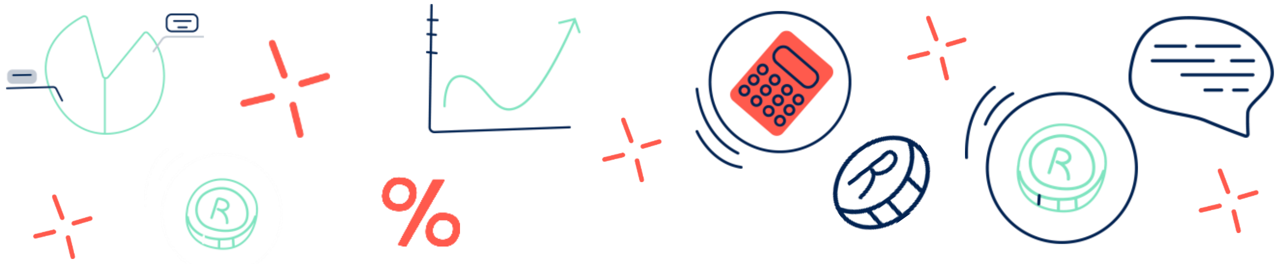
Truffle Asset Management

Economic Commentary
December 2024



The return of Trump

Donald Trump's victory for a second presidential term and the Republican's gain of Congress drove a US equity market rally over the quarter. The market was cheered by Trump's campaign promises to cut taxes and reduce regulations which would be pro-growth and support the US earnings outlook. However, Trump's proposed tax cuts, additional trade tariffs, and immigration clampdowns would also be inflationary. This, coupled with a strong labour market and buoyant economy, has given the US Fed reason to slow the pace of interest rate cuts in 2025.

The US bond market responded to the increased inflationary outlook, with US 10-year real rates moving up to 2.23% by the end of the quarter. The market is now only pricing 50bps of cuts over the next year, down from previous expectations of 175 bps. Overall, the US economy remains strong with the latest Atlanta Fed's GDPNow model estimating GDP growth to be 2.6% for Q4, whilst unemployment remains low at 4.2%.

Higher growth expectations have offset the impact of higher bond yields and inflationary concerns, resulting in the S&P500 delivering a return of 2.4% over the last quarter. The breadth of the rally remains narrow, with the equally weighted S&P500 index declining by 1.9%. The Magnificent 7 continue to be the key driver of the US stock market return and represent over a third of the Index weight.

While Trump's policy direction is broadly clear, the timing and extent of these changes remain unknown. Proposed tariffs may appear draconian but could also be used as trade negotiating tools with the likes of China and Europe. Trump's top tariff target remains China; however, US tariff increases create risk for the EU region. Europe, as a manufacturing and export hub, will need to rely on European consumers to mitigate some of this headwind to its GDP growth. With inflation falling, rate cutting in Europe has begun, and further reductions of over 100bps in 2025 are expected.

Risks pushed out

On a forward PE of 22, the S&P500 remains expensive relative to history and relative to bond valuations. We estimate that the expected excess return of the S&P500 over the bond yield is less than 1%. However, rising consumer confidence levels and continued buoyant economic growth could continue to support the current expensive valuations. While inflation tail risks remain a concern given Trump's policies, the continued productivity growth of circa 2% achieved over the last few years, coupled with a moderation of tariff implementation could keep inflation in check.

Despite being expensive on a purchasing power parity basis, the dollar is likely to remain strong due to higher interest rates and resilient growth, especially relative to the struggling economies of Europe and China.

A strong dollar would keep rising US debt concerns at bay and enable the Treasury to maintain an elevated budget deficit, which would benefit growth. Ultimately, this will be a headwind as deficit spending as a percentage of GDP is more than double the 50-year median of 2.9%. The Congressional Budget Office is forecasting debt to GDP to rise by a further 22% over the next decade from a current level of 100%, which is already above the World War II peak.

Uncertainty is set to continue in 2025 as the global impact of Trump 2.0 and the far-reaching impact of policy changes begin to unfold. The impact of the US becoming more internally focused and less concerned with the state of the world is a significant change not seen since World War II, which was followed by a global order of cooperation and globalisation, including the formation of global organisations like NATO, IMF and WTO. High levels of global economic growth and security driven by globalisation are now under threat. The implications are difficult to determine and quantify but will likely be negative for global growth prospects.

China preparing for change

China remains sluggish and the Chinese consumer weak. The economy continues to export deflation with the latest PPI print at - 2.5%.

The impact of significantly higher tariffs on Chinese exports to the US and China-US trade policy changes will be negative for the Chinese economy, but the extent remains uncertain. Unlike Trump's previous presidential term, China has had more time to position for the outcomes of potential change, and efforts include increased trade with the rest of the world. China's share of exports to the US has declined from a peak of 22% six years ago to the current 13.5%. China's announcement to ban exports to the US of several critical metals used in high-tech and military applications was also a retaliatory shot across the bow.

Local measures may mitigate pressure from the US. The Politburo has recently stated that they have shifted their monetary policy stance for the first time since 2011 and will adopt a "moderately loose" monetary policy in 2025. More importantly, they have signalled further fiscal support is in the pipeline, the degree of which will likely be influenced by the extent of tariffs from the US.

China's key economic problem remains a lack of consumer confidence and spending. Concerns around financial well-being have resulted in birth rates nearly halving from pre-Covid levels which has significant negative consequences for long term growth. Income growth has also slowed disproportionately for lower-income groups. Stimulus will need to take the form of welfare measures to instil some level of consumer confidence and encourage spending from a large savings pool. Unfortunately, the Communist Party's draconian approach to governing increases the risk of maintaining the depressed status quo of the consumer.

Real estate investment has been steadily reducing as a percentage of Chinese GDP. Hence, the current base of demand for commodities like iron ore and copper should be reaching more sustainable levels. This provides some underpin for miners listed on the JSE.

While the outlook for the Chinese economy remains lacklustre and the quantum and nature of stimulus over 2025 remains uncertain, there is still reasonable economic growth and a number of well-run companies with healthy balance sheets that are trading on cheap valuations.

South Africa ended the year stronger

Recovery in pockets of the SA economy continues. Whilst Q3 GDP was disappointing because of agricultural contraction, household consumption expenditure and gross fixed capital formation expanded. SA's economy should feel the boost of lower inflation as inflationary pressure remains benign at this stage. SA retailers (primarily Pepkor and Mr Price) printed positive double-digit revenue growth for October and November. This is likely driven by consumers spending their available savings from the introduction of the Two-Pot retirement system. Trading updates from SA Banks signaled that credit loss ratios are improving.

Encouragingly, S&P revised South Africa's credit rating outlook to Positive, reflecting their view that improved political stability and steps to reform will boost private investment and GDP growth. Transnet has recently announced eagerly awaited market-friendly rail tariffs, which will allow the private sector to dramatically improve rail volumes and deliver consequent GDP growth.

As mentioned in prior commentaries, a few government reforms are already benefiting growth, including easier access to visas for skilled workers and tourists. This, coupled with lower oil prices and reduced imported diesel volumes from Eskom, should benefit South Africa's current account. Looking ahead, continued progress at Eskom and Transnet and delivery of key services like water are critical. Treasury bypassing some of the problematic municipalities and paying an equitable share directly to some Water Boards will hopefully go some way to rectifying the current unsustainable situation.

We remain optimistic that a SA GDP recovery in 2025 will continue to be supported by an improved political landscape, cyclical factors, and ongoing growth-supportive reforms. Whilst Retailer's valuations are now above their 10-year medians, most Financials are still trading at discounts to their long-run valuations. Should GDP growth remain on a sustained trajectory, both sectors could benefit.

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Morningstar Awards were awarded to Truffle Asset Management (Pty) Ltd on 23 March 2022, 22 March 2023, and on 14 March 2024. Details available on request.

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