PCM

PEAK CAPITAL MANAGEMENT

Unwinding the Trump Trade

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Brian Lockhart

Following what political commentators called a disastrous showing by President Biden during the June 27th debate, the odds that former President Trump would return to the White House spiked. Pressure for Biden to withdraw from the race hit a crescendo over the next month before he finally gave into the immense pressure. Prior to Biden leaving the race, the odds of him winning the White House dropped to just 11% according to betting odds site PredictIt with Trump reaching 65% likelihood of winning the election.

Market analysts quickly began to identify the sectors and companies they believed would benefit from a second Trump administration. The S&P 500 rose 50% during the 2016 to 2020 period but some sectors did far better under Trump's focus on tax cuts, low interest rates, and deregulation. Technology, for example, rose 150% over the same period while Consumer Discretionary (think Apple) rose 103%. Energy also outperformed the broad market but was hindered by the brief period of negative oil prices during the COVID pandemic.

PredictIt Markets Leaderboards Support Login Sign Up

Presidency Congress Donald Trump Kamala Harris

Who will win the 2024 US presidential election?

Contract	Latest Yes Price	Best Offer			Best Offer
Donald Trump	56¢ 1¢	57¢	Buy Yes	Buy No	44¢
Kamala Harris	45¢ 2¢	46¢	Buy Yes	Buy No	55¢
Robert Kennedy Jr.	2¢ NC	3¢	Buy Yes	Buy No	98¢
Gavin Newsom	1¢ 1¢	2¢	Buy Yes	Buy No	99¢
Ron DeSantis	1¢ NC	1¢	Buy Yes	Buy No	N/A

Predictit.org odds on July 24, 2024.

With Trump having a stranglehold over Biden in the polls, traders bid up stocks of companies seen as benefitting from Trump's pro-growth agenda widely referred to as the Trump Trade. When Biden made the decision to end his candidacy and endorse VP Harris as the Democrat candidate, the polls immediately tightened to almost a dead heat causing many traders to abandon the Trump Trade.

The Trump agenda is widely seen as inflationary, particularly as a result of the impact of rising tariffs on foreign trade. Lower corporate tax rates are also seen as potentially reducing government revenues and putting pressure on deficits lifting Treasury yields. Offsetting the impact of higher tariffs might be lower energy costs that are expected from the 'drill baby drill' policy. Trump's policies are also seen as favorable for finance, especially M&A, and cryptocurrencies. On the negative side of the trade, EV companies are already getting hit given Trump's public comments to end all Federal EV mandates his first day in office. Other sectors that have come under pressure are Utilities and Healthcare.

The latest polling from RealClearPolitics shows Trump leading Harris by just 1.7% with likely voters, within the margin of error on all polls. Betting data, however, still shows a different story as oddsmakers do not see the race being nearly as close as polls suggest. Current betting odds are -147 on Trump and +164 on Harris. That means you have to risk $147 to win $100 on a Trump victory while a $100 bet on Harris would pay off $164 if she were to win. This translates into a 63% likelihood of a Trump win and 37% change of Harris winning suggesting the Trump Trade may have further to run.

The performance of the broad economy is not considered to be all that different depending on which party controls the White House. There remains strong debate about whether or not interest rates, and inflation, can fall without the economy suffering a recession. The Federal Reserve is structured to mitigate the impact of party changes in the White House so I would not expect significant differences in monetary policy between the candidates.

I expect there to be a lot of "noise" in the markets that will likely mean higher levels of volatility through the election. We are seeing a rotation of leadership in the markets right now as the AI technology trade has taken breather and stock advances have been more broad with small caps showing life for the first time in quite a while. Defensive stocks like financials, utilities and healthcare have recently outperformed as the tech-heavy Nasdaq has pulled back. I view this as likely to continue as investors seek equity positions that offer a level of "safety" with rising volatility in the midst of political uncertainty.

What does an ideal political outcome look like for investors? History has shown that market performance is highest when government control is divided. The odds are very high that Republicans will take control of the Senate in 2024. This is based on the number of seats the Democrats have to defend in states that Trump won in prior election cycles. With Trump holding a strong betting edge on the White House, a divided government will rely on Democrats controlling the House after this November. Republicans hold a very narrow margin today (8 seat advantage) and the outcome in November is considered to be a toss-up.

"What does an ideal political outcome look like for investors? History has shown that market performance is highest when government control is divided. "

My best advice for investors right now is to hold companies that demonstrate positive earnings growth and trade at reasonable valuations.

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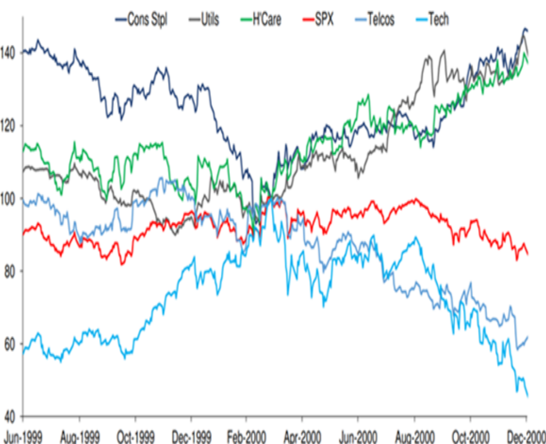
The Great Rotation

S&P 500 and the five top level industry sectors with the largest divergence around the March 2000 Tech Bubble. 100 = Tech bubble peak on March 27th, 2000.



The Magnificent 7 stocks have suffered the last month as the shine on the AI trade lost some of its luster. As defensive stocks have come to life, it reminds me of what is still referred to as the Great Rotation that happened when the Tech Bubble burst in March 2000. No one knows what the future holds, but there were many similarities between the rapid rise of AI stocks and what happened in the late 1990's with Telecom and Internet stocks. The market over the trailing 12-months has been similar to the late 90's in that the cap weighted index has greatly outperformed the equal weight index as only a handful of stocks are able to drive the index higher while the average stock in the index has lagged.

- Trading in mid-July revealed the largest divergence between the 5 best performing sectors and the 5 worst performing sectors since March 27, 2000, more than 24 years ago.
- If a significant rotation does materialize, expect defensive sectors like Healthcare, Utilities, and Consumer Staples to be the "new leaders" for the markets while Information Technology and Communication Services fade.
- There will be debate about the necessity of a Bear Market if a significant market rotation does occur. The 7 largest stocks in the S&P 500 are all technology stocks and represent over 30% of the index.

Gold Shines

Not surprisingly investors have bid the price of gold higher as an anticipated hedge against inflation. Over the past six months, gold is higher by roughly 17%, as measured by the SPDR Gold Trust. By comparison, equities are higher by roughly 11% over the same period, as measured by the S&P 500 Total Return Index. We've seen a succession weaker economic data, and, consequently, a heightened expectation that the Federal Reserve, at the conclusion of its open market committee meeting this month, will hint that interest rate cuts are on the horizon, perhaps as early as September.

- If rates are indeed cut, then the holding cost of owning gold, which pays no interest, becomes less onerous. Investors may continue to bid the price of gold higher, especially if the downside risk to equities increases (i.e., multiple contraction). Historically gold has exhibited a low to negative correlation to stocks during times of stress.
- Despite a deceleration in price increases, inflation still is above the Fed's 2% long-term target. This scenario provides a continued supportive backdrop for gold as a store of value. Likewise, the opportunity costs of holding gold decrease with lower interest rates.

Semi Trade in Doubt

This past month, after a monumental rise over the last year, the semiconductor trade appears to have faded following a report that the United States was considering tighter curbs on exports of advanced semiconductor technology to China. As a result of the report, semiconductor stocks, represented by the VanEck Semiconductor ETF (SMH), fell 7.12%. In the days since, the semiconductor ETF has fallen an additional 11.6% as of today's writing. The latest concerns for chip investors stem from Washington's recent protective stance towards the U.S. semiconductor manufacturing industry, which it views as strategically important in competing against China. Should there be a second Trump presidency, many policy experts expect the U.S. to continue focusing on semiconductors, potentially offering more support for domestic chipmakers such as Intel compared to their foreign counterparts.

- Trump, seeking to regain the presidency in the upcoming November election, told Bloomberg Businessweek that Taiwan should pay the United States for its defense, as it does not give the country anything in return. These remarks sent U.S.-listed shares of Taiwan's TSMC - the world's largest contract chipmaker - down 8%.
- Nvidia's revenue from China stood at about 18% of its total revenue as of the end of April, compared to 66% just one year ago. The decline in revenue is likely the result of tighter curbs on exports of advanced semiconductor technology to China.

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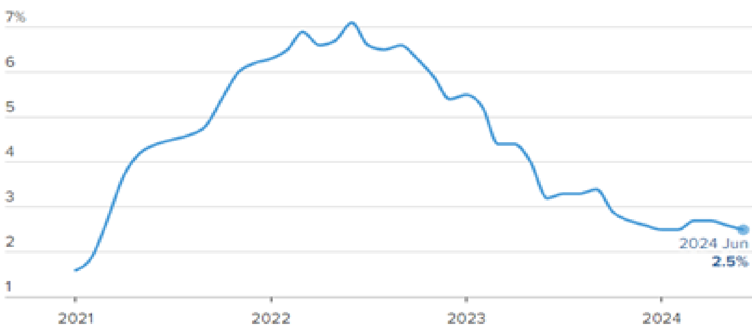
Quinn VandeKoppel

Macro View – Fed Policy Outlook

As we head into the final days of July, the Federal Reserve is set to reconvene for its two-day FOMC policy meeting. While there is a high likelihood of no change in their target rate during this meeting, according to the CME Group FedWatch Tool, many will be eager to hear the Fed's plans for the remainder of the year. There are now predictions for up to three interest rate cuts before year-end. A likely 25 basis point interest rate cut in September would be the first reduction since the early days of the COVID-19 pandemic, when inflation rose to its highest level in over 40 years. However, Fed officials, specifically Fed Chair Jerome Powell, have been cautious in their remarks, stressing that there is no set policy path and that decisions will be guided by data.

Personal consumption expenditures index

Year-over-year percent change



Source: U.S. Bureau of Economic Analysis
Data as of July 26, 2024

Taking Stock – Change on the Horizon

This past weekend, former President Donald Trump spoke at the annual Bitcoin conference, the largest of its kind in America, where he promised to make the United States the "world leader in bitcoin and other digital currencies if elected." Trump, positioning himself as a crypto advocate in contrast to the current Biden administration, hinted at firing current Securities and Exchange Commission Chair Gary Gensler due to the SEC's rulings on digital tokens and lawsuits against bitcoin exchanges. During the conference, Trump also proposed creating a national bitcoin "stockpile" that he said would serve as a "permanent national asset," though he did not provide specific details. If the government were to create a bitcoin reserve, prices could see a significant increase with the Treasury directed to fund the stockpile. However, this idea is still speculative and would face significant hurdles before being implemented.

Fixed Income – Attractiveness of Mortgage-Backed Securities

Like most bond investments lately, yields have risen compared to the past 15 years. Mortgage-backed securities (MBS) relative yields appear attractive compared to other types of fixed-income investments. The average yield-to-worst of the Bloomberg US Mortgage-Backed Securities Index is currently near 5%, off recent highs but well above the pre-pandemic trading range, according to Bloomberg data. This compares favorably to the average yield of the 10-year Treasury note, which is closer to 4.2%. With yields near 5%, investors focusing on short-term investments don't need to sacrifice much yield when considering MBS, while still helping limit reinvestment risk. Given their relatively high credit quality, agency mortgage-backed securities should be considered a part of a portfolio's core bond holdings.

Technical – Small Cap Breakout

Back in April, we noted that Small Caps, represented by the iShares Russell 2000 ETF (IWM), appeared poised for a breakout. After consolidating over the next few months, the small-cap index finally broke through the resistance level of 205 in July and accelerated to the upside. Now, the index is currently at a level not seen since November 2021, and it wouldn't be unreasonable to anticipate another consolidation period over the next few months until the Federal Reserve's September FOMC meeting. Barring any surprises in economic data between now and then, markets are currently predicting a 100% probability of a rate cut, with an 88% probability of at least one rate cut, according to the CME Group's FedWatch Tool. With inflation numbers expected to continue declining, interest rates could follow suit, which would likely be bullish for small-cap stocks in the coming months.

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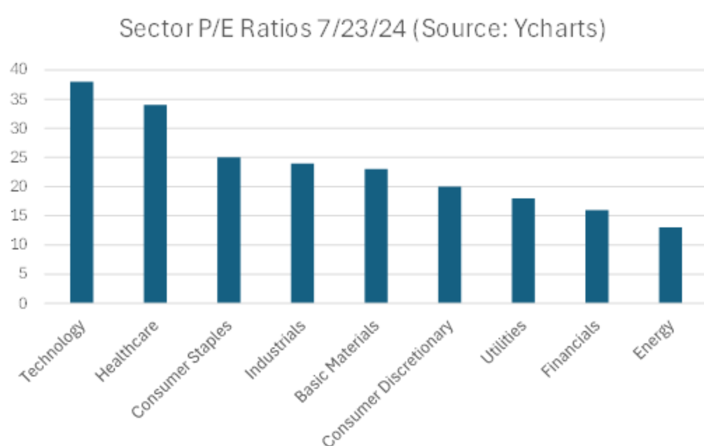
Has the Rotation Arrived?

Clint Pekrul, CFA

We have written extensively about the recent dominance of mega-cap growth stocks and the AI fueled rally that has driven the S&P 500 to record highs. Over the past five years the S&P Technology Sector Index, including dividends, is higher by approximately 23% on an annualized basis, and carries a roughly 40x price-to-earnings ratio. Technology still represents roughly one-third of the broader S&P 500 Index.

By comparison, the remaining eight sectors of the S&P 500, from financial to consumer discretionary stocks, trade at roughly half the valuation of the technology sector, on average. The chart below illustrates the current price-to-earnings ratio across the equity sectors:



However, something interesting happened in mid-July whereby mega-cap stocks experienced a meaningful selloff while the average stock – that is, companies across sectors with lower P/E multiples – did not. In fact, some sectors traded higher over the period. This pattern has not been prevalent for some time. Naturally, the rotation raised eyebrows.

It's noteworthy that recent economic data points to weakness in the manufacturing sector. The latest ISM Manufacturing Index, which surveys purchasing managers across manufacturing firms, indicates recent weakness. The latest reading of 48.5 suggests the sector is contracting.

Purchase managers surveyed indicated an "an unwillingness to invest in capital and inventory due to current monetary policy and other conditions," per the report. Furthermore, prices paid for inputs fell to their lowest level in six months.

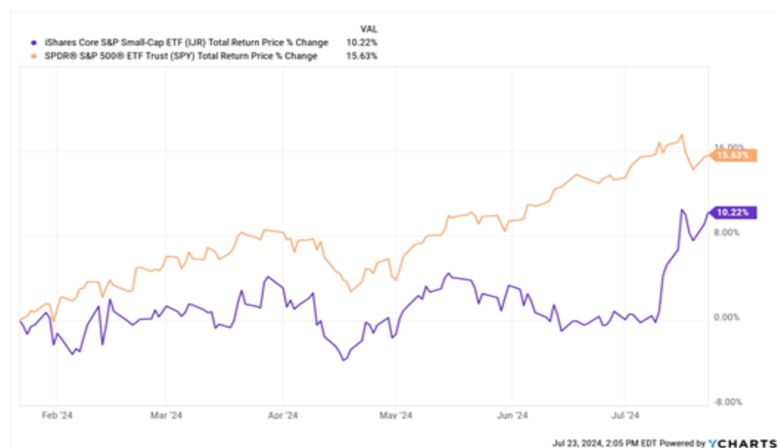
The survey response was closely watched because it strongly suggests that the Federal Reserve is close to lowering interest rates, a move that would be welcomed by equity investors. The effective fed funds rate has remained at 5.3% for almost a year and is at its highest level since before the GFC.

Too Expensive or Too Cheap

There are several explanations for what we've experienced over the past several weeks in terms of sector rotation. One reason mega-cap growth stocks have had an incredible run, aside from the growth potential of AI technology, is that they are largely immune from higher interest rates due to their large cash reserves.

For companies that don't have the benefit of large cash reserves, and must finance their way through the business cycle, higher interest rates have been a considerable headwind. However, if the Federal Reserve does indeed lower its target rate later this year, this headwind will abate. Consequently, stocks that have been shunned now look more attractive (i.e., lower interest expense implies greater reinvestment and earnings growth potential).

Nowhere was the rotation more pronounced than in small-cap stocks, which have struggled mightily with tighter monetary policy. The chart below illustrates the recent breakout of the S&P 600 Index:



Small cap stocks rallied roughly 10% over nine trading days. It's not unreasonable to think that should the Fed lower interest rates not just once but consecutive times, that small cap stocks could make up considerable ground on the large-cap S&P 500 Index.

Conversely, investors will scrutinize mega-cap valuations as companies report Q2 earnings. While these companies are highly profitable, will they continue to grow earnings that exceed consensus estimates, particularly given their size?

In other words, can their future earnings support their current valuations? If not, it does not bode well for the S&P 500 Index and could support further rotation into other sectors.

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Q: What is your short-term outlook for Bitcoin?

There is no doubt that Bitcoin is becoming far more of a mainstream asset class than cryptocurrency was even a year ago. The obvious sign of how acceptable Bitcoin has become is the large ETF's that now give investors the opportunity to own Bitcoin in traditional brokerage accounts. The "institutionalization" of Bitcoin allows for a much more broad investor base than existed when you needed a digital wallet in order to hold the cryptocurrency.

Bitcoin seems to be consolidating the gains it made over the last 2 years since the beginning of 2024; probably a very healthy sign for future advances. At just below $68,000, it is within a couple of percentage points of where it began the year. A period of consolidation helps to facilitate a healthy trading pattern instead of a feast or famine trading pattern that existed over the prior 5 years.

I expect Bitcoin to remain the most trusted of the cryptocurrencies even as some investors speculate in other offerings. In late July, an ETF was launched with Ethereum as the underlying asset class. Ethereum has a market capitalization of around $420 billion or roughly one-third of Bitcoin's $1.3 trillion market cap. That a second cryptocurrency is now traded as an ETF, I think that suggests crypto will see higher days in the future. In some ways, Bitcoin is in the process of potentially replacing gold as a primary US dollar replacement.

Bitcoin captured headlines earlier in the year when it hit 73k in mid-March after rallying from roughly 39k in late January. Prices have more-or-less plateaued since then and currently trade at approximately 67k. What is interesting about bitcoin and crypto in general is how quickly investors have adopted the concept with the advent of spot-price ETFs. Consider that the iShares Bitcoin Trust (IBIT), which launched with $10m to start the year, now boasts $22.2 billion in AUM and is roughly one-third the size of the SPDR Gold Trust, which launched in 2004.

While the futures AUM dwarfs the traded funds, adoption from retail investors continues to accelerate. In fact, the total AUM in the digital asset funds is roughly $80 billion according to Morningstar. These trends suggest crypto will become more widely adopted and mainstream, which should be supportive. But investors should be cautious when Wall Street floods the market with new products. There are now 72 publicly traded ETFs that track digital assets who's fundamental, or intrinsic, value is incredibly difficult to estimate. Given its speculative nature, it's difficult to predict short-term price movements with accuracy, but the current trend seems to be higher.

Q: Is China about to enter a recession?

I do think China's economy is in trouble and likely headed towards a recession in late 2024 or early 2025. The more important question to ask, in my opinion, is whether or not the global economy can avert a recession if China indeed experiences a recession. China was responsible for 34.9% of global economic growth in 2023 according to IMF data, compared to just a 15% contribution by the USA. With Europe in a "slow growth" cycle, the world can ill afford an economic contraction in China or the USA.

China's downfall, not surprisingly, is real estate. The well documented "ghost cities" where vacant buildings dominate the landscape representing billions in unrealized investment losses. Construction spending in China, a major component of their economy, has fallen by more than 60% in 2024 according to IMF data that may lead to an overall economic contraction. Debt in China, accumulated mostly from real estate spending, has reached 288% of GDP and is now a factor in forecasts of future growth. Many assets today are unable to generate sufficient income to service the debt they hold.

China also faces massive demographic challenges as their labor force population, ages 15-64, is already shrinking and expected to fall by approximately 1% per year according to the IMF. Countries in the West have largely been able to offset slowing demographics through immigration but China has negative net immigration. By the year 2030, the reduced working age population is expected to see more than a 15% structural reduction in economic growth.

Recent data out of China, the world's second largest economy, is not encouraging. The most recent GDP reading of 4.7% for the second quarter was below expectations and was slower than the 5.3% reading for the first quarter of the year. If we smooth over the disruptions from COVID in 2020, when China's GDP contracted by -10% on a year-over-year basis, and the subsequent rebound in 2021, the longer-term trend for China's GDP has edged lower.

One issue that China faces is weak consumer demand stemming from falling property prices and lower wages. For example, retail sales have slowed to an 18-month low, thus causing businesses to slash prices (i.e., deflation). Without further government stimulus to stem the negative wealth effect, it seems doubtful that China can achieve their 5% growth target anytime soon. Beijing's policy makers recently announced plans to provide proactive stimulus measures to distribute economic growth more evenly throughout the region. It seems the overriding concern is weak aggregate demand domestically and the policymaker's ability to stem the tide and avoid further deflationary pressures.

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