The Market Implications Carried by the GOP Wave

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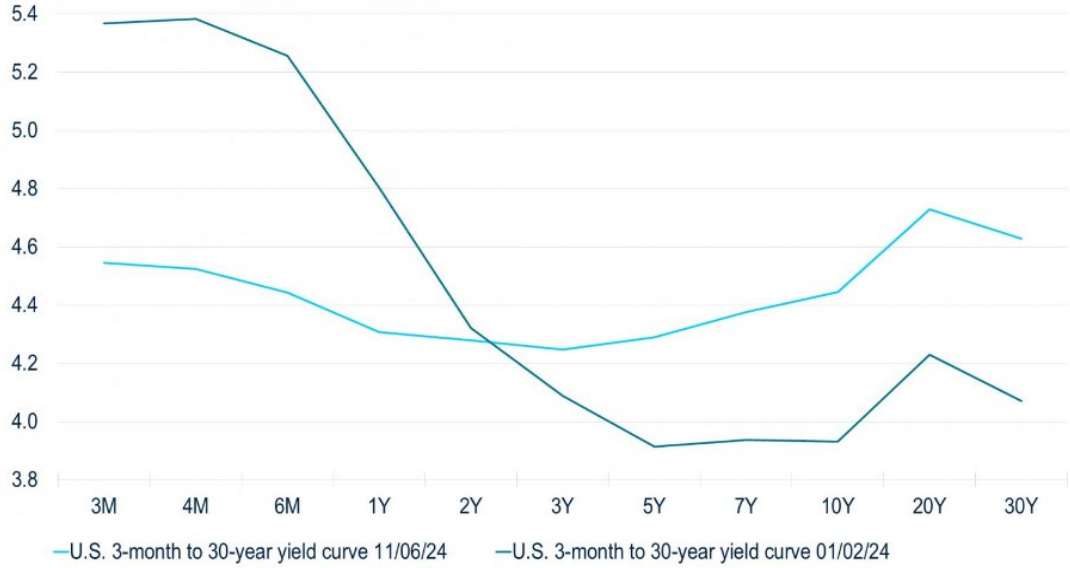
The outcome of the U.S. elections emerged sooner than many expected as a Republican wave is set to place the GOP in control of the White House, the Senate, and possibly the House of Representatives. We see Wednesday's significant market reaction as more of a confirmation of the moves over recent weeks - which is understandable from a directional perspective - rather than another, new paradigm. As such, the following provides our post-election takeaways on interest rates, investment risks, and credit conditions, while the accompanying link points to our assessment of how a GOP wave may affect economic conditions going forward.

Heading into the elections, our multi-sector strategies were slightly short to neutral on developed market duration as rates traded across a historically wide range, which we expect will continue going forward. We also see further pressure on the U.S. yield curve and the outright level of rates given that President-elect Trump's stated policies will likely be more inflationary, while growing deficits will continue to fuel a relentless wave of Treasury supply.

With that context, we will continue to trade the interest-rate range with a bias towards higher U.S. rates and a steeper yield curve (Figure 1). From a broader perspective, the correlation between global Treasury rates should continue to decline amid the dispersion in growth and inflation dynamics, likely prompting more uneven central bank policy responses. As a result, these may be conditions where European and EM local rates outperform as continuation of the relatively strong backdrop for the U.S. dollar may only serve to push non-U.S. policy rates lower.

FIGURE 1: The recent steepening in the U.S. yield curve should continue with the Republican wave.



Source: Bloomberg.

On the risk side, the rationale exists for higher stock prices over the near term given the potential lift from reduced corporate tax rates, but valuations are already quite stretched. Therefore, the bullishness may not extend to the long term given equities' expensive starting point, unlike recent past elections when valuations were not nearly as extended.

On the credit side, we are treading lightly with close input from credit research. Within multi-sector strategies, we are already using the post-election rally to pare certain risk exposures. It is really a simple story of asymmetric risk/reward as tight spread levels squarely cap the upside, leaving one quite vulnerable to the downside. While there are technical reasons that spreads may continue to grind tighter - e.g., the consistent bid for long corporates from pension funds/LDI players - that is a component of the rationale to pare risk into market strength. As we reduce certain areas of risk, we also continue to focus on safe carry opportunities.

From a sector perspective, our multi-sector strategies continue focusing on global financials while moving in on the spread curve. Considering the recent pressure on agency mortgages, MBS appear attractive (even with elevated volatility) relative to U.S. investment grade corporates.

Leverage finance is a case in point for stretched valuations and requisite input from credit analysts. At this point, the sector is more of an idiosyncratic/active management play than an asset allocation decision. A higher interest-rate environment will continue to pressure the most levered capital structures, which should continue to breed an elevated distressed backdrop.

Looking ahead, this is a good news, bad news story. The bad news is that passive allocators may experience lagging returns relative to the risk they assume. The good news is that dispersion across the sector will remain high, which should continue to provide ample opportunity for credit selection throughout the various stages of a credit cycle.

As additional details of a Trump administration fall into place, we will update our economic scenarios and sector expectations in our Q1 2025 market outlook.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, PGIM Fixed Income, as of November 2024.
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PGIMJ113443
4007964-20241107