: Thanks Christian, lots of food for thought. Brian, any last words on what you're watching from here?

Brian Garrett: Yeah, sure. You know, I think that Christian makes a great point in terms of looking for laggards globally, I would also be looking for laggards domestically. Underowned sectors within the U.S. equity market that have not quite kept up with the Mag Seven. I think there's going to be a lot of opportunity for a rally there. And then I also think that as Christian mentioned, late cycle, you should be overweight equities. My expectation is that the cost to hedge a portfolio will continue to decrease throughout the rest of this year and potentially in the next year. And so if you are going to be kind of going out on, the risk spectrum, you know, the cost to protect that, that equity exposure is likely to come in and could be very attractive in the next couple of months.

Allison Nathan: Christian, Brian, thanks so much for joining us.

Brian Garrett: Thank you very much.

Christian Mueller-Glissmann: Thanks for having us.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Wednesday, November 6, 2024. I'm your host, Alison Nathan. If you want to hear more from Goldman Sachs, listen to The Markets. On this Friday's episode, we'll hear one trader's take on whether the post-election rally can continue through next week. Look for it wherever you get your podcasts.

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