US Election 2024

Before and After

TRANSATLANTIC PRIVATE CLIENT GROUP
of Oppenheimer & Co. Inc.

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Many of our clients worried about US elections and pondered their significance. They have happened, executive cabinet nominations are known and legislature committee heads too. Market volatility often follows election days before resolving into a trend, this time continuing a broad rally that had its beginnings a month before.

> Changing of the guard… nearly two years after the S&P 500 bottomed in October 2022, more stocks are finally pitching in to help push the index higher, just as many bullish investors had hoped.
> *—Dow Jones, 3 October 2024*

From the investor's point of view, we avoided the worst of what polls indicated: a fractional percentage win by one candidate or the other. The election would then have been fought in Congress and courts, a result unclear for months and with exceedingly negative repercussions, e.g. a worse than 20% market decline. We positioned against that risk by trimming some higher beta holdings.

Coming policy is being outlined, albeit with noise to filter, providing a basis along with precedent to make reasoned assessments of the significance for us as investors. Whitehouse policies will have impact in detail, but epochal change in government is far less likely than is being trumpeted.

I will outline what we see unfolding and positioning for it. Signs are promising for many more companies. A corollary is that the few companies that outperformed since 2023 could lose at least some of their leadership luster.

First, circumstances oblige me again to comment on market anomalies. It is background to why we think that the average stock can experience a relative catch-up in coming years.

S&P Index Outperformance

The S&P 500 continued an idiosyncratic rise, in nature without precedent, reminiscent of the Meme Stock fervor of 2021. Bull markets broaden to include most stocks. Not this time. The same small minority dominated in 2024 as in 2023—the Magnificent 7 (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla.)

> Barrons observes that this anomaly has been "the greatest concentration of capital in the smallest number of companies in the history of the US stock market.
> *—(20 Sept 2024)*

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Frustratingly, prudent diversification and GARP strategies (seeking growth at a reasonable price) led to trailing the index. I wrote last autumn that the market looked poised to broaden, as is expected when profit estimates are looking up for more companies.

> Companies excluding the Magnificent 7 are expected to post their first quarter of year-over-year earnings growth since fourth quarter 2022. Meanwhile, growth for the Magnificent 7, which drove S&P 500 earnings… is expected to slow… the start of a trend of growth broadening across the market.
>
> *—Investopedia, January 2024*

The Magnificent 7 stocks' narrow rally began in 2023. Defying expectations it continued.

As observed last year,

> The Magnificent Seven drove 84% of global returns. That matches what's going on in US markets. [They] drove 117.8% of total returns. The S&P would be down on the year if not for the seven tech giants.
>
> *—DataTrek & Investors Business Daily, 23 November 2023, on the start of the rally*

The Magnificents continued until just those 7 stocks reached a value...

> ...roughly equal the combined value of the UK, Japan, and Canada's stock markets.
>
> *—Business Insider, 3 Jan 2024*

... and kept going.

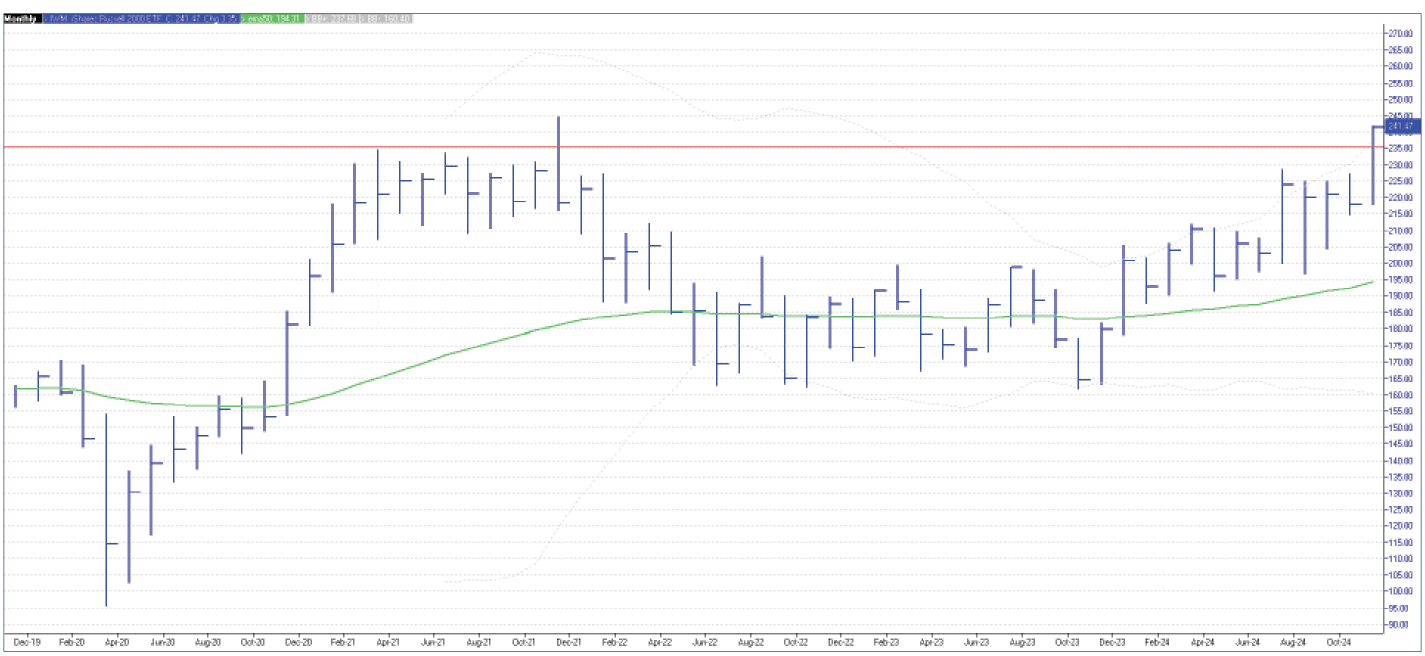
The S&P 500 index is capitalization weighted. That means the higher the Magnificent 7 go, the more of the index they represent, a curiosity of that index's construction. S&P tracks a companion index, the S&P Equal Weight. As its name implies, it doesn't overweight any one or few stocks but gives a balanced weight to each of the component companies. The difference between the two indexes offers another remarkable picture of this market.

> The performance gap between the cap-weighted and equal-weight indices over the last two years is the widest in ~24 years. In fact, the equal-weighted index is now unchanged since the start of 2022.
>
> *—Zerohedge, 17 June 2024*

As we noted before, bull markets can start in one or a few sectors, but then widen considerably. This one has bided its time to do that. Marked relative valuation differences should finally see more stocks participate. They are overdue for a catch up.

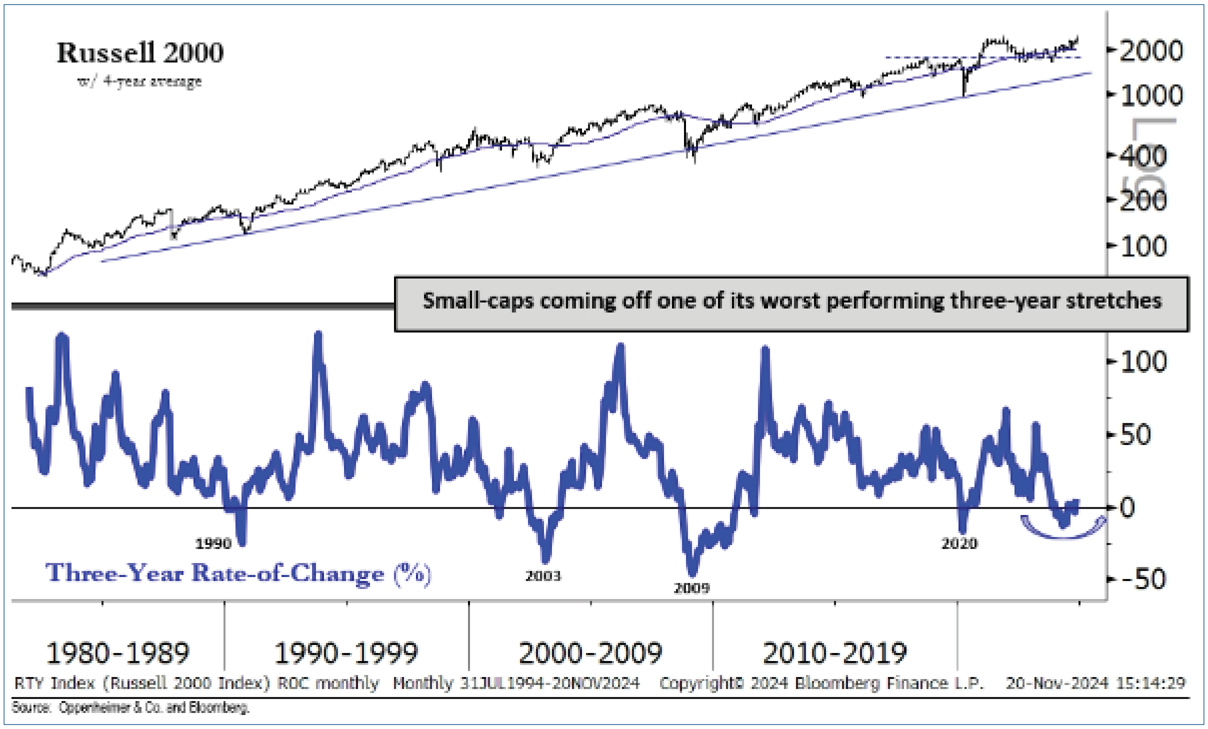
Small Stocks Lag

Another rare phenomenon: the S&P repeatedly hit new highs while small companies remained mired in a bear market. This 2019-2024 Russell Small Cap chart shows smaller companies failing to achieve the levels of February 2021—over 40 months lagging. Only after the elections did they break their unusually long slump.



Reuters monthly chart.

A longer chart back to 1980 shows the rebounds of smaller companies in the past.



Ari Wald, Oppenheimer & Co., 20 November 2024.

Small company prosperity is desirable for three reasons. For an economy, investment in small enterprises finances innovation. For investors, diversification across market capitalization can spread risk and enhance returns. For growth investors, emerging innovators matter. Said someone who should know…

> Every time, it's been the new players who were the dominant players in the next generation. It was rare and nonexistent when the leader in the prior one was one of the top three leaders in the next 1, 5 or 10 years.
>
> *—John Chambers, founding Chairman of Cisco, quoted 6 December 2023.*

He led a small innovator to one of the 20th century's great corporate successes.

We expect small and mid-sized companies to narrow the atypical performance gap.

Should We Load Up on S&P Index Leaders and Skip The Rest

It's tempting to chase what is outperforming, however

> If it seems like it can't go on forever, it won't.
>
> *—Old stock market dictum*

That applies to outperformers as well as to underperformers.

Nvidia and other Magnificents produced marvelous business results. However, a lopsided market can point to risks, on the evidence of past market precedents. With just 7 stocks comprising 34% of the index, 493 companies are squeezed into the remainder of the index.

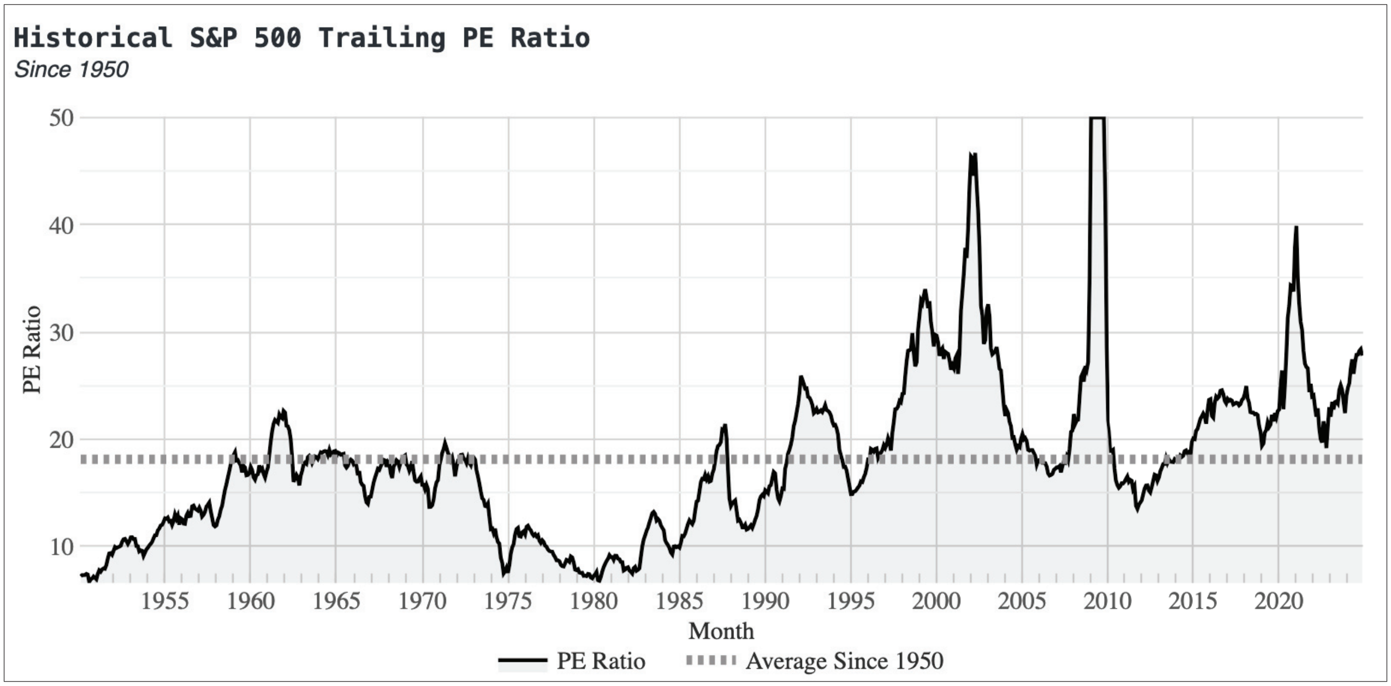
We own Magnificents but with diversification into other stocks. Diversification is a precept of prudence required of advisors and trustees. It has not been a winner lately, but market flows ultimately spread to less expensive stocks that can deliver lasting relative performance. And…

> Biggest Isn't Always Best. Twelve stocks' market value rose to the top of the S&P 500 since 1926, including Microsoft, Cisco and most recently Nvidia. Just buying those and holding was a winning stock-picking strategy, right? Wrong.
>
> The [former leaders] going back to 1990 lagged on average since becoming the index top dog. And some by large amounts.
>
> Cisco became the most valuable S&P 500 stock in March 2000. Shares are down 29% since.
>
> *—Investor's Business Daily, October 2024*

I am not drawing Nvidia in the same shades. Success merits a premium. That said, cautionary tales like Cisco's are told for a reason. One can esteem the Magnificent 7 as businesses while being chary of high valuations.

> The Magnificent Seven were valued at more than 30 times expected earnings… the other 493 companies in the S&P 500 were valued at 19 times. Many companies were still trailing the S&P 500 year-to-date, suggesting there could be plenty of room for them to catch-up.
>
> *—Dow Jones, 3 October 2024.*

The Magnificents are doubly as expensive as the average long-term market PE of 17x. Nvidia forward PE exceeds 47x, near triple. The Magnificents skew the valuation above trend, yet the rest of the market is not far from the long-term average.



From stockmarketperatio.com

The Magnificents and their smaller subset "The Fabulous Five" had an earnings advantage coming out of 2022. That has steadily narrowed in favor of the broad market.

> While consensus 2024 forecasts imply a 31% gap between EPS growth for the five stocks and the median firm the gap is expected to narrow to 8% in 2025 and only 4% in 2026.
>
> *—Bloomberg, 17 June 2024.*

Historically, markets trade on earnings 12 to 24 months out. This market has tarried in looking as widely as is typical with earnings generally accelerating. Markets follow earnings which is why a relative broadening ought to continue.

The recent popularity of index and leveraged ETFs combined with the particularity of S&P 500's weighting systems causes market lopsidedness. The phenomenon feeds on itself in a circular manner:

> Imagine you have two companies, and they are both worth $1 billion on a fair value basis, but one is valued by the market at $500 million and the other one at $2 billion. When a market capitalization-weighted index fund gets $5 to invest in those two companies, it will put $4 in the $2 billion company and only $1 in the $500 million company. The overvalued stock gets 4x the new investment. As a result, it then outperforms while the undervalued company underperforms.
>
> *—Famed value investor David Einhorn, 24 April 2024.*

Such excesses are ultimately corrected through "rotation," when investors channel money out of high PE stocks into cheaper ones. It's simple arithmetic, but often requires a catalyst; perhaps the election was it.

News Flows and Day Trading

The uneven market has further causes and consequences.

With news ubiquitous in everyone's palm, digital media compete for pageviews with dramatic, not to say shrill, headlines. The financial press used to be sober. The perfectly satisfactory "rise" or "decline" are now supplanted by vault, skyrocket, crater and crash for the normal ebb and flow of economic activity. Hyperbole leads to capricious price moves as day traders key off headlines and algorithms key off traders.

Legacy media are not driving this. News and quasi-news are consumed via social media like Reddit, Telegram or WeChat (with its 1.3 billion active users.) Television is newer than the Economist, Financial Times or Wall Street Journal, but is not addressing day traders.

> The median age of an MSNBC viewer is 70 years old. Fox News is 69. Even MTV is 51 years old.
>
> *—Nick Kapur, Rutgers University. 26 May 2024*

Daytrading.com estimates that

> The highest concentration of day traders is found in Asia, representing 33% of the total. Around 16% of day traders are in the US.

Continuing around the world, they reckon:

- Europe at 16%
- Africa 14%
- Middle East 10%
- South America 6%
- Central America 3%
- Oceania region 2%

US Magnificent 7 stocks are unusually popular with traders worldwide.

> Asian retail traders help drive 24-hour market for US stocks.
>
> *—Financial Times, 27 December 2023*

> One of South Korea's leading trading platforms is setting up a New York subsidiary as Korean retail investors pour money into US equities.
>
> *—Bloomberg, 14 August 2024*

Round-the-clock platform Blue Ocean has reported a 55-fold annual increase in trading. Afterhours speculators trigger price swings while traditional funds are quiescent. On a regular trading day perhaps a fifth of volume is fueled by their fleeting bets, without counting algorithms.

> Investors pursue a 'high-risk high-return' strategy, spurred on by sensational news and tips from YouTubers, Telegram and other social media… investment spans are getting shorter and shorter, swayed by news flows with no fundamental basis.
>
> *—Financial Times, 9 October 2023*

An estimated 95% of day traders lose money and 87% quit in 3 years. While they are with us, their ardor drives favored stocks to spike, then sparks swift drops when reality and hope diverge.

Several financial firms offer cheap trading to retail traders. That gives their algorithmic fund clients and affiliates opportunities to profit by arbitraging individuals' trades. Is that fair for? Regulators might one day pursue tighter rules.

Generation Z was mocked for flocking to a handful of Meme Stocks, like unprofitable cinemas AMC and struggling GameStop. Meme Stocks flew. Then they fizzled. In contrast, the Magnificent 7 have robust profits. Still, one wonders: are they the Boomer generation's Meme Stocks?

Daily Volatility

If it seems stock price moves are more erratic than you remember, you are right. Isabel.net recently reported that we hit a 15-year record for volatility on earnings days.

> Nine stocks that missed estimates are down 18.2% from July 16... The market is punishing negative earnings surprises more than average. Ford's results missed forecasts and punishment was swift. From July 22 to July 26, shares crashed 21%.
>
> *—FactSet, 12 August 2024.*

Ford declined 21%, even with a PE ratio less than 9x. Valuation discounts should provide a smaller distance to decline. Not lately. Stocks with established records must contend with myopic current fads. They do recover but that can take months.

If ever there was an argument in favor of diversification, price volatility is one.

Dividend Stocks and Bonds

Our Dividend Income strategy did better than we expected of a normally tranquil part of the market. On average, current portfolio yields exceeded 4.5% at the end of last quarter compared to 10-year Treasury bonds at 4.14% and the S&P 500 yield at 1.3%. Prudently administered dividend stocks are a useful income source, taking some of the place of the long bonds in standard portfolio allocation models.

> Over time, dividend growth has exceeded inflation… since World War II, the spread between dividend growth and inflation has been more than 200 basis points.
>
> *—Matt Burdett, SeekingAlpha, 25 June 2024*

We favor dividend stocks, even though in traditional models drawing on 20th century data bonds were deemed less risky. Post-2008 bond coupons make them more vulnerable to price decline because of duration risk (glad to explain to anyone with the patience.)

> The total return on 30-year bonds has dropped 45% since April 2020, the biggest four-year loss since 1919.
>
> *—SeekingAlpha, 20 May 2024.*

Looking Ahead

The 24-hour news cycle is unhelpful in forming long term assessments. Better to examine precedents and read more widely and deeply.

The President-elect's last term was longer on rhetoric than wholesale change. Caustic tweets often proved a prelude bargaining—perhaps an extension of rough and tumble interactions in New York's construction industry. Bluster between North Korea's Kim and Trump led to a meeting of the two countries' leaders after 2/3 century of cold war. Who imagined 2016 insults directed at "Little Marco" Rubio would presage his nomination as Secretary of State?

> *Jeff Bezos: I'm optimistic on Trump. Amazon founder hails the president-elect's 'more settled' approach to leadership —Telegraph.co.uk, 4 December 2024*

It is important to note that the coming administration will not have a super-majority in Congress. Tax, spending and major policy changes will have to be worked out through the Legislature's time-tested process of reconciliation—between two parties and among seasoned pragmatists.

What Seems Likely to Benefit

Most companies will benefit as the corporate tax rate stays at previously lowered levels (candidate Harris would have raised them.) How great a further cut Congress approves is a question. Tax code simplification is decades overdue but must clear a thicket of special interests. Business incentives like accelerated depreciation and other capex inducements are more likely, especially where onshoring and domestic manufacturing are encouraged. We favor industrial companies.

Infrastructure spending was to be supported under Biden's IRA act. How that continues will be debated, but Pres. Trump supports capital renewal in aid of national competitiveness.

Demand for data center and cloud capacity will keep growing, regardless of which party does what. Data centers need vast amounts of power, water, cooling, and other infrastructure.

> Generative AI systems… use up to 33 times more energy than computers running task-specific software. Each AI-powered query consumes ~10 x more than traditional search. AI is expected to be 3.5% of the world's electricity consumption by 2030. US data centers alone could consume a whopping 9% of electricity generation… a two-fold increase over current levels.
>
> *—Cornell University, 17 June 2024*

Nuclear energy comes to the fore for clean electricity as the world tallies a digital economy's needs. It is today safer than bygone technologies. We learn, for example, that 95% of waste that formerly was stored can be reused.

> There is a way to use almost all the uranium in a fuel rod. Recycling used nuclear fuel could produce hundreds of years of energy from just the uranium we've already mined, all of it carbon-free.
>
> *—US Government, Argonne National Laboratory, 22 June 2012*

General business-friendly policies are a boon for commercial real estate, especially with an administration that views it as an economic growth engine. However, new hybrid work practices keep office space in excess supply; there is no rush to invest in other than targeted properties.

Residential housing stands to benefit, with tax relief for the consumer and tax incentives for developers. All good for GDP growth and construction equipment profits, if environmentally deleterious with more land opened to development.

"All real estate is local," and some regions will continue to benefit from migration away from high-tax states.

Speaking of migration, a wholesale purge of undocumented immigrants would substantially raise costs for builders.

Small and midsized companies should benefit to a greater degree than multinationals. Their domestically focused business will enjoy tax and regulatory relief. Multinationals will get tax breaks, but tariffs are headwinds for Walmart, Home Depot, and all who contract for supply from abroad. Tariffs invite reciprocal restrictions, a hindrance for any global enterprise.

Domestic energy companies are to receive largess. Downstream chemicals and plastics could also benefit. Natural gas faded to the background as a power source, but it is a first and easily achievable step away from dirtier fuels.

Technologies for efficiencies in business, healthcare and government keep growing. Robotic implementations are accelerating. Shifts from product sales to cloud subscriptions are becoming the preferred business model, a further extension of virtualization. Again, one must be careful as to valuations and the overall business cycle; tech spending is cyclical.

After a strong run, precious metals stocks are stalled by a strong Dollar. Longer term, their role as an inflation hedge could prove useful as reductions of fiscal deficits could be less than promised, a challenge in all legacy industrial nations.

Retailers are struggling as inflation has consumers cutting back. Less talked about is a massive overbuild yet to be worked off. As malls consumed acres of countryside from the 1980s onward, retail chains proliferated, selling largely undifferentiated, low-cost (to them) imported products. Stores and restaurants that consumers perceive offer differentiated price/quality advantages are doing well. Others will add to a series of ongoing bankruptcies/restructurings, winnowing competition.

Online shopping keeps growing, with the portion coming from mobile devices up ~10% since last year to 55% of all transactions during the recent Cyber Monday sales—an amazing transformation in buying habits, from mall trawling to shopping by phone.

In another transformation, consumers now prefer travel and “experience” over goods; this will continue. Cruise line bookings are robust, and air travel is up, although the latter industry perennially struggles with cost management and could make a hash of it. Online travel benefits apace. Car rentals are giving way to Uber, Lyft, etc.

Likely to Experience Headwinds

Healthcare companies, especially pharmaceutical, are targeted for price controls. The rhetoric isn’t new: debate dates from the 1990s. While potentially closer to action, progress could slow in Congress where lobbies carry weight. Prospective Health & Human Services head Kennedy plans strict measures, yet Whitehouse Chief of Staff Wiles was an influential pharma lobbyist. Let’s see.

Processed foods and beverages are in Mr Kennedy’s sights and have seen stock price declines. Consumer staples were working off Covid-heightened valuations so were vulnerable. PEs will continue to contract and will present future opportunities, but not soon. Purveyors of healthier food options are profiting from changing consumer tastes.

Semiconductors and chip equipment are under Biden export restrictions which will continue in the new administration. They are less onerous than feared last month, leading to recovering stock prices, but it is early yet. We retain positions but are watchful.

Government inefficiency has begged remedy for decades. Which contractors to the government are at risk remains to be seen, but some targets are obvious. Defense spending was specifically criticized by Elon Musk—no surprise:

> *The Pentagon… failed its seventh audit in a row, with the nation’s largest government agency still unable to fully account for its more than $824 billion budget.*
>
> *—The Hill, 15 November 2024*

Green technology, solar power and EV makers, were highflyers in 2020, but have languished despite incentives in Europe and USA. Incentives are at risk, with demand already waning.

> *While automakers and suppliers are betting big on future demand for electric vehicles, a near-term global slowdown is causing pain, including bankruptcies…and production cuts. Investment in capacity and technology development has outrun actual EV demand, boosting pressure on companies to cut costs.*
>
> *—Reuters, 20 Jan 2024*

One must watch the Magnificent 7. Alphabet, Google and others were targeted by Biden’s FTC for antitrust queries, in addition to actions in the EU. The new administration heralds laissez-faire. However, Trump’s circle bore an animus toward some companies—hence Meta’s Zuckerberg (hat in hand?) November visit to the President in Florida. Don’t be surprised if regulators are allowed to continue their inquiries. The companies could be worth more split up, but aggressive regulatory action would initially be uncomfortable.

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The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. Frank Russell Co. ranks US common stocks from largest to smallest market capitalization at each annual reconstitution period. The Russell 2000 Index represents a small percentage of the total market capitalization of the Russell 3000 Index. It is considered to be generally representative of US Equity Small and Mid Cap performance.

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