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The Trump Stock Euphoria Starts to Fade

Tariffs, deficits and stretched valuations give Wall Street pause

By Jack Pitcher Follow

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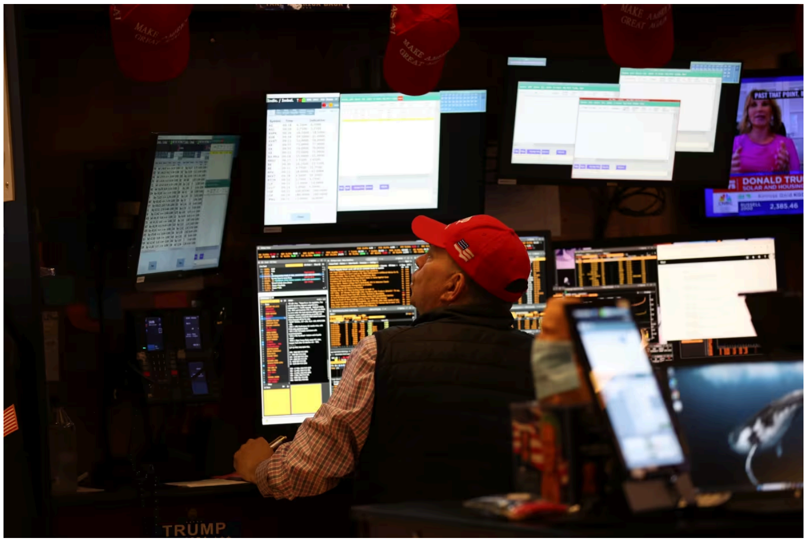

Stocks already look expensive by many metrics. PHOTO: LIU YANAN/ZUMA PRESS

Can the postelection market rally continue? Some on Wall Street are skeptical.

Investors cheered the unexpected Republican sweep of the presidency and both houses of Congress, salivating over the potential for new pro-business policies. Stock indexes set records, and stock funds posted historically high inflows.

That rally has faded as President-elect Donald Trump fills out his cabinet and analysts grasp for policy details. Perhaps the most crucial question for markets:

How serious is Trump about tariffs, which are widely regarded as inflationary and could reach their highest level since the 1930s if delivered as promised?

"We think the inflation battle was almost won coming into the election," said Kevin Khang, head of global economic research at Vanguard. "But a potential tariff, depending on what the policy actually looks like, could have a big impact."

The Trump presidency makes Vanguard "more cautious" on its economic growth forecast. His term could stoke inflation, Khang said, both through tariffs and because deportations of immigrants would tighten the labor-market supply, especially in perennially understaffed industries such as construction and hospitality.

The S&P 500 has soared 24% this year, buoyed by artificial-intelligence hype and optimism that lower inflation means less-restrictive monetary policy going forward. Lower interest rates typically encourage risk-taking and help boost stocks, and the Federal Reserve has slashed its benchmark rate twice since September.

But Fed officials are publicly questioning whether further cuts are needed right now as more data point to a strong economy. Derivative traders are currently pricing in several more rate cuts in 2025, and stocks could decline if those don't come.

The prospect of tariffs has some of Wall Street's biggest players on edge. Republican megadonor Ken Griffin, a hedge-fund titan and founder of Citadel, told students in the U.K. on Monday that he was "very anxious about the president's willingness to engage in tariffs as a matter of trade policy," Bloomberg reported.

Hedge-fund titan Ken Griffin is uneasy about using tariffs in trade policy. PHOTO: SCOTT MCINTYRE FOR THE WALL STREET JOURNAL

But higher-than-anticipated inflation, and in turn higher rates, is one of the biggest risks to that forecast, said David Kostin, chief equity strategist at Goldman.

"Why might we get higher inflation? It could be from immigration policy changes. It could be from tariffs. It could be from fiscal policy shifts. That's one area we're focusing a lot of attention on," Kostin said.

Valuations are one of the biggest things making investors uneasy. The S&P 500's cyclically adjusted price/earnings ratio is currently around the 97th percentile based on data going back to 1930, according to Goldman.

If the eye-popping returns are to continue, earnings need to grow rapidly or valuations need to push to new heights.

"Really extended valuations on equities means we're vulnerable to shocks, turbulence and volatility," said José Torres, senior economist at Interactive Brokers. "While Trump and his administration are likely to boost corporate profitability, we learned during Trump 1.0 that it's usually not smooth sailing."

Geopolitical risks related to the wars in Ukraine and the Middle East combined with memories of Trump's at-times chaotic governing style make it easy for some investors to picture valuations falling back to earth.

The cabinet nomination process has already put some sectors on edge. Investors slashed billions of dollars of value off the world's top vaccine makers after Trump nominated vaccine skeptic Robert F. Kennedy Jr. as Health and Human Services secretary. Meanwhile, Trump nominated Cantor Fitzgerald chief Howard Lutnik, a tariff advocate, to lead the Commerce Department.

Donald Trump's choice of Robert F. Kennedy Jr. as Health and Human Services secretary reduced vaccine makers' value. PHOTO: ANNA MONEYMAKER/GETTY IMAGES

Wall Street hopes the new Trump administration will deliver corporate tax cuts and boost growth by cutting regulatory red tape, but a lack of details has made consequences hard to project.

Trump's "unusual policy mix and high uncertainty about their timing, magnitude and combination leaves investors with a range of potential outcomes, from good to bad," Jason Draho, head of asset allocation Americas at UBS Global Wealth Management, wrote to clients this week.

The uncertainty is welcome news for investors like Nouriel Roubini, the economist nicknamed "Dr. Doom" who presciently said in 2006 that a U.S. housing-market slowdown could cause a global recession.

Roubini is managing the newly launched Atlas America exchange-traded fund. The defensive-minded product aims to provide inflation-protected returns that aren't correlated to broader market performance through a portfolio of short-term Treasurys, gold, real estate and agricultural commodities.

"The new presidency is targeting a tariff, which is highly inflationary, the printing of the dollar to devalue it and reshore manufacturing, and tax cuts, which may mean they have to turn the printing presses on," said Reza Bundy, chief executive of Atlas Capital Team. "We think our product is made for this administration."

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