Stephens
Investment Management Group®

The following contains a brief discussion of the equity markets from Senior Quantitative Analyst, Charles Clavel, CFA.

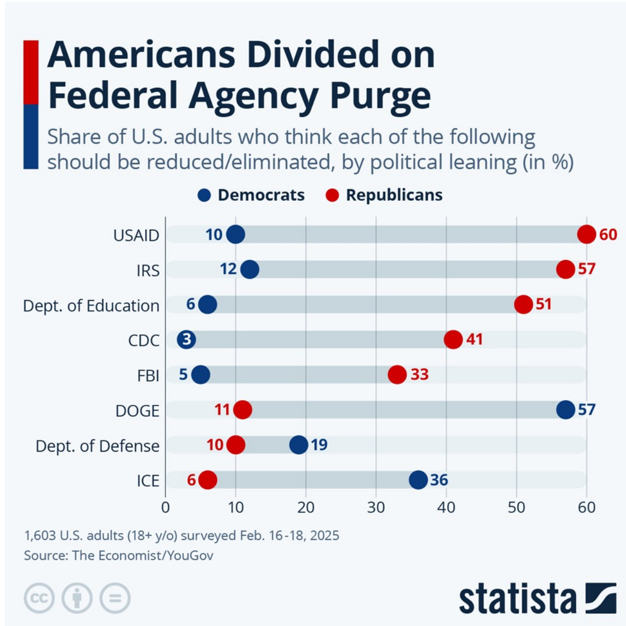
The DOGE Barks, The Economy Stalls?

Over the last 4 decades (from 1980 to 2020), there has been a dichotomy within sovereign bond markets. Large, developed economies have been able to run increasingly large budget deficits without much objection from bond investors. By contrast, fiscal excesses in the rest of the world have been met with swift punishment by bond vigilantes, in the form of rising bond yields or declining currency (and in many cases both). **Since the global resurgence in inflation that followed the large stimulus packages enacted as a response to the COVID crisis, it seems that investors' tolerance towards excessive deficits in large, developed economies has now waned**. In 2022, the UK's bond yields rose sharply in response to the "mini budget" proposal by then Prime Minister Liz Truss, which included substantial tax cuts and energy subsidies, leading to her resignation and the dropping of those stimulus plans. Late last year and early this year, France's degrading fiscal position has led to a rise in long term bond yields, which are now on par with those in Greece (once considered the poster child of fiscal profligacy in Europe). Finally, last week, Germany's proposal to loosen its debt brake rules to allow more spending on defense and infrastructure is driving a substantial spike in bond yields, not just in Germany but across European sovereigns.

It doesn't look like the US has reached that point yet, and the reserve currency status of the US dollar means that it has more runway than any other country. However, the high deficits incurred in the past two years – which don't seem justified given that the economy was not in crisis – have raised concerns among investors. **The fact that prominent financial figures like Jamie Dimon and Ray Dalio (who is publishing a book about how countries become broke) have publicly raised the alarm about the US's fiscal situation shows that, unlike in the past, the issue is now being taken seriously**. Given the high debt-to-GDP ratio, the country can hardly afford a meaningful rise in interest rates, and Scott Bessent has made no secret that his goal is to lower long-term interest rates. To achieve that goal, he aims to bring the deficit down to 3% of GDP from the current level of 7-8%.

Elon Musk's DOGE has been tasked with finding potential spending cuts, starting with instances of waste, fraud and abuse, which can most justifiably be put on the chopping block. So far, there have been many announcements, but the DOGE savings tracker (https://doge.gov/savingsindicates) shows 105 Bn of estimated savings, which remains modest relative to a nearly 7 Tn budget. Will DOGE be able to cut 1 Tn or even 2 Tn as mentioned during the campaign last year? As we mentioned before, making meaningful government cuts is a challenging endeavor, given that there are complex laws governing how cuts can be made, and several checks and balances that constrain the president's authority in that regard. In addition, most of the spending consists of entitlements, defense, and interest on the debt, which are highly unlikely to be subjected to cuts.

The biggest impediment to meaningful cuts in my view is the lack of a large enough consensus on cutting government spending. First, our very individualistic culture means a reduced appetite for shared sacrifice. People may be in favor of austerity…. but not on themselves. Lower income earners typically are in favor of raising taxes on "the rich". Conversely, higher income earners are for cutting social programs which they typically don't benefit from. Besides, Americans seem to be divided on how big of a role the government should play in the economy and in society more generally. The chart below from Statista shows that Republicans are mostly in favor of making cuts in government entities like USAID, the IRS, and the Department of Education, while Democrats are not. The only consensus that seems to exist is on the defense budget, which only a minority of supporters from both parties want to cut



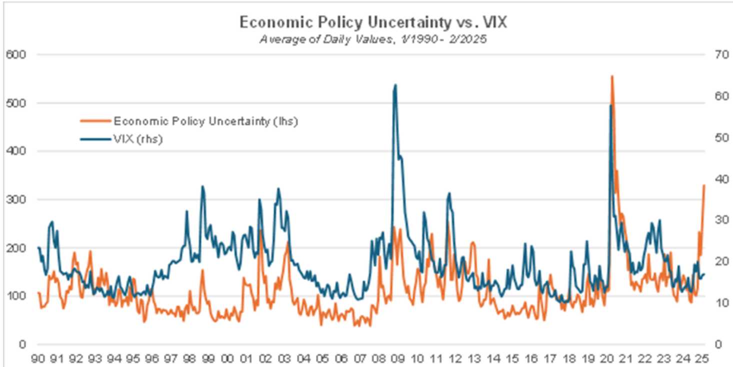
Source: Statista (www.statista.com)

If meaningful cuts are indeed implemented, the problem is that it will deprive many people of their jobs and incomes, and not just federal workers in D.C. Private sector companies who depend on government contracts, or state/local government entities who receive federal grants may have to lay off workers, which would have a negative multiplier effect on the economy, as the people impacted reduce their consumption expenditures. **Even if those cuts are justifiable and a good thing for the country in the long term, they will impose some austerity on the US economy** and reducing the deficit from 7-8% to 3% of GDP is quite a bitter potion to swallow.

Besides, the negative impact from austerity will be felt immediately while the positive effects from economic reforms only bear fruit in the long term. Given that election cycles in the US are extremely short and that the incumbent president's party typically gets punished in the subsequent mid-terms, the current administration is facing the risk of a significant blue wave in 2026 should they implement cuts that are too deep. Historically, countries have not implemented austerity until they absolutely had to, like Indonesia in the late 1990s following the Asian crisis or Southern European countries in the 2010s. In both cases, austerity created significant political and social upheaval in the few years following its implementation, and it took a decade for the benefits to truly manifest themselves.

As the saying goes, the dog barks but the caravan moves on. It wouldn't be the first time that an attempt at government reform ends up getting nowhere. Both the Grace commission under President Reagan and the National Partnership for Reinventing Government under President Clinton ended up achieving little. Given his campaign promises to "drain the swamp" and cut excessive government spending, **Trump may feel compelled to follow through with some actual cuts, but he is politically astute enough to pivot quickly if his approval rating takes a meaningful dive. He has already reminded Elon Musk that the proper tool to use is a scalpel, not a hatchet**. In other words, that DOGE may bite, but probably not that hard…

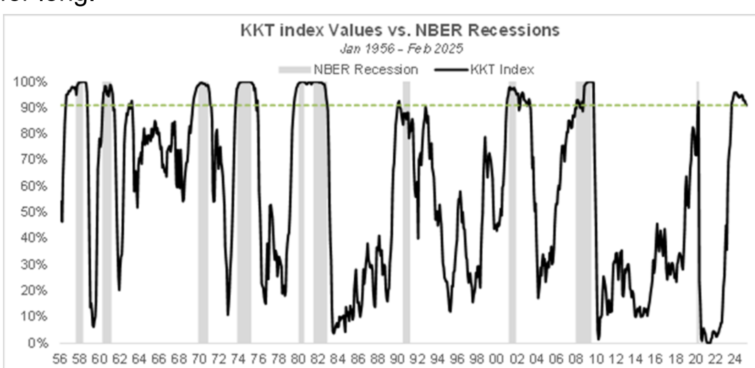
The chart below shows the historical values of the economic policy uncertainty (EPU) index and of the VIX (which represents market uncertainty). The methodology behind the EPU index is explained in the paper "Measuring Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis (https://www.policyuncertainty.com/media/EPU_BBD_Mar2016.pdf). It relies on counting newspaper articles that conjointly mention uncertainty, the economy, and some policy related terms (like congress or legislation). Since 1990, the two measures of uncertainty have been highly correlated (with a 0.47 correlation between the monthly percentage changes for the two data series), but **since the presidential election, policy uncertainty has jumped substantially while the VIX has been much less volatile.** The impending government spending cuts are a source of economic uncertainty, but it is not the only one. Tariff policy is also highly uncertain (with big tariff announcements that are postponed shortly thereafter), and it likely causes business leaders to put investment decisions on hold until the government provides more clarity.



Source: Bloomberg

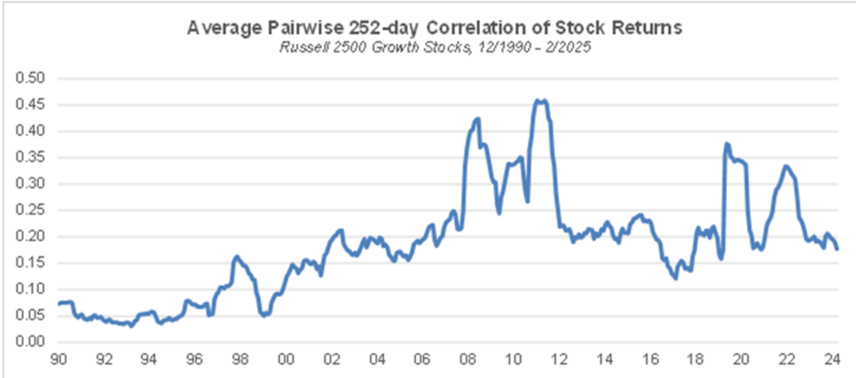
In any case, **the narrative of a Trump/DOGE recession has started to appear in the mainstream media.** After having ignored the signs that the US economy was slowing over the past 18 months, investors and economic forecasters are suddenly waking up to the possibility of a recession, which they ascribe to the policy uncertainty and government spending cuts from an administration that took office only 1.5 months ago. In its March 6th release, GDP Now pegs real economic growth for Q1 2025 at -2.4% vs. 2.3% just 10 days ago. The drop in net exports (and more specifically, the rise in imports) is the main explanatory factor for that forecast. Businesses frontrunning tariffs, along with substantial gold imports from London and Switzerland, may help explain the surge in imports, but those phenomena are temporary and thus not indicative of a protracted economic decline. The bad weather across large swathes of the US may also contribute negatively to economic growth this quarter. As to the impact of DOGE's cuts (Torsten Slok, Chief Economist at Apollo, estimates that 1 million jobs may be lost as a result), it will certainly be significant in the D.C. area, but likely more muted for the US economy as a whole.

After flashing "recession" signals since late 2023, **the KKT index has been on a slow but steady decline since last August (it has continued to decline in February vs. January) and is getting closer to non-recession territory**. If this trend continues, one could reasonably expect the US economy to get out of its current recessionary/slow growth state this summer. **This forecast seems counter-intuitive, but it would be consistent with the implementation of stimulative measures following a few bumpy months**, for example meaningful rate cuts by the Fed, a DOGE related tax refund (whereby part of the DOGE savings would be redistributed to taxpayers), or the inclusion of infrastructure provisions in the upcoming budget reconciliation bill. As mentioned before, the Trump administration has no incentive in allowing a recession to linger for long.



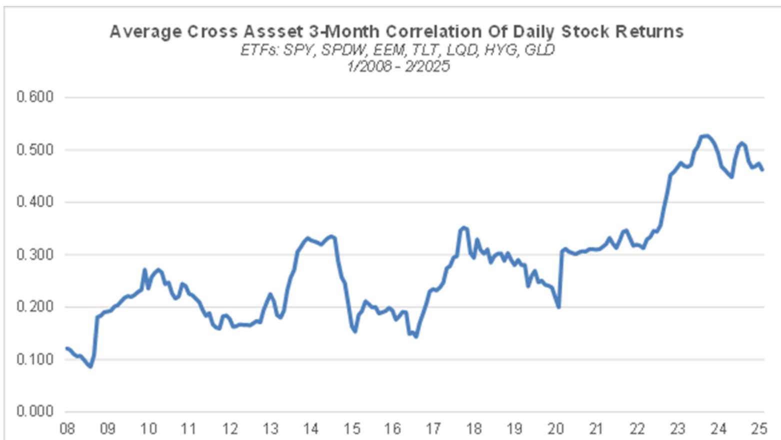
Source: Source: St Louis Fed's ALFRED database, Robert Shiller's data (http://www.econ.yale.edu/~shiller/data.htm), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington

In the past couple of weeks, the equity market has started pricing in an economic decline, with a 7-8% drop in the S&P 500® since its peak on 2/19. However, **our long-term gauge of investor sentiment, the average pairwise correlation of stock returns, remains near the long-term median, suggesting that investors are not yet in panic mode.**



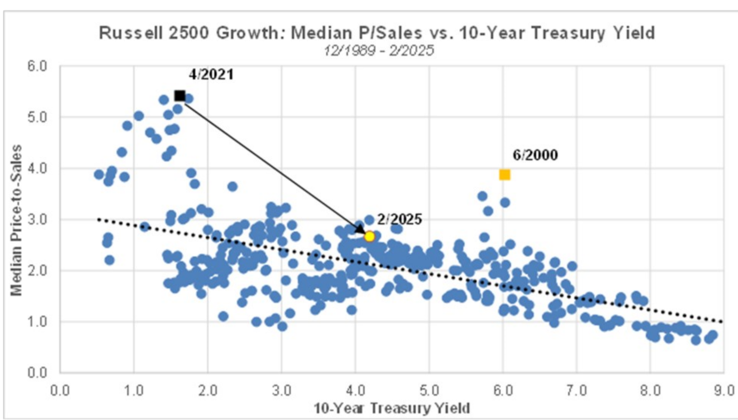
Source: FactSet, SIMG Analysis

The chart below shows the average trailing 3-month cross asset correlation of daily returns for various financial assets: US equities, developed markets ex. US equities, emerging markets equities, long term Treasuries, investment grade bonds, high yield bonds, and gold. The correlations were calculated based on returns to ETFs that are representative of those various asset classes and have a relatively long history. Cross asset correlation has been trending up since the GFC. A high cross asset correlation is an indication of positive risk sentiment, since it means that investors are bidding up asset classes indiscriminately. Cross asset correlation has declined somewhat since its peak in the fall of 2023 but remains elevated.



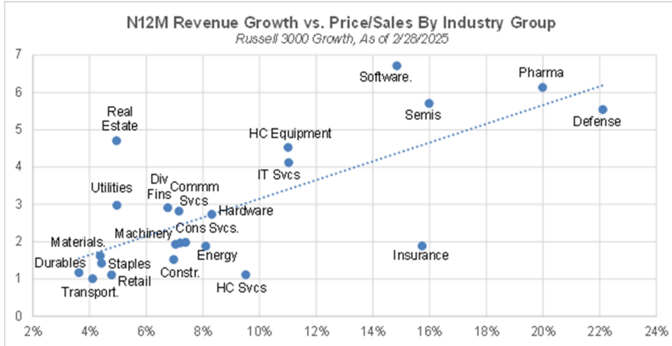
Source: FactSet, SIMG Analysis

The market decline towards the end of February has brought down the median price-to-sales valuation of small & mid cap growth stocks to a level that is consistent (albeit at the high end of the range) **with the current level of the 10-year yield.**



Source: FactSet, SIMG Analysis

At the industry group level, there is a 0.73 cross sectional correlation between the median price-to-sales multiple and the median next 12-month expected revenue growth. The chart below shows that, within the growth universe, **transportation, retail, healthcare services and insurance look meaningfully under-valued relative to their expected growth rates**. By contrast, real estate, utilities, software and semis seem over-valued relative to growth expectations.



Source: FactSet, SIMG Analysis

Regarding styles, **the best performing cohorts year-to-date have been large caps, low volatility and high-quality stocks, consistent with stock pickers positioning their portfolios towards an economic slowdown**. By contrast, small caps, high volatility, and junk stocks have underperformed materially.

Style Performance, Top or Bottom Quintile vs Market
Russell 3000 Growth Universe, Through 2/28/2025

	High Volatility	Low Volatility	Most Shorted	Least Shorted	Large Caps	Small Caps	Quality	Junk	High Rate Sensitivity	Low Rate Sensitivity	High Passive Ownership	Low Passive Ownership
Jan 2025	(2.6%)	(0.2%)	0.1%	(0.6%)	3.1%	(3.0%)	0.3%	(2.4%)	0.3%	0.6%	(0.1%)	(1.7%)
Feb 2025	(3.5%)	5.0%	(3.8%)	4.7%	2.6%	0.8%	4.3%	(2.6%)	0.3%	1.2%	(0.8%)	(1.8%)
2025	(6.1%)	4.8%	(3.7%)	4.1%	5.8%	(2.2%)	4.5%	(5.0%)	0.6%	1.8%	(0.9%)	(3.5%)

Source: FactSet, SIMG Analysis

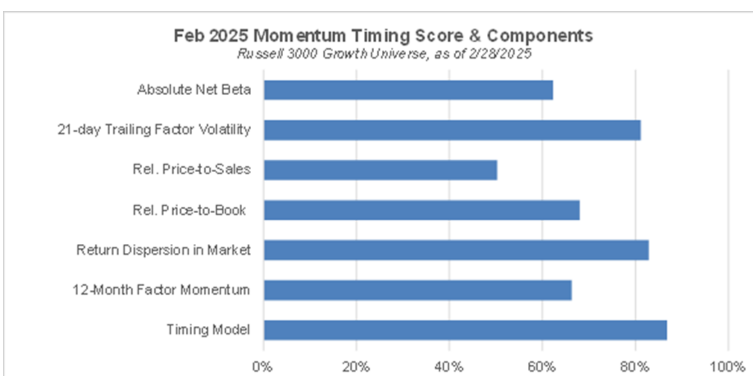
Within the factor space, top ranked stocks in terms of price-to-sales, FCF yield, and ROE have out-performed, consistent with the above-mentioned investor tilt towards quality. **High growth and high momentum stocks have under-performed last month.**

Model and Factor Performance, Top Quintile (Top Tertile for Industry Model) vs Market
Russell 3000 Growth Universe, Through 2/28/2025

	Fwd P/E	Price/Sales	FCF Yield	ROE	Gross Profit	Total Yield	Sales Growth (T12M)	Sales Growth (FY2/FY1)	12-M Price Mom.	1-M. Mom. Reversal	Earnings Revisions
Jan 2025	0.7%	1.4%	0.7%	0.1%	1.8%	(0.6%)	2.2%	(1.3%)	1.0%	0.1%	(0.3%)
Feb 2025	0.7%	2.0%	2.0%	2.7%	1.6%	1.2%	(1.1%)	(4.0%)	(1.5%)	0.4%	0.9%
2025	1.4%	3.3%	2.7%	2.8%	3.5%	0.7%	1.1%	(5.4%)	(0.5%)	0.5%	0.6%

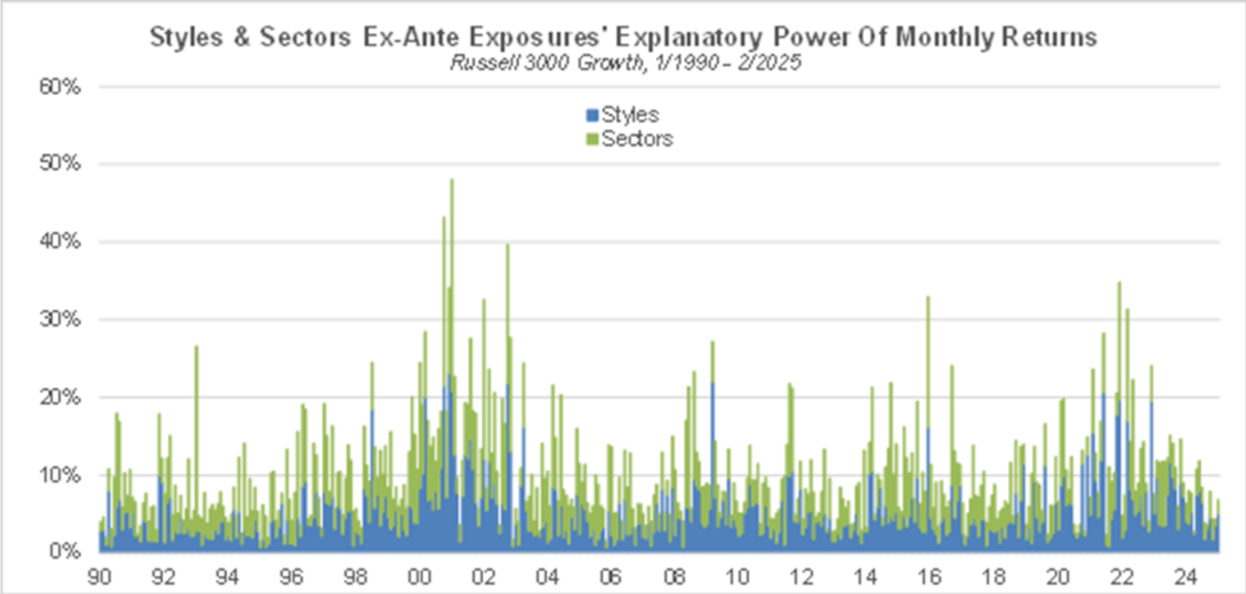
Source: FactSet, SIMG Analysis

At the end of January, our momentum timing model indicated that February would be a bad month for high momentum stocks, which turned out to be correct. **The model now indicates that high momentum stocks are also at high risk of under-performing in March**, primarily because of the momentum factor's high recent volatility and the high return dispersion within the growth universe.



Source: FactSet, SIMG Analysis

The percentage of cross-sectional monthly return dispersion (within Russell 3000® Growth stocks) that is explained by exposures to styles and sectors has been slightly above median in February. This percentage tends to spike during periods of macroeconomic stress or high market volatility and tends to be low when investors are in risk seeking mode.



Source: FactSet, SIMG Analysis