

# FOLLOWING THE FUNDAMENTALS

3RD QUARTER 2024: ISSUE 31

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

## THE HAVES VS. THE HAVE-NOTS

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

As many of you know, raising children can be quite the task. It's nearly impossible to pick one aspect of parenting that is the most difficult, but with the English language being tough to master, my wife and I are constantly correcting the grammar of our children. A few years ago, I corrected the grammar of our youngest child and the correction hit a little bit different. My son said, "Dad, how come a lot of my friend's dads have hair on their head and you have not?" After correcting his grammar, it quickly sunk in that as a follically challenged man, I am one of the have-nots.

Over the last 18 months, many companies in the S&P 500 have likely found themselves feeling a similar feeling as I did that day. While the S&P 500 has performed well at the index level, those gains have been largely concentrated in just a few winners creating a large divergence between the haves and the have-nots. According to Morgan Stanley, over the past 18 months, as many as 75% of the constituents of the S&P 500 were underperforming the index that they are the majority of. In this edition of our quarterly update, we are going to cover why we believe rising interest rates have had a much larger impact on small businesses (have-nots) as opposed to large-cap (haves) companies that dominate the market weighted S&P 500.

### IN THIS ISSUE WE'RE COVERING

Interest Rates & Loan  
Implications P 2

The Haves vs. the Have-Nots P 4

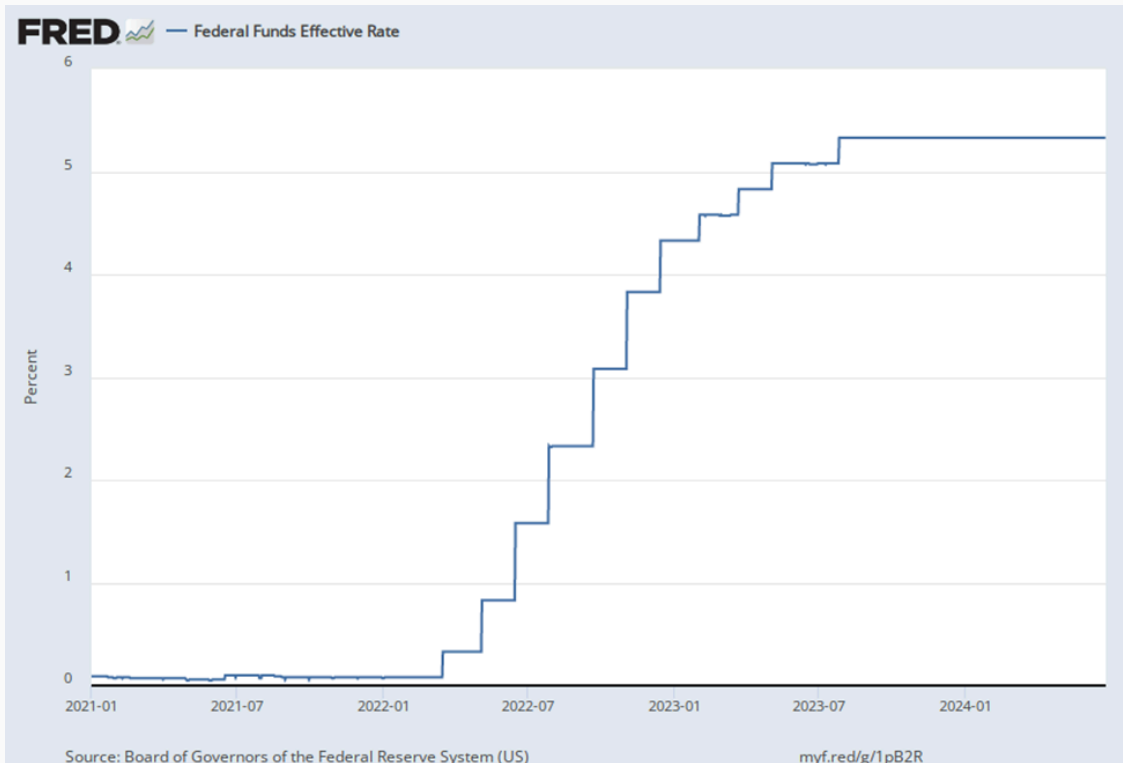
Conclusion P. 7

Webinar Information P. 8

4300 E. 53rd Street  
Suite 300  
Davenport, IA 52807  
563-344-4327

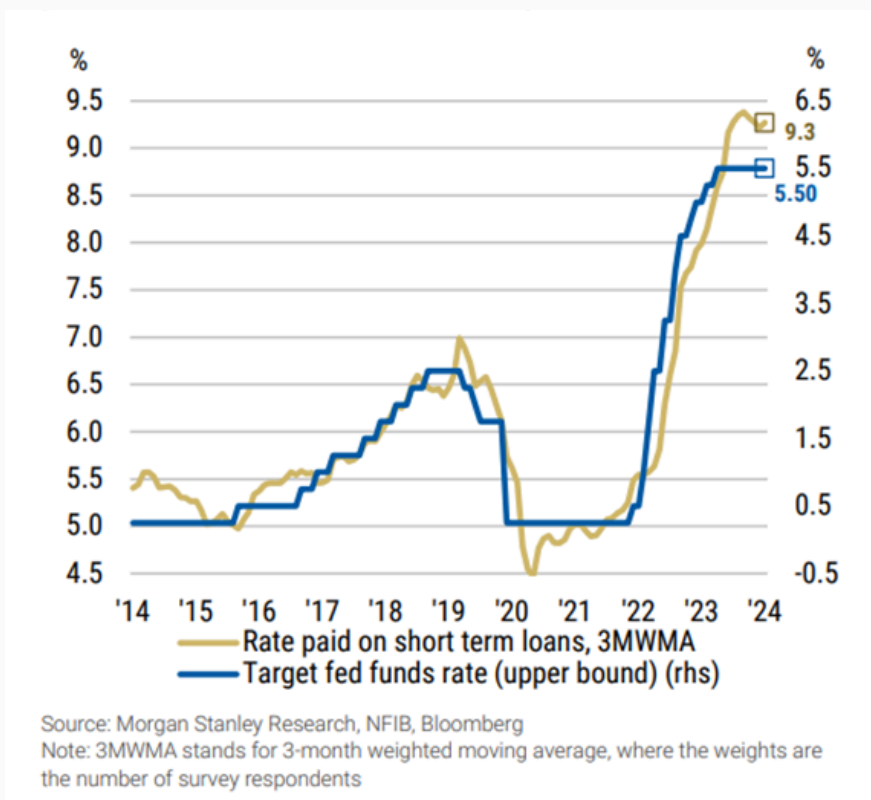
# INTEREST RATES & LOAN IMPLICATIONS

Over the past few years, we have covered the rise in interest rates quite extensively in our quarterly updates. As seen below, as inflation readings were registering greater than 9% in the summer of 2022, the Federal Reserve was embarking on a rate hiking cycle that went from 0% to over 5% in less that 2 years.

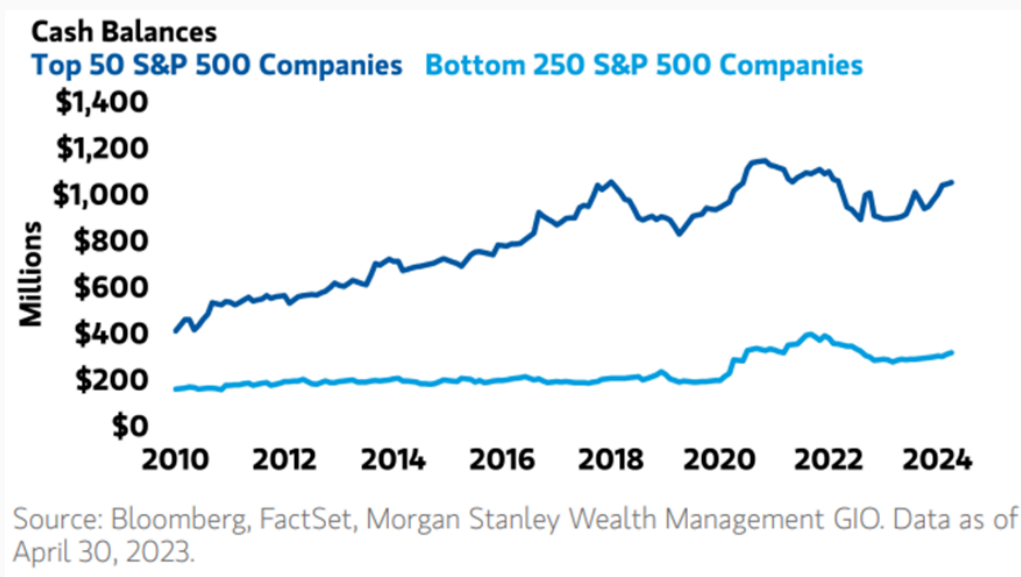


Board of Governors of the Federal Reserve System (US), Federal Funds Effective Rate [DFE], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/DFE>, June 27, 2024.

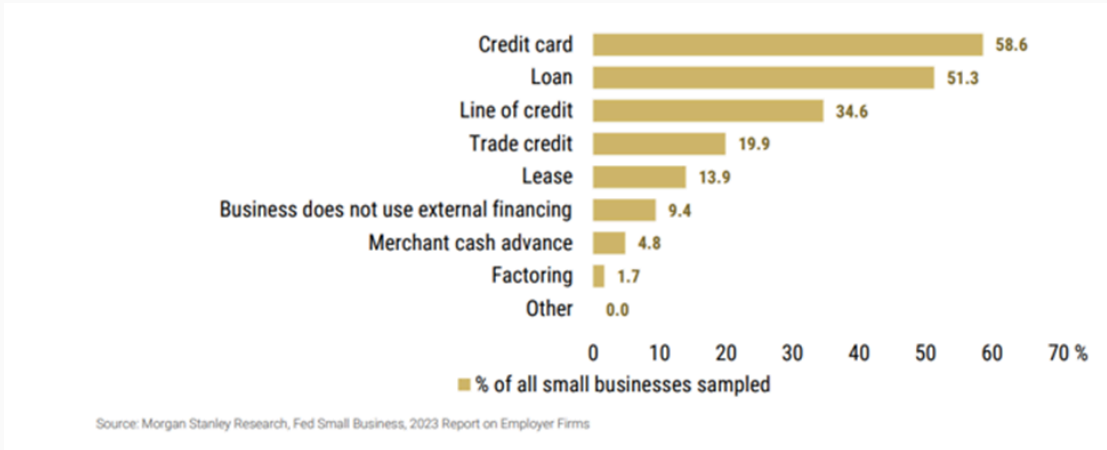
A few of the topics we have covered recently that we believe were impacted by higher rates have been a slowdown in housing, commercial real estate, and bank lending. This quarter, we are going to cover the impact higher rates have had on small businesses. With the Federal Funds rate rising, so has the rate that small businesses are paying to finance their business. According to the National Federation of Independent Business survey (NFIB), the interest rate paid by small businesses has more than doubled since it's recent trough in 2020.



The impact felt by the small business community has been much greater than the impact on the largest constituents of the S&P 500. We believe this is because the largest companies in the S&P 500 have significantly larger cash balances and don't rely on financing at the same level as small businesses. Below, you can see that the largest 50 companies in the S&P 500 have 3-4 times more cash on their balance sheet than the bottom 250 companies of the S&P 500.

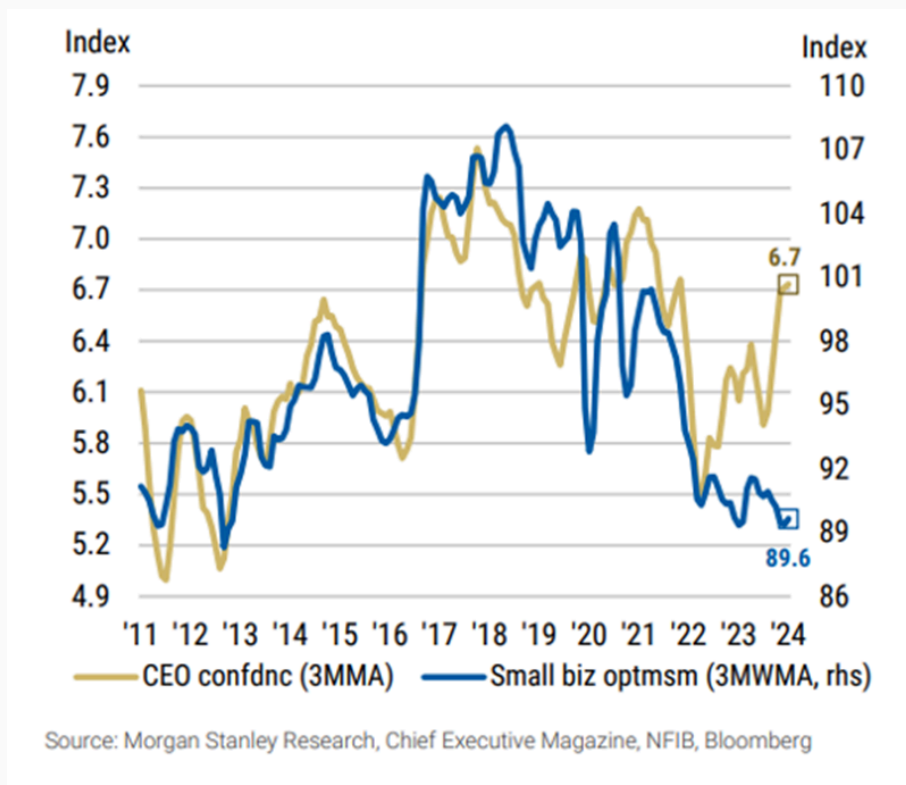


While large companies have been using their cash balance to fund growth and expansion, small businesses have been taking on debt that requires interest payments to fund their growth initiatives. In a recent small business survey, more than half of the small businesses surveyed regularly used credit cards and loans to fund their businesses.

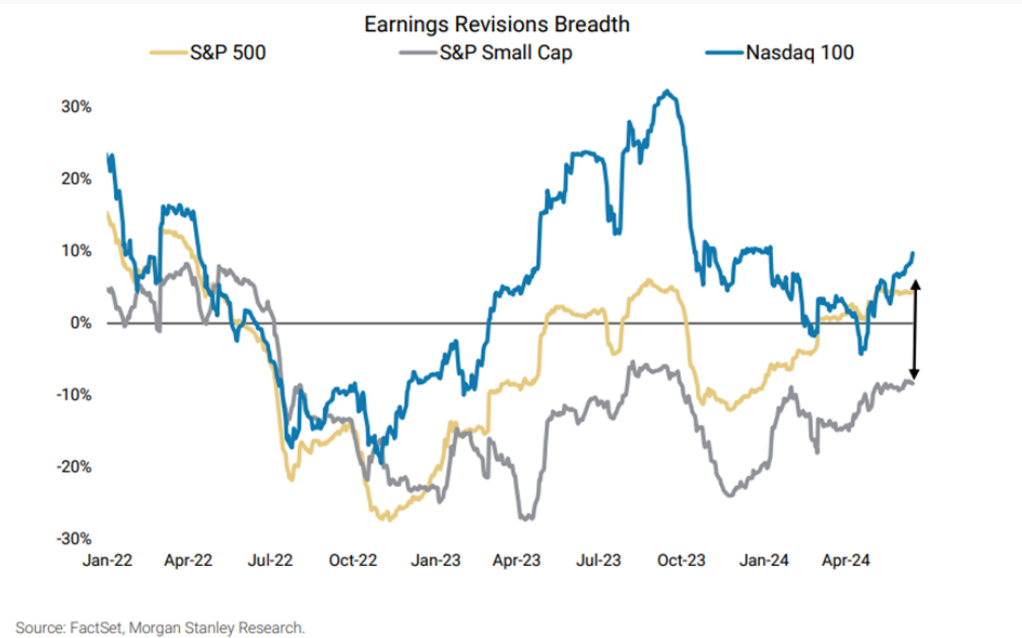


## THE HAVES VS THE HAVE-NOTS

We believe this dynamic has led to the discrepancy between the confidence CEOs feel and current readings of the small business optimism survey. As the Federal Reserve started raising rates in early 2022, the confidence levels of CEOs (larger companies) and the optimism of small business owners started to diverge. Since 2022, CEO confidence has rebounded nicely while Small Business Optimism is hovering near the lowest levels of the past 15 years.

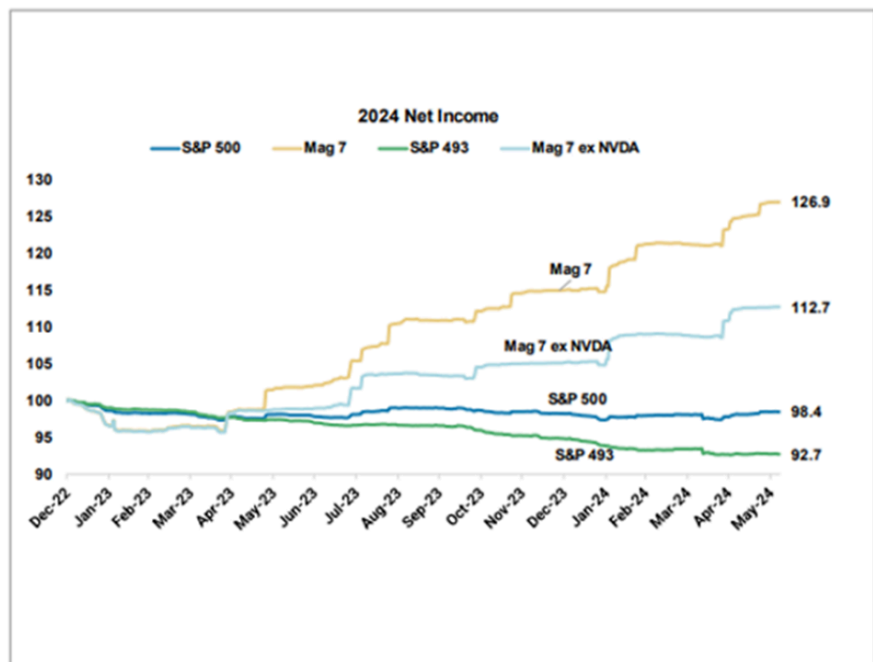


With the wide divergence between CEO confidence and small business optimism, it's no surprise that the earnings profile between large and small-cap companies have diverged as well. Earnings revisions in the S&P 500 turned positive earlier last year and have continued to read significantly better than the levels registered by the S&P Small-Cap Index.



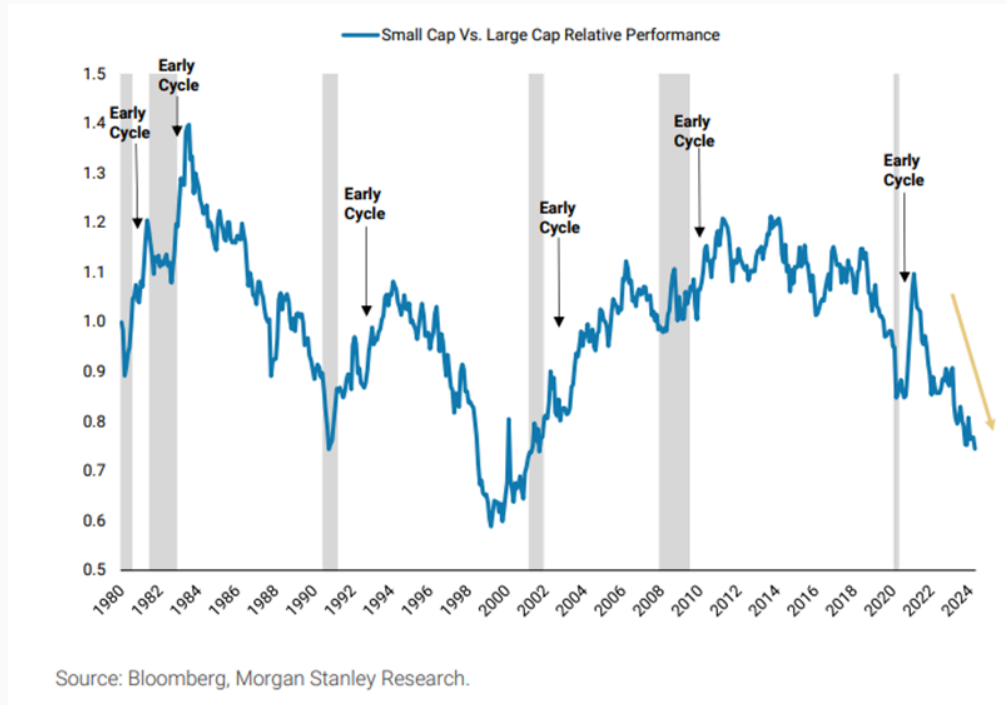
Narrowing in further, we believe the discrepancy between the haves and the have-nots is worse than what the previous revisions chart shows. Since December of 2022 through May of 2024, the net income of the Magnificent 7 has been the primary driver of the net income growth in the S&P 500. Over that period, the net income of the Magnificent 7 has grown by 26.9% while the rest of the S&P 500 or the S&P 493 has contracted by 7.3%.

### Earnings Revisions Have Been Very Concentrated

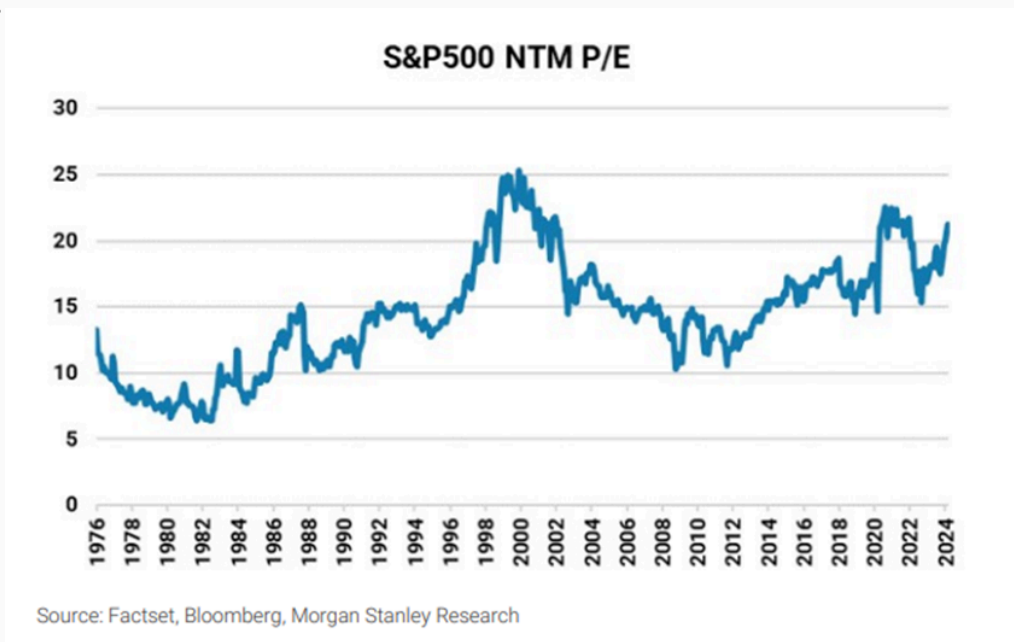


Source: FactSet, Bloomberg, Morgan Stanley Research. Left as of May. 31, 2024.

The divergence in confidence levels and earnings has also led to a large divergence in the performance of large and small-cap stocks. Over the past two years, large cap stocks have outperformed small-cap companies at levels rarely seen. Going back the last 45 years, the level of relative outperformance of large cap stocks compared to small cap stocks has only been worse during the late 1990s.



As large-cap stocks have outperformed small-cap stocks, we have also seen the Price to Earnings ratio of the S&P 500 grow to historically high levels. The Next Twelve Months Price to Earnings ratio of the S&P 500 currently sits above 21 times the expected earnings of the S&P 500. Looking back the past 50 years, the only two instances that ratio has been higher is during the late 1990s and 2020-2021 when Covid stimulus was rampant.



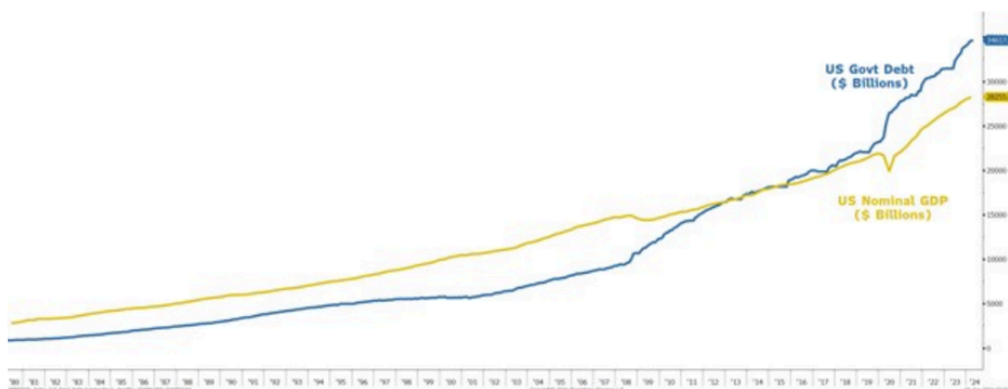
# CONCLUSION

In last quarter's update, we expressed that our concern for a potential economic downturn had decreased due to the high levels of deficit spending by the US Government and the recent increase in levels of immigration. In our view, those factors are supporting the US Economy and until those factors dissipate, economic readings will likely continue to stay positive.

While our concern for an imminent downturn in the economy has lessened, we are still holding a cautious stance in the portfolios that we manage due to the narrowness of the stock market and the historically high valuation levels previously discussed. Additionally, if our view is correct that government spending and elevated immigration levels are the primary pillars supporting the US economy, a change in those policies could have a negative impact on economic production. We feel it is prudent to better understand the future of those policies before taking on additional risk in the portfolios we manage.

Looking out past the election later this year, we are also keeping an eye on total debt accumulation. While we don't know what the future holds, we are concerned about the level of government spending and debt accumulated over the past 10-15 years. As seen below, the level of US Government Debt has overtaken and is outpacing the level of economic growth in the US. Our concern in the long run is if the US were to face an economic downturn, the US Government may not have the ability to back the economy the way it has in the past due to the large amount of debt that has already been accumulated.

**Exhibit 8:** Debt Is Outpacing GDP



Source: Bloomberg, Morgan Stanley Research

# JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on July 23rd 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](mailto:allie.girardin@morganstanley.com) for the Invitation and Registration Link

## DISCLAIMERS

views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

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>

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

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

This material contains forward looking statements and there can be no guarantees they will come to pass. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley as to accuracy or completeness. There is no guarantee that any investments mentioned will be in each client's portfolio.

This material has been prepared for informational purposes only. It does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley Smith Barney LLC ("Morgan Stanley") recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Morgan Stanley Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Past performance is no guarantee of future results.

Morgan Stanley Smith Barney LLC. Member SIPC.  
3681134 07/24