Five Questions From The Road

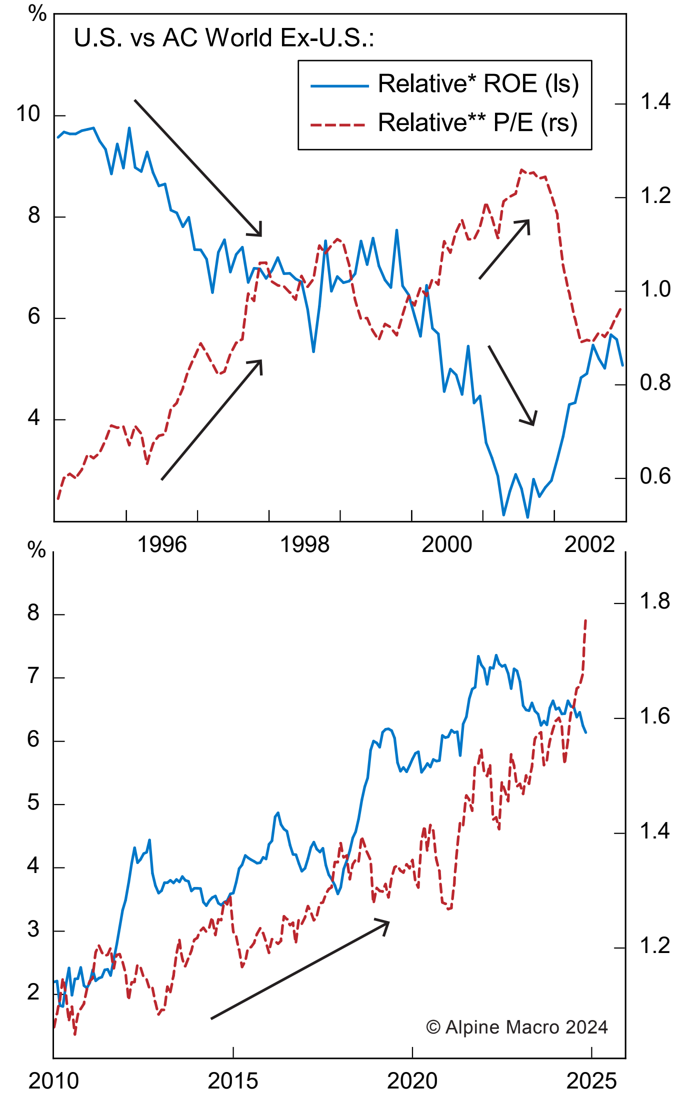
We traveled to the U.S. Midwest earlier this month to meet with asset allocators. Naturally, investors were focused on the dominance of American stocks, and still grappling with the implications of the shifting political landscape in Washington. While expectations leaned optimistic, there was ample discussion around possible spoilers.

This brief report addresses the five recurring questions raised during our meetings. It will hopefully serve useful to many of our readers who are likely contemplating these very same topics.

U.S. equity outperformance has kicked into a higher gear post-election. What conditions would prompt you to reduce an overweight allocation?

It is still too early to bail out on a U.S. overweight for investors concerned with shorter-term cyclical performance. Beyond favorable Trump policies such as deregulation and corporate tax cuts, the widening productivity gap between the U.S. and global peers is unlikely to peak soon. Therefore, it is unclear whether

Chart 1 Are U.S. Relative Equity Multiples Grossly Misaligned?



*Calculated as a difference
**Calculated as a division
Note: All series are calculated based on large/mid/small cap indexes; source: MSCI

EDITORIAL TEAM

Bassam Nawfal
Chief Asset Allocation Strategist

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Chief Global Strategist

Tony Boeckh
Editor-in-Chief

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Harvinder Kalirai
Chief Fixed Income & FX Strategist

Mark McClellan
Chief U.S. Bond Strategist

Jeremy Huang
Research Analyst

relative multiples are grossly misaligned with what is warranted.

A comparison to the mid-to-late 1990s provides useful context. During that period, U.S. equities became increasingly expensive relative to global markets, even as American firms experienced a steady decline in their relative return on equity (**Chart 1**, top panel). Investors, captivated by the allure of exceptional returns, largely ignored deteriorating fundamentals.

This pattern has not been repeated over the past 15 years. Markets have exhibited consistent discipline, rewarding U.S. equities in proportion to their rising superiority in return on capital (**Chart 1**, bottom panel). Unless earnings expectations collapse or investor confidence falters, the likelihood of a sudden reversal in U.S. equity outperformance remains low.

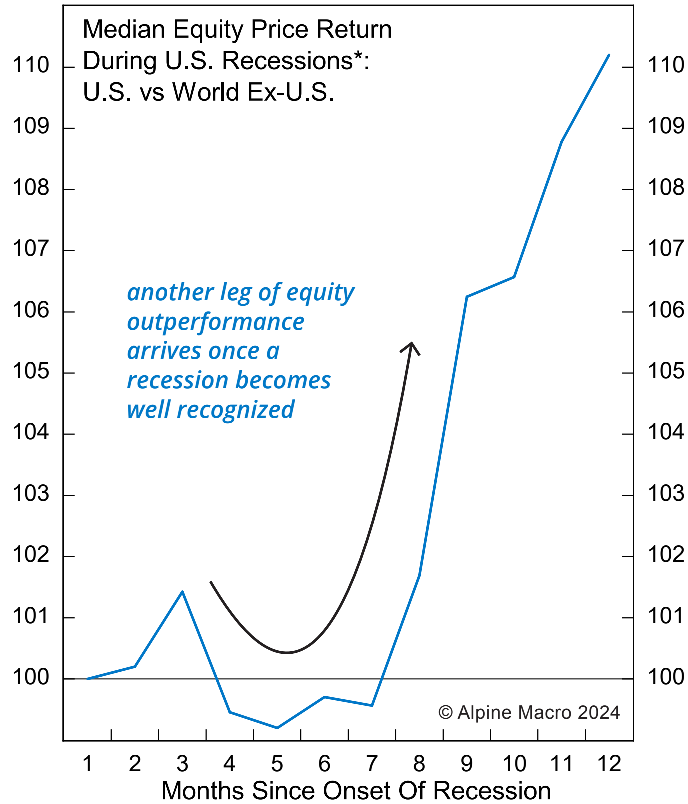
In fact, a decisive cyclical rotation away from the U.S. may only occur *after* the next recession. U.S. equities generally outperform during recessions, given their more defensive nature compared to international stocks. U.S. common currency returns are further bolstered by the counter-cyclical dollar, which strengthens during growth downturns (**Chart 2**). Bear in mind that even after the dotcom bubble burst in early 2000, U.S. stock outperformance persisted until 2002.

The U.S. does appear to be experiencing a mini-productivity boom. What is driving this upswing, and how sustainable is it?

Productivity trends unfold in long cycles spanning a decade or more. Growth in labor output-per-hour — noisy residual data that requires smoothing — reached a trough in 2016.

The upturn accelerated in the wake of the pandemic for two key reasons.[1] First, there was a major reallocation of workers away from low-productivity sectors (i.e., restaurants, hotels) into high-productivity sectors. Second, hybrid working allowed a balancing of focused remote work with collaborative in-person interactions, leading to improved efficiency. However, the productivity tailwind from these two factors has likely run its course.

Chart 2 **Any Recession Would Prolong U.S. Equity Dominance**



*Sample includes 7 NBER-defined recessions since 1969, excluding the 2020 pandemic; expressed in U.S. dollar terms and rebased to 100 at start of recessions; source: MSCI

1 Alpine Macro *U.S. Bond Strategy* "U.S. Bond Strategy For 2025 (Part 1)" (December 5, 2024)

Looking ahead, capital spending and renewed business dynamism should be the key propellants:

- U.S. R&D continues its structural rise, now accounting for 3.5% of GDP compared to 2.5% in the mid-1990s. Private investment in AI, a particularly fertile ground for productivity enhancements, is moving higher at breakneck speed.

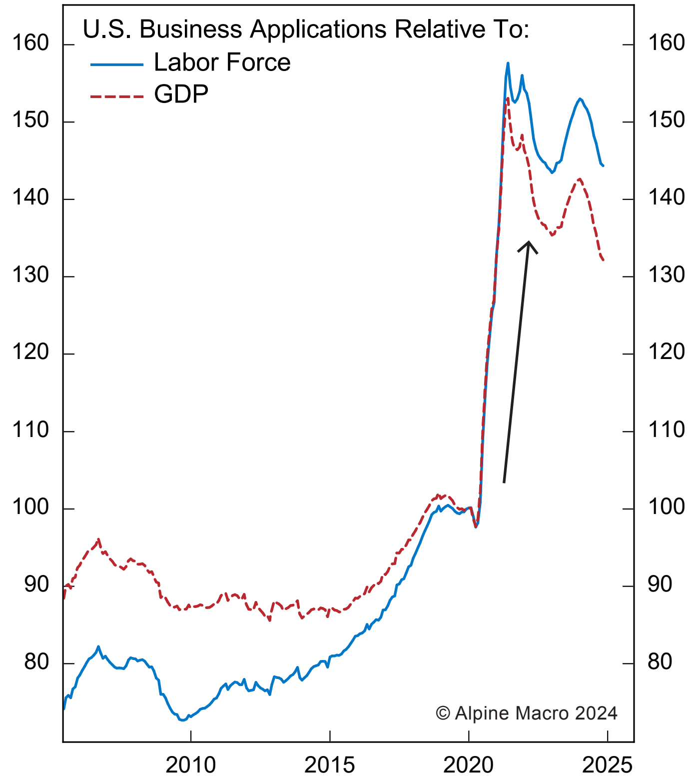
- The surge in job turnover has fueled a wave of entrepreneurship, pressuring incumbents to innovate. Even when adjusted for labor force and GDP size, business formations remain 30-45% above pre-pandemic levels (**Chart 3**).

It is important to note that general-purpose technologies, like the internet and AI, often take years to manifest in productivity statistics. For example, only 4% of firms have adopted AI to improve their operations. Optimistically, this suggests that productivity gains related to the field may just be getting underway.

Trump has clearly shown a preference for a weaker dollar given his obsession with reducing trade deficits. Yet you do not seem to think he will achieve this goal. Why?

This underscores the contradictions that sometimes arise between Trump's intentions and the practical outcomes of his policies. Deregulation and tax cuts would bolster domestic growth, keeping interest rates higher than they otherwise would be and attracting capital inflows. Meanwhile, tariffs function as a growth tax on trading partners, prompting currency depreciation relative to the dollar as the simplest compensatory mechanism.

Chart 3 **Booming Entrepreneurship Should Spur Productivity Gains**

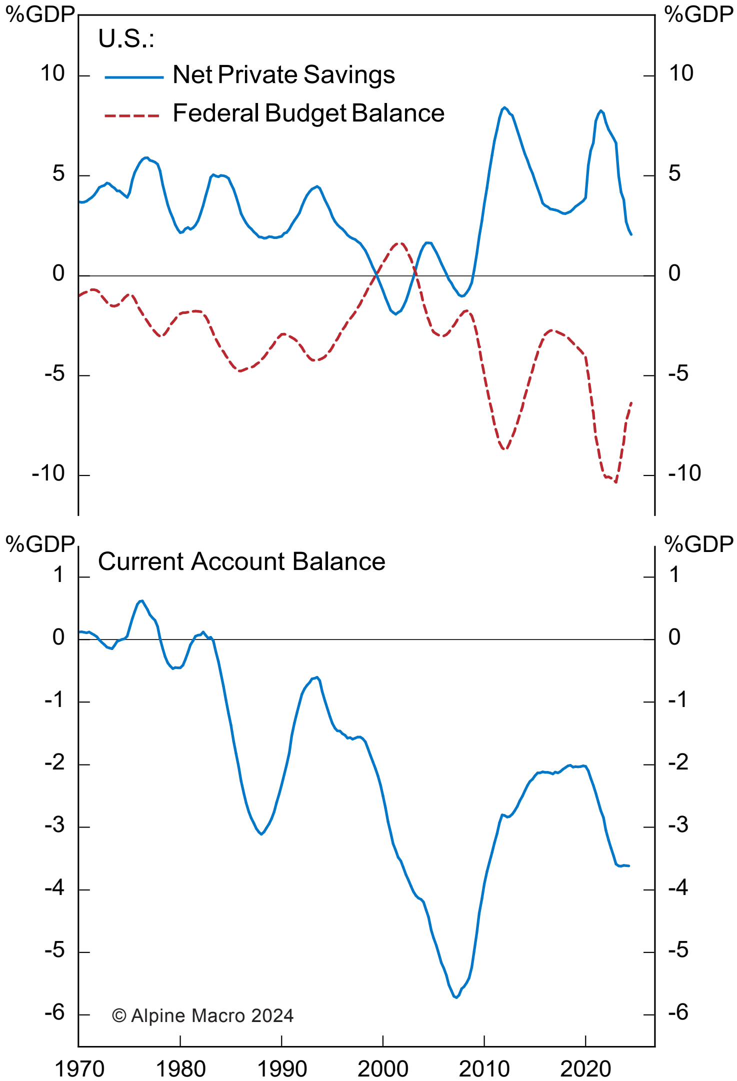


Note: Both series are shown as a 12-month moving average and rebased to Dec 2019=100

It has been suggested that Trump might demand dollar-weakening measures from key trading partners in exchange for tariff relief. However, we are skeptical of the efficacy of this approach, as it would again shift global growth momentum toward the U.S., reinforcing upward pressure on the greenback.

Ultimately, any policy that does not address the fundamental savings and investment imbalance in the U.S. cannot deliver a sustained dollar weakening. Instead, a more appropriate course of action would be to tighten fiscal policy (**Chart 4**), which would allow the Fed to cut rates more aggressively. As our *Global Fixed Income & Currency Strategy* cogently explains, this would enable Trump to achieve his

Chart 4 Lowering Fiscal Deficit, Not The Dollar, Would Reduce Current Account Deficit



Note: Series are shown as a 1-year moving average

desired trifecta: a narrower trade deficit, lower interest rates, and a weaker dollar.[2]

You present a compelling argument for why tariffs are deflationary.[3] But could stricter immigration enforcement represent the real policy risk of reigniting inflationary pressures?

Stricter immigration enforcement could reduce the labor supply in industries reliant on undocumented workers,[4] driving up wages to attract replacements. However, whether this would stoke inflation is doubtful.

Table 1 Deportations Would Restrain Aggregate Supply *And* Demand

Effect On Real GDP Growth In 2025 Under Two Deportation Scenarios

	High Deportation*	Moderate Deportation*
Direct effect on GDP Growth	-0.2	-0.1
Additional effect owing to reduction in consumer spending	-0.1	-0.0
Additional effect owing to higher savings among immigrants in the U.S.	-0.1	0.0
Total effect on GDP growth	***-0.4***	***-0.1***

*High deportation scenario assumes net migration of -650K, while moderate deportation scenario assumes net migration of 1.2 million
Source: The Brookings Institution

Any analysis must approach the issue through the lens of both aggregate supply and demand. Academic research suggests that, in the medium term, reduced aggregate demand would roughly offset the decline in the economy's output potential (Table 1). Sectors where prices may rise (i.e., agriculture, construction) would be balanced by falling prices in areas where demand drops and supply is inelastic (i.e., rental housing).

2 Alpine Macro *Global Fixed Income & Currency Strategy* "Tariffs, The Trade Deficit, The Dollar & Inflation" (November 22, 2024)

3 Alpine Macro *Global Strategy* "Market Implications Of Trump 2.0" (July 22, 2024)

4 Unauthorized immigrants are disproportionately represented in occupations such as housekeeping, cooking, construction labor, grounds maintenance, and agriculture.

Second-order impacts also come into play. Contrary to popular belief, migrants *do not* receive more benefits from the system than they contribute. In reality, foreign-born workers and their dependents pay about $1,300 more annually in federal taxes than they receive in federal benefits.[5] Therefore, any forceful deportation campaign could constrain public spending or necessitate higher taxes elsewhere, both of which would dampen economic activity and price pressures.

Of course, consideration should also be given to whether implementing large-scale deportation is even feasible, given likely legal and logistical obstacles. We expect Trump to ultimately water down campaign promises to make them more palatable to voters and markets.

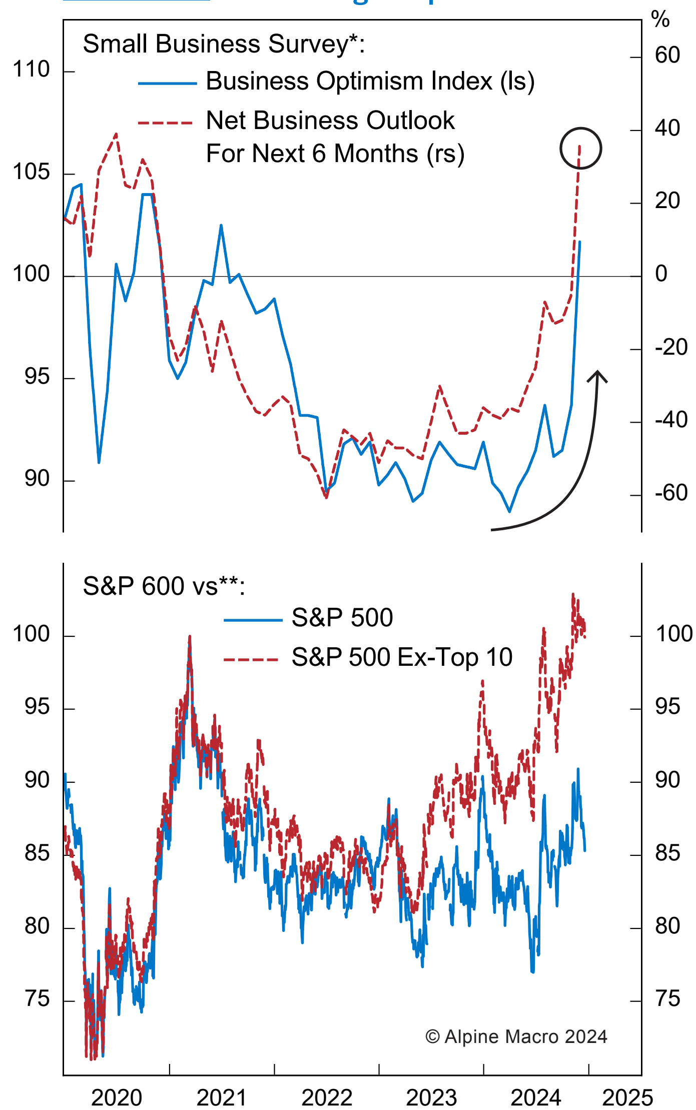
What is keeping you constructive on small caps, given the limited downside to yields?

Our overweighting of small caps has been premised on easing financial conditions, brightening earnings prospects, and a potential unlocking of a substantial valuation discount. Not only do all three factors remain intact, but are likely to be bolstered by Trump's anticipated policies:

- Smaller companies, with less economies of scale, stand to benefit disproportionately from regulatory and tax relief. Notably, 25% of small businesses cite red tape or taxes as their primary challenge.

- Smaller firms are less vulnerable to trade restrictions, deriving just 25% of their revenue internationally compared to 40% for larger firms. Additionally, small businesses often rely more on imports and could even gain from a stronger dollar if tariffs rise.

Chart 5 **Small Caps Outperforming Outside Of The Mega-Caps**



*Source: National Federation of Independent Business
**Rebased to March 12, 2021=100; source: S&P Global

5 Although the data is not broken down by immigration status, the fiscal contribution of unauthorized immigrants is likely higher than that of authorized immigrants, as they are more commonly of working age.
East, C. (2024, September 18). *The labor market impact of deportations*. The Brookings Institution. Retrieved from https://www.brookings.edu/articles/the-labor-market-impact-of-deportations/

The latest NFIB survey underscores the prevailing optimism, with small business sentiment surging to post-pandemic highs (**Chart 5**, top panel).

Encouragingly, small caps have handily outperformed the bottom 490 stocks in the S&P 500 since mid-2023 (**Chart 5**, bottom panel). This trend aligns with our theme of a broadening out in earnings and equity performance, extending into previously lagging market segments.

Bassam Nawfal
Chief Asset Allocation Strategist

A Unique Mind On The Markets