

US economy and markets: what's the state of play as Trump takes office?

Schroders

As President Trump begins his second stint in the White House, Schroders' investment experts consider the current state of the US economy and the stock and bond markets.

With Donald Trump taking office, investors need to pay attention to which campaign trail promises become policy priorities. This will have implications for the economy, equities and bonds. Below, our experts consider the current state of play and lay out what they are watching most closely.

US economy resilient, but stagflation is a risk

Many investors went into 2024 worrying about a US recession, but that did not materialise. Heading into 2025, **Senior US Economist George Brown** says, "We continue to find market expectations for the US economy too pessimistic. The consumer is in good shape and, with the labour market cooling rather than collapsing, household spending should continue to drive growth. US GDP numbers for Q3 2024 were revised up, and Q4 looks to have been pretty solid in terms of growth."

The Schroders Economics Team forecasts US GDP growth of 2.5% for 2025, accelerating to 2.7% in 2026. This would see inflation remain higher than previously assumed, with the Federal Reserve (Fed) cutting rates once in 2025 before hiking in 2026.

These forecasts are predicated on certain assumptions around Trump's policy agenda. "Slim Congressional majorities should limit Trump's more extreme inclinations but still be sufficient to extend his expiring tax cuts and support his deregulatory efforts," explains George Brown. "And while we do expect he will implement protectionist policies, we are sceptical they will include a universal baseline tariff. Likewise, we suspect his efforts to expel illegal immigrants may not reach the promised scale of 20 million."

However, if Trump were to implement his stated policy agenda in full, the implications for the US economy could be rather different. The Schroders Economics Team has also modelled a more aggressive scenario that includes 60% tariffs on all Chinese goods, plus tariffs on the rest of the world, alongside strict immigration limits and deportations.

If that scenario comes to pass, **George Brown** says, "Weaker trade, a pause in investment decisions and a general shock to confidence would be likely to tip most economies around the world towards recession and lead to significant interest rate cuts.

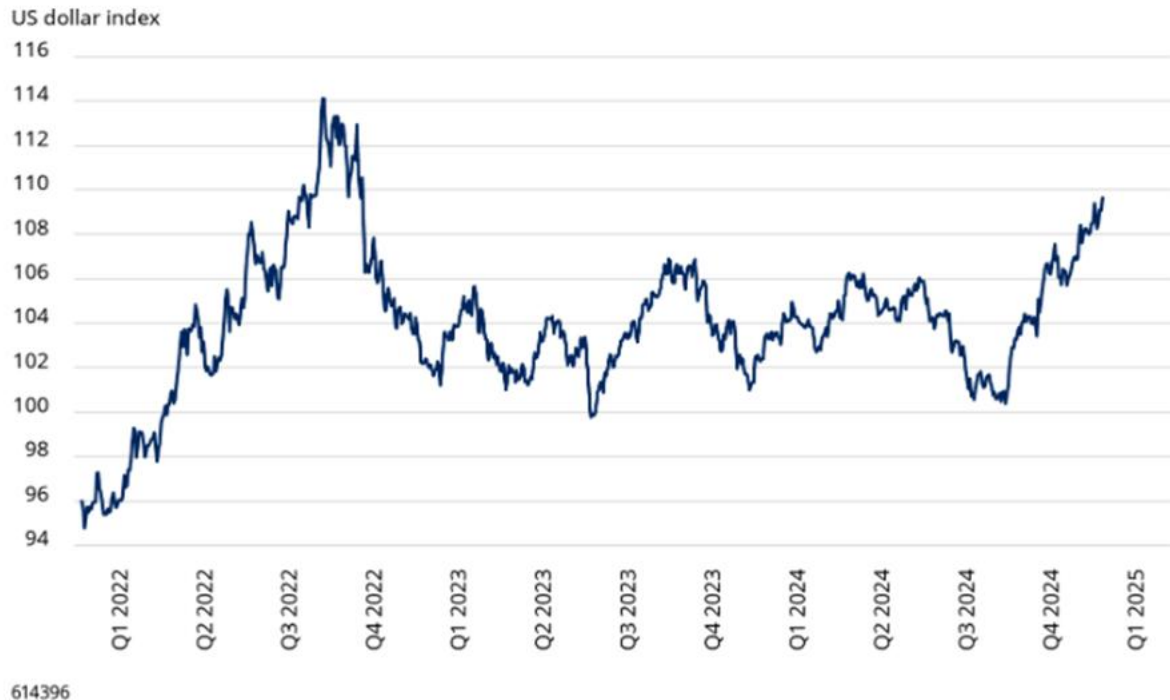
"But this mix would have more of a stagflationary impact for the US. In other words, while the US's growth outlook is also diminished under an aggressive Trump scenario, slower growth would be accompanied by more, rather than less, inflation. An aggressive Trump may try to deliver large fiscal stimulus, but stronger demand would quickly run into a deteriorating supply side of the economy. GDP growth would probably slump in the first instance due to huge disruption, before receiving some boost from stimulus measures heading into 2026."

A key difficulty for investors is assessing the likelihood of any given policy being implemented, and this difficulty will continue until clarity on policy direction emerges. **David Rees, Senior Emerging Markets Economist**, says, "Financial markets could price in any of these policies during the course of 2025, even if they never actually come to fruition, leading to increased volatility across asset classes."

Inflation outlook contributing to dollar strength

Multiple factors combined to send the US dollar higher at the end of 2024. These factors included expectations of higher interest rates in the US relative to other major central banks, as well as higher US growth compared to other regions.

Dollar index close to two-year high



Source: FactSet, as at 10 January 2025. The US dollar index is a measure of the value of the US dollar relative to a basket of foreign currencies. Past performance is not a guide to future performance and may not be repeated.

Policy on trade will also have a significant influence on the dollar. David Rees says, "Any imposition of tariffs would tend to be supportive of the dollar because it would go some way towards equalising out the impact of tariffs on trade and activity. We also expect support from interest rate differentials to re-emerge, so a stronger dollar is likely to remain for a while longer."

But the dollar could see some swings before policy on trade is confirmed by the incoming administration. An example is the recent leg down on the chart above in early 2025, which came amid reports – later denied – that trade tariffs could be applied more narrowly than feared.

Fiscal outlook holds key to bonds

Fixed income markets have also seen some significant recent moves, as investors price in the likelihood of Trump's policies and their potential impact on inflation and interest rates.

James Bilson, Fixed Income Strategist, says, "Heading into the second Trump administration, bond markets have been repricing higher in yield due to a combination of strong growth, stickier recent inflation prints and expectations for further reflationary policy under a new government. Bonds now price between one and two 25-basis point (bp) Federal Reserve cuts for 2025, having priced more than four as recently as September."

US bond yields on the rise since September 2024



Source: FactSet, as at 10 January 2025. Past performance is not a guide to future performance and may not be repeated.

As they are with economic activity more broadly, bond market investors will be closely watching policy action on trade and immigration. James Bilson adds, “Most of all, however, we will be watching fiscal policy. This has become crucial for markets during and since the pandemic, and nowhere more so than the US.

“At the onset of Trump’s second term, the budget deficit is large – especially for an economy at full employment” James says. “Moreover, given demographic headwinds, projections are for deficits and debt to be on an explosive path. For bond markets, this is a problem – and one that market pricing is clearly responding to, with term premium (the payout for investing in longer-dated bonds) rising sharply.”

From a corporate credit perspective, Lisa Hornby, Head of US Fixed Income, adds, “Risk assets are entering this period from an expensive starting point. Corporate credit spreads, or the excess premium one receives over Treasuries, are at the more expensive end of their multi-decade range. And yet, the driving force behind tight credit spreads has been the amount of demand given the attractive all-in yield. It is difficult to see what reverses the direction of credit spreads while yields remain elevated.” (All-in yield is the total return from an investment – including interest or dividend payments as well as capital gains or losses - expressed as a percentage of the original investment amount).

Can US equity exceptionalism continue?

Turning to the stock market, US dominance of equity markets is at record levels. At the end of 2024, the MSCI USA index made up 74% of the MSCI World Index, and 67% of the MSCI All-Country World index (Source: LSEG DataStream, MSCI and Schroders).

What’s more, outside the peak of the dotcom bubble, US equity valuations are close to their most expensive in the past 143 years. Regardless of the incoming administration’s policies, there are question marks over whether these valuations can be sustained.

US valuations are uncomfortably high

US cyclically-adjusted price-earnings multiple (CAPE)



Source: Robert Shiller, Schroders. Data January 1871-December 2024. CAPE = price divided by 10-year average earnings, in inflation-adjusted terms. Past performance is not a guide to future performance and may not be repeated.

Duncan Lamont, Head of Strategic Research, says, "The US being expensive is not a new phenomenon, nor is the relatively high weight of the US in global markets. US stocks also have a lot going for them, including soaring US productivity versus the rest of the world, better economic momentum, and corporate buying.

"More favourable demographic projections are another advantage, although a shift to a less accommodative stance on immigration could easily remove this."

For investors concerned about high US valuations, one option is to look down the market capitalisation scale, given that small- and mid-cap companies are more cheaply valued than large caps.

Bob Kaynor, Head of US Small & Midcap Equities, says, "The US benefits from a strong labour market and likely policies from the next Trump administration that support domestic growth.

"Small- and mid-cap companies are much more likely to have customer bases that are either exclusively or predominantly in the US. For that reason, small- and mid-cap stocks can provide investors with more direct exposure to the US economy. Given how expensive large caps are today, small- and mid-cap stocks also provide a less costly way to gain that exposure."