



Solidifying the Mid-Cycle Narrative

Within Our Election Framework

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Solidifying the Mid-Cycle Narrative Within Our Election Framework

INTRODUCTION

We are finally in the home stretch of the much-anticipated November 5th U.S. election.

Although sentiment in battleground states has shifted incrementally in favor of former President Trump over the past three weeks, his lead over Vice President Harris in polling is still within a margin of error. **The presidential election effectively remains more of a toss-up as opposed to a landslide.**

With the control of the Senate strongly expected to flip from Democratic to Republican and control of the House likely to follow the winner of the presidential race, a Trump victory thus points to a likely red sweep, whereas a Harris victory is generally associated with a divided government.¹

Given the proactive role in which the government plays across many fronts over the last decade, from immigration to climate policy, the outcome of the upcoming U.S. elections will have long-lasting and nuanced effects on the economy and financial markets.

That said, when the dust settles, absent a Democratic sweep (a relatively low probability event in our view), **we do not see the future trajectory of the U.S. economy deviating dramatically within our election framework.**

We are of the view that the economy is in the mid-cycle business phase. The economic expansion likely has more room to go. We see a recipe for broader, self-sustaining growth over the next couple of years.

UNPACKING THE MID-CYCLE NARRATIVE

On the monetary front, thanks to the Federal Reserve seeming victory over inflation, **the Fed now has more freedom of movement and, therefore, the ability to act more aggressively if needed.** Such a development is reassuring given the modern track record of the central bank's eagerness to proactively defend growth.

The inherent dovishness of the Fed came across loud and clear in the Fed's asymmetric responses towards managing the balance of its dual mandate - price stability and maximum employment. It took more than one year of consecutive monthly increases in inflation as measured by the Consumer Price Index (CPI) - to historic levels not seen in half a century - for the Fed to abandon its "transitory" narrative and initiate a rate hike campaign. In sharp contrast, alarmed by only two sequential weaker-than-expected monthly jobs reports over this past summer, the Fed hastened its policy shift and kicked off its rate cutting cycle, with a substantial 50 basis point jumbo cut no less.

In short, central bankers have ample ammunition and seemingly no hesitation to use it, if needed, to support labor and growth.

However, an accommodative monetary policy alone is not sufficient to propel the economy on a sustained basis.

The aftermath of the global financial crisis (GFC) still serves as a vivid reminder of that. Despite unprecedented liquidity injections by the Fed, including three controversial rounds of quantitative easing (QE) from 2008 through 2013 of over \$3.5 trillion, the U.S. economy still experienced arguably one of the most sluggish early-cycle recoveries in modern times.

¹Sources: 538 and Real Clear Politics.

This is at least partly attributed to the various degrees of the austerity mindset embraced by politicians across all levels of the government, which counteracted the extremely loose monetary actions in the years following the GFC.

The efficacy of monetary policy in terms of its ability to influence the economy has a limit. Low interest rates compress risk premia and drive up asset prices. This mainly benefits those who own more financial assets but does not necessarily spread the capital throughout the economy to stimulate genuine, self-sustained growth.

Thus, we highlight the importance of fiscal policy, which takes effect in a more immediate and tangible fashion.

As most COVID-era spending programs come to an end, a potential handoff fumble between the public and private sector is the most likely cause for a recession in the coming year, if one does occur. **The risks of an imminent fiscal cliff deserve close monitoring. However, our base case is that government spending will not ease drastically as we head into 2025.**

In fact, a key conclusion drawn from our election framework is that **the U.S. economy will continue to experience an expansionary fiscal policy whether we end up with a Trump victory with a red wave or Harris victory with a split congress.**

The flavor of fiscal actions is expected to vary meaningfully depending on who ends up in the White House, but the truth is that **both parties have abandoned fiscal conservatism.** While politicians in Washington recognize the increasing burden of rising U.S. government debt, absent an imminent crisis, no one is willing or has the political capability to solve this problem.

In addition, **industrial policy is here to stay.** The three legislations passed in 2022 – the CHIPS and Science Act, Infrastructure Investment and Jobs Act, and Inflation Reduction Act – collectively signaled a new economic framework for the U.S.

From subsidies, tax incentives, to tariffs, **the bipartisan embracement of industrial policy is fundamentally motivated by priorities such as economic competitiveness and national security**, which according to polling most Americans would generally support .

Given an accommodative monetary policy backdrop, the continued active role of the government in the economy going forward is critical to our mid-cycle narrative.

At the moment, the U.S. economy is maneuvering a game of confidence.

In the U.S., the economy goes as the consumer goes. Therefore, a slowdown in consumer spending is a necessary ingredient for recession. Consumption growth, in turn, is largely a function of three variables: household balance sheets, real income growth, and the state of the labor market.

With inflation pressures fading, investor focus over the last few months has drastically shifted to **labor, which appears to be the weakest link of the economy.**

Since early 2024, there have been clear signs of a slowing of the pace of labor market expansion, particularly a pullback in hiring activity. This is likely associated with corporations adopting a “wait and see” approach, putting capital expenditures on pause and preserving optionality until there is more clarity around the macroeconomic environment after the November elections.

While a slowdown in new hires has historically been a leading indicator of more detrimental economic developments, such as an increase in permanent job losses, **we believe that the labor market today is far from a demand-driven layoff spiral.**

Notably, although the unemployment rate rose above 4% in early summer, it has been hovering around that level since then. While in a downward trend, new job creation, on a three-month rolling basis, remains above its pre-COVID long-term averages.

As macro shifts tend to have significant momentum behind them, we are acutely aware of the risk of an overshoot in the rebalancing or normalization of the labor market from post-COVID extremes.

The outstanding question is whether labor will stabilize once it has reached a satisfactory equilibrium. The answer, we believe, lies in the state of business confidence over the coming months and quarters.

Because the public sector carried the labor market through the COVID years, the overall business and household balance sheets came out of this period better than they were before 2020, with less leverage and stronger income growth to support spending.

With the most significant fiscal policy impulses behind us, in order to sustain growth, it is critical that the private sector takes over the baton. The success of the handoff from public to private, we believe, is **a function of willingness rather than ability**, given the fundamentally very healthy financial backdrop.

Going forward, it is our view that the presence of a supportive monetary and fiscal policy environment is the key affirmation that the private sector needs to lift its confidence and ramp up capex and hiring to ultimately propel the U.S. economy forward on a self-sustained basis.

MARKET IMPLICATIONS

On equities, we expect some degree of a rally coming out of the election, simply thanks to a meaningful amount of uncertainty being taken out of the market, absent the unlikely outcome of a blue sweep (which will likely trigger a bearish equity market response given the anticipated changes such as higher taxes and tighter regulations and thus the potentially resulting adverse effects on future corporate earnings).

From thereon, **we are moderately bullish on U.S. equities with several important nuances.**

Historically, policy easing against a reasonably strong economy is a blockbuster combination for risk assets. However, the challenging valuation setup in U.S. large cap equities limits an index-level return potential over the near term. With improving investor confidence in the outlook of continued economic expansion, we expect **further broadening out within the U.S. equity market, with the performance of the S&P 500 index in 2025 to be driven more so by the 493 smaller constituents than the top seven companies.** Along with the same line of thinking, we expect **cyclicals to outperform defensives.**

In addition, while **leaning into assets levered to growth**, we favor companies with more domestic exposures as opposed to global. From a fundamental earnings perspective, the U.S. has the advantage of being a more isolated economy compared to many other developed peers such as Europe and Japan. They are adversely affected by China, which is stuck in a structural balance sheet recession with no plausible near-term solutions and a lack of business-friendly policy incentives. Given such, within U.S. public equities, **we consider the mid cap space a sweet spot.** On the one hand, mid cap companies have higher earnings sensitivities to improving or stabilizing economic conditions versus large cap, not to mention much more attractive valuations. On the other hand, mid cap stock prices are less vulnerable to the risk of upside surprises in interest rate expectations versus small cap.

Given our expectation of further broadening out within equities, as well as the extreme income bifurcation of consumers, such a combination translates into a fertile hunting ground for active managers relative to market cap-weighted passive strategies. With **dispersion on the rise** and generally a less trend-dominant market, we **favor fundamental over systematic** within equity long/short hedge funds.

Lastly, we balance our cyclical views with our secular outlook, which argues for **maintaining some exposure to structural winners.** Thanks to technological advancements in artificial intelligence, the world may be at the cusp of a historic leap in productivity. However, the intellectual property of such technologies is concentrated in the hands

of a few players. While the tension between AI investments and monetization may drive price movements in the near term, the power of being at the top of the value chain – in the form of revenue growth, profit margins – has the potential of increasing exponentially over the long term.

On rates, we see a decent likelihood of nominal rates not falling as quickly and as much as market expectations.

If the current economic expansion has more room to run, the continued growth will likely stimulate a moderate pickup in inflationary pressures. Correspondingly, the nature of rate cuts in the coming quarters will be more aligned with a mid-cycle normalization – as opposed to a recession-akin cutting cycle – with target policy rates potentially settling around 4% by the end of 2025.

Such a combination of growth and rate bodes well for floating rate credit across public and private, especially if investors seek out nuggets in the more complex, illiquid, niche segments that are under the radar.

As we look further out on the yield curve, long-term nominal interest rates have risen meaningfully over the past few weeks. Still, we consider the levels today just within the range of fair values given our expectations of a modest pickup in inflation expectations.

We assign a low probability to a genuine U.S. debt spiral, thanks to the symbiotic relationship between U.S. exceptionalism (i.e., productivity leaps) and fiscal sustainability. A temporary spike in yields followed by a short period of messy recalibration is far more likely.

That said, **the back end of the yield curve is likely to remain vulnerable as concerns around fiscal deficits come in and out of market focus.**

Within our framework of post-election macroeconomic scenarios, **aside from having a hedge against equity selloffs in a recessionary event (growth down, rates down), we do not see a strong argument for**

intentionally adding to duration exposure given the somewhat limited gains (e.g., yield pickup, diversification potential) relative to the substantial increase in uncertainty associated.

We view commodities as the single most effective way to improve resilience in the context of our mid-cycle portfolio positioning.

We closely monitor **the risks of a meaningful increase in inflation driven by long-lasting supply shocks**, from escalating geopolitical conflicts in the Middle East to the South China Sea. Such inelastic inflationary dynamics would significantly constrain policy movements, across both monetary and fiscal, and thus have spillover effects into private sector capex and household consumption.

Separate from assets such as oil and base metals, **we continue to maintain our long-term bullish view on gold**, primarily driven by the ongoing trend of central banks around the world seeking further diversification in their holdings and lesser dependence on U.S. dollar-based assets, partly due to the increasingly noisier geopolitical environment.

Gold would also serve well as a tail hedge against potential fiscal policy mistakes that may trigger severe consequences for the U.S. dollar. That said, it is important to clarify that our bullish narrative of gold does not hinge on de-dollarization.

CONCLUSION

At the end of the day, the key to attaining long-term investment success lies in striking a calibrated balance between maintaining resilience against unexpected macro shocks with agility across terrains and selectively expressing high-conviction and positive convexity views effectively through deliberate, nimble portfolio positioning. While it is tempting to be drawn into the noise surrounding the election, it is critical to decipher the quality of various inputs into one's cyclical narrative. We now have more clarity around the trajectory of growth relative to that of rates – a crucial factor for how we express our differentiated tactical positioning.

45 ROCKEFELLER PLAZA FLOOR 5
NEW YORK, NY 10111

PRINCIPAL AUTHOR

Chloe Duanshi, CFA

Head of Macro & Investment Strategy,
Rockefeller Global Family Office

EDITOR

Joan Park

Investment Strategy Specialist,
Rockefeller Global Family Office

EDITOR

Doug Moglia, CFA

Macro & Market Strategist,
Rockefeller Global Family Office

PHOTOGRAPHY

Getty Images



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