Morgan Stanley

FOLLOWING THE FUNDAMENTALS

1ST QUARTER 2025: ISSUE 33

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

ARE THE HAVE-NOTS THAWING OUT?

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

As we mentally prepare to experience another frigid Iowa winter, it's way too early for local readers of this newsletter to start thinking thoughts of warmer weather to come. Maybe next month, if Phil doesn't see his shadow, we can start to think about warmer weather. While we must wait, Small Business in the US is starting to feel optimistic and hoping to thaw out sooner than later from the long winter they have faced the past few years.

In our previous quarterly update from Q3 2024, titled "The Haves vs the Have-Nots", we wrote about the divergence we were seeing between large and small companies in the US. Small companies have faced several headwinds the past few years including inflation, lack of labor supply, and higher interest rates that led to historically low readings in the Small Business Optimism Index. Those headwinds led to significant out performance for the S&P 500 vs the Russell 2000 over that period. Observing performance from 12/31/21 thru 10/31/24, the S&P 500 returned 19.72% while the Russell 2000 returned -2.11%. (ThomsonOne)

In this edition of our quarterly update, we are going to re-visit the Haves vs the Have-Nots and why recent optimism from small business could change what to expect going forward.

IN THIS ISSUE WE'RE COVERING

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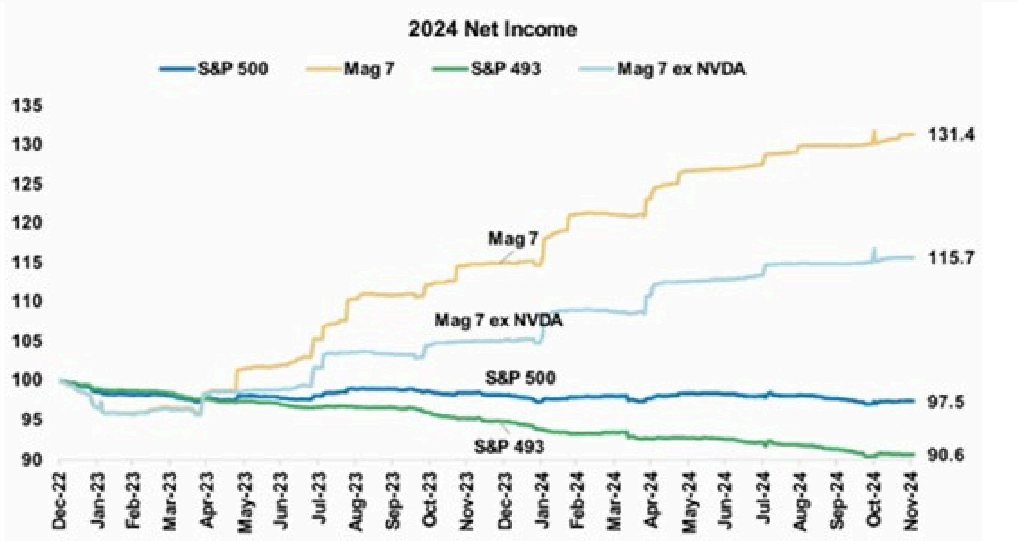
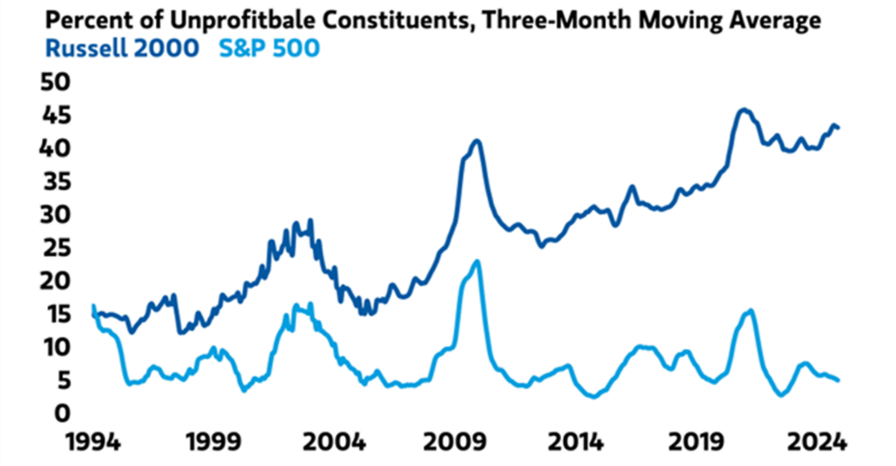
THE HAVES VS THE HAVE-NOTS

In previous updates, we covered that we believe high inflation, lack of labor supply, and higher interest rates are some of the many head winds that have faced small companies in the US. As seen below, the 2024 net income growth of the S&P 500 was concentrated to the “Mag 7”, a group of 7 mega-cap companies while the rest of the “S&P 493” saw their net income contract.



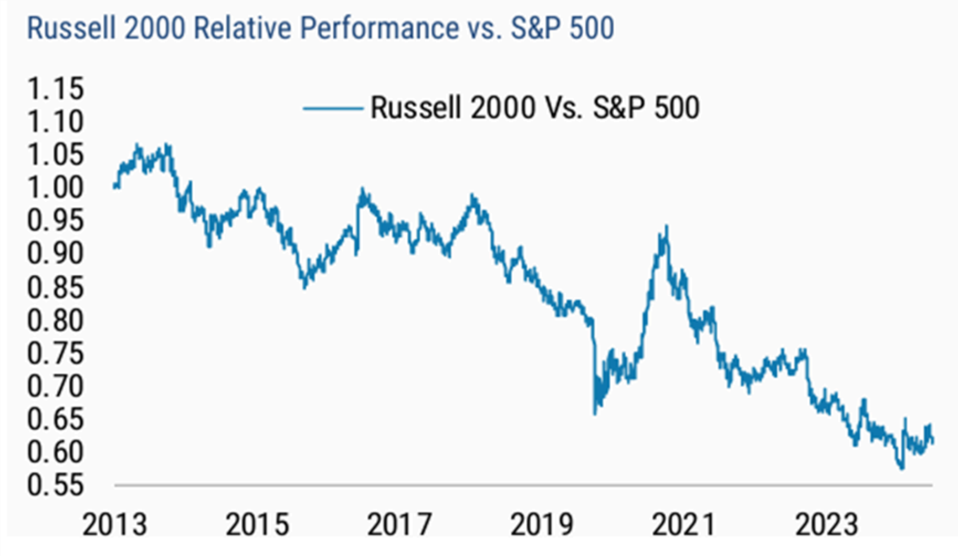
Source: FactSet, Bloomberg, Morgan Stanley Research. As of Nov. 30, 2024.

While most of the “S&P 493” has struggled compared to the “Mag 7”, the divergence between the haves and the have-nots is even more extreme when comparing the S&P 500 to the much smaller companies that make up the Russell 2000. With the headwinds smaller companies have faced, the percentage of unprofitable companies that make up the Russell 2000 is hovering near the highest levels seen in the last 30 years. Significantly higher than the percentage of unprofitable companies in the S&P 500.



Source: Bloomberg, Morgan Stanley Wealth Management GIO. Data as of November 30, 2024.

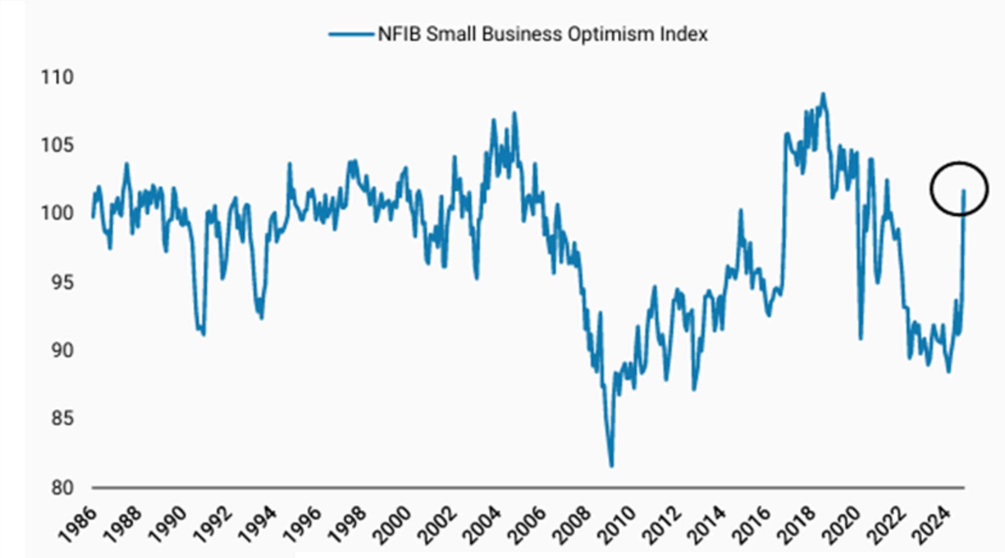
As seen below, the Russell 2000 saw positive relative performance compared to the S&P 500 in 2020-2021, but that trend reversed as the smaller companies started experiencing the headwinds previously discussed. With the smaller companies struggling to keep up with the earnings growth of the S&P 500, the performance of the indices again diverged in favor of the S&P 500.



Source: FactSet, Morgan Stanley Research. As of Dec 13 2024

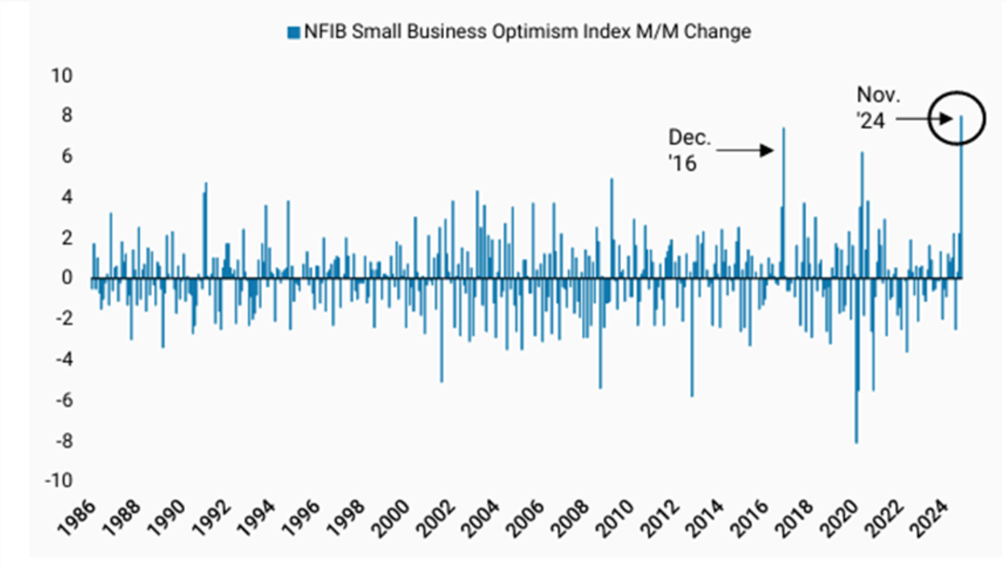
ARE THE HAVE-NOTS THAWING OUT?

With the headwinds small businesses have been facing the past few years, the Small Business Optimism Index has been hovering at levels only seen during and after the Great Financial Crisis of 2008-2009. However, this data point got a major boost this past November after the election in the US. As seen below, the Small Business Optimism Index rose 8 points last month to 101.7.



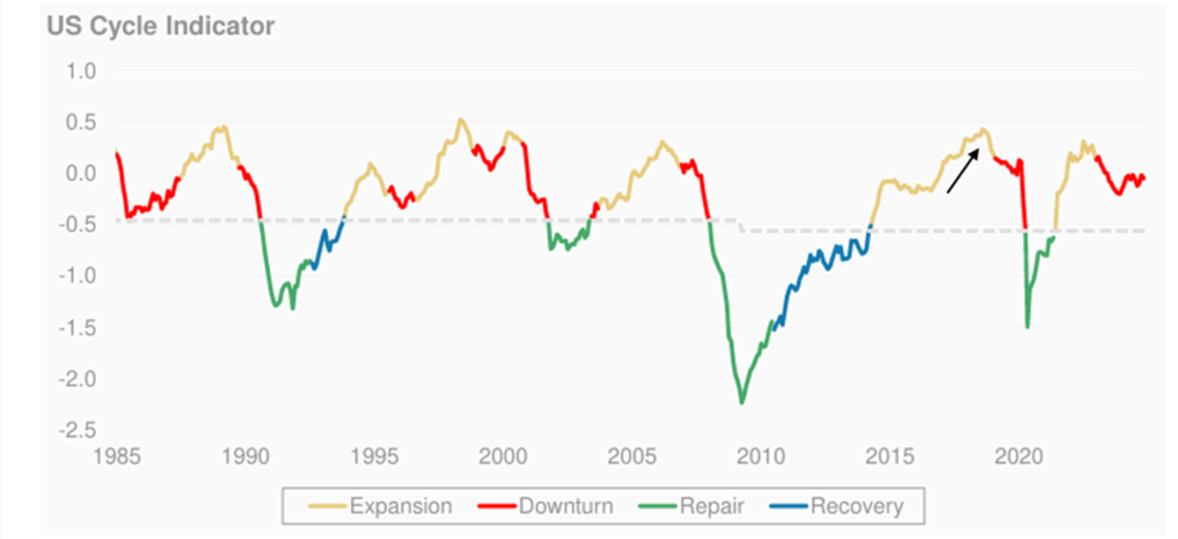
Source: Haver Analytics, Morgan Stanley Research.

This 8-point jump was the largest one-month increase the index has seen in the nearly 40 years that the survey has been conducted. Outside of a recession, the only time we have seen that large of a one-month move was in December of 2016, which also coincided right after an election in the US.



Source: Haver Analytics, Morgan Stanley Research.

Using 2016 as a guide, shortly after the December spike in the Small Business Optimism Index, we saw Morgan Stanley's US Cycle Indicator accelerate to the upside. We are cautiously optimistic that if the large increase in the Small Business Optimism Index holds as it did in 2016, the US Cyle Indicator may be able to exit the "downturn" reading it's had for the past few years and enter back into "expansion".



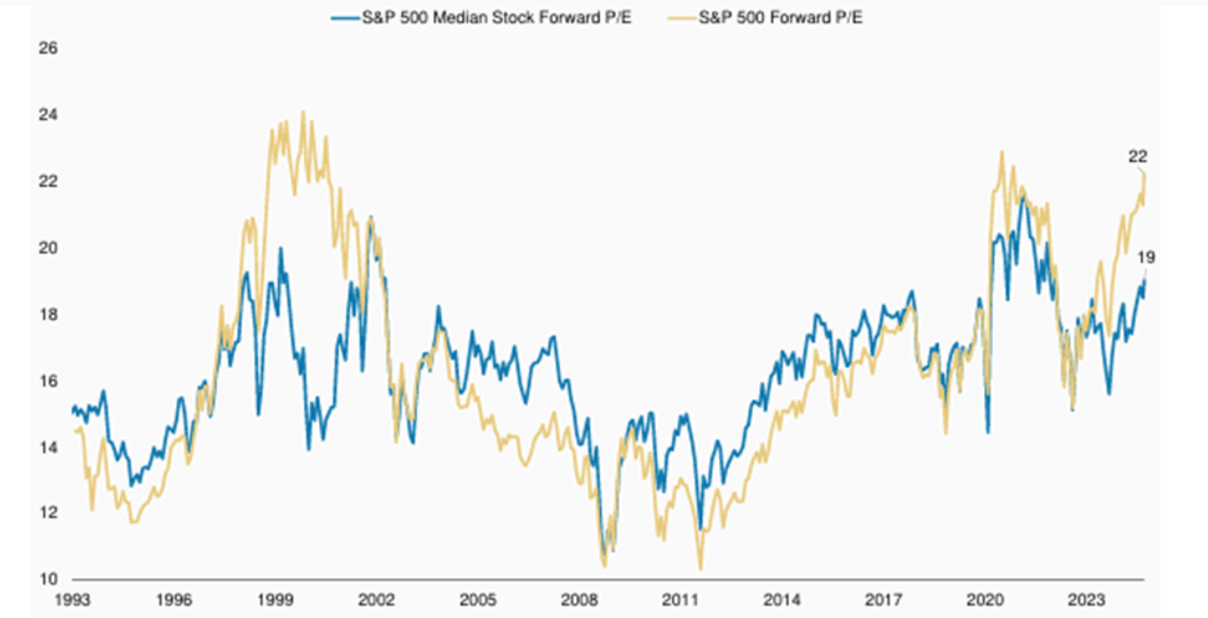
Source: Bloomberg, Datastream, Haver Analytics, Morgan Stanley Research

CONCLUSION

Over the past 12-18 months, we expressed concern that the economic expansion the US was experiencing was largely due to the historically high levels of deficit spending by the government. We believe high levels of government spending led to many of the headwinds facing small companies in the US. The lack of labor supply was made worse by large levels of government hiring, high levels of deficit spending added to inflation, and finally, high levels of inflation led to higher interest rates which has disproportionately affected small companies who rely on short term loans to operate.

With the historic rebound in the Small Business Optimism Index, we are cautiously optimistic that the economy can start to experience organic growth and no longer rely on government spending for expansion. We don't believe the success of this transition will be determined immediately and expect a volatile 6-12 months of headlines and economic data. However, if this transition proves to be successful, we will likely become more constructive on the US economy.

Finally, we also believe a successful transition from reliance on government spending would be beneficial for many stocks outside of the “Mag 7”. As the “Mag 7” dominated performance and earnings growth, investors flocked to the mega cap names and the Forward P/E of the market cap weighted S&P 500 has grown to levels rarely seen the past 30 years. We believe a successful transition could allow the Have-Nots of the past few years to finally feel the heat!



Source: Compustat, Morgan Stanley Research.

JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on Tuesday January 21st at 6:00PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link.

Like to plan ahead? Here's the schedule for the remaining 2025 Following the Fundamentals Webinars: April 15th, July 15th and October 21st. Additional information and times to follow.

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Investing in smaller companies involves greater risks than those associated with investing in more established companies, including significant stock price fluctuations and illiquidity.

Diversification does not guarantee a profit or protect against loss in a declining financial market.
Indices are unmanaged. An investor cannot invest directly in an index.
For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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CRC # 4121012 12/30/2024