

DIAMOND HILL

INVESTED IN THE LONG RUN

A Contrast in Starting Conditions

Jan 2025

Some investors have looked to the years following the 2016 election as a potential rough guide for what may happen in equity markets over the next several years. One challenge with that view is that the two time periods have very different starting conditions, which leaves less margin of error moving forward, as illustrated in Exhibit 1.



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Exhibit 1 — Then and Now

Variable/Condition	2016	2024
S&P 500 Price-to-Earnings	18.5	21.8
S&P 500 Net Profit Margin (%)	10.7	12.8
US Core Inflation (%)	2.2	3.3
US 10-Year Treasury Yield (%)	2.5	4.5
US Unemployment Rate (%)	4.8	4.2
US Deficit % of GDP (%)	3	7
US Debt % of GDP (%)	105	124
Globalization Trend ¹	Continuing	Reversing
Geopolitical Risk ¹	Simmering	Near Boiling

Source: Bloomberg. As of year-end or most recent available as of publishing. ¹Represents the author's opinion.

The S&P 500 Index delivered a 16% annualized total return in the four calendar years following the 2016 election, and that came in a low inflation environment, so real returns were about double the long-term historical average.

However, much of that return was driven by an improvement in several economic and financial variables — increasing corporate profit margins in part due to lower tax rates, declining unemployment helping to drive growth in earnings and an expansion in the peacetime, non-recessionary federal budget deficit that helped accelerate economic activity, also boosting corporate earnings.

Several additional factors served as supportive starting points for the strong equity performance over this period. While US stock market valuations were above long-term averages, they were still quite reasonable when combined with historically low inflation and interest rates. The continuing trends of globalization and relatively low levels of geopolitical risk supported domestic companies' ability to expand profit margins.

These starting conditions that supported equity returns following the 2016 election have changed dramatically in the eight years since then. As seen in Exhibit 1, we are now facing higher equity valuations (particularly for large-cap stocks, less so in the mid-cap and small-cap areas) despite higher inflation and interest rates, already historically high corporate profit margins along with very low unemployment rates, much higher federal budget deficits despite not being in a recession or directly involved in a “hot war,” and deteriorating globalization and geopolitical trends, which will create challenges for businesses on the cost-saving front.

These more difficult starting conditions do not guarantee a poor outcome. Still, they will make it harder to generate improving business fundamentals, leaving less margin of error and room to maneuver if unexpected challenges arise.

What could make this scenario a positive one for stock investors? The most obvious candidate is a significant productivity increase, perhaps driven by the increasing use of artificial intelligence. That is far from a given, and society still needs to deal with what happens to workers who might lose their jobs in such a productivity miracle, which is not an insignificant concern given the political environment of the last decade. Other saving outcomes for domestic equity investors could include a sharp decline in inflation and interest rates while earnings growth remains solid or a rapid drop in geopolitical tension that allows the benefits of globalization to re-emerge. While possible, none of these scenarios seem to be a high probability at present.

How do we, as investors, manage through this environment? Appreciating the risks of both leverage and economic cyclicalities are two thoughts that come to mind. Leverage can enhance equity returns but can also create significant additional risk, particularly in high and/or rising inflationary and interest rate environments. We continue to own some stocks with above-average leverage, such as Post Holdings (POST). Still, we are being especially diligent in confirming our conviction that such businesses will be able to generate sufficient cash flows even in stressed environments to manage their debt load. Where we have less confidence, we have either trimmed or exited positions, including in the banking, airline and real estate industries.

Sensitivity to economic cyclicalities is another quality that can lead to generous stock returns if the fundamentals of the businesses cooperate. However, stocks with those characteristics, on average, tend to fall much more in market downturns than less cyclical stocks. The nature of the downturn might impact that pattern – for example, whether it is caused by a slowdown in economic activity and corporate earnings or an acceleration of activity that leads to a rise in inflation and interest rates, pressuring stock prices.

We have maintained some exposure to economically sensitive stocks where we have high conviction in the strength of the fundamental trends and the attractiveness of the valuation. Several of these stocks can be found in the industrials sector, where tailwinds of reshoring, electrification and industrial automation continue to drive favorable growth for businesses like WESCO International (WCC) and Regal Rexnord (RRX), and there continue to be select opportunities in other sectors.

At the same time, we have increasingly found more attractive prospects in several stocks that typically exhibit less exposure to the economic cycle. This group includes recent purchases in health care positions Labcorp Holdings (LH) and Teleflex (TFX), technology company Verisign (VRSN) and defense contractor Huntington Ingalls Industries (HII). In addition to being very attractive on a standalone basis, these positions should support our tendency to protect client capital in down markets, should we face such an outcome in the future.

As always, we appreciate our partnership with clients, and we will continue to work diligently to construct the best portfolio we can for you, maintaining our shared focus on a long-term time horizon.

As of 31 December 2024, Diamond Hill Small-Mid Cap and Mid-Cap Strategies owned shares of Post Holdings Inc, WESCO International Inc, Regal Rexnord Corp, Labcorp Holdings Inc, Teleflex Inc, VeriSign Inc and Huntington Ingalls Industries Inc.

S&P 500 Index measures the performance of 500 large companies in the US.

The views expressed are those of the author as of January 2025 and are subject to change without notice. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Investing involves risk, including the possible loss of principal. Past performance is not a guarantee of future results.