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MARKETS IN FOCUS

Election Insights

Tuning out the election noise

Focus on ‘bipartisan’ secular growth themes

By Joey Del Guercio and Matt Orton, CFA

Photo illustration using Adobe generative artificial intelligence

Introduction: Don’t invest for an outcome.

Elections are often associated with increased volatility due to the uncertainty created by potential policy changes. As a result, markets tend to exhibit weaker performance heading into an election and to get a lift once the perception of certainty has returned.[1] For some investors, this brings a temptation to predict outcomes and position portfolios accordingly, but history shows that this approach rarely works out.

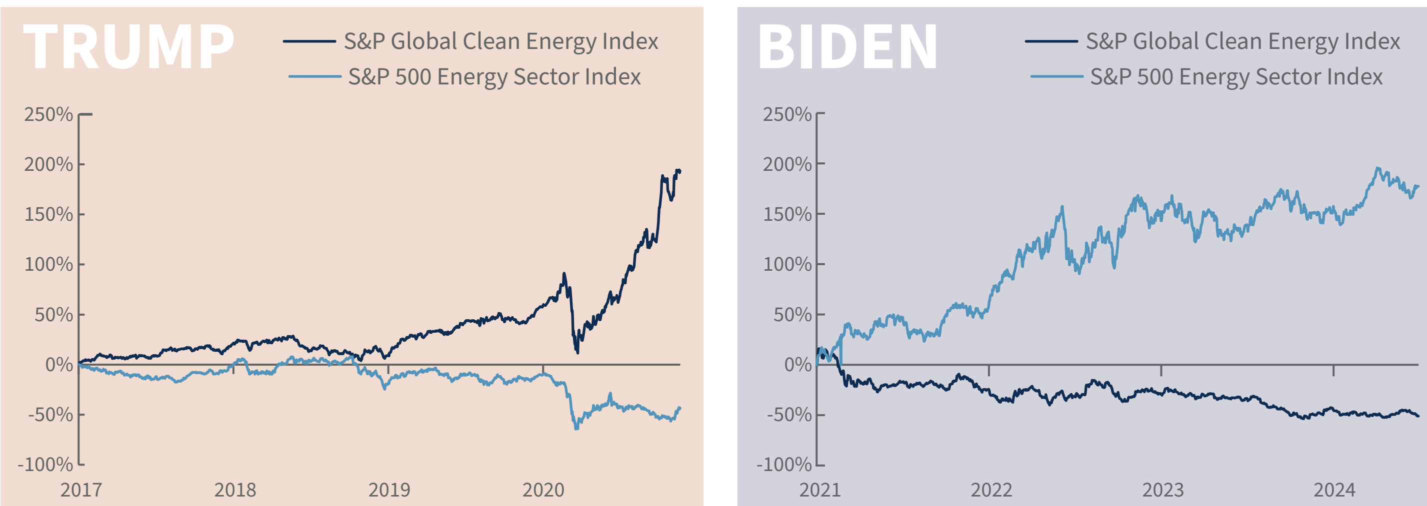
With the 2024 U.S. presidential election fast approaching, we believe investors should resist the desire to pick sides and to position around potential outcomes. Instead, we favor a focus on leaning into durable long-term investment themes which we view as having bipartisan support:

- Defense spending.
- Reshoring and infrastructure.
- The growth of artificial intelligence.

We believe quality companies exposed to these themes to have a better chance of coming out ahead regardless of election results, and we would advocate using elevated volatility or election-induced downside opportunistically to consider building long-term positions, depending on your individual situation. If our campaign had a bumper sticker, it would say: Invest agnostic of outcome.

The dangers of picking sides

Two energy subsectors. Two administrations. Two surprise outcomes.



Source: Bloomberg, as of 10/18/2024.

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of Oct. 18, 2024

Play offense with defense

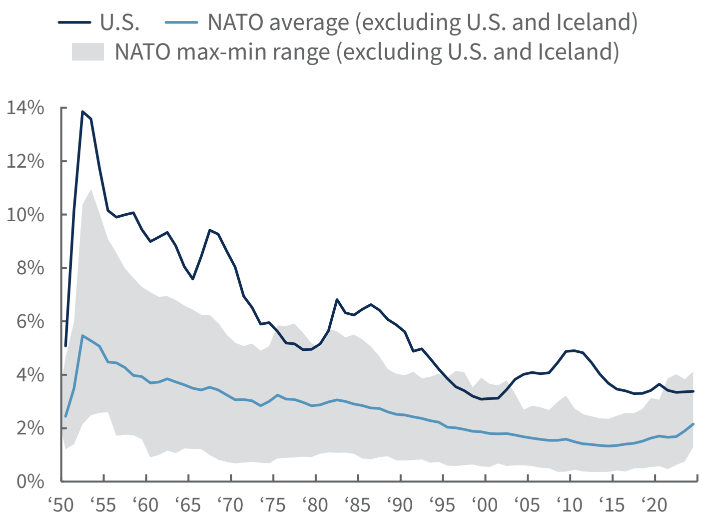
In a multi-polar world with several ongoing hot wars, both sides of the aisle worry that the U.S.'s dominance is under increasing pressure. Moreover, both sides are openly committed to defending and perpetuating the concept American exceptionalism – the sense of history, leadership, and purpose that has afforded our country the safety, security, and excess that we've all come to expect. Maintaining U.S. dominance, and protecting the West broadly, necessitates increased spending and investment in defense.

The defense sector has been an area of outperformance over the past year with the space being increasingly attractive given the more belligerent global threat environment. In addition to the explicit threats of more active adversaries, the defense sector is driven by the implicit threats posed by artificial intelligence breakthroughs. In its history, the U.S. Department of Defense has announced three "Offset Strategies," where the goal is to offset its adversaries' technological advancements by being the clear leader. The first Offset Strategy was centered around nuclear power in the 1950s, the second Offset Strategy was centered around precision-guided missiles and stealth technology in the 1970s, and the Third Offset Strategy announced in 2014 is centered around the United States achieving unambiguous leadership in artificial intelligence and autonomous systems. AI is a tailwind for defense companies as new technology necessitates an increase in spending to out-innovate our adversaries.

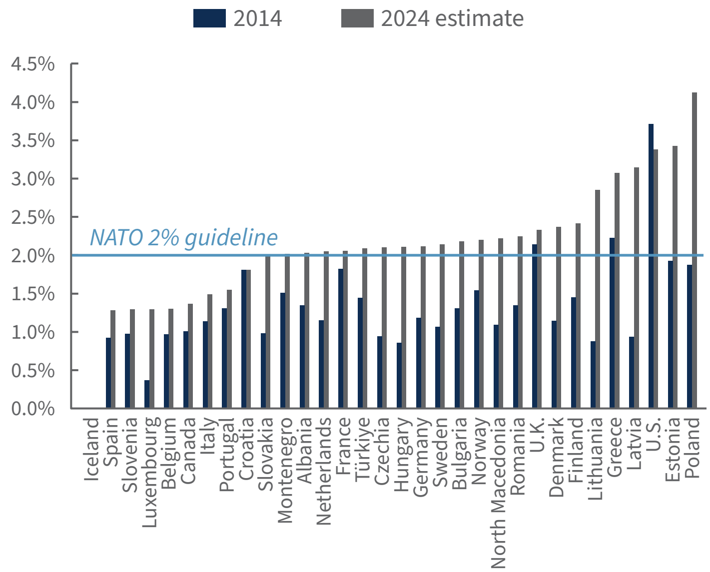
While it might seem like the United States is already spending enough on defense, the level of spending is actually suppressed as a proportion of gross domestic product (GDP) relative to historical levels. So, there's certainly scope for U.S. defense spending to pick up, but this theme isn't simply a U.S. story. The U.S.'s NATO allies are expected to spend at least 2% of GDP on defense going forward, which is why the defense sector has been an oasis of outperformance in Europe's otherwise underperforming market. We believe domestic and allied defense companies – especially those most on the cutting edge – are primed in our view for continued outperformance as defense spending continues to trend higher globally.

NATO defense spending

NATO defense spending as a proportion of GDP



NATO defense spending as a proportion of GDP (2015 terms)



Source: SIPRI, NATO; as of 9/30/2024. https://www.sipri.org/databases/milex. https://www.nato.int/cps/en/natohq/topics_49198.htm

Reshoring and infrastructure

In an increasingly multi-polar world, the trend of reshoring and the decoupling of global supply chains have gained significant momentum. Geopolitical tensions and the desire for greater economic security are driving countries to bring manufacturing and production closer to home. This shift is not only a response to political pressures, but also a strategic move to enhance resilience and reduce dependency on foreign supply chains. The COVID-19 pandemic illuminated just how fragile the global supply chain is, and nations took note of how vulnerable their supply chains are to exogenous shocks.

The ongoing decoupling of supply chains creates substantial opportunities for investment, and there is broad support for initiatives aimed at revitalizing American manufacturing and encouraging reshoring efforts. The best example of which is the CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act of 2022, in which the United States pledged more than $50 billion toward domestic semiconductor research and development and almost $40 billion toward domestic semiconductor manufacturing.

For a multitude of reasons, and despite being the world's technological powerhouse, the United States has fallen sharply behind in semiconductor manufacturing compared to global standards. The semiconductor industry is vital from a technology and defense perspective, but it happens to be an extremely fragile and global industry:

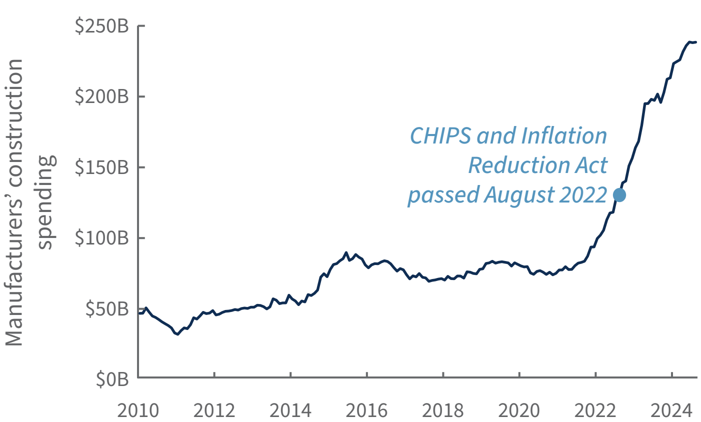
- There's one company in the world that makes the cutting-edge extreme ultraviolet (EUV) light lithography machines that are used in the production of chips, and it is located in the Netherlands.
- There's one semiconductor foundry in the world that we feel stands far above its competitors as the undisputed best manufacturer of cutting-edge chips in mass, and it is located in the territorially disputed Taiwan.
- The process of producing semiconductors is complex and widely distributed. The Semiconductor Industry Association has said that a semiconductor may cross international boundaries as many as 70 times before reaching its final destination.[2]

Consequently, sovereigns, and especially the United States, plan to invest heavily in key domestic industries like semiconductors in seeking true strategic sovereignty.

Meanwhile, the zeitgeist of software companies and the asset-light business model has dazzled investors for the past 30 years, leading to an underinvestment in the physical world. Corporate capital expenditures relative to revenue have fallen markedly over this time, but the reshoring and decoupling of supply chains is poised to change this. We believe investors can capitalize on the expected resurgence of capital expenditures by focusing on sectors that are in a position to benefit from increased infrastructure spending and the re-shoring of key industries. This includes companies involved in construction, engineering and design, and manufacturing, as well as those providing the technology and services needed to support these efforts.

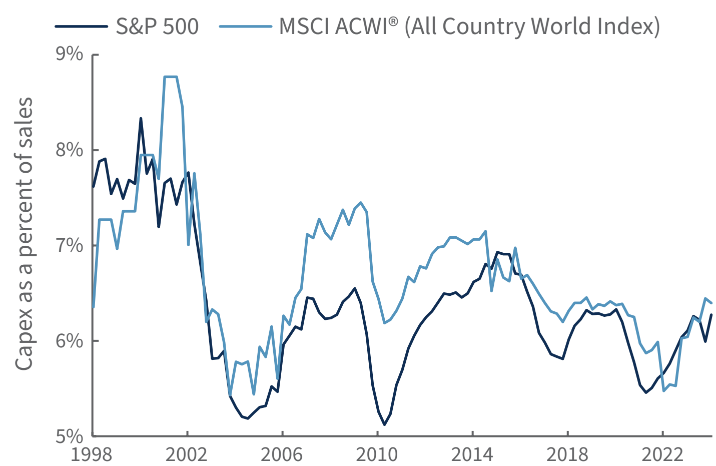
U.S. CHIPS and Inflation Reduction Acts continue to fuel growth

U.S. construction spending by manufacturers ($billions)



Global capex below historical levels

Capital expenditures as a percent of sales, quarterly data



Sources: U.S. Census Bureau, Bloomberg, as of 9/30/2024.

[2] Building Resilient Supply Chains, Revitalizing American Manufacturing, and Fostering Broad-Based Growth, White House report, June 2021, p. 53. Available at: https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf

AI 2.0

Of course, we must discuss the investment opportunities in the most obvious long-term trend: artificial intelligence. But we believe semiconductors and software aren't the only way to get exposure to AI. The tangential AI opportunities – what we call "AI 2.0" – extend outside of technology into various sectors like industrials, utilities, and materials.

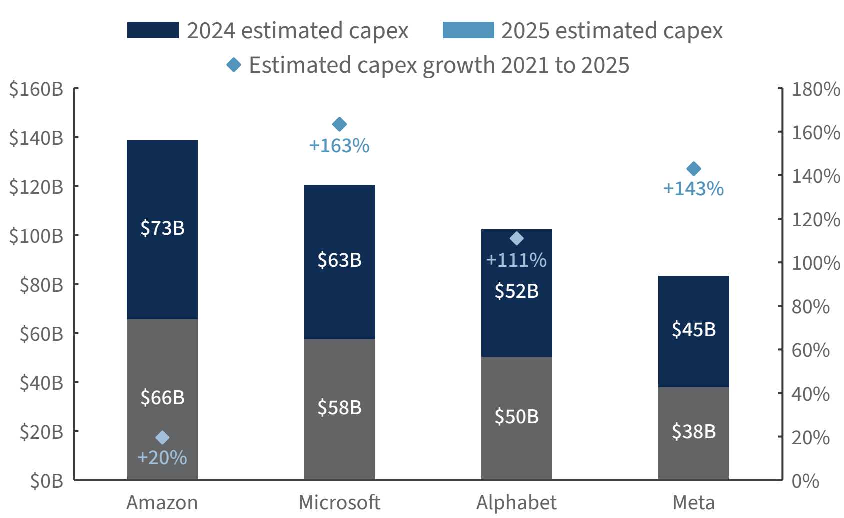
We believe the long-term growth opportunity in AI is compelling, and while the market may question the valuations and long-term winners in the semiconductor and application software space, the infrastructure buildout remains on solid footing. The hyperscalers have substantially increased their capital expenditures (capex), committing to spend more than $400 billion over the next two years alone to build out their respective AI infrastructures. Multiple CEOs have commented that the risks to underinvesting far outweigh the risks to overinvesting, giving investors added confidence in AI investment for the foreseeable future. This capex arms race stands to benefit companies whose products lie in and around data centers, as well as those who service and construct them.

Data centers are already a $215 billion global market that grew 18% annually from 2018 to 2023, and their growth is expected to accelerate as corporations and eventually individuals adopt AI. AI chips (i.e., graphics processing units, or GPUs) require three to four times more electrical power than traditional central processing units (CPUs), spitting off far more heat. These data centers get extremely hot; they must be cooled down and the heat needs to be siphoned away from the relatively fragile electronics. We see this as an attractive opportunity for many electrical equipment companies in the industrials sector that build and service data center cooling systems.

Furthermore, the power-hungry AI infrastructure will cause the U.S.'s long-stagnant electricity demand to finally grow, incentivizing the production of cheaper energy and investment in the U.S.'s antiquated grid. Microsoft's recently announced partnership with Constellation Energy Group to revive the Three Mile Island nuclear plant exclusively to power its data center needs is a vivid example of a hyperscaler seeking cheaper energy; this is just a glimpse of the future. That energy is going to need to travel to where the end-demand is, which we expect will inherently benefit the electric utilities charged with energy distribution. But the ecosystem is going to need to invest in itself to increase efficiency. The average U.S. power cable is currently 35 to 40 years old. Transferring electricity requires copper, and we're going to need a lot of it to replace the cables on the grid, which creates more demand for the copper miners in the materials sector. Modernizing the grid will take a long time and a lot of capital. Capex beneficiaries like electrical equipment companies, electric utilities, and machinery companies involved in construction look set to ride the wave.

AI capex spending

Hyperscalers are spending big, with more to come



This is not a recommendation to purchase or sell the companies mentioned herein. This chart is for illustration purposes only.
Source: Bloomberg, as of 10/18/2024.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

International investing presents specific risks, such as currency fluctuations, differences in financial accounting standards, and potential political and economic instability. These risks are further accentuated in emerging market countries where risks can also include possible economic dependency on revenues from particular commodities or on international aid or development assistance, currency transfer restrictions, and liquidity risks related to lower trading volumes.

Definitions

American exceptionalism is an idea centered on the notion that the United States holds a unique position as a nation because of historical, ideological, and/or religious reasons. Proponents of American exceptionalism often advocate for the United States to play a leading role in global politics.

An asset-light business model aims to reduce a company's fixed costs and assets by transferring its physical assets, technology, people, and/or processes to other entities.

A central processing unit (CPU) is the primary part of a computer that processes data and handles the computer's execution of commands and overall functions.

Capital expenditures, or capex, are monies used by a company to buy, improve, or maintain physical assets such as real estate, facilities, technology, or equipment, and may include new projects or investments.

The CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act is federal legislation passed in 2022. It aims to increase investments in U.S. semiconductor manufacturing capacity, while also aiming to support the development leading-edge technologies, such as quantum computing, AI, clean energy, and nanotechnology, while also looking to create high-tech hubs that can foster a larger and more inclusive science, technology, engineering, and math (STEM) workforce.

Construction spending by manufacturers is a sector tracked by the U.S. Census Bureau's monthly Value of Construction Put in Place Survey (VIP). The survey covers construction work done each money on new structures or improvements to existing structures for private and public sectors.

An exogenous shock is an unexpected event that takes place outside an industry, sector, or even an economy and that results in sudden negative changes on countries, their populations, their economies, and their capital markets.

A graphics processing unit (GPU) is a type of electronic circuit used in a wide range of applications that include parallel processing, graphics and video display, and artificial intelligence.

Gross domestic product (GDP) is the total value of goods and services provided in an economy during a specified period, often one year.

Growth investing is a stock-buying strategy that focuses on companies expected to grow at an above-average rate compared to their industry or the market.

Hyperscaler refers to the largest cloud computing providers that can provide massive amounts of computing resources and storage at enterprise scale.

The Inflation Reduction Act (IRA) is federal legislation passed in August 2022. It aims to help curb inflation by directing spending toward reducing carbon emissions and lowering health care costs, while also aiming to improve taxpayer compliance through increased funding for the Internal Revenue Service.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

Mega-cap stocks are the largest publicly traded companies as measured by market capitalization. Generally, this refers to companies with market capitalizations over $200 billion.

NATO, or the North Atlantic Treaty Organization, is a political and military alliance of 32 countries from Europe and North America that is organized to guarantee their security and cooperation.

Reshoring describes an effort to bring manufacturing and other services back to the United States from overseas operations.

Secular trends are large-scale and ongoing changes in economies and societies that have the potential to drive broad and lasting economic, technological, social or other kinds of changes.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The S&P Global Clean Energy Index is designed to measure the performance in global clean energy-related businesses from both developed and emerging markets, with a target constituent count of 100.

The S&P 500® Energy comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

The MSCI ACWI® (All Country World Index) measures the performance of large and mid-cap stocks across 23 developed markets (DM) and 24 emerging markets (EM) countries. Developed market countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. Emerging market countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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