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Strategy for Uncertainty? Raise Quality

Key Takeaways

- The month of September is historically the only month that has a negative average return for the S&P 500 (-1.2% since 1930). The month of October averages a drop when counting only US presidential election years (-0.6%).
- Portfolios don't "mature" on November 5. If you are fatigued by "soft landing" vs "hard landing" debates or put off by US election uncertainty, we'd favor allocating to higher quality dividend growth and investment grade yield strategies rather than attempt to "time markets."
- It takes a strong balance sheet and industry position to grow dividends consistently. A strategy of investing in consistent dividend growers (so-called "Dividend Aristocrats") has outperformed the S&P 500 return over the past 30 years. While it has trailed the Nasdaq 100, it's done so with 42% less average annual volatility.

Potential Portfolio Implications

- Reflecting uncertainty, "defensive" industries such as utilities have a history of outperforming the S&P 500 by 2.2 percentage points on average in the six-months prior to US presidential elections since 1990, then underperforming by 1.4 percentage points in the six-months after. Current market trends are conforming to this pattern.
- "High dividend yield" strategies have outperformed in the past two months, but this is partly a reflection of the sharp decline in large cap US Tech shares (the market cap weighted semiconductor index – comprised 60% of Nvidia – is off 22% since early July). We would tend to favor high quality consistent dividend growers over the "highest yielders" after recent market moves. We also doubt that a single AI-tech play will dominate markets in 2025.
- Small cap stocks – measured by the Russell 2000 – have a history of strong outperformance only in the first year of a new economic recovery. They have to go through a recessionary contraction before this happens. Since credit markets have been solid and there has been no "near death" moment for the Russell, we don't see a particularly strong return outlook for lower quality SMID. As discussed in last week's CIO Bulletin, higher quality, less leveraged SMID growth shares are a different investment.

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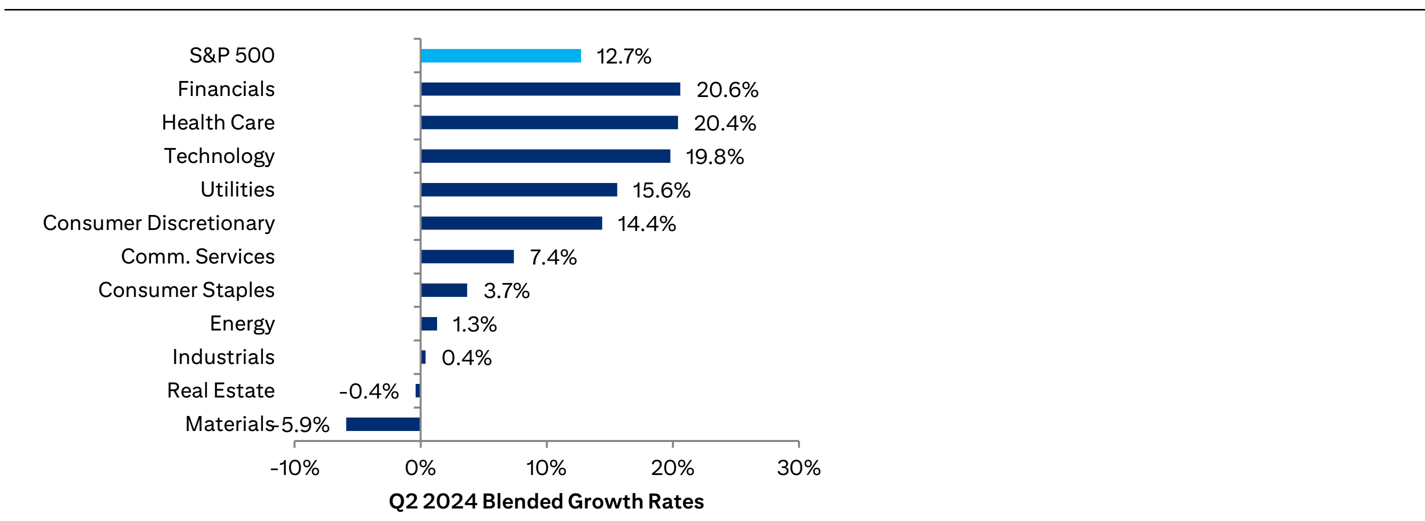
Tech Wins Bronze Medal for Once

Is the glass half full or half empty? As an investor, your answer might depend on your current portfolio allocation and preference of time horizon. As we discussed in last week's CIO Bulletin, US equities have pulled back, unable to return to the July 16 high, a level that represented a roughly 20% year-to-date total return. The weakness of large cap US tech – off about 13% from the July high – is one indication of risk aversion that could dampen the overall equity market in the near-term. However, with EPS gains for 9 of 11 economic sectors – with financials and healthcare outgrowing tech EPS in 2Q – one might make a stronger forward-looking case now that investors have sobered up (see **FIGURE 1**).

Why has tech suddenly done so badly? There are a number of reasons, but it feels as though tech has lost its "exclusive growth rights." This has implications for portfolio strategy in the year ahead.

FIGURE 1: S&P 500 sector EPS gains this year through Q2



Source: Factset and Bloomberg as of August 29, 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

First, we would note that a skittish performance of markets about two months ahead of an uncertain US presidential election is entirely normal. Weak data and weak markets frequently go hand in hand in late summer. Since 1930, the only month that averages a negative return for the broad US market is September (though many positives and negative have been experienced in particular years). When one includes only US presidential election year uncertainty, the weakness extends to October (see **FIGURE 2-3**).

FIGURE 2: US equity market returns by month since 1930

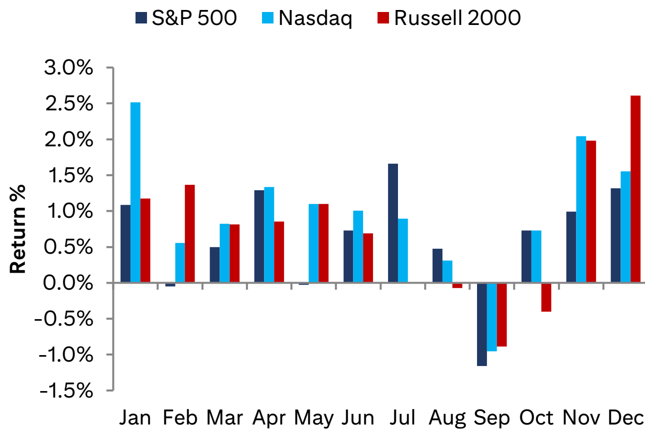
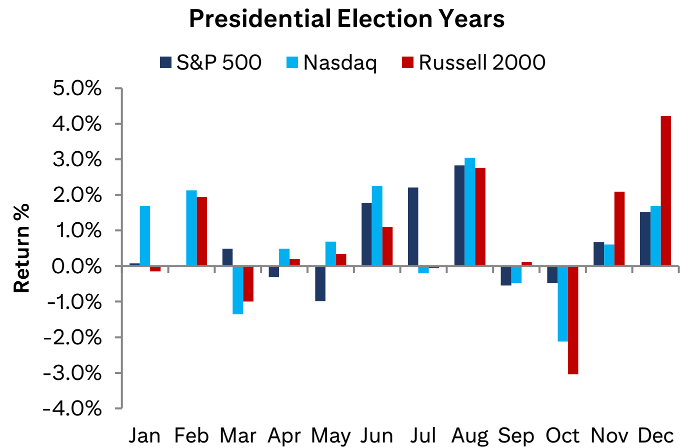


FIGURE 3: US equity market returns by month during election years



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Defense to offense vs "straight down the middle"

We are cautious of depending on historic patterns without assessing wider factors. But to date, it is notable that the composition of market activity is also following historic, election year norms. As **FIGURE 4** shows, defensive industries such as utilities, healthcare, and staples have typically outperformed a downwardly biased equity market in the six-months before US elections. On average, they go on to underperform a rising US equity market in the six months after US elections are out of the way.

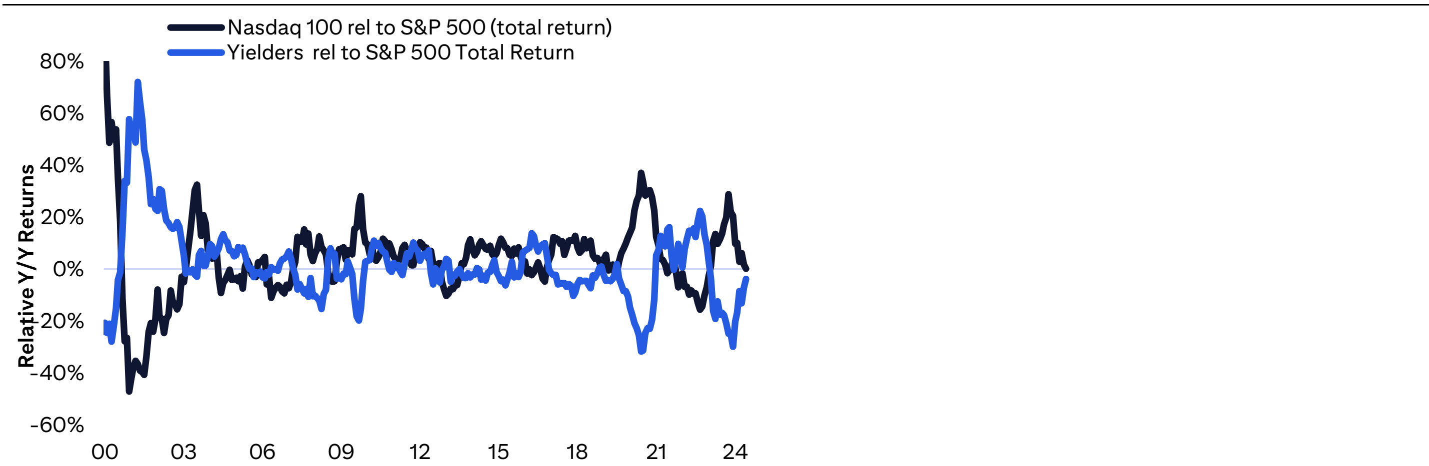
FIGURE 4: Equities and bonds historically showed defensive bias into US elections, recoveries thereafter (election years since 1990)

	Equities (Since 1990)				Bonds (Since 1996)		
	S&P 500	Defensives	Cyclicals	MSCI AC World	US Treasuries	Inv. Grade	High Yield
6 months before presidential elections	-0.58%	1.61%	-1.20%	-2.73%	0.01%	-0.68%	-1.60%
6 months after presidential elections	6.47%	5.08%	9.06%	8.22%	-1.33%	0.66%	3.03%

Source: Bloomberg as of September 4, 2024. Defensive sectors include Health Care, Telecommunications, Consumer Staples, and Utilities. Cyclical sectors include Tech, Industrials, Financials, Energy, Consumer Discretionary, Real Estate, and Materials. The proxy for US Treasuries is Bloomberg US Aggregate Government – Treasury index. The proxy for Investment Grade is Bloomberg US Corporate Investment Grade index. The proxy for High Yield is Bloomberg US High Yield – Corporate index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

What are some wider factors one should consider to understand markets now? For one, tech shares posted one of the five strongest outperformance periods in the past 25 years through early July. With just three US tech mega-caps rising to nearly $10 trillion in aggregate value in 1H 2024, returns were "sucked" out of other industries. Until 2Q of this year, EPS gains were sparce for most sectors. AI promises beckoned until the momentum faded. But since July, equity investors have turned to the tangible returns of high dividend yielders such as utilities as interest rates fell.

FIGURE 5: Nasdaq 100 and Dow Jones Select Dividend Yield Index Return vs S&P 500 (12-months)



Source: Bloomberg as of August 31, 2024. The proxy for yielders is Dow Jones Select Dividend Yield index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

With tech correcting lower "high current yield" shares reaching record high levels, we would emphasize the left-behind dividend growth shares that have lagged (see **FIGURE 6-7**). Tech (offense) and utilities (defense) are necessary components of a diversified equity portfolio. But even together, the two sectors wouldn't make for a complete portfolio.

FIGURE 6: S&P 500 Dividend Aristocrats return relative to S&P 500

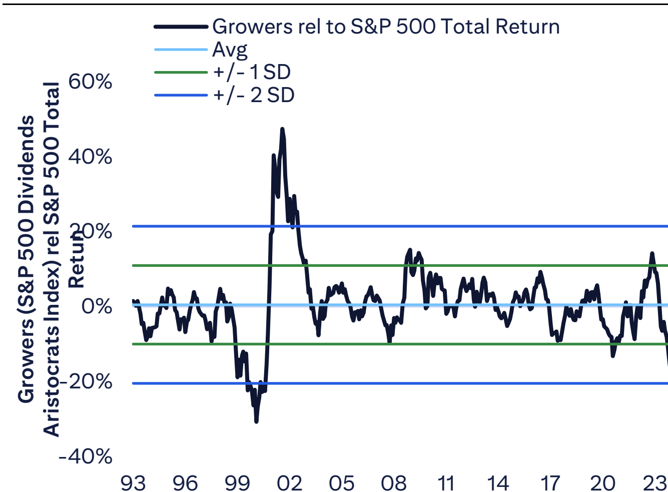
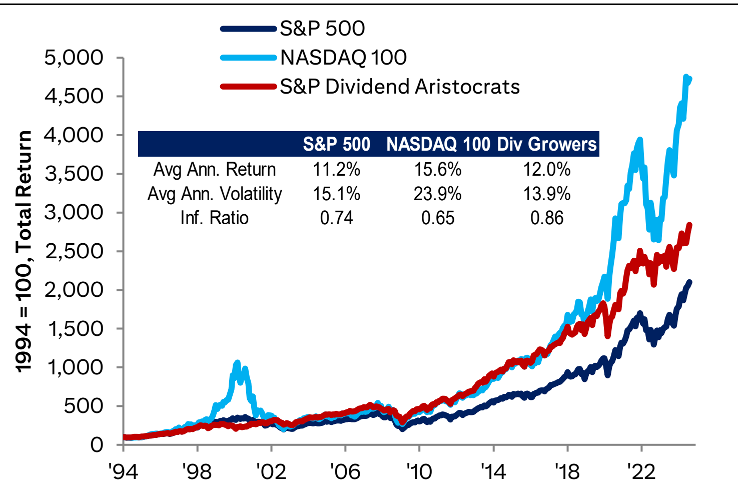


FIGURE 7: S&P 500 vs Nasdaq 100 vs S&P 500 Dividend Aristocrats total return



	S&P 500	NASDAQ 100	Div Growers
Avg Ann. Return	11.2%	15.6%	12.0%
Avg Ann. Volatility	15.1%	23.9%	13.9%
Inf. Ratio	0.74	0.65	0.86

Source: Bloomberg as of August 31, 2024. The proxy for growers is S&P 500 Dividend Aristocrats. In the right chart, the information ratio is the return divided by the volatility. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Election and economic policy uncertainty is likely to remain high until early November at a minimum. This should not stop investors from assessing if their portfolios are positioned to best suit their needs. The days of a 5% cash yield are nearly over with the Fed set to cut policy rates on September 18. So are the days when a single stock drove nearly a third of US equity market returns as Nvidia did this spring. Intermediate duration bonds are still yielding more than the Fed's own expected policy rate over the next few years and can still benefit from Fed rate cuts, if marginally. Most global equities – apart from US tech – trade near long-term historic valuations.

But what is a standout that may potentially endure through a variety of uncertain scenarios? The discipline of managing a firm to pay a higher dividend over many years "screens out" most firms, leaving a high-quality bias. This is not always what produces the highest return over short periods. Over cycles, it tends to eliminate heavily indebted firms.

Heavily indebted cyclical firms that survived economic crashes historically produced large "bounce-backs" in the year following the start of new economic cycles (see **FIGURE 8-9**). While we often wish we could tell investors a more exciting story, no economic crash appears at hand, and certainly none has already happened. Without a large drop first, a stronger burst of performance for low quality leveraged cyclicals is not at hand.

FIGURE 8: Russell 2000 vs US high yield bond returns Y/Y%

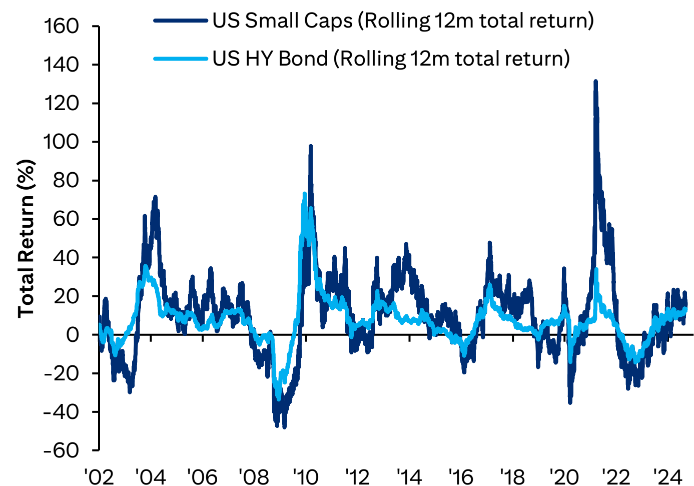
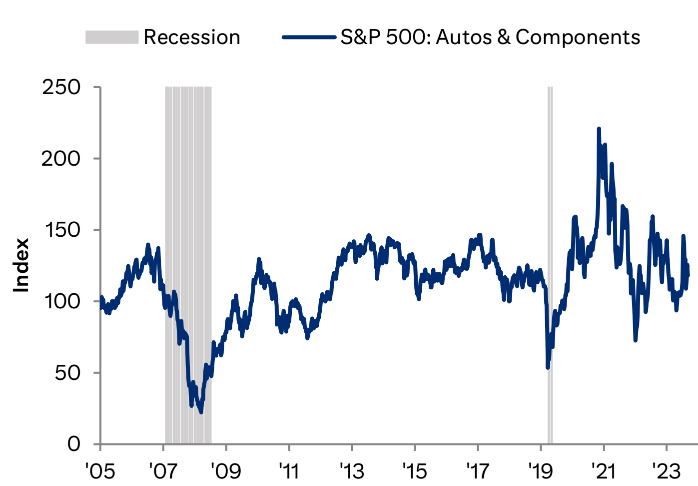


FIGURE 9: S&P Autos and Components group



Source: Bloomberg as of September 5, 2024. The proxy for US small caps is the Russell 2000 index. The proxy for US high yield bonds is the Bloomberg US Corporate High Yield Total Return index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

US employment data – ambiguity reigns

In August, US employment grew by 142,000 in the survey of establishments and 168,000 in the separate survey of households. Following the pattern of the past year, data over the previous two months was revised down.

The slowdown in employment growth is a well-established pattern following the surge back from the pandemic shock (see **FIGURE 10**). It does nothing to challenge forthcoming easing steps from the Fed. It also does little to clarify if policymakers will act boldly or timidly when they take their initial step to cut policy rates on September 18 (markets are evenly split at the moment in assessing whether the cut is 25 or 50 basis points).

The severe drop in services-related employment in 2020 was unprecedented and unique to the pandemic situation. As we've discussed in recent CIO Bulletins, the rebound in services employment clouded the impact of Fed tightening in 2022-2023. Fed easing is meant to avoid exacerbating a further slowdown.

Importantly for investors, the narrow industry collapse and rebound in services employment of recent years didn't sharply boost national output and profits. GDP and profits weakened in 2022-2023. As we discussed two weeks ago, easing can help interest-rate-sensitive components of the economy recover. Even with a slowdown in labor demand, we see no collapse in the economy to come (see **FIGURE 11**).

As we discussed three weeks ago, due to the pandemic, the economy isn't closely "following the rules" that a context-free historical analysis might suggest.

FIGURE 10: US nonfarm employment

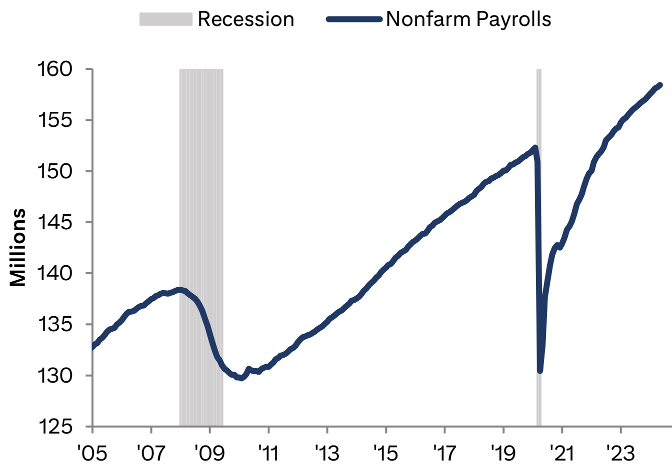
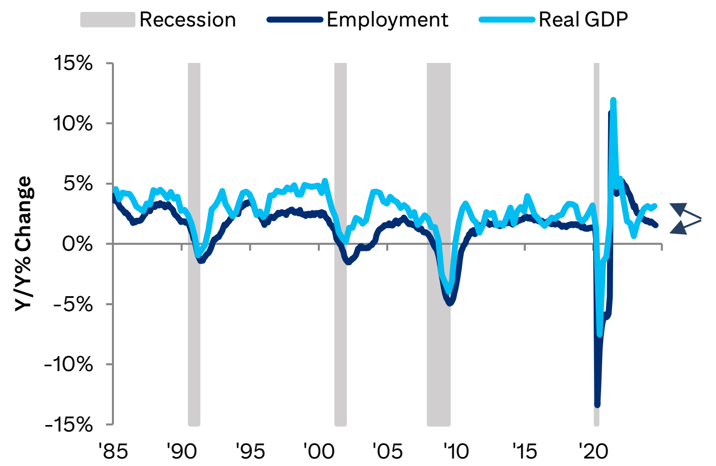


FIGURE 11: US real GDP and employment Y/Y%



Source: Haver Analytics as of September 6, 2024.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
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