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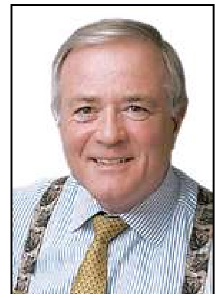
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Election clarity drives markets higher; policy uncertainties loom

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November's decisive presidential election outcome unleashed a wave of market optimism, with the S&P 500 reaching new highs and delivering its best performance through the first three quarters of any year this century. The S&P achieved record high closing prices more than 50 times through the end of November. The Dow Jones Industrial Average crossed 44,000 for the first time, while after the election the Russell 2000 index of small-capitalization stocks surged 8.6 percent — its largest weekly gain since April 2020.

As it became clear that the uncertainty of a potentially contested election was removed, investor cash that had been sitting on the sidelines came pouring out of money markets and gold and into equities. Optimism about the favorable regulatory and tax treatment for corporate America took hold. Sector rotation was dramatic and immediate. Banks surged on expectations of regulatory relief and increased M&A activity, with JPMorgan Chase, Wells Fargo and Goldman Sachs all rising more than 12 percent in the session after the election. Industrial stocks, particularly equipment manufacturers and domestic steelmakers, rallied on prospects of protective tariffs.

The Federal Reserve continued its measured approach to monetary policy, cutting rates by 0.25 percent to a range of 4.5 percent to 4.75 percent, following September's larger 0.5 percent reduction. There was a highly unusual, single dissenting vote – the first opposing a Fed chair in almost 20 years. Fed Gov. Michelle Bowman expressed concern that the inflation goal has not been met and further rate cuts might reignite it. In fact, October's core PCE (Personal Consumption Expenditures) inflation ticked up to 2.8 percent, moving away from the Fed's 2 percent target. This persistent inflation, combined with continuing strong employment, has led markets to reduce expectations for the pace of rate cuts in 2025.

Bond markets are signaling their own narrative about the economy's direction. The yield for the 10-year Treasury has unexpectedly retreated from recent highs, while corporate bond spreads remain tight, suggesting continued confidence in corporate earnings. The Treasury yield curve, which measures the difference between long-term and short-term interest rates, has flattened considerably — a pattern that historically often precedes economic slowdowns as investors bet on lower future growth. The mixed signals in the fixed-income markets reflect the broader tension between current economic strength and uncertainty about policy implementation in the years ahead.

As I have long reminded readers, consumers drive 70 percent of the U.S. economy, and November's retail earnings provided crucial insights as to how their dollars are being allocated. Walmart reported impressive results, with U.S. comparable sales rising 5.3 percent and e-commerce growing 22 percent, driven by strength in both essential and discretionary categories. In contrast, Target's comparable sales rose just 0.3 percent, with consumers pulling back on nonessential purchases. This divergence suggests that while overall consumer spending remains resilient, there is increasing price sensitivity and a growing divide between value-oriented and premium retail segments.

Looking ahead, proposed trade policies could significantly impact consumer spending. When the U.S. imposes a tariff, it's effectively a tax paid by U.S. importers, not foreign exporters. These costs typically get passed on to American consumers through higher prices. While tariffs can protect domestic industries, they often lead to retaliatory measures from trading partners and create ripple effects throughout supply chains. The incoming administration's pledge to implement 25 percent tariffs on Mexican and Canadian imports, along with additional Chinese tariffs, could raise prices on everything from fresh produce to electronics. Economists estimate these measures could add 0.75 percent to consumer prices in 2025, with specific sectors facing steeper increases – for instance, automobile prices could rise by $3,000 per vehicle.

Just as in 2016, the challenge lies in distinguishing between campaign rhetoric and policy implementation reality, between short-term market reactions and sustainable investment trends. While investors await December's Fed meeting for signals about future rate cuts, the market is already pricing in an optimistic outcome, trading at 27 times trailing 12-month earnings compared to a historical average of 19 times. Against this backdrop of high valuations and policy uncertainty, a diversified portfolio remains the most reliable strategy for participating in opportunities while managing the inevitable risks ahead.

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