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Principal Asset Management℠

# U.S. election results:
## Around the world in emerging markets

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On the heels of what many viewed as one of the most consequential U.S. presidential elections in recent history, President-elect Donald Trump secured victory by a larger margin than widely expected, winning all seven swing states and easily obtaining the necessary 270 electoral college votes. In Congress, Republicans secured a majority in the Senate and the House of Representatives, resulting in a "red sweep," allowing the president-elect to potentially apply the bulk of his election proposals, including the most radical on tariffs, immigration and tax cuts. A mildly positive note is that the election results were clear-cut and the Democrats have shown a willingness to deliver a smooth transition, as there appears to be little risk of legal challenges.

The initial global market reaction has been to extend the so-called "Trump trades," resulting in a stronger U.S. dollar, higher U.S. yields, and stronger U.S. equities. That said, compared to pre-election expectations in such a scenario, the pricing of the outcome has been somewhat underwhelming. That may be explained by hopes for some dilution of the most radical proposals, as well as the fact that the implementation timeline may be eventually more drawn-out. Something market players also learned during the first Trump presidency is that Mr. Trump himself may change his mind on key issues at short notice, which makes accurate pricing all the more difficult. In the short term, with inauguration day not until January 2025, a "lame-duck" period has started, during which markets may not have much to "grind-on" apart from key nominations and occasional statements by the president-elect. This could potentially make foreign exchange and rates markets fade the initial weakness. An absence of further adverse market reaction into December could lead to some unwinding and short covering into year end. Ultimately, we will have to position portfolios on likely long-term Trump policies, but the quantum and impetus of these policies may be hard to anticipate before January.

Prior experience and economics suggest the following potential risks:

- Higher and potentially less sustainable fiscal deficits from unfunded tax cuts.
- Higher inflationary pressures in the U.S. from immigration restrictions and tariffs; slower growth in the rest of the world.
- Disruption to the Federal Reserve's (Fed) cutting cycle in mid-2025, with the possibility of rate hikes resuming at some point in case of unfunded tax cuts.
- The independence of the Federal Reserve and Supreme Court rulings will likely be scrutinized, as those institutions remain key guardrails of institutional credibility.
- Among emerging countries, an early focus on China, Mexico, Ukraine and the Middle East with regards to potential trade sanctions and/or diplomatic pressures to end conflicts.

### Immediate election impacts on emerging market debt and currencies

In terms of the immediate reaction to the election results, the clear bias was for emerging market (EM) foreign exchange weakness against a strengthening U.S. dollar. Since election day, most emerging market currencies were down anywhere from -2.1% (Chinese yuan) to -3.0% (Mexican peso). These declines came after significant weakness in the pre-election month, so additional currency weakness may be limited.

Meanwhile, EM credit spreads have followed the global tightening trend, mostly through passive tightening in the face of U.S. yield increases presenting an opportunity to trim exposure to overpriced or "in-focus" Trump-levered names.

Select markets, such as Ukraine, are up 1.5-3.0%, as the market is pricing quicker odds of a ceasefire (despite potential political fallout in the long term for Ukraine and Europe). Frontier countries' external debt has behaved as expected, seeing stable to rising prices as the global risk appetite for credit and higher yields remains alive for now. More idiosyncratic stories, including Turkey, Israel, Taiwan, and Argentina, should remain relatively unaffected.

## Macro considerations: China, Europe, and EM ex-China

### China

Amid continued concerns over consumer spending and unfavorable economic conditions in the country, we believe that China will have to continue with additional stimulus measures over the next few months to cushion their own domestic slowdown together with the impact of likely trade tariffs—which they should be among the first to face after inauguration day. How much and how effective any additional stimulus will be, remains an open question. We feel that anything short of a more convincing social safety net (which President Xi Jinping is notably against) or a "builder of last resort" initiative for the property sector may not create a lasting impact.

Moreover, China could also decide to "weaponize" the yuan in the face of U.S. tariffs, but that move is unlikely to be used before January's inauguration. We believe markets may still need to price in more yuan weakness in the coming months.

### European Union

Looking to Europe, despite the high likelihood it will be a key collateral victim of the U.S.-China rivalry, the European Union is already preparing to adopt a more transactional approach to Trump, likely by demonstrating higher defense spending (many countries are now above NATO's minimum contribution of 2% of gross domestic product), buying U.S. equipment and oil, and aligning on select China containment measures to avoid tariffs.

A key spanner in the works, however, may be Trump's decisions regarding Ukraine and whether a settlement leaves the door open for more Russian aggression in the region. It is worth noting that EU politics have increasingly leaned toward the right since 2016, potentially creating some proximity, though Europe might remain an easy punching bag for Trump.

Ultimately, an EU under duress could still find a silver lining in terms of necessary competitiveness reforms, boosting its own defense, common borrowing, and fiscal alignment. Meanwhile, we believe that the European Central Bank will likely reduce rates by more than the Fed through the end of 2025.

### EM ex-China

EM central banks were already increasingly reluctant to cut rates, in light of recent USD strength, and that is likely to continue given higher U.S. yields and uncertainty over how the Fed will react to the Trump administration's economic policies. This could constrain EM growth prospects or prompt governments to seek a looser fiscal stance. Some EM central banks, particularly in Asia, may also consider intervening as an effort to counter excessive currency weakness and limit inflationary pass-through risks. As for the International Monetary Fund, as geopolitical tensions remain high, we anticipate that they will remain supportive of many EM frontier countries for the foreseeable future.

**Middle East:** Strong U.S. support for Israel is unlikely to waver under the new administration. It's possible we see a revival of the Abraham Accords—a bilateral declaration of normalized diplomatic relations between Israel, the United Arab Emirates, and Bahrain, signed at the White House in 2020—coupled with a more marginalized Iran. However, this could be hampered in the short term by the continuation of Israel's ongoing conflict with Hamas and Hezbollah, until Israel feels their initial "war goals" have been achieved.

**Latin America**: It remains unclear how the broader region outside of Mexico will fare under Trump. In Argentina, President Javier Milei's ideological proximity may help the country receive more IMF benevolence, which may also apply to El Salvador. Peru, Chile, Ecuador, and Colombia are unlikely to receive the administration's immediate focus, although their cooperation will be required to take back illegal migrants and/or convicted nationals. Mexico will remain top of mind for Trump. There, the key issues include curbing the flow of drugs into the U.S., immigration and border security, the rerouting of Chinese exports to the U.S. via Mexico, and U.S. industrial investments in the country. This adds to self-inflicted issues including a controversial judicial reform and budgetary pressures.

That said, we expect a transactional approach from Mexico, as we struggle to see how the U.S. economy can totally cut off from its southern neighbor. We see scope for more collaboration on drugs, immigration and Chinese exports, and U.S. corporates will likely be vocal in protecting their manufacturing operations there. We anticipate more short-term pressure on the Mexican peso but are constructive on local rates and Pemex credit. We note that the recent 2025 budget proposal looks credible and alleviates some short-term worries. There could be a "glass half-full" thesis materializing for Mexico into 2025.

**Asia ex-China**: Whereas we expect U.S. tariffs on China to be implemented shortly after inauguration, we expect tariffs to be used more as bargaining chips with other Asian countries to pressure them to side with the U.S. rather than China and to clamp down on the rerouting of Chinese exports through their territory. Taiwan may receive more support from the U.S., in a further provocation to China, but the pressure to choose a side will also increase for countries in Southeast Asia.

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Overall, given the pre-emptive market response to a Trump victory, we anticipate that the quantum of any short-term weakness into year-end to now will be more limited on local yields, and foreign exchange, with EM spreads remaining close to recent tights. The approach will likely be increasingly differentiated among countries and sectors at risk, as investors better flesh-out the actual impact of potential Trump policies.

### Strategizing for the uncertain path ahead

We believe the Trump and "red sweep" state of play to be close to priced in, as far as what can reasonably be anticipated. The impetus and timing of likely measures are where the uncertainty remains. We will not be able to assess the measures until early 2025 but, as always, the worst is never a sure outcome. Markets may switch to a "glass half-full" approach, hoping for dilution and procrastination of the most extreme measures, possibly extending any year-end rally into early January. The actual time of reckoning on "Trumponomics" will have to wait for later in 2025.

Meanwhile, EMD may continue to fare reasonably well on fundamentals, given that many of our countries are not in the first line of fire of a Trump administration. Notable exceptions are China, Mexico, and a handful of specific situations. Yields have risen once again and more "value for money" has been created, while short-term EM fundamentals and technicals remain supportive. We are likely to turn long EMD risk again at some point before year-end 2024, with a bias toward foreign exchange and duration.

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