November 14, 2024
Commentary

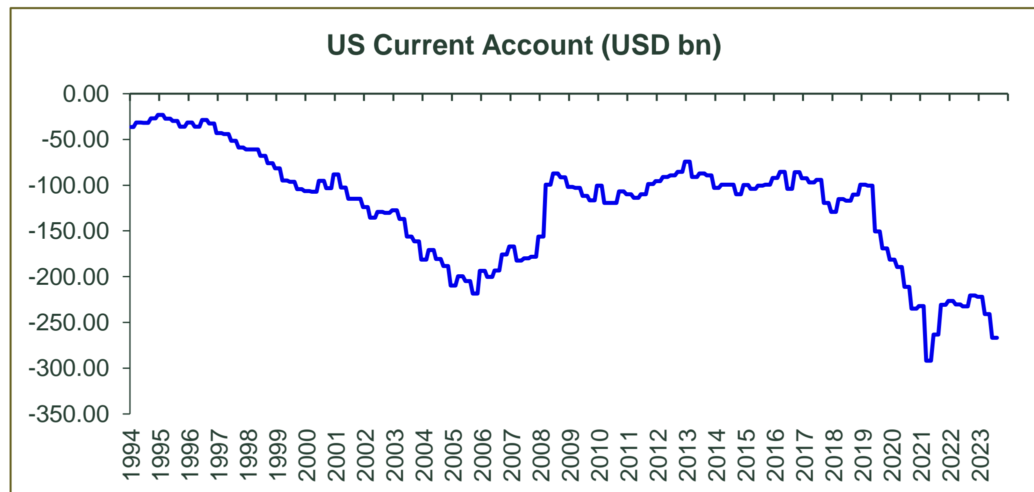
Weekly Market Update

Insight of the Week

Tariffs and Inflation

The U.S. current-account deficit is the combined balance of trade in goods and services. The US has a long history of running a deficit, where purchases from abroad outnumber the amount exported, and has continued its downward trajectory. The deficit widened by 10.7%, to $266.8 billion in the second quarter of 2024. The widening of the deficit reflects an increase reliance on imported goods, with goods trade contributing largely to the imbalance. The second-quarter deficit was 3.7 percent of current GDP, up from 3.4 percent in the first quarter.

One of the key components of Trump's economic agenda is the use of tariffs, particularly on Chinese imports, to reduce the trade imbalance. Tariffs make imported goods more costly and will encourage businesses and consumers to shift their demand to domestically produced goods. This would theoretically reduce the dependence on foreign goods, fostering domestic production and job growth.



Source: FactSet as of 11/12/2024.

However, the effectiveness of tariffs on the trade balance is quite complex and will have lasting implications. In the short term, tariffs have inflationary consequences. When the cost of imports rise it usually is passed on to consumers, leading to higher prices and thus inflation. Over time, the magnitude of inflation will depend on whether domestic, or re-routed production can meet demand at competitive prices. If more local production cannot quickly scale up to meet demand, inflationary pressures may become more pronounced, potentially affecting the US consumer and in turn becoming a headwind to economic growth.

Source: State Street Global Advisors, FactSet.

Equities

Small Caps Poised for Resurgence

The small cap premium is predicated on the notion that smaller companies are riskier and less efficient. Investors, therefore, expect a higher return to compensate for the risk taken. However, the US small cap premium has waned overtime as large cap stocks have outperformed significantly over the recent years.

A key factor behind this decline in small cap premium is the changing composition of the large cap index, which has become dominated by a few mega-cap tech firms. Representation of Technology companies in the large cap index is 19.2%[1] more than in the small cap index. Consequently, the Russell 2000 has underperformed the S&P 500, particularly during the periods of market volatility and uncertainty. However, when we compare the returns of the Russell 2000 with the S&P 500 equal weighted index (which neutralizes the large size of the mega cap tech companies) over the last 10 years we still see large cap outperformance (10.8% annually vs 8.9% of Russel 2000), although smaller than many headlines suggest.

Furthermore, market dynamics have favored larger companies. Technology has enabled smaller firms to innovate and access new markets. However, it has intensified competition between large players in an arms race to implement and invest more in cloud computing and artificial intelligence. Macroeconomic factors have also contributed to small cap premium dormancy. The prolonged low interest rate environment post GFC has allowed large firms to borrow at favorable rates, facilitating growth through M&A and capital investment. In contrast, smaller companies typically face restricted access to credit and heightened sensitivity to interest rate fluctuations as they have a higher proportion of short term and floating rate debt. This leads to a higher debt burden and lower credit ratings for small caps, making them more vulnerable as interest rates rise.

It is interesting to note that the small cap premia has declined consistently over the years as shown in the below table. However, on the back of attractive valuations and a favorable macroeconomic backdrop, the tide seems to have turned in favor of small caps as they surged 8.6%[2] since the first rate cut in September.

	Russell 2000 Relative Return - Annualized (%)									
Index	25 Years	20 Years	15 Years	10 Years	5 Years	3 Years	2 Years	1 Year	6 Months	3 Months
S&P 500	0.30	-2.31	-2.74	-4.41	-6.12	-6.90	-8.90	1.30	5.67	12.14
S&P 500 Equal Weighted	-1.64	-2.06	-1.87	-1.93	-2.87	-3.85	1.11	8.32	11.47	20.26

Source: FactSet as of 11/12/2024. Russell 2000 Relative Returns calculated as Russell 2000 annualized return minus the annualized returns of the S&P 500 and S&P 500 Equal Weighted.

Additionally the new Trump administration might benefit small caps. Their domestic revenue focus aligns with government policies aimed at stimulating economic growth such as infrastructure spending and tax reforms. Proposed investments in infrastructure projects would open new growth opportunities for smaller companies in construction, manufacturing and related industries. Since smaller companies generally pay higher effective tax rates than larger multinational companies, proposed tax cuts would benefit smaller companies disproportionately, improving

[1] Source: FactSet. Data as of October 31,2024.
[2] Source: FactSet. Data as of November 12,2024.

their profitability. Potential deregulation would reduce compliance costs and operational burdens, making it easier for smaller businesses to expand. Moreover, smaller companies would be largely insulated when compared to larger multinational companies from the negative consequences of the implementation of widely anticipated trade tariffs.

The combination of Fed rate cuts, Trump's victory and current valuations make for a more favorable environment, helping to propagate a resurgence in small caps.

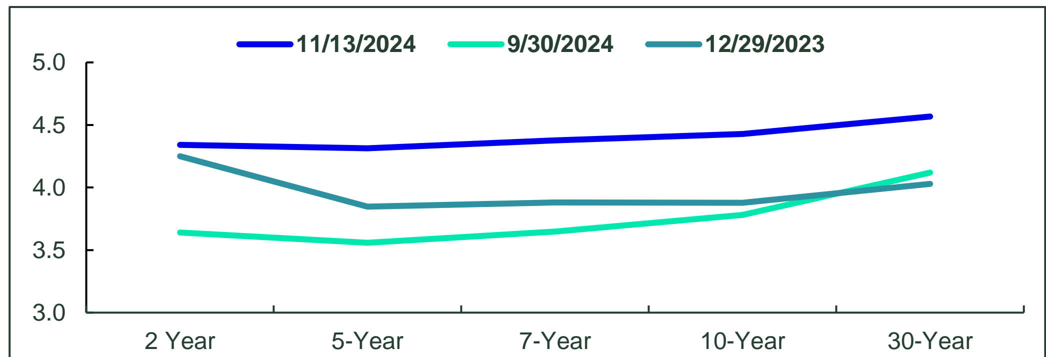
Source: State Street Global Advisors, FactSet.

Fixed Income

Bond Markets Vary after Election Results

Equity markets and other risk assets have rallied in the wake of Donald Trump's decisive victory, but bond markets are concerned that several of the President Elect's proposed policies, including corporate tax cuts and tariffs, could cause a resurgence of inflation and lead to a pause in the Federal Reserve's rate cutting cycle.

Corporate tax cuts implemented during the first Trump administration in 2017, and set to expire in 2025, are expected to be extended. For certain companies that make their products in the U.S., tax rates may be further reduced to 15%. These tax cuts would increase the deficit and require the Treasury to issue more debt at higher rates. National debt is expected to increase by ~$8 trillion over the next decade. Import tariffs on Chinese goods could be as high as 60% and up to around 20% for other countries, resulting in an overall increase in the price of goods.



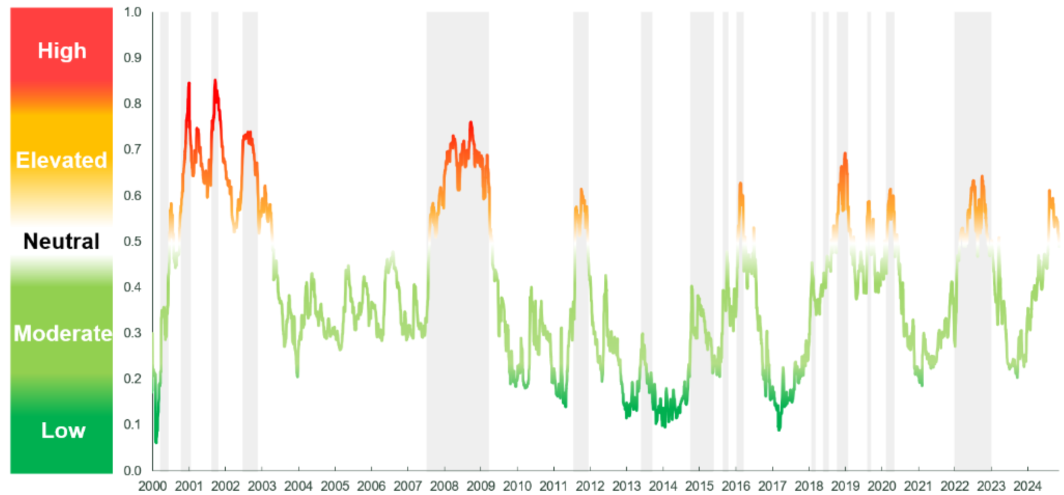
Source: Bloomberg as of 11/13/2024..

As a result of these policy concerns, U.S. treasury yields have increased across the curve, and markets have lowered rate cut expectations to 4 cuts (down from 6 cuts) by the end of 2025.

Source: State Street Global Advisors, Bloomberg.

Market Regime Indicator

The Market Regime Indicator (MRI) represents a proprietary multi-asset class model designed to characterize risk appetites within the capital markets.



Source: State Street Global Advisors, Investment Solutions Group (ISG). As of November 13, 2024. The data displayed is not indicative of the past or future performance of any SSGA product. The above data represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of four risk regimes: Low Risk, Moderate, Normal, Elevated and High Risk.

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*Pensions & Investments Research Center, as of 12/31/23.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

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