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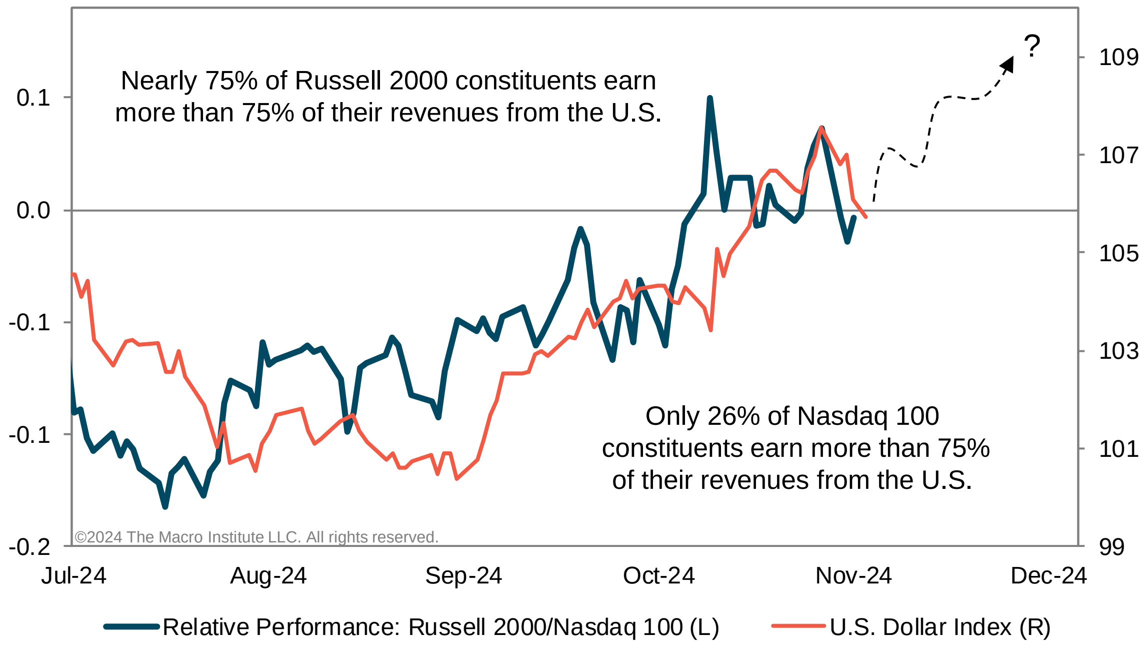
TRAHAN MACRO RESEARCH

December 5, 2024

The Single Most Important Stock Trait In 2025 … U.S.-Centricity?

We don't typically associate small-cap leadership in equities with a stronger U.S. dollar, but these are not normal times. Usually, the U.S. dollar trends lower when the world economy is picking up stream. That's a world characterized by a growing appetite for risk and when cyclicality – which small-cap indices have plenty of – becomes the dominant theme in the marketplace. This time around, we have sluggish growth around the world BUT policy proposals from the new U.S. administration that are clearly protectionist in nature. What is very clear is that all things U.S.-centric are catching a bid and that will likely continue.

Small Caps And The U.S. Dollar Part Of The Same Macro Trade



Not All The Same!

Percent Of Revenues Earned Domestically	
Russell Micro	87%
Russell 2000	81%
S&P 600	80%
S&P 400	76%
S&P 500 Value	68%
S&P 500	60%
S&P 100	55%
Dow Jones	54%
S&P 500 Growth	54%
Nasdaq 100	49%

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The higher reading for the ISM Manufacturing Index in November is certainly consistent with small-caps doing better. After all, stronger leading indicators usually imply risk-on markets and that is a world where smaller and more cyclical indices perform well. That said, better data in November is not the real story here as U.S.-centricity as a theme is working broadly within the U.S. equity markets. As the table above highlights, smaller equity indices, by their nature, tend to have less revenue exposure to the rest of the world and in today's macro backdrop that is clearly a desirable trait.

Interestingly, it's not the typical emerging markets this time around that seem most impaired when it comes to global growth. Indeed, it is Japan, the U.K., China and several large economies that are facing real issues in this cycle. Most importantly, perhaps, some of the policy proposals from the incoming administration, and their protectionist tendencies, could very well accentuate poor conditions overseas. In this week's report, we discuss this unusual backdrop and what it implies for the U.S. dollar and stock selection within U.S. markets. Hope everyone is having a great week. Best, Francois

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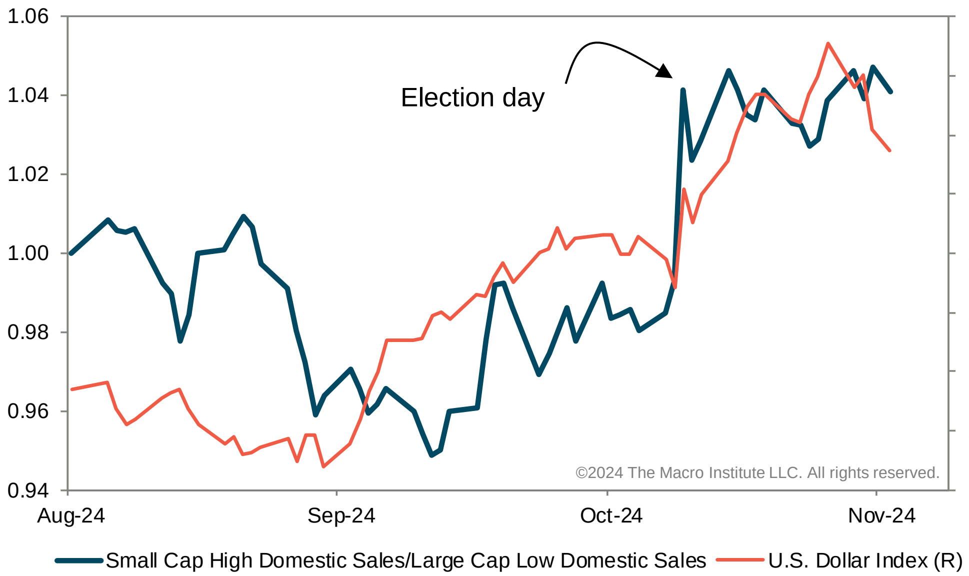
The Election Trade In A Nutshell: U.S.-Centric Revenue Exposure

In the lead up to and following the U.S. election in November, asset classes and equity market factors that have outperformed speak to investors rotating into U.S.-centricity. The obvious call out in that respect is the U.S. dollar which has rallied since early September on the back of deteriorating global growth exacerbated by the potential fallout of protectionist trade policies. Within the U.S. equities space, small cap, with its high domestic revenue footprint, has followed dollar trends over this same period.

Small Cap Names With High Domestic Exposure Have Outperformed



No cherry picking going on here – what we see below is the consistency of the foreign sales trade dynamic. It is pervasive across sizes and styles of the U.S. equity market. While the chart above indicates a preference for small domestic vs. large foreign (no style overlay), even within the large cap space from value to growth, those businesses with more revenue generated in the U.S. have outperformed those with a more multinational footprint. The same dynamic is evident across mid- and small-cap land as well, which showcases the breadth of this trade. SCG is the one outlier in this matrix.

Companies With Large Domestic Revenue Exposure Are The Winners

	Value	Core	Growth	
Large Cap	9.3%	3.5%	4.9%	High Domestic Rev
Large Cap	8.0%	3.2%	3.9%	All
Large Cap	7.1%	1.1%	2.2%	High Foreign Rev
Mid Cap	9.7%	6.1%	6.8%	High Domestic Rev
Mid Cap	7.5%	4.0%	4.3%	All
Mid Cap	2.0%	1.8%	3.1%	High Foreign Rev
Small Cap	8.4%	5.7%	1.3%	High Domestic Rev
Small Cap	7.3%	5.2%	6.4%	All
Small Cap	5.2%	5.2%	8.9%	High Foreign Rev

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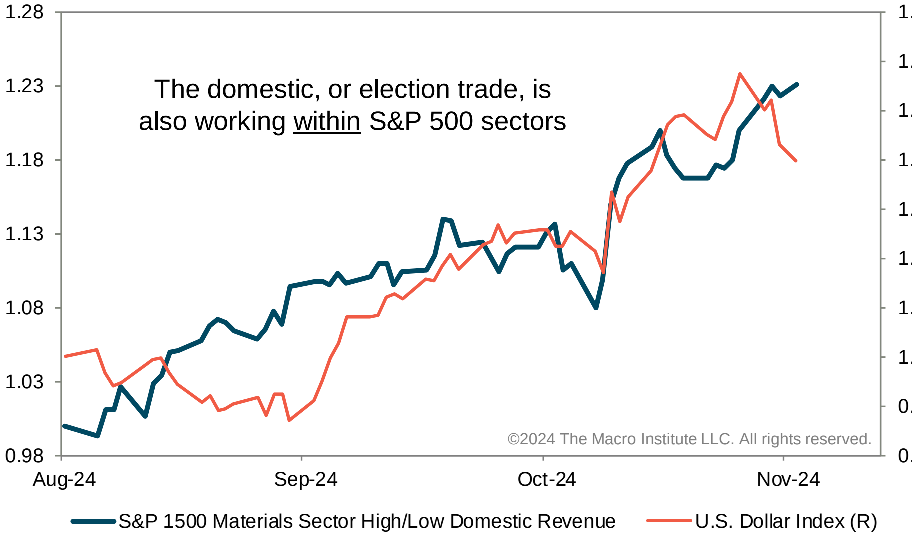
High domestic revenue exposure outperformance is a consistent theme across size and styles since the election.

U.S.-Centricity Also Driving Returns For Sectors And Factors

With small-cap domestic firms working well since September through the election, how is this reflected in sector performance? In general, Cyclicals have the most pronounced performance differential between domestic and foreign exposure. In other words, those running a book of cyclical equities must be relatively more cognizant of each security's footprint relative to growth investors. One of the explanatory factors of this relationship is each sector's sensitivity to U.S. dollar trends. Bottom line: firms with relatively smaller exposure to the rest of the world are leading the charge.

Level Of Domestic Revenue Also Influential For Sectors



Most Pronounced "Within" Cyclicals

High/Low Domestic Revenue Performance Since Election	
Materials	12.1%
Energy	7.0%
Financials	6.3%
Health Care	5.8%
Communication Services	4.9%
Information Technology	4.2%
Consumer Staples	3.3%
Industrials	0.8%
Consumer Discretionary	-2.6%

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While a strong USD should support U.S. consumer spending given the import-centric nature of the U.S., more foreign-focused Discretionary stocks outperformed domestic ones. This can be partially explained by micro factors. The table and chart below reveal how this bullish U.S. and USD trade have proceeded within the realm of investment factors. For example, on the lower left, we split high P/B by geographic footprint. High domestic revenue significantly outperformed low domestic revenue within this cohort of stocks. In essence, the geographic footprint is also impacting performance at the factor level.

Domestic Revenue Boosting Returns

High/Low Domestic Revenue Performance Since Election	
High Price To Book	5.3%
High Quality	3.6%
Low Beta	3.5%
Low EPS Growth	3.3%
Low Price To Book	2.3%

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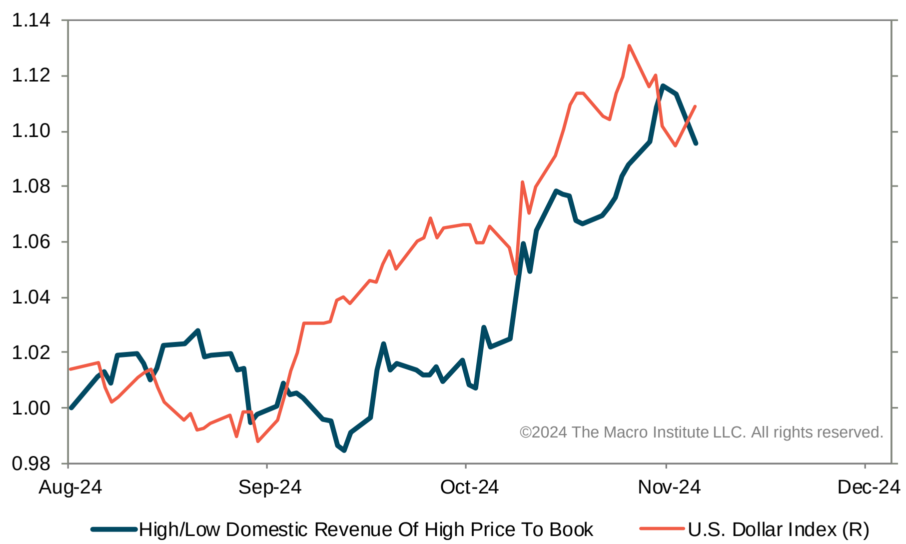
The Level Of Domestic Revenue Also Impacting Factors



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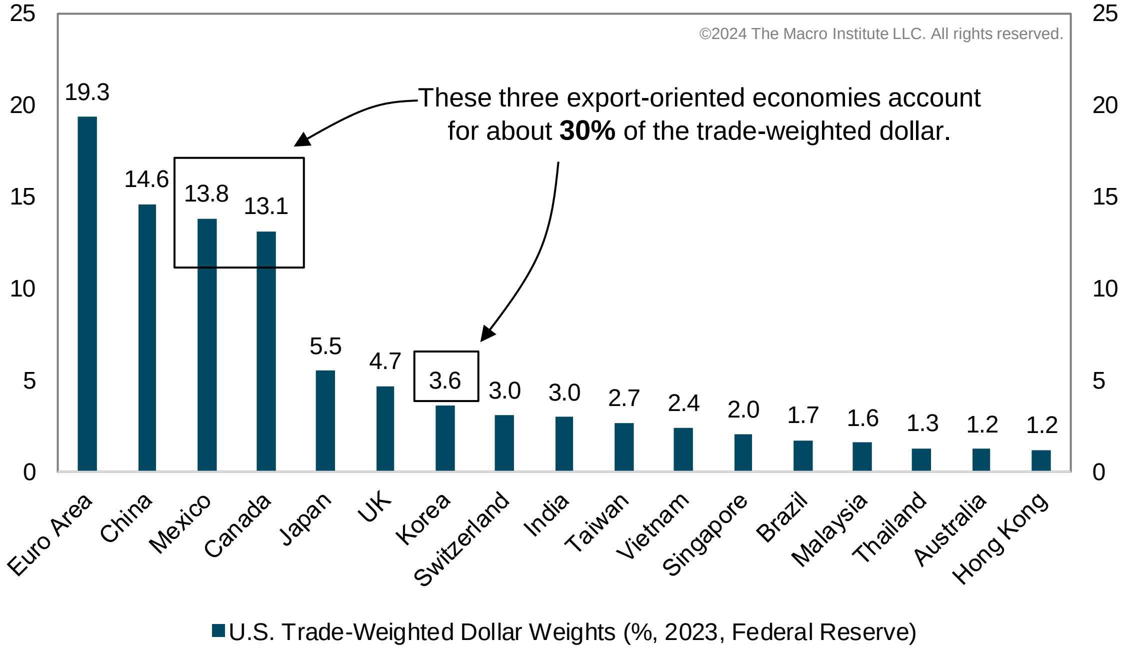
Risks Greater In Some Global Markets Than In Others

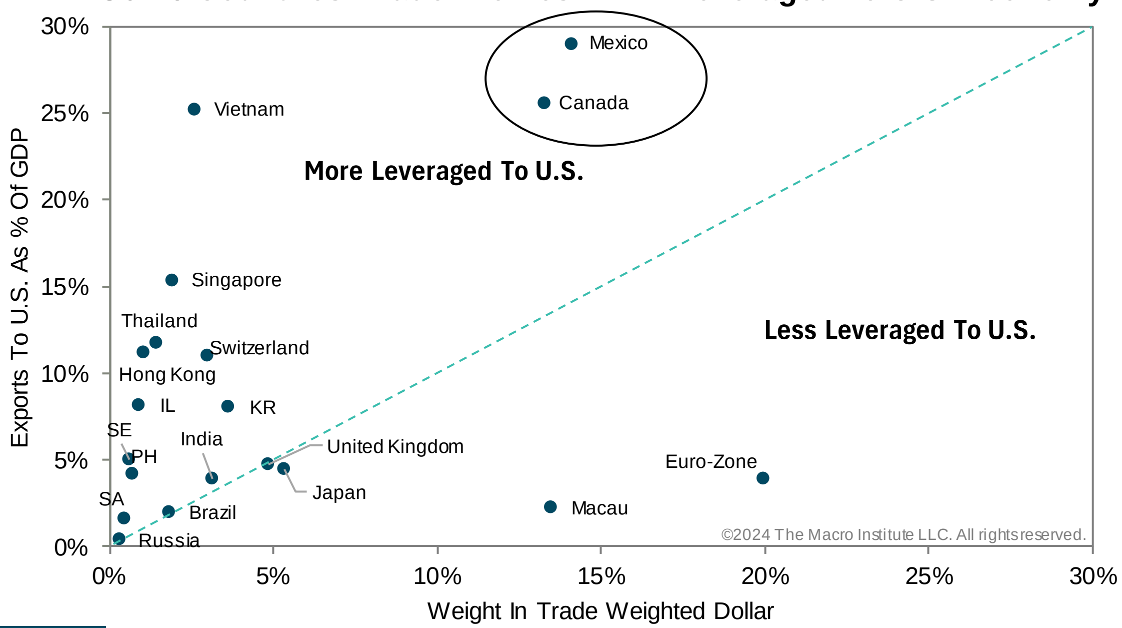
Before we get to our forward-looking bullish USD view, it's critical to understand the trade-weighted dollar's composition and how exposed the U.S.'s various trade partners are to the ebbs and flows in the U.S. economy and policy proposals. The Euro Area comprises nearly 20% of the TWD but as the chart at the bottom reveals, it's dependency on U.S. consumption isn't that significant compared to nations like Mexico and Canada. Nearly 1/3 of the weight of the TWD is just three export-oriented economies.

Makeup Of The U.S. Dollar A Good Starting Point For Analysis BUT …



The potential tariffs are meaningful, and a large U.S. bargaining chip, because exports to the U.S. account for nearly 30% of Mexico's GDP and 25% for Canada. On 11/25 when president-elect Trump announced a 25% tariff on all Canadian products to the U.S. beginning 1/20/25, the CAD/USD immediately fell 1.2% and likely sparked last weekend's trade conversation with President Trudeau. This was not unique to the CAD (see MXN/USD). To the extent any tariffs are enacted, it would act as a major foreign market growth headwind which directly supports a higher USD. We'll discuss this more later.

… Some Countries' Trade Profiles VERY Leveraged To U.S. Economy



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Policy Proposals Complicated BUT Ultimately Dollar Bullish (1/3)

The Trump policy proposals are a fluid situation for macro forecasting. As we saw over the weekend with the U.S. and Canadian leaders meeting in person, they are evolving constantly. In fact, ECB President Christine Lagarde was quoted in the Financial Times urging European leaders "*not to retaliate, but to negotiate*." Based on what we know **now** about the fiscal policy regime come January, we remain bullish on the USD. Our macro framework in terms of policy proposals can be viewed through three aspects: growth prospects, interest rates, and currency flows.

Policy Proposals USD Bullish Using Most Macro Forecasting Frameworks

Growth Prospects — Likely To Slow More In RoW Due To Tariff Drag

- Tariffs

Interest Rates — Likely To End Up Higher Than Otherwise

- Tariffs
- Deportations

Flows — More $$$ Likely To Remain In The U.S.

- Tariffs
- Deportations
- Austerity
- Deregulation

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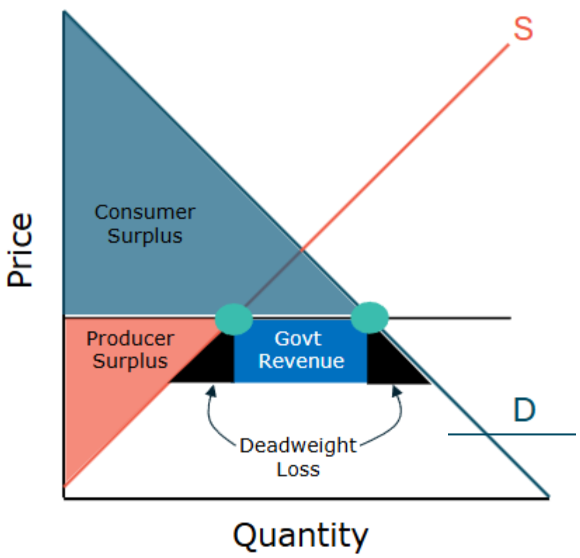
Tariffs represent the new administration's key policy tool, and it touches on all three framework items above. The prior Trump term and 2018-2019 is likely the most applicable example of how new trade policies will be enacted and the associated pushes/pulls on the macro environment. The bottom left diagram is admittedly academic but goes to show the reduction in consumer income (relative to a free trade economy), government revenue, and deadweight loss or inefficiency generated by trade policies above that of the free trade price. In practice, the Jan-18 imposition of 20-50% tariffs on large residential washing machines proved inflationary in the immediate term before retreating by the end of 2019.

2018 Experience Confirms Tariff Theory And Their Inflationary Consequences



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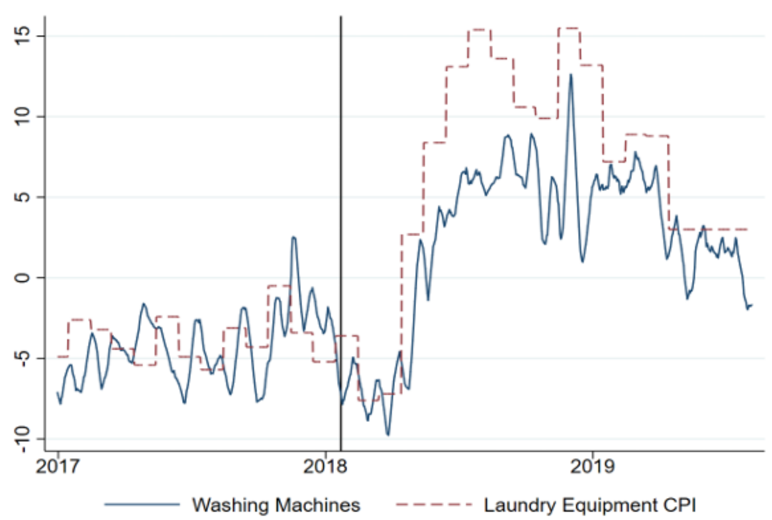
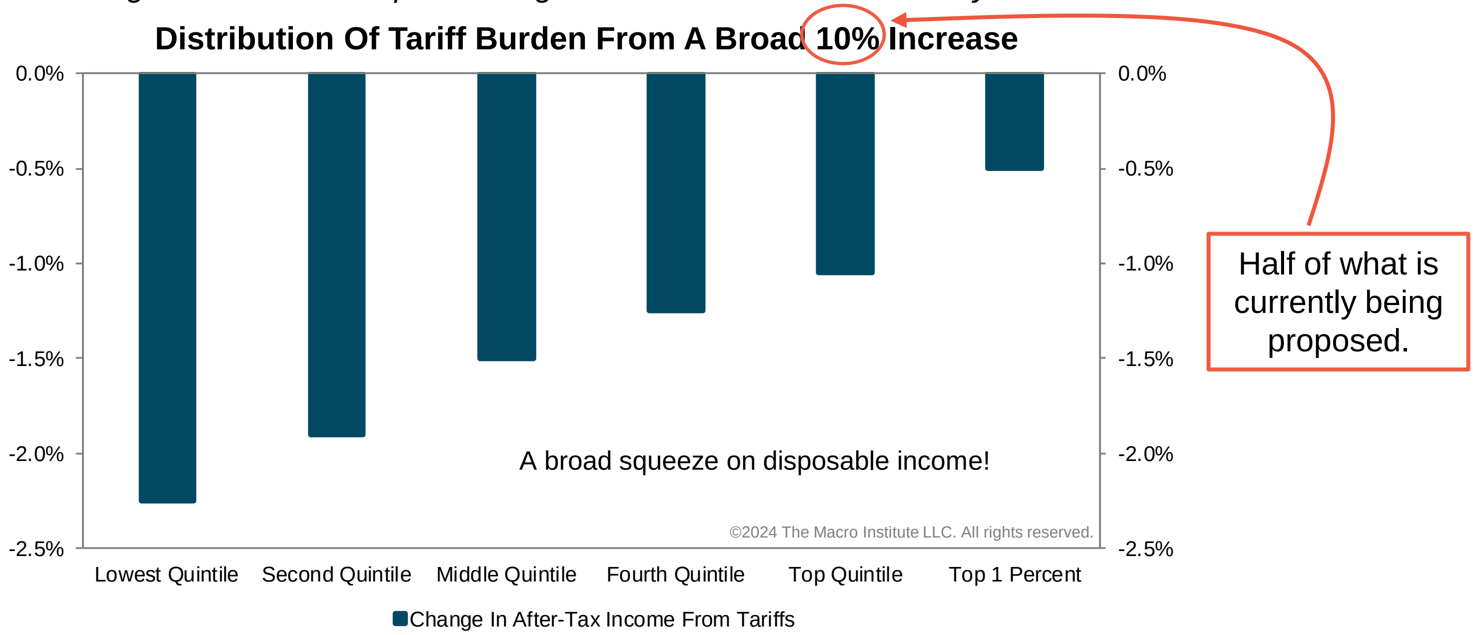


Source: Cavallo, Alberto, *Tariff Passthrough At The Border And At The Store: Evidence From US Trade Policy*, 2019.

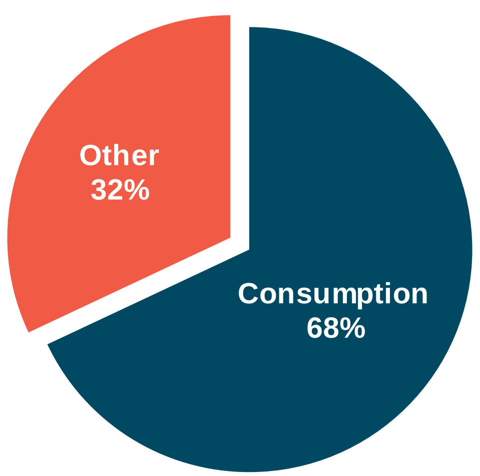
Policy Proposals Complicated BUT Ultimately Dollar Bullish (2/3)

There are of course numerous estimates on different tariff scenarios but what we see below from the Council of Economic Advisers is that the lowest quintile of earners face the largest headwind from the policies. One added complication to the analysis is the rate and cadence with which producers pass along any price increases to consumers. According to a 2019 study by NBER, "… *import tariffs exhibited rapid and high passthrough to some sectors such as washing machines, slower but ultimately high passthrough to tires and low passthrough to some sectors such as bicycles*."

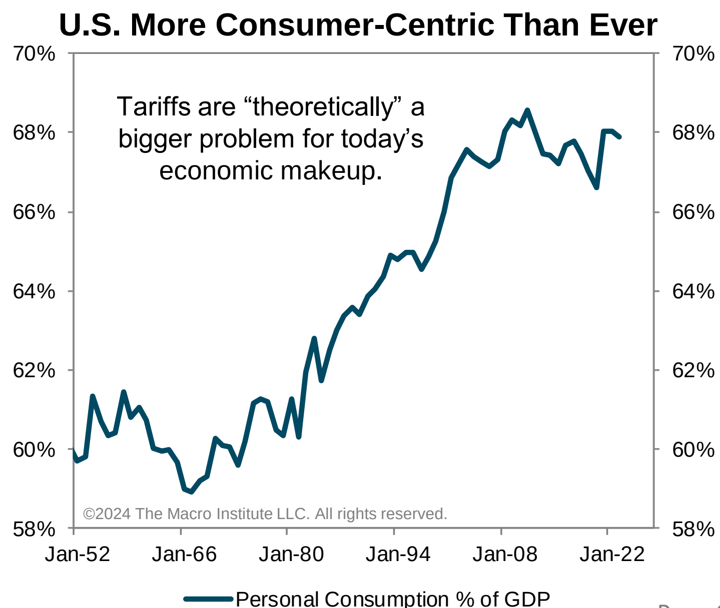


Source: Council of Economic Advisers

The same study also indicated that retailers, at least by 2019, absorbed some of the tariff drag through a hit to profitability. Pre-buy activity ahead of tariff implementation and relocating orders away from China allowed some firms a buffer against raising consumer prices. The point is the tariffs are generally inflationary to the end consumer over time, with some wrinkles, depending on the industry. Import tariffs are of particular concern in the U.S. because the economy has never been this sensitive to consumer behavior historically. Personal consumption now accounts for 68% of GDP, meaning the U.S. will need a stimulative fiscal countermeasure to offset the tariff drag on spending.



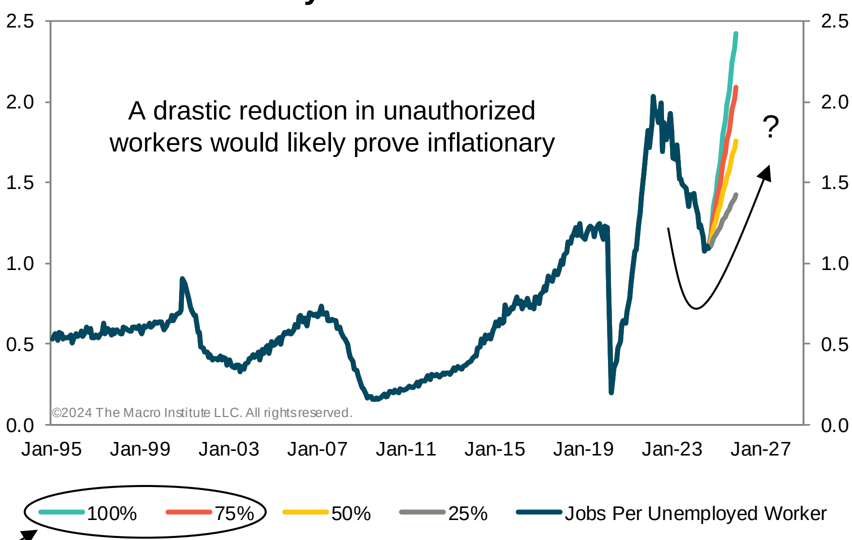
% of GDP, 2023



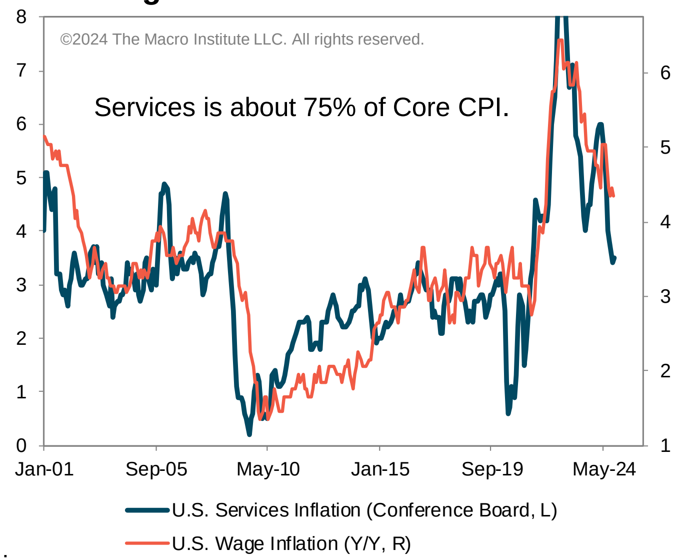
Policy Proposals Complicated BUT Ultimately Dollar Bullish (3/3)

While the imposition of new tariffs likely puts upward pressure on inflation and rates and helps propel the dollar higher, changes in immigration policy may prove to be an even bigger catalyst for the USD than tariffs with even more question marks. Exact details on timing and the number of illegal immigrants to be deported remain scant. What we do know is that immigration impacts labor supply. It has led to downward pressure on wages, and ultimately core CPI. With the U.S. labor market currently sitting at just ~1.0 jobs per unemployed worker, any significant reductions in the workforce could reignite inflation.

Labor Market Key Driver Of U.S. Inflation Trends



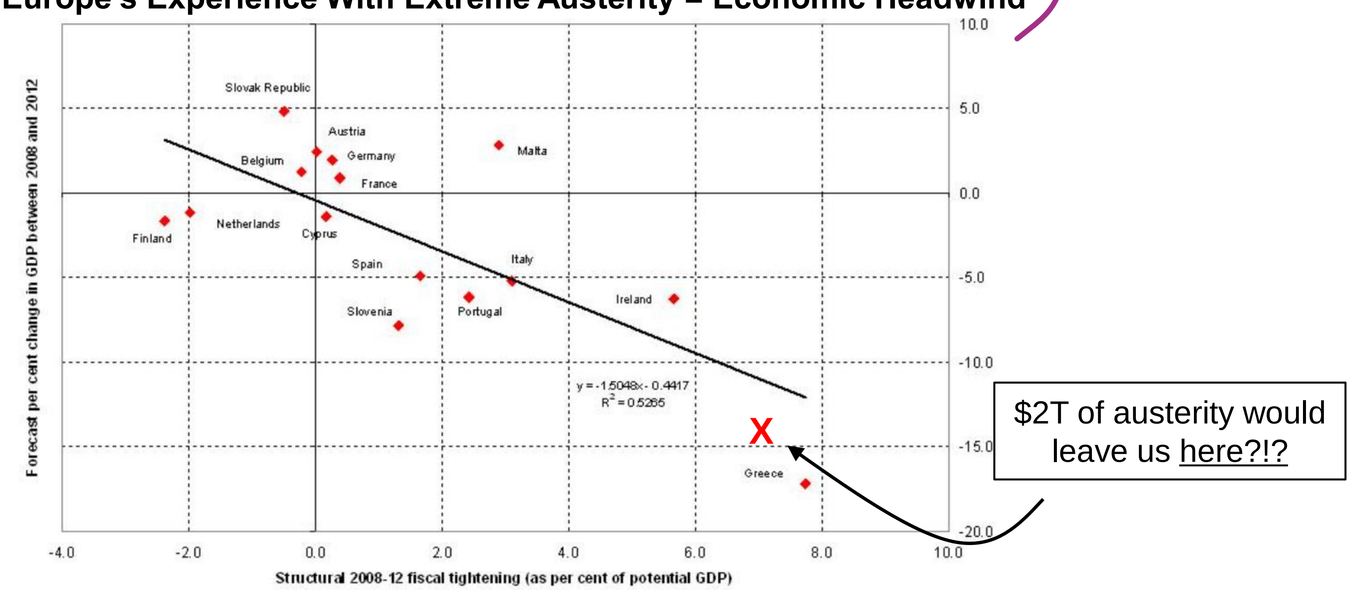
Wage Inflation ≅ Core Inflation



These scenarios would be worse for inflation than the 2021 inflation experience.

Another major initiative of the new administration is austerity – and with a 7% federal budget deficit at only 4% unemployment – not a moment too soon. Elon Musk floated $2.0T in potential budget cuts from the Biden Administration's FY24 budget with outlays of $6.9T. Mandatory programs such as Social Security, Medicare, and Medicaid were ~$4.3T in spending (Defense was ~$900B) so it will be a big challenge politically to achieve such a target over the short run. Nevertheless, as we saw in post-GFC Europe, austerity did not come without pain, economically speaking. Applying Europe's fiscal tightening model to $2.0T in cuts or ~7% of U.S. GDP, suggests potentially stiff headwinds to GDP.

Europe's Experience With Extreme Austerity = Economic Headwind



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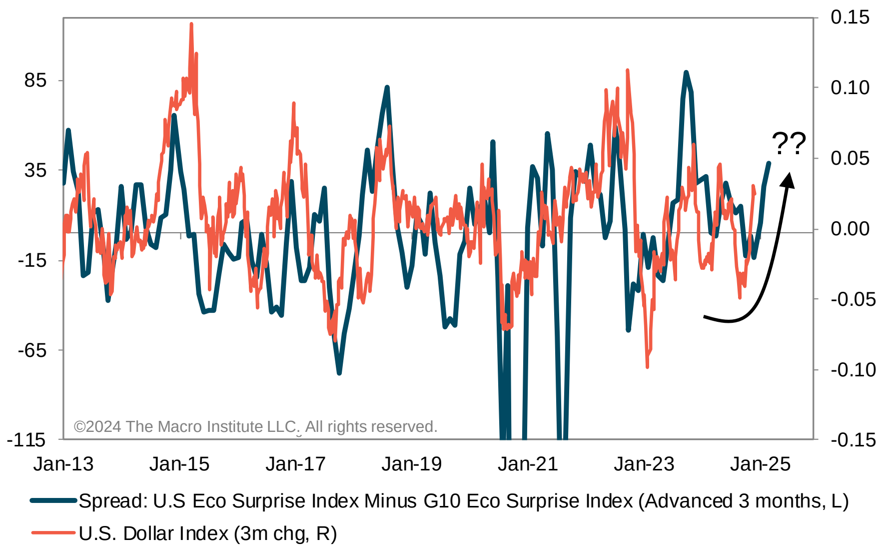
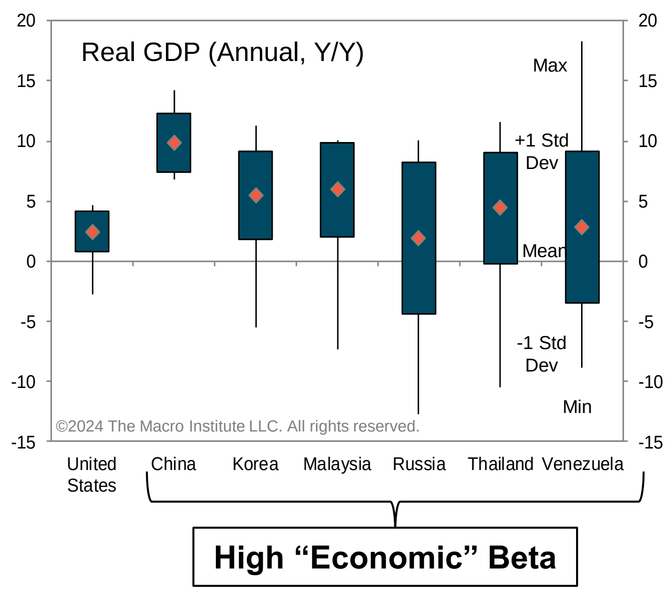
Policy Proposals And Their Pathway To A Stronger U.S. Dollar

To the extent that austerity works to curb government spending, it could represent some offset to inflationary pressures from tariffs and deportations. However, it's the flow through of these policies to the rest of the world that represents the greatest risk to world GDP growth and leads us to a higher dollar thesis. One of the most consistent macro relationships is the tendency for strong dollar regimes to appear when RoW economic growth stalls. Investors tend to seek relatively safer low beta U.S. assets when export dependent or emerging markets falter. Fiscal austerity ≅ less U.S. imports.

Rest Of World At Greater Economic Risk

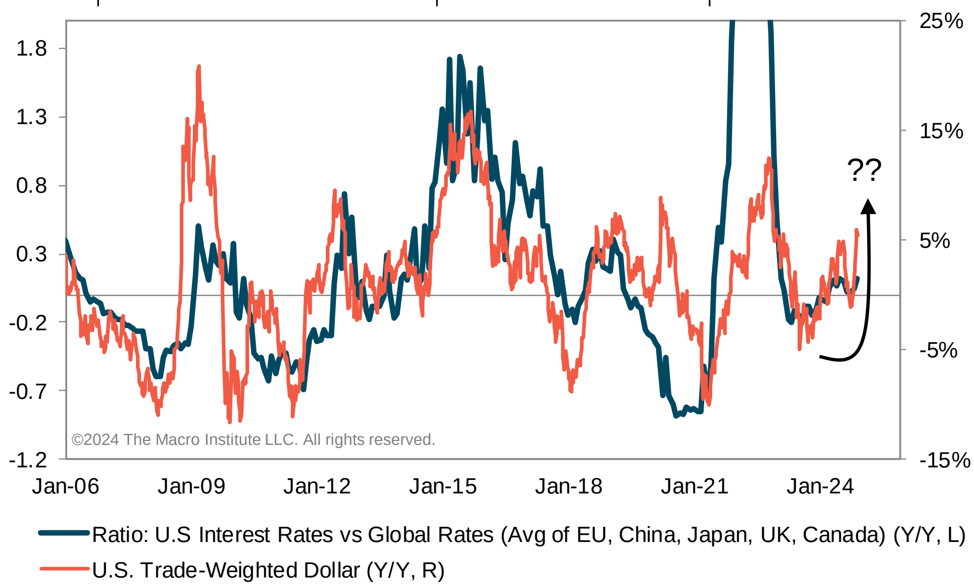


U.S. More Stable Than Most Economies



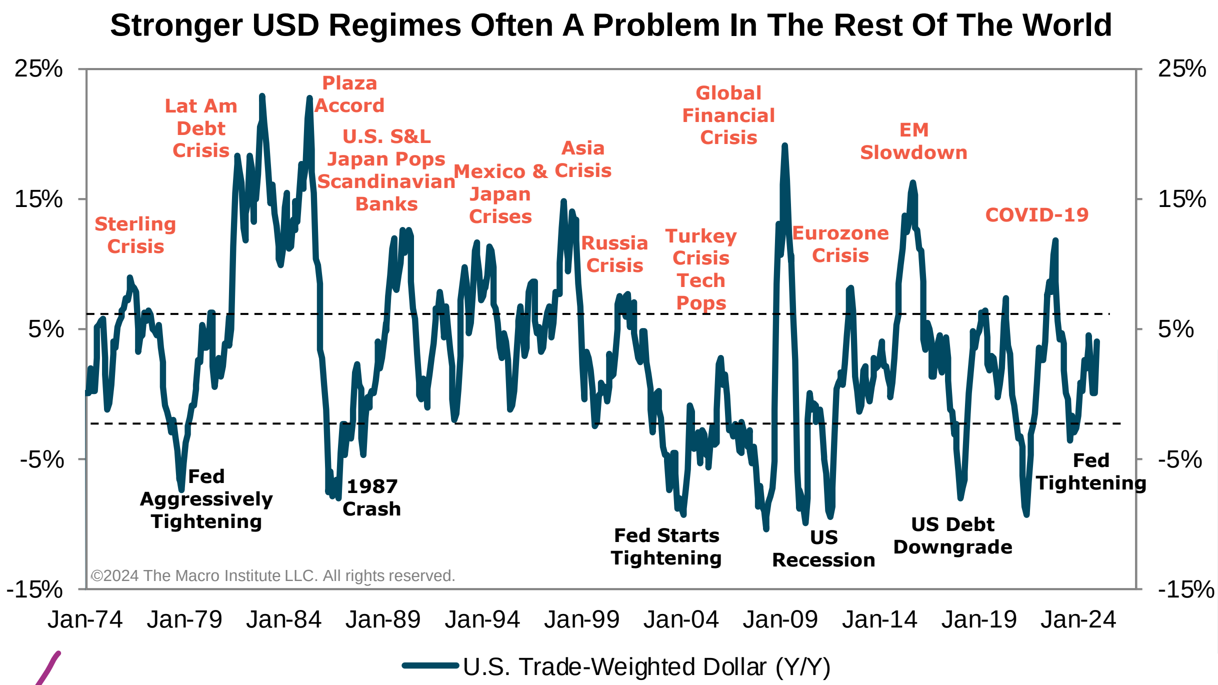
The cleanest way to showcase the impact of potential policies and the dollar is illustrated below, where we map the change in U.S. interest rates against an average of global interest rates. This time series tends to move in sync with the U.S. TWD. The highly consumption-based U.S. economy cannot withstand inflationary regimes, and the Federal Reserve's mandate includes an inflation component. This means it's rare to have pervasive inflation without an accompanying hiking cycle. Inflationary policies suggest to us that U.S. rates remain relatively bid relative to the already-no-growth RoW (even pre-tariff). Currency will tend to flow in the direction of the higher yielding assets such as Treasuries priced in the USD.

↑ Domestic Inflation = ↑ Interest Rates = ↑ U.S. Dollar



A Complicated Relationship Between USD Trends And Global Risks

Increases in the trade weighted dollar tell us a lot about the macro environment. As we saw on the prior page, interest rate differentials are a great coincident indicator of dollar trends. Global PMIs are another great coincident (and inverse) relationship with the dollar. Slowing global growth (i.e., falling PMIs) tends to result in strong USD regimes as investors shift into safe-haven assets. There's a feedback loop that can exacerbate the situation. The chart below shows that there tends to be a major crisis in any year the TWD increases over 5%. The bottom line is that the USD is often a gauge of global risks.



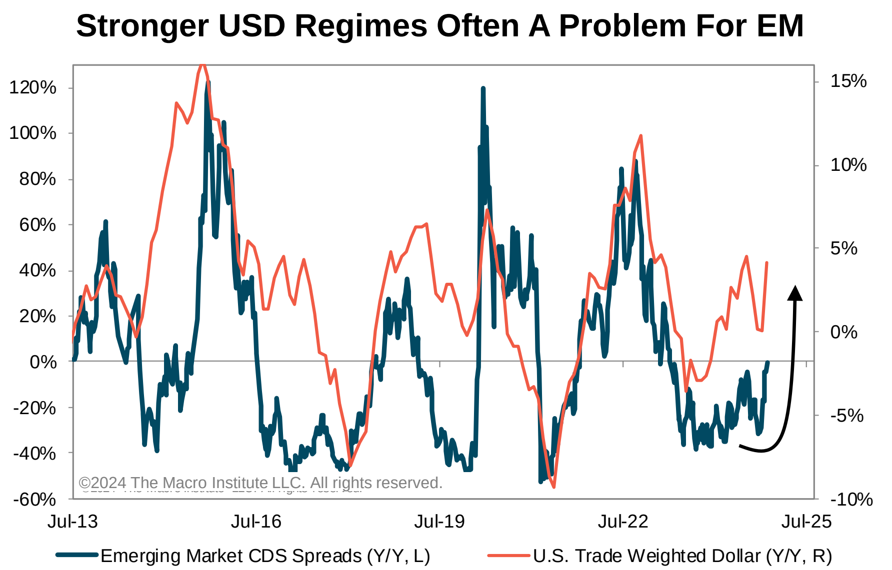
Strong USD → Global Tightening Territory

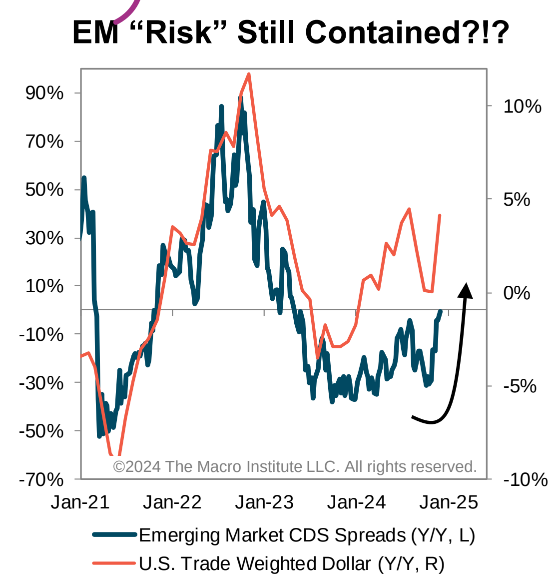
Problem for the rest of world as a stronger USD weighs on global PMIs

Weak USD → U.S. Tightening Territory

Problem for the U.S. as a weaker USD weighs on the U.S. consumer

It's not just slowing growth that causes global risk-off behavior and financial incidents. Highly indebted nations see their dollar-denominated debt relative to their local currency balloon during these regimes. Alongside the dollar moving higher, there's a tendency for emerging market CDS spread to blow out. The price to insure from default risk increases as the dollar pressures EM debt markets. The last few data points in the clip chart on the right are extremely interesting, as it appears CDS spreads are creeping higher post-election as the market contemplates the direction of the USD.





A Good Starting Point For Stock Selection: U.S.-Centric Revenues

We will likely spend a lot of time talking about the importance of a U.S.-centric revenue footprint in the coming year (years?). The table below helps explain why small-caps appear to have caught a bid, while large-cap Tech's momentum has slowed some. These two indices are not exactly apples to apples, but the source of their revenues, geographically speaking, looks VERY different. There is simply a lot more to choose from in the smaller indices when it comes to U.S.-centric firms. There are other variables impacting these two indices, but revenue geography is about to take a larger role.

Rule Of Thumb: Domestic-Revenue Exposure Mostly Inverse To Market Capitalization

	Domestic Revenue Exposure		
Index	Weighted Average	Simple Average	Names With Greater Than 75% Exposure
Russell Micro	87%	87%	80%
Russell 2000	81%	83%	74%
S&P 600	80%	80%	68%
S&P 400	76%	75%	57%
S&P 500 Value	68%	70%	48%
S&P 500	60%	69%	45%
S&P 100	55%	62%	32%
Dow Jones Industrial	54%	60%	27%
S&P 500 Growth	54%	65%	38%

High Domestic Exposure

High Foreign Exposure

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We left out the Utilities and REITs sectors from most of our discussion thus far, as they are obviously almost exclusively U.S. centric. The two sectors have performed well in the wake of the elections, even when interest rates were trending higher. When it comes to stock selection, however, the importance of the geographic footprint is going to matter more in sectors like Industrials or Consumer Discretionary, where there is great disparity in this regard. The screen below is oversimplifying things a tad, but it will likely become a great place to start when it comes to stock selection.

A Sample Stock Listing Of U.S. Revenue Exposure

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Lower Deciles Rank Better In All Categories

Universe: S&P 500

TMI Domestic Revenue

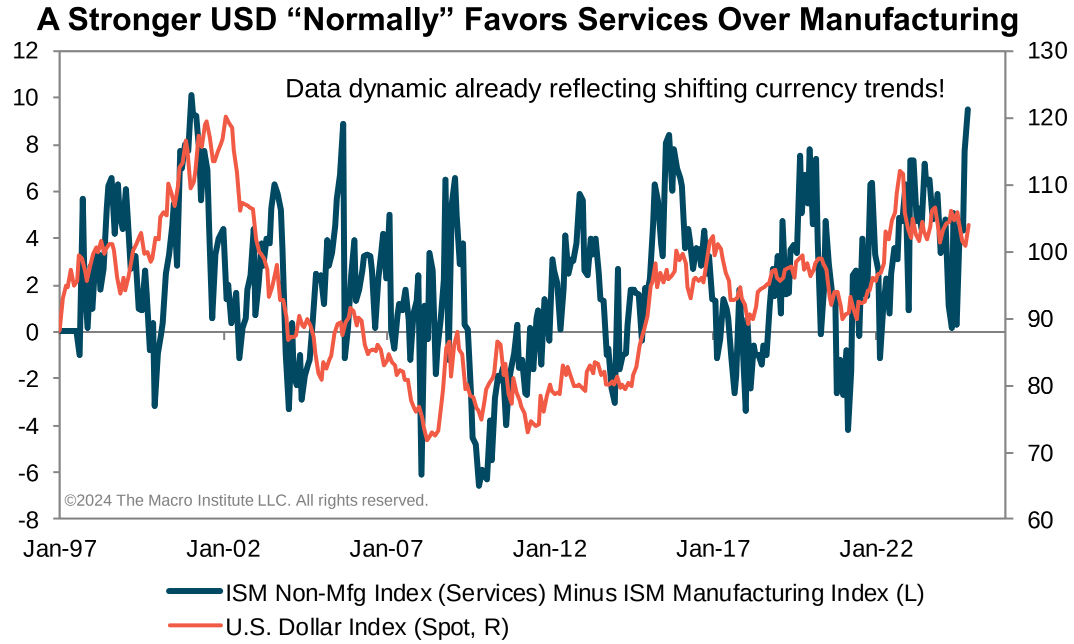
Ticker	Name	Domestic Revenue	Domestic Revenue	Price	Market Value	Sector	Industry
AMTM	Amentum Holdings, Inc.	1	100	$ 23.94	5,805.2	Professional Services	Industrials
HII	Huntington Ingalls Industries, Inc.	1	100	$ 192.78	7,624.0	Aerospace & Defense	Industrials
PAYC	Paycom Software, Inc.	1	100	$ 231.39	12,988.5	Professional Services	Industrials
CPB	Campbells Company	1	100	$ 45.60	13,758.8	Food Products	Consumer Staples
DG	Dollar General Corporation	1	100	$ 78.41	17,107.2	Consumer Staples Distribu	Consumer Staples
MOH	Molina Healthcare, Inc.	1	100	$ 309.95	17,267.0	Health Care Providers & Se	Health Care
DGX	Quest Diagnostics Incorporated	1	100	$ 161.50	18,027.0	Health Care Providers & Se	Health Care
JBHT	J.B. Hunt Transport Services, Inc.	1	100	$ 183.90	19,081.1	Ground Transportation	Industrials
FOX	Fox Corporation Class B	1	100	$ 44.39	20,805.6	Media	Communication Services

For complete list, different benchmark, or monthly model updates:

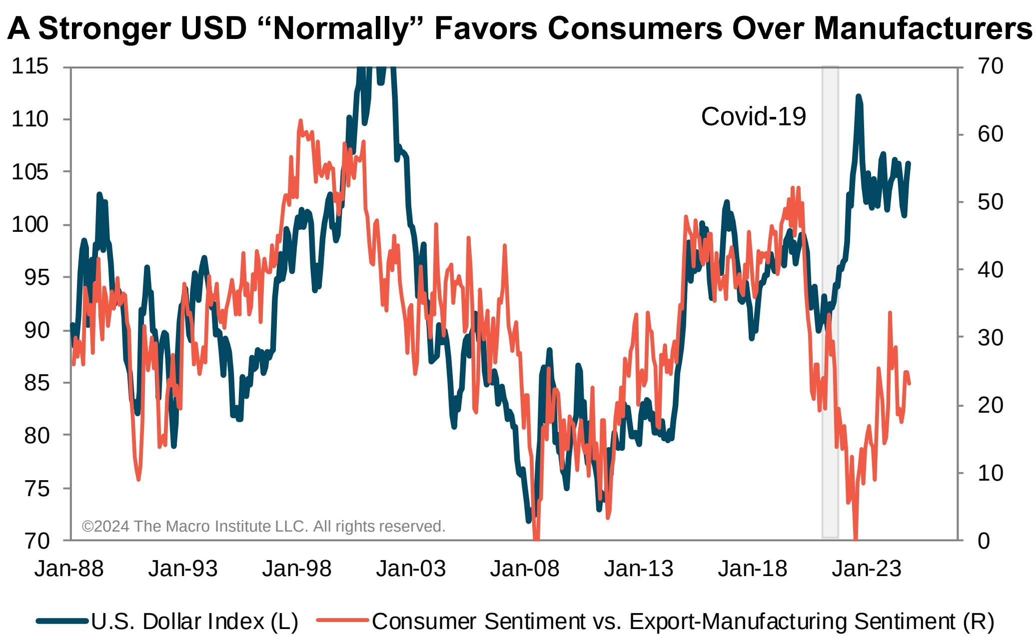
Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

Annex: A Macro Backdrop That Favors Services Over Manufacturing?!?

Under normal circumstances, a stronger dollar regime is synonymous with a relatively-healthier services sector, at least when compared to manufacturing. Surely, services is more U.S.-centric overall, and a stronger USD is typically a sign of weaker prospects abroad, which has a disproportionate impact on manufacturing. Manufacturing is also typically far more cyclical (or volatile) than services, as there is an inventory component to the dynamic. At this time, the historical relationship has held up in the face of a stronger USD, and all other things equal, we would expect services to fare relatively better near-term.



Considering the story above, it should not be surprising to hear that there's a similar relationship between consumer sentiment and export sentiment. After all, consumers find relief in a stronger dollar via lower inflation while exporters face a less competitive environment. Now, the macro backdrop might be a bit different in a world of tariffs, especially when it comes to inflation. The potential for retaliatory tariffs and slower global growth, all else equal, might just weigh on export sentiment MORE than the impact of inflation on consumer sentiment. It's an unusual relationship, but the dynamic should hold.



Consumer sentiment typically strengthens relative to exporter sentiment when the USD is appreciating.