GAMCO
ASSET MANAGEMENT

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Q3 2024 Commentary

THE GREAT ROTATION?

Markets rose in the third quarter with considerable breadth and strength, driven by the Fed's beginning of its rate cut cycle with a 50 bps reduction in the Federal Funds Rate target. While the rising tide lifted all boats, "value" stocks beat "growth" stocks and small capitalization stocks beat large caps for the first time since Q1 2021. Lower interest rates generally act as a positive catalyst for equities by reducing borrowing costs, fostering robust M&A, increasing consumer spending, renewing investor risk appetite and leading to higher valuation multiples. All else equal, lower rates are usually better for companies with cash flows coming further in the future, which would normally favor growth stocks. However, the Magnificent Seven and especially AI related companies have driven the vast majority of market gains for the last two years, leaving other stocks trading at much lower valuations by comparison. Additionally, many companies considered value stocks are economically sensitive, so they are beneficiaries of lower rates and the perception that the Fed may actually pull off the soft landing for the economy it has been trying so hard to engineer.

This optimism about the economy and the stock market comes amidst an uncertain and increasingly tense geopolitical situation. The war in Ukraine continues on, with no end in sight or much progress from either side. Conflict in the Middle East is escalating, with Israel's war against Hamas in Gaza spreading to military action against Hezbollah in Lebanon and now even direct conflict with Iran. As of the writing of this letter, oil prices are rising on the expectation that some portion of Iran's production may be taken out in response to its direct (but unsuccessful) missile attack on Israel. Lastly, the outcome of the U.S. presidential election and the makeup of Congress could have profound implications for the U.S. and global economy: what will happen to personal, corporate, and capital gains taxes? Will new and higher tariffs be imposed, and will there be retaliatory measures enacted by other countries? How will fiscal decisions impact the deficit? Regulation? Will the U.S. continue to support allies around the world, including Taiwan, where most advanced chips are manufactured? We will not know the answers to these questions until November (we hope).

Merger & acquisition activity is already responding to lower rates and increased confidence about the economy. Global M&A value was up 16% for the first nine months of 2024 to $2.3 trillion, with deals for U.S. targets up 18%. Notably, private equity M&A has grown by 40% this year and now comprises 24% of deal activity, up from 20% in the same period last year. A continued decline in rates should bolster activity going forward, and no matter who wins the election, the FTC is unlikely to be as hostile to deals as it is now.

As value-oriented stock pickers, we find the current market conditions exceptionally favorable for our methodology. Our focus remains steadfast on identifying exceptional businesses trading at a discount to Private Market Value with catalysts to surface value. We will continue to use the volatility provided by Mr. Market to increase our stakes in great companies at attractive prices.

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