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Executive Summary

Numerous policy changes were put forward during the presidential campaign. Although there are many offsetting effects and high uncertainty for actual policy changes, here are my takeaways:

- I expect a small temporary increase in inflation (0.5%) next year.
- Interest rates are likely to go up by about 1% total.
- Larger effects are possible; we should be cautious and vigilant for risks and opportunities.

The equity markets remain in risk loving mode for now with signs of speculative excess in plain sight. If history repeats itself, risk lovers will be rewarded with large losses.

Analyzing the Impact of Potential Government Policies

President Trump has promised many changes for government policies under his new administration. As investors we would like to assess the potential impacts of these policy changes on asset returns and our spending power. At the same time we need to estimate the probabilities of these changes given that presidents don’t always do what they say, and sometimes cannot deliver changes when congress does not go along.

In particular, we want to consider the following sources of change:

- Tariffs (i.e. taxes) on imported goods
- Immigration and Deportations
- Taxes – rates, deductions, exclusions, tax expenditures
- Government spending and subsidies
- Government actions to reduce regulations and support industry.

The macro-economic (big picture) variables at play are inflation, short term and long term interest rates, and prospects for economic growth and/or recession.

For each policy area I chose several scenarios. I estimated the probability of each scenario and potential consequences. There are a lot more details in this than you probably care to read, therefore this analysis is relegated to Appendix A. I also looked at estimates from the ChatGPT4.o and Claude artificial intelligence models. Most of their estimates were roughly similar to mine but there were a few big discrepancies[1].

Clearly there are many possible combinations of policy changes that might interact and offset one another. Let's focus on the "highlights", meaning those policies with the largest potential financial impacts. My analysis of these scenarios by policy area follows.

Tariff Policies

To put tariffs in context, here is the breakdown of imports to the U.S.:

Tariff target	Imports as % GDP
China	1.5
Mexico	1.7
Canada	1.6
Other countries	9.1

Tariffs on China rise to 60%

This would mean that a laptop computer priced today at $1,000 could end up priced at $1,600. I think the probability of this actually happening is about 40%. It is more likely China will make some concessions to get a lower rate. If it does happen, I think it likely that tariffs would be phased in over 3 years or more to reduce recession risk and cushion the impact on inflation. Since Trump's first term, U.S. imports from China have declined. Therefore even a large tariff rate will have limited impact, especially if phased in to allow for adjustments. If it does happen on day one, I put recession likelihood at 50%. At worst, this policy would result in a one-time .9% increase in prices over the phase in period.

Tariffs on countries other than China, Mexico, and Canada rise to 15%

Because this is rather extreme and would antagonize allies and the whole world, I put the probability of implementation at just 20%. Because trade with this group of countries is about 6 times our trade with China, the impact is far larger, even with the much lower tariff proposed. In the worst case we could expect a one-time price rise of 1.4%. Because the tariff rate is lower and spread over a wider range of industries, my estimate of recession risk is 40% in the case where this is implemented immediately rather than phased in over several years.

[1] I theorize that they are not using the contextual statistics I show in this article but are merely parroting other writers' using extreme estimates to try to influence the politics.

Other Effects of Tariffs

As businesses and consumers react to changes in relative prices due to tariffs, demand will shift towards domestic substitutes and this should spur more investment in the U.S. We will likely see interest rates go up because there will be lower foreign earnings to be invested in U.S. bonds while demand for borrowing in the U.S. will rise. I estimate rates could go up .50% to 1.0% in reaction to broad based tariffs. Higher rates in turn, will cause some portion of tariffs to be offset by a strengthening of the dollar. There is also a good chance that trading partners reciprocate by raising tariffs again our exports. This could at least partly offset incentives to invest in the U.S. In summary there will be many complex interactions that will serve to move the economy to a new equilibrium where we save more and invest more in domestic production to replace imports.

Immigration Policies

To understand the impact of immigration policy, here are some relevant statistics:

- The U.S. labor force is 168.4 million.
- Immigration in 2019 was 568,000.
- Immigration in 2023 was 2,800,000.
- There are an estimated 12.6 million illegal immigrants in the U.S.
- The last Trump administration carried out 1.5 million involuntary deportations over four years.
- Through September 2024 the Biden administration conducted 1.4 million involuntary deportations, but this excludes an additional 3 million expulsions carried out under Title 43 which allows expulsions to prevent the spread of disease.
- There are 44 million U.S. born 16- to 64-year-olds not in the labor force which is an increase of 10 million since the year 2000.

Immigration is brought back down to pre-Biden levels

Given that this is such a key issue, the probability of this happening is at least 95%. This would mean a reduction in population growth of about 2.2 million annually. Since economic growth is a function of population growth and labor force participation, this policy, in isolation, would reduce growth in gross national product by about .66%[2]. This could be mitigated by an increase in labor force participation by native born Americans and by productivity improvements.

[2] This assumes 50% of illegal immigrants are of working age and participate in the labor force.

Involuntary deportations rise to 3.5 million per year[3]

This would require a substantial increase in resources. As we've seen, spending priorities involve complex negotiations in congress. Therefore I put the probability at 30%. If it does happen, the U.S. would see outright population declines. All else equal, I estimate economic growth would be .95% lower per year. In the near term there would be severe labor shortages in affected industries. I put the probability of recession in this scenario at 50%. It will, however, take at least a year to get funding and hire agents to carry out such a policy. In the longer run, the reduction in competition for jobs for non-college educated Americans could encourage more of them to come back into the labor force – albeit at higher wages than the illegal immigrants they replace. This would eventually offset some or all of the reduction in immigrant labor. Still this would be a very disruptive adjustment process for the economy and affected businesses. We could see an increase in bankruptcies in industries such as construction and agriculture that use a high proportion of illegal immigrant labor.

Tax policy changes

The tax policy changes mooted are not likely to have large impacts in the near term because they are small relative to the size of the economy. But, over time, if tax cuts are not matched by spending cuts it will drive up inflation or interest rates or both (by increasing government debts relative to gross national product).

The Department of Government Efficiency (DOGE)

I give DOGE a 0% chance of achieving their $2 trillion goal for reduced government spending. Trump has promised not to cut entitlement spending, so there is no viable path to cutting total spending this much. But, if it did happen, the impact would be very large since this represents 6.8% of gross national product. In that case I estimate a 90% chance of a recession if implemented over 3 years or less. Interest rates would drop .75% to 1%.

Assessing Likely Policies and Offsetting Effects

Although the probabilities I've assigned to the tariff policy scenarios are all below 50%, I do expect that there will be less drastic tariff increases on a large percentage of imports. These policies will increase short term inflation and will likely push up interest rates in the near term. Longer term, lower trade deficits would probably help push down interest rates.

Immigration policies will likely cause labor shortages and reduce economic growth in the near term until investments compensate to produce higher productivity growth and/or labor participation rates for Americans with less education move back towards historical levels. The impact on prices will be mixed because fewer people also means lower demand as well as lower supply.

The tax policy changes that are likely to pass will have very little financial or economic impact at the economy-wide level. The proposed elimination of taxes for social security is

[3] Since there are about 12.6 million illegal aliens with more coming every day, deportations would need to reach this level to come close to the new president's stated goals during his 4 year term.

something of a wild card that could do damage to the nation's finances (while helping retirees in the short run). If this tax elimination is not combined with a solution to the 2033 automatic cut in benefits, retirees will need to start planning for those cuts.

Successful reductions in government expenditures would counteract some of the inflationary policies listed above. Such polices could also push interest rates in the opposite direction (meaning down). Although big and sudden government spending decreases could push us into recession until the economy is able to reallocate those resources, it is unlikely such changes will be large or sudden. In the longer run a significant increase in the efficiency of government spending would enable faster growth with lower interest rates.

Reductions in regulations seem very likely for this administration. These policies will help offset some of the effects of other polices by lowering interest rates and increasing economic growth. The size of impact is not as large as my more extreme scenarios above but could be enough to offset less extreme versions of the proposed policy changes.

Weighing the Impacts for Investing Strategy

In the policies above, some will increase inflation while others will decrease inflation (but probably by lesser magnitude). Likewise there are potentially offsetting effects on interest rates and economic growth.

Higher tariffs and a reduced labor force seem to be recipe for inflation, higher interest rates, and business disruptions that risk slower growth and recession. On the other hand, slower growth would tend to reduce inflation, as would the productivity enhancing investments likely to be triggered by the policy changes.

Reductions in regulatory burdens and taxes will increase productivity and growth. While big decreases in government costs would likely be beneficial in the long run, big changes that happen quickly would be a negative factor in the near term.

Whether the changes trigger a recession depends on a few key policies and their speed of implementation. Therefore, overall the probability of recession is still less than 50% in the near term. We will need to see what changes actually get implemented to avoid over-reacting to political rhetoric.

Overall, I expect a .5% increase in inflation for a year. Long term interest rates will likely rise 1.0% compared to what they would otherwise have done. Of this, roughly .5% has already happened since the market began pricing in a Trump victory. Population, labor force and economic growth will likely decline by .9% compared to the status quo.

The homebuilding industry, in particular, faces a very challenging environment. Consequently I've reduced exposure to this industry in the real estate portfolio and may eliminate it entirely if the most drastic scenario materializes. Residential real estate stocks might benefit from higher inflation but that could be offset by higher interest rates and reduced population growth.

Long term bonds have been marked down in price and may have further to go; but their yields offer attractive returns in this environment. Especially when compared to

S&P 500 index stocks which are facing increased risks while hovering at a speculative peak in valuation. Floating rate bonds should perform well, although major weakness in the economy could offset their advantages if it leads to the Federal Reserve cutting rates and/or increasing credit risks.

Clearly there are a lot of moving parts here; there are a lot of ways this can play out other than a most likely set of circumstances. Thus, caution is warranted. As always, I will remain vigilant for risks and opportunities.

Current Investment Environment: A Risk Loving Market

Like most people, I find it difficult to see people doing really dumb things and getting rich by taking advantage of others' greed. This requires projecting enough confidence to attract a large gullible crowd with the money to earn the leader a fortune despite the lack of investment merit. Such schemes always involve "confidence men" betting other people's money. These things can go on for years depending on the market environment. Often these investments are outright fraud. For example Charles Ponzi, Bernie Madoff and Sam Bankman-Fried created pyramid schemes that crossed the line to illegality. Then there's Adam Neuman, founder of We Work, who took billions from Softbank without going to jail.

The latest get-rich-quick magician is running a company called Microstrategy. The idea is simple: buy a volatile speculative asset (Bitcoin) and convince investors its worth twice as much if you hold it for them. Then sell new stock at double what you paid for your assets (which your investors could have bought for themselves). Rinse and repeat. This appears to be legal, but it will end badly – someday.

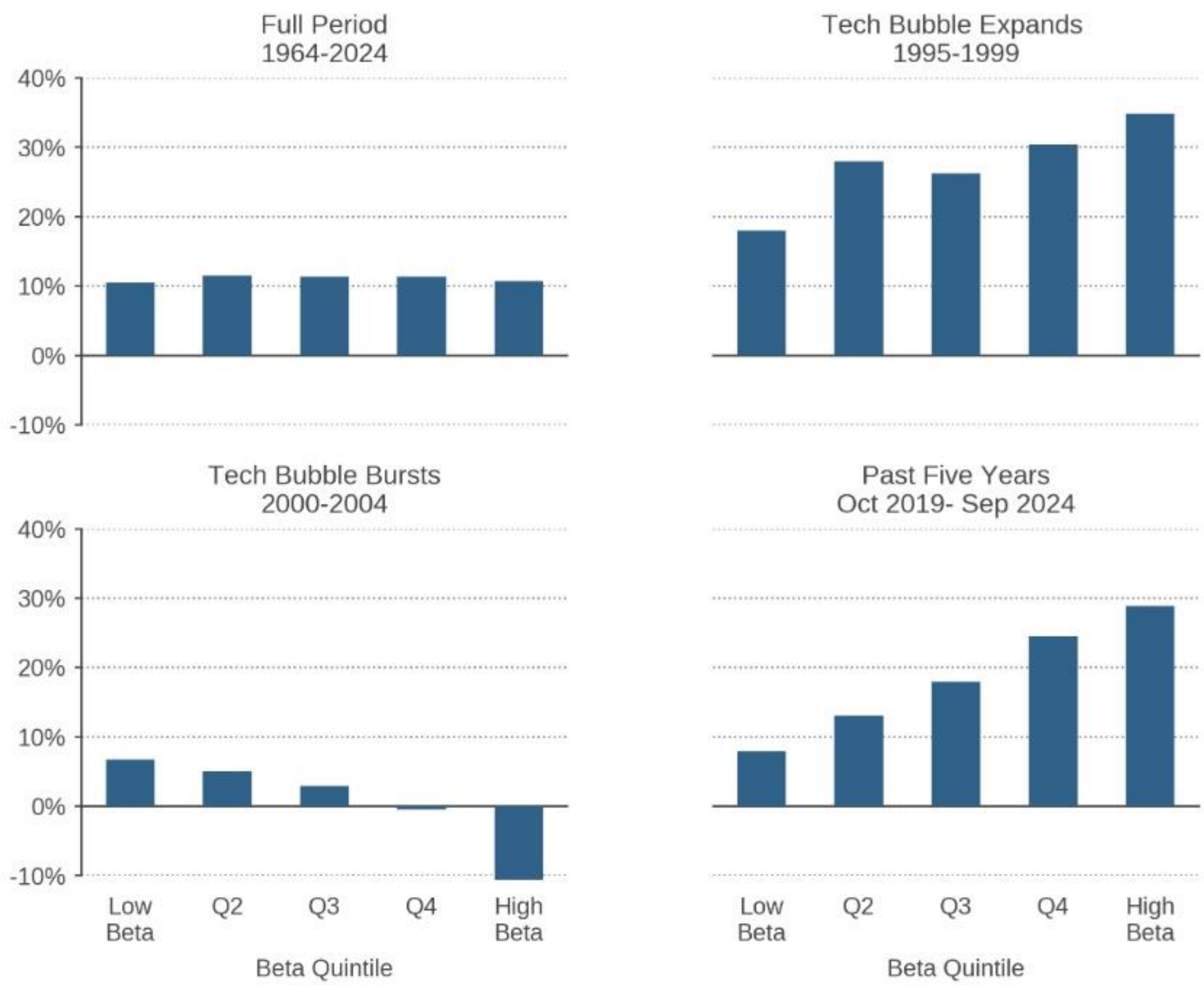
This is just one indicator of the speculative risk-loving market that we're in now. The stock market was already at unsustainable valuations when the election results drove it even higher. After assessing the new president's proposals, I have a hard time understanding the enthusiasm for the stocks that have the most room to fall. I've been reading quite a bit of commentary about the weirdness of this market. Let's look at some data to put the current market in context.

The charts on the next page are from the blog of an institutional investor called Acadian. These bring back memories of my years in grad school studying a theory called the Capital Asset Pricing Model which claimed that riskier stocks offered higher returns. In this model, and in these charts, risk is measured by a variable called Beta. The Beta of a stock tells you how much it moves up and down compared to the overall stock market. A stock with a Beta of .5 goes up half as much as the market and also down half as much. Likewise a stock with a Beta of 2 would move two times the move of the market, on average. To create these charts they've sorted the universe of stocks into five risk classes (quintiles) from lowest risk on the left to highest risk on the right. The vertical axis of the graphs measure average annualized returns for each of the five risk categories over the period of data for each graph. Therefore if bars are higher on the right, it means riskier stocks earned higher returns but if all the bars are about equal, there were no additional returns for taking more risks.

The full period of their data is 1964-2024. Below are four graphs. The first, at upper left, is the full period. This refutes the idea that riskier stocks produce higher long run returns. Here we actually see slightly higher returns for the lower risk quintiles.

To the right of that we see that during the speculative tech bubble of 1995 to 1999, higher returns were indeed produced by the riskiest stocks. But because we know that in the long run this does not hold, we should expect a period of better returns for low risk stocks.

This is what we find in the lower left chart for the 2000-2004 period after the Tech Bubble Burst.



Finally, the lower right chart shows 2019-2024. For these last five years we've been in the portion of the market cycle where investors have earned higher returns by embracing more risk. Since we know this does not work in the long run, we should expect a reversal at some point so that the lower risk stocks outperform the higher risk stocks.

Our Defensive Equity portfolio was designed to come from the Lowest Beta Quintile. I cannot say when these low Beta stocks will make up for the last 5 years but I'm pretty sure this won't take another 5 years.

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Appendix A

Tariff Policies

Scenario Description	Likelihood	Significant Financial Impacts
Tariffs on China rise to 60%	40%	Inflation up .9% for one year. 50% chance of recession if increase is not phased in over at least 3 years. Interest rates would likely rise .5%
Tariffs on China rise to 30%	40%	Inflation up .45% for one year. 25% chance of recession if increase is not phased in over at least 3 years. Interest rates would likely rise .25%.
Tariffs on Mexico rise to 25%	20%	Inflation up .4% for one year. 25% chance of recession if increase is not phased in over at least 3 years. Interest rates would likely rise .25% -.50%
Tariffs on Canada rise to 25%	10%	Inflation up .4% for one year. 25% chance of recession if increase is not phased in over at least 3 years. Interest rates would likely rise .10%
Tariffs on the rest of the world rise to 15%	20%	Inflation up 1.4% for one year. 40% chance of recession if increase is not phased in over at least 3 years. Interest rates would likely rise 0.25% -.50%

Immigration and Deportation Policies

Scenario Description	Likelihood	Significant Financial Impacts
Illegal immigration reduced to pre-Biden levels	95%	Economic growth slows by .66% due to slower labor force growth partially offset by productivity increase.
Annual deportations rise to 1 million per year.	60%	Economic growth slows by .2% due to labor shortage.
Annual deportations rise to 3.5 million per year	30%	Economic growth slows by .9% as labor force contracts and severe labor shortage disrupts certain industries. 50% chance of a recession.

Tax Policies

Scenario Description	Likelihood	Significant Financial Impacts
Social security taxes are eliminated	20%	Increase of .5% in interest rates.
Other targeted groups get tax exclusions	10%	Increase of .1% in interest rates
Clean Energy tax expenditures are reduced.	70%	Decline in inflation of .1%, decline of .1% in interest rates.
The limit on deduction of local taxes is doubled.	60%	None
The Corporate tax rate is reduced to 20%.	10%	Economic growth increase of .2%.

Government Spending and Subsidies

Scenario Description	Likelihood	Probable Consequences
EV tax credit is eliminated.	80%	Decline in inflation of .1%, decline of .1% in interest rates.
DOGE causes a $2 trillion reduction in government spending	0%	90% chance of recession. Interest rates would drop .75% to 1%.
DOGE causes a $500 billion reduction in government spending	10%	40% chance of recession. Interest rates would drop .25% to .5%.

Government Actions to Reduce Regulations and Support Industry

Scenario Description	Likelihood	Probable Consequences
Deregulation initiatives reduce compliance and other costs by $100 billion annually.	50%	Decline in inflation of .2%. Economic growth increase of .3%.
Restrictions on energy production and export are eliminated	90%	Decline in inflation of .2%. Economic growth increase of .4%.