WILL STRONG RETURNS BE TRUMPED?

In our 2024 outlook we concluded that 2024 was set to surprise as the year of 'reflation' for economic growth and risk assets. We pointed to an acceleration in the global industrial cycle, improving global credit creation, the wind-down of QT, the likelihood of interest rate reductions in major economies from mid-year and the belief that China would ramp up efforts to stimulate its economy.

These proved to be powerful forces with global and local equity markets on track to record 25-30% returns in CY24, making it the strongest returning year since the 2009 post-GFC recovery. Looking back, there is no question 2024 was a year of financial market reflation. The big question is what comes next?

the 2025 outlook macro

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From Reflation to Rotation

Every cycle is different, yet expectations for another strong year for global equities look misplaced. Much of the global outlook and the direction of financial markets in 2025 will be tied to the Trump 2.0 administration's policies, the response of China and other tariff-targeted nations and the risk of escalation of conflicts in the Ukraine and Middle East.

While there are some positive effects that may materialise from a Trump presidency, our analysis suggests a higher debt, higher inflation and lower growth environment is more likely. On balance, we think markets will continue to give an optimistic assessment of Trump's return to the White House into early 2025, but ultimately we expect a rotation into bonds progressively through the remainder of the calendar year.

The impact of Trump and his policies

Not even Trump knows what policies and shocks lie ahead for the next four years. It is highly likely they will bring heighten volatility as markets return to being reactive to Trump's predilection for shock announcements. In terms of policy, his campaign was large on expensive policy announcements and light on policy detail, making estimating the economic and market implications more challenging than usual.

Indeed, the numbers simply don't add up. Team Trump claims that they will cut the US budget deficit from 7% to 3% of GDP by 2028 represents a fiscal drag of 1% of GDP per year. Yet Trump's election platform sums to US$7.5 trillion in election promises over the next 10 years, approximately 2.5% of GDP of fiscal stimulus per year to 2028. It suggests an implausible quantum of yet to be announced budgetary savings equivalent to 3.5% of GDP per year.

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This simply will not happen. There is little prospect that Trump 2.0 can cut defence or entitlement expenditure sufficient to get near this target. Nor is there any realistic chance they can generate sufficient above 'potential' economic growth to drive a tax revenue windfall to close that gap. Team Trump's stretch target is to generate 3% p.a. economic growth through deregulation, cheaper energy and efficiency gains. This sounds impressive yet is exactly the pace of economic growth that has been achieved over the prior two years.

It requires an enormous suspension of logic to suggest large tax reductions and large spending increases can be delivered and yet generate an improved budget deficit profile. Either the deficit will not fall, or spending and tax cuts plans will be watered down materially. Despite this uncertainty, there are very few economists that believe that Trump's policy prescriptions will deliver stronger economic growth, lower inflation and lower interest rates. There are even fewer still that believe that he will repay a single dollar of government debt. We are most certainly in this camp.

For the record, if Trump's plan was implemented in full, we believe US inflation would be ~1% higher than the baseline scenario while US economic growth would be ~0.75% lower in 2025-26. The impacts are smaller if the US only impose tariffs on China, but there is no scenario in which an escalation in trade restrictions boosts economic growth and lowers inflation. If fully implemented, we believe Trump's US$7.5 trillion in election promises will push government debt to economically unsustainable levels over the next decade.

Given the relatively orderly reaction in bonds, the bond market appears to be assuming that Trump will find savings elsewhere or that the size of the spending promises will be watered down dramatically. However, if you reduce the size of the fiscal package – or unleash Elon Musk to cut trillions from fiscal programs – then the US consumer will see all of the inflationary aspects of the tariff policies and less fiscal stimulus to drive economic growth.

We believe financial markets are underestimating Trump's intentions. We assume approximately half of Trump's policies are implemented. As a consequence, post Trump's victory we have:

- Revised UP our 2025 economic growth assumption by 25ppts to 2.75%;
- Revised DOWN 2026 and 2027 economic growth forecasts by 50ppts in each year to 1.75% and 1.25% respectively;
- Revised UP our US inflation forecasts by 50ppts in 2025 to 2.5% for core-PCE; and
- Revised UP our Fed funds forecast by 50bps by the end of 2025 to a terminal rate of 3.75%.

The ROW response

Trade policy is not a zero-sum game. Increasing tariffs in one country that leads to retaliation in other countries not only lifts the costs of traded goods, it increases uncertainty and ultimately reduces investment, employment and global economic growth.

It is curious that Trump is suggesting tariffs of 25% on Canada and Mexico as part of an objective to reduce illegal migration and illegal drug importation. That is, in his very first initiative, Trump's tariffs are being deployed for reasons that stretch well beyond addressing the issue of perceived trade imbalances. Placing tariffs on near neighbours responsible for crucial raw materials, food and auto industry parts is obviously inflationary. If fully implemented, this alone will add at least 0.5% to US inflation in 2025, let alone the prospect of escalation to other countries.

Tweets are not policy, but it is clear that Trump's intention is to cause as much discomfort as possible for trade partners until some of his objectives are met. Some countries can be expected to retaliate proportionately, some will seek to arrive at a compromise and some, including Australia, will largely be spectators and collateral damage in the wave of uncertainty that such policies will unleash.

Our base case is that the tariffs will also be selectively applied by the US to Europe. In response, the ECB will be forced to ease policy further, European governments will be forced to divert more expenditure to defence, and ultimately will allow greater access for US products into the European market at the expense other trading partners. This is a Euro negative story, and whatever Trump hopes to achieve via tariffs may merely be undone by a more competitive Euro and lower interest rate settings over the medium term.

In China, we believe that the existing set of pro-cyclical stimulus is starting to show some signs of traction and that that momentum is set to continue into 2025. Tariffs are a complication for China's economic recovery plans, but the US is not the target market for the majority of China's manufactured goods. China is far more focussed on exporting to the rest of the developing world. From this perspective, we don't believe a US-China trade war will materially alter the demand for commodities in China.

Moreover, China will likely take further fiscal steps in early 2025 to stabilise its growth path, including further policies aimed at clearing excess housing inventory and creating more sustainable construction sector growth. We estimate that the recent lift in established house sales in China in the wake of recent policy announcements has shrunk the excess inventory of established homes to less than 3 years (from 4 years) in just the past three months.

From Australia's perspective, it is feasible that China exports will be largely insulated from the impact of a US-China trade war. Moreover, Australia will likely be a recipient of cheap manufactured product from China as goods are diverted to countries without tariff restrictions. In this respect, it is not clear the inflationary impact from a US-China trade war will be material for Australia. It's possible it proves disinflationary depending on just how much excess China production is diverted into our market.

Japan and South Korea may well prove to be beneficiaries of a US-China trade war, given still robust demand growth for their exports and very weak local currencies. Both countries appear set to post current account surpluses in excess of 4% of GDP in early 2025. Should Trump policies lead to smaller US rate cuts by the Fed and a higher USD, as we expect, then this will only continue benefitting Japan and South Korea's trade-focused economies.

On balance, we expect global economic growth to average 2.8% in 2025 (refer Chart 1), starting off with solid growth momentum before faltering somewhat through 2H25.

Chart 1: Yarra's forecasts are less optimistic than consensus

	YCM forecasts Real GDP (% growth)						YCM Less Consensus Real GDP	
	2021	2022	2023	F 2024	F 2025	F 2026	F 2025	F 2026
Advanced Economies								
United States	5.7	2.1	2.5	2.6	2.8	1.8	↑ 0.9	↓ -0.3
Euro Area	5.3	3.5	0.5	0.7	0.9	1.0	↓ -0.3	↓ -0.4
Japan	1.7	1.1	1.9	0.0	1.0	0.8	↓ -0.2	↓ 0.0
United Kingdom	7.5	4.0	0.1	1.0	1.2	1.1	↓ -0.1	↓ -0.4
South Korea	4.0	2.6	1.4	2.4	2.0	1.8	↓ -0.1	↓ -0.4
Canada	4.6	3.6	1.1	1.1	1.8	1.7	→ 0.0	↓ -0.4
Australia	4.3	3.7	2.0	1.2	1.8	2.3	↓ -0.3	↓ -0.3
New Zealand	5.3	2.8	0.7	0.4	1.6	2.5	↓ -0.4	↓ -0.1
Sweden	4.6	2.9	-0.2	0.7	2.0	1.9	→ 0.0	↓ -0.4
Norway	4.0	3.7	1.1	0.7	1.4	1.7	↓ 0.0	↓ -0.1
Developing Economies								
China	8.1	3.0	5.2	4.8	4.6	4.4	↑ 0.1	↑ 0.2
India	-7.5	8.7	8.7	7.0	6.7	6.5	↓ -1.1	↓ -0.4
Russia								
Brazil								
World (PPP weighted)	6.3	3.5	3.2	3.2	2.8	2.6	↓ -0.3	↓ -0.5

Source: YarraCM

Australia in 2025: improving off a low base but policymakers have been more of a hinderance

This time last year it was commonplace for forecasters to suggest Australia was at high risk of recession in 2024. Our view was that tepid conditions would persist into early 2024 and that not only would Australia avoid recession, it would likely accelerate sequentially through 2024. Our view was that better global growth, still supportive commodity prices, backlogs in delivering construction projects, financial buffers supporting robust consumption by wealthier and older households, and population pump priming would sustain positive economic growth. In the back half of the year, we flagged that income tax cuts combined with moderating inflation and the commencement of an interest rate easing cycle would help generate real income growth, prompting a modest economic recovery.

Most of these forecasts have materialised. We are yet to see the hard evidence of that modest economic recovery outside of better confidence readings at the consumer and business level. Nevertheless, it does appear that our forecasts remained on track, with one important exception. We expected that the RBA would lag the rest of its peer group by only a few months in easing interest rates. As most major central banks kicked off their easing cycles from mid-2024, the RBA has refused to move to an easing bias, and it seems the RBA is guiding financial markets to not expect rate cuts until May 2025.

While it's churlish to suggest that the RBA is wrong and they should have commenced the easing cycle into the end of 2024, the evidence suggests that the RBA is likely misreading the inflation threat in Australia. There are three main reasons:

1. **Inflation is falling:** the proportion of items above the mid-point of the target band continues to rapidly decline. Currently 49% of the items in the CPI basket are expanding at a pace below 2% – the bottom end of the target band (2-3%). Typically, the RBA would be well into an easing cycle with a distribution of inflation that is this supportive. Moreover, the four monthly CPI prints available for the financial year suggests inflation has fallen 0.2% so far in 2024-25. This is the biggest bout of deflation in a four-month period since the data commenced in 2017, excluding the COVID period. High base effects are keeping trimmed mean elevated, but those base effects will fall out in the coming months and reveal a far more benign underlying reading.
2. **Subsidy assumptions appear misguided:** electricity and rental subsidies have contributed to weak inflation in recent months, but it is important to note that the RBA's assumption that these subsidies will lapse in 2025 is likely wrong. The Treasurer has signalled his intent to extend these subsidies in the May Budget. Thus, not only is the RBA's forecast for CPI likely to be 0.5% too high into the end of 2024, it is also likely to be close to 1% too high through 2H25.
3. **Inflation drivers are being misread:** the RBA's primary argument is that private sector services inflation remains too high due to excessive demand. However, just 9% of the basket is discretionary services. Overwhelmingly, the source of high services inflation is in non-discretionary publicly administered prices (e.g. rates, medical and education services), rent and insurance. It is simply nonsense to associate sticky services inflation to excess demand growth. Services inflation is mostly a function of lagged indexation from the prior year and lags from prior strength in wage growth. With wages surprising the RBA on the downside in each of the past three quarters and indexation lags to be far more modest in 2025, the RBA's concerns over services inflation remaining elevated through 2025 appear misplaced.

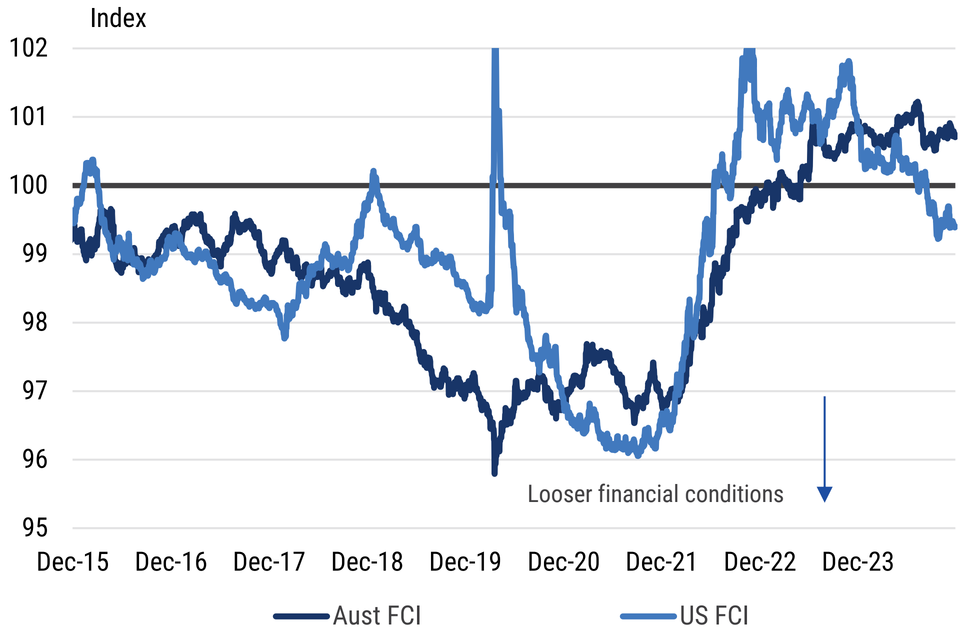
Importantly, private sector wage growth has slowed to 3.5% (y/y) and market sector productivity is expanding at 1.0% (y/y). This is the combination that Phillip Lowe has long dreamed of in his quest for inflation to be sustainably in the middle of the RBA's target band. In other words, conditions are already in place for monetary policy to return to a neutral stance. On our estimates, financial conditions are restrictive and to achieve a neutral setting 125bps of easing in the cash rate is required, all else equal.

We expect 4Q24 CPI trimmed mean to be just 0.5% (q/q). Although the RBA claims it needs two quarters of good inflation to ease, that is based on their current forecasts. We think they will be downgrading their inflation views due to better recent inflation data, the inclusion of subsidies in their 2025 forecasts and will likely downgrade their economic growth forecasts in 2025.

Excess government spending may be the key factor that is keeping the RBA on their heels. However, it is important to note that this investment is contributing to the net capital stock expanding at the fastest pace since pre-COVID and, together with a surging labour force, the supply side of the economy is now clearly expanding quickly. A forward-looking central bank would recognise this and calibrate policy accordingly.

The combination of excess public spending growth, excess price increases by government and semi-government agencies and a central bank that has adopted a backward-looking approach to policy setting has seen policymakers be more of a hinderance than help to a private sector recovery.

Chart 2: Australian and US financial conditions



Source: YarraCM

Private demand recovery. Public sector headwinds.

Nevertheless, a private sector recovery is still likely. This recovery will be driven by improved real income growth supporting a modest consumer recovery and ongoing private investment growth. There is also evidence that single home construction is being dragged higher by the sheer scale of the housing shortage, despite record lows for affordability and lacklustre apartment approvals.

Two of the main domestic challenges for 2025 will be largely political in nature. Navigating a hotly contested federal election in early 2025 will likely do little to expedite private demand growth, especially as much of the investment outlook is tied to the energy transition upon which the major parties appear to have very different stances. A minority government is possible, if not probable, and that will do little to alleviate investment uncertainty and additional fiscal spending beyond cost-of-living subsidies looks unlikely at this stage.

The biggest swing factor may well come down to the competition between the major parties to expedite a population growth slowdown. While the intention is to help alleviate pressure on infrastructure and rents, a sharp policy-induced slowdown in population growth could easily become the biggest hurdle to economic growth in Australia in 2025 and 2026.

We expect Australian economic growth to average 1.75% in 2025 and 2.25% in 2026. We expect the RBA to cut interest rates by 100bps in 2025. We expect 10-year bonds to finish 2025 at 3.75% and the A$/US$ to finish 2025 at 68c.

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Tactical positioning: Rotating from equities to bonds as the year unfolds

From a financial market perspective, a modest economy recovery won't provide the type of cyclical leverage that will drive a material uplift in EPS growth. After two years of negative EPS growth for the Australian market, 2025 will likely be improved but market multiples are demanding and equity risk premia is historically low. With bonds closer to fair value given the prevailing economic conditions we can see the attraction of carrying a more even weighting towards fixed income and equities as we move through 1H25.

In the near term, we expect that loose US financial conditions will inspire some nearer term economic and EPS upgrades in the US before Trump's policies ultimately weigh on future growth expectations. As such, equities may remain in favour in the early part of 2025, however, we expect sentiment will turn before we reach mid-2025. In the interim we expect bonds to bake in higher inflation risks and renewed fears of excessive debt issuance in early 2025, providing an opportunity to lift bond holdings in the remainder of 2025.

In short, it's a case of sticking with offshore equities into early 2025, leaning back towards domestic market in anticipation of China stimulus and deeper-than-expected RBA rate cuts, before looking for opportunities to lift bonds to an overweight position through 2H25.

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