October Commentary

Cutting A Pizza, Wonka Bars, and Playing Wordle

My alarm goes off at 5:45 a.m. every workday, and Wednesday, November 6, was no exception. After waking from a brief night's sleep as I stayed up until 1:30 a.m., I promptly checked the Associated Press (AP) app on my phone to see the election results—this was different than my usual routine of walking my Goldendoodle (Marley), making coffee, and doing the Wordle. For clarification, taking Marley out first and drinking a hot cup of java takes priority over everything each morning and always happens in that order. Truthfully, I wasn't surprised with the results and wouldn't have been if the vote tally had gone the other way. The most glaring realization that crossed my mind before any caffeine helped jump-start my brain was this—it seems increasingly more difficult to place too much trust in the polls, and nothing in U.S. politics shocks me any longer.

What caught my attention after taking my first sip of coffee was the pre-market trading in U.S. stocks. From my AP app, I went straight to Yahoo Finance and then Bloomberg to find that domestic equity futures were up a ridiculous amount. The Dow Jones Industrial Average (Dow) was up over 1,200 points, and the sun had not yet risen. And bonds? They were going in the opposite direction by almost the same pace. It was a sharp reaction to an election and a somewhat unusual way to start the day. Regardless, I nursed my coffee and got the Wordle in four tries, which is my average. So, I took solace in knowing some normalcy remained in the world.

But why the extreme reaction in the overnight markets? Didn't investors know either former President Trump or current Vice President Harris would win the election? Wasn't it, by most accounts, supposed to be so close that any outcome shouldn't have been so surprising? Wasn't the decision between two relatively known candidates? Furthermore, the stock market has performed quite well over the last few years, so why the exuberance because of a change in the Administration? I am sure there are any number of folks pondering that same question. Truth be told, many have speculated the market would have rallied regardless of who had won the election. The reason: investors hate "uncertainty" and having the incessant political unpleasantness in the rearview mirror ended the unknown concerning the election outcome. While rallies don't always happen the day after an election, they occur often enough to make it a good bet, given even odds. But does uncertainty explain the severity of the market reaction? I mean, over 1,500 points on the Dow just because an election is over. That seems quite extreme, doesn't it?

I could argue the caustic nature of this year's campaign and the divergent worldviews of the presidential candidates undoubtedly made investor vacillation much more severe. Think of it this way: have you ever faced having your spouse or significant other drag you to an event you don't want to attend? I am talking about anticipating the function like you would if getting ready to have a root canal. Then, while it certainly was not your idea of fun, it happens, and it's over. Done, finished, and you don't have to listen about it or dread it any longer. If you can follow that example, you might be able to project this simplistic logic onto domestic investors on November 6. After all, it is inconceivable that everyone who enjoyed the considerable market rally on the day after the election was just a Trump supporter. I mean zero, zip, nil, nada chances they were alone in the market exuberance; Harris supporters, without question, squeezing extra dollars and cents out of their investment portfolios as well. The adage that a crisis is a horrible thing to waste is often true, especially when you are making money from it. While some may find the term "crisis" in this context to be unwieldy, the point is that savvy investors are always looking to take advantage of situations in which they can make money.

Exacerbating the inherent uncertainty of most election cycles was the significant divide on the big issue of corporate taxation between the presidential candidates. There are no two ways about it; if November 6 were any indication, this appears to have been an acute pressure point given the equity market's reaction. Consider this excerpt from Howard Gleckman's November 1, 2024, blog on taxpolicycenter.org: "Tax increases: Nowhere do the candidates' tax plans differ more. Harris would raise the current 21% corporate tax rate to 28% while Trump would cut it to 20% for most corporations and 15% for those that manufacture their products in the U.S."

Frankly, that spread between 15-28% is a stark difference, and I am talking about enormous. For a large corporation with $1 billion in pre-tax income, that difference equates to $130 million. And for a smaller business with an income of $1 million, they get to keep an extra $130,000. Trust me, investors like extra profits, and the CFO's office can do a lot of stuff at a small business with an added $130K hitting the bottom line. Why is this important? Rightfully, many investors are starting to wonder what the stock market can do for an encore in 2025. Corporate profitability has been acceptable recently, though a bit underwhelming compared to analysts' estimates. Further, some pundits are forecasting a slight slowdown in economic activity to start 2025, though others are constructive for improved earnings under the new administration and its policies.

While not overly intuitive, what would happen if one of the presidential candidates proposing tax cuts wins an election while investors are fretting about future profitability? If the post-day election rally is any indication, it would be like discovering a golden ticket inside a Whipple-Scrumptious Fudge-Mallow Delight Wonka Bar. To that end, I will argue even the bluest of the blue, corporate CEOs wouldn't want to pay 28% in taxes to the IRS when all they must pay is 15%. If you find such a corporation, I might suggest you look to buy shares of a different company. But all of this begs the question: "Won't this decrease in the corporate tax rate be bad for the Federal budget deficit?" While that may seem logical because lower tax revenues mean less money in the government's coffer, the most honest answer is maybe. If Company XYZ can use the tax savings to grow its business more rapidly and/or increase shareholder wealth, the growth in general economic and market activity might be enough to offset the decrease in tax receipts due to lower tax rates. What gets lost in translation is this: reducing a tax rate is NOT the same as lowering taxes. Consider this: in 2017, the same year as the current President-elect's "Tax Cuts and Jobs Act," total income taxes in the United States were $1.6 billion. In 2024, they are estimated to be $2.5 billion. If my math is correct, this is a nearly 60% increase in nominal income tax receipts. Over the same period, Gross Domestic Product (GDP) grew from $19.6 billion to $29.3 billion—a 49.65% increase in nominal economic activity. How can tax receipts increase faster than nominal GDP growth after a considerable cut in marginal tax rates? Pretty neat trick, huh? To help it make sense, follow this concept: a smaller piece of a larger pie will often be bigger than a large piece of a small pie. If that is hard to envision, let's say we cut a 16" pizza into eight like-sized slices and a 12" pizza into six slices. Which do you think has the larger individual slices? If you answered the 16" pizza, you are correct. Ah yes, $\pi r2$ to the rescue—I knew I would use it one day!

So, there you have it—why the market reaction was so extreme, or at least a few potential reasons. Suffice it to say, there are undoubtedly others. However, when presented with an opportunity to make money, investors will focus on the known or easily deduced when they have the chance. Said differently—people often vote with their hearts, but investors always vote with their wallets. Believe it or not, that was on my mind Wednesday morning, November 6—after I got the Wordle in four, again.

Happy Thanksgiving to everyone. Until next month—

by David Lackmann
Florida Director of Investment Management

FIRST AMERICAN BANK

www.FirstAmBank.com

Illinois | Florida | Wisconsin