Market Impact of Evolving U.S. Policies

GREGORY J. LEONBERGER, FSA, EA, MAAA, DIRECTOR OF RESEARCH, MANAGING PARTNER

Over the past 12 months, we have seen significant policy evolution on behalf of the U.S. in regard to taxes and Chinese tariffs, and the upcoming mid-term elections will no doubt affect future policies as well. Of particular interest is the impact of these policies on the capital markets, and what this means for institutional investors.

The new tax law reduces personal and corporate rates, which should mean that consumers have more money in their pockets and companies retain more of their profits. Economic growth in the U.S. is primarily driven by consumption, so it is logical to think that economic growth will increase since consumers will retain more of their earnings. Of course, the current legislation mandates that the personal tax cuts sunset by 2027, so the increase to GDP is expected to be temporary, but nonetheless accretive to economic growth.

More meaningful is the reduction to corporate taxes, which are expected to increase company profitability and should bode well for stocks, particularly those whose parent companies source the majority of their revenues domestically. Value stocks should benefit more than growth stocks, and small-caps should benefit more than mid- and large-caps.

Unfortunately, there is no such thing as a free lunch: since the government is collecting less in tax revenue but still spending about the same amount, additional borrowing is necessary to balance the budget. Fortunately, running a deficit is nothing new in the United States, although there is some concern that the additional borrowing needed to balance the budget will increase interest rates. Naturally, this could be damaging to fixed income returns, and shorter duration strategies will lose less than their longer duration counterparts. Perhaps a bit surprising to many is that international equities tend to be positive when rates increase, which should help offset fixed income losses in a portfolio.

In total, the tax cuts should drive GDP higher while equities (U.S. and non-U.S.) are expected to benefit, with small-caps in the U.S. the biggest winner. Higher rates could mean trouble for most fixed income strategies, but overall the tax cuts should be a net positive result for the economy and institutional portfolios.

The tariff war with China has grown from market noise to a realistic threat for the global economy and capital markets. Given the relative infancy of the tariffs, it is difficult to precisely predict the ramifications, but suffice to say markets are concerned. Similarly, it is difficult to determine who stands to win or lose the most between the U.S. and China. The U.S. imports a larger dollar amount of goods from China than it exports to China, so there is a greater amount of goods on which the U.S. can impose tariffs. However, many of these imports are inputs for goods that are ultimately produced and consumed here in the U.S., thus it's possible these tariffs could just mean higher prices for U.S. consumers. In terms of capital markets, growth stocks — particularly tech companies — stand to lose the most as the tariff war progresses.

Finally, mid-term elections create another layer of uncertainty in the capital markets, and the data supports that. In most mid-term election years, market corrections are common and typically in the double digits; markets spend most of the year looking for direction, and tend to take off in the 4th quarter, once mid-term elections are

CONTINUED >

complete and more clarity around future policies is available. For this set of mid-term elections, the House of Representatives may flip from Republican control to Democrat control, but the Senate and President will both be led by Republicans. Regardless if the House is Republican or Democrat-controlled, U.S. equity markets have averaged double digit positive returns when the President and Senate have been controlled by Republicans, so investors will no doubt be curious to see if that trend continues.

Ultimately, it is impossible to deny that evolving U.S. policies can impact the capital markets. However, they are one of many market dynamics which can drive markets higher or lower, and trying to make portfolio decisions simply on U.S. policy is not a profitable portfolio management strategy. Rather, we encourage clients to adhere to their investment policy statements to meet their long-term risk and return objectives and recognize that short-term market volatility — whether driven by policy or other forces — is natural and to be expected but should not be relied upon as an exclusive compass for portfolio management.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

About Marquette Associates

Marquette Associates is an independent investment consulting firm that guides institutional investment programs with a focused client service approach and careful research. Marquette has served a single mission since 1986 – enable institutions to become more effective investment stewards. Marquette is a completely independent and 100% employee-owned consultancy founded with the sole purpose of advising institutions.

For more information, please visit www.marquetteassociates.com.