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Markets in a Minute

Guy Foster, Chief Strategist, and Janet Mui, Head of Market Analysis, discuss the expected trajectory of interest rates following central bank rate cuts last week, and the latest news on China's stimulus package.

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As anticipated, last week was very significant for investments. It was dominated by the U.S. elections, but also included some key interest rate decisions and some additional political developments.

We won't dwell on the elections as we covered those last week. At the time of writing, it remains likely the Republicans will achieve a clean sweep of both chambers of the U.S. Congress (the Senate and the House of Representatives) as well as the presidency. However, the race for the House of Representatives has not yet been called definitively.

The reaction to the results was largely intuitive. Equities generally benefitted, reflecting the prospect of less regulation and potentially lower taxes. However, some investors have a slight concern on two fronts. On one hand, the erratic nature of President-elect Donald Trump could warrant an increased premium for risky assets, suggesting their price should fall. On the other hand, the imposition of tariffs, which should reduce global growth, could weigh on equities.

That said, it shouldn't come as a great shock that the more optimistic interpretation of a Trump presidency outweighed these concerns, which mimics the market reaction to his first tenure.

The potential impact of Trump's tariffs

Tariffs, according to economic theory, are a negative sum game. There may be winners and losers, but in aggregate, growth should be reduced – not least because typically, tariffs imposed by one country will be met by retaliatory tariffs. However, due to the U.S.'s current account deficit, tariffs are likely to reduce imports and therefore increase growth.

While the U.S. equity market does not perfectly reflect the U.S. economy, and the same is true for most other regions to differing degrees, it still seems safe to believe that tariffs improve the outlook for U.S.-listed companies relative to the outlook for companies in other jurisdictions. The main burden of tariffs falls upon companies selling goods cross border, but in time, they'll be able to mitigate this challenge if they can relocate their manufacturing to the U.S. and get behind the tariff barrier.

Indeed, President-elect Trump sees them as a means to encourage foreign direct investment into the U.S. That, alongside reduced environmental protection and regulation, is expected to provide a boost to growth through investment. This was reflected in gains for companies that will facilitate this investment.

The costs of renewed global trade friction would fall on economies that are very open and run current account surpluses in goods. The Eurozone meets these criteria, so the election result is an undesirable development alongside a host of additional challenges the region is facing, such as the loss of gas supplies from Russia, and weakness in the Chinese export market.

Germany divided on government borrowing rules

So great are these challenges that Germany has been considering radical changes to its fiscal framework to address them. But opinions are divided on the best course of action, with German Chancellor Olaf Scholz having effectively triggered an early election this week, reflecting divisions within his three-party coalition.

Scholz fired Finance Minister Christian Lindner, who's the chairman of the pro-business Free Democratic Party (FDP), over a refusal to suspend rules limiting new government borrowing. Scholz has now called for a confidence vote in January, which he seems certain to lose. Next year's federal election will therefore be brought forward to March from September.

As it stands, the Social Democratic Party (SDP) has moved from first place to third in the polls. The centre-right Christian Democratic Union (CDU) would likely be the biggest party, but the further-right Alternative für Deutschland (AfD) would also have a good chance of being the official opposition, representing a very meaningful shift in the political landscape of Germany.

The coalition had been quite dysfunctional but seems to have collapsed most tangibly due to the FDP's intransigence on the topic of German rules limiting new borrowing. Two of the coalition partners, the SDP and the Greens, favour expanding debt to fund initiatives like tackling climate change and strengthening the military.

The rules restrict annual structural deficits to 0.35% of GDP and were enshrined within the German constitution in 2009. The debt brake has historically had quite broad support, including from the SDP and CDU, which were the big two parties in German politics. Most major parties are, however, having some internal debate on the topic, and support typically ebbs the further to the left you go. But even within the CDU, relaxation of the debt break is being discussed.

So far, the far-right AfD party still seems quite unified in its support of the debt brake. This is perhaps not what you'd expect from a party that can be seen as socially populist. The far-left Die Linke has been the only consistent opponent of the rule.

European services activity remains weak

Last week's economic surveys offered an opportunity to test the health of different regions. They showed Europe still seems to be missing out on the ongoing global expansion in services activity, with the region's weakness stemming from its core in France and Germany. Other parts of Europe have seen some improvement, and the U.S. remains the relative bright spot. The UK saw only a slight moderation in services activity but has the prospect of higher employment taxation to wrestle with.

UK and U.S. see interest rate cuts

The Bank of England cut interest rates by 0.25% on Thursday. It acknowledged that it may only cut rates slowly, because despite the tax increases announced in the Autumn Budget, the government will pump more money into the economy through public spending – particularly over the next two years.

The Federal Reserve also cut interest rates by 0.25% this week, but it will want to see how tax policy evolves before deciding on the impact this will have on interest rate policy.

A less than impressive dragon

Looking to China, and its economic activity continues to underwhelm. Last week, all eyes were again on another political press conference following a meeting of the Standing Committee of the National People's Congress.

Hopes that further fiscal stimulus would be launched were again dashed. Instead, confirmation was given of a six trillion yuan plan to swap the expensive liabilities of local government financing vehicles for cheaper debt issued by the local government itself.

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