Q4 Markets Commentary and Outlook – 2024

Portfolio & Market Highlights

- While market momentum seems to be leaning bullish, it's critical that we level set current and future market expectations. The new year kicks off with two consecutive years of near 25% gains in stocks and 173%+ (S&P500) since the COVID lows. The exuberant environment gives us pause as an overly positive news and data outlook may already be reflected in current valuations. And while we remain modestly positive on the economy and the agenda of the new administration, the reward-to-risk in equities has shifted from "favorable" to "balanced" at best.

- According to FactSet, for Q4 2024, the estimated (year-over-year) earnings growth rate for the S&P 500 is 11.9%. If that level is attained, it would mark the highest (year-over-year) earnings growth reported for the index since Q4 2021. We are a bit less optimistic, especially towards the back half of the year. Based on our mid-range target, we expect the S&P 500 to end 2025 between 6250-6450, representing a 9.7% return for the year at the high-end.

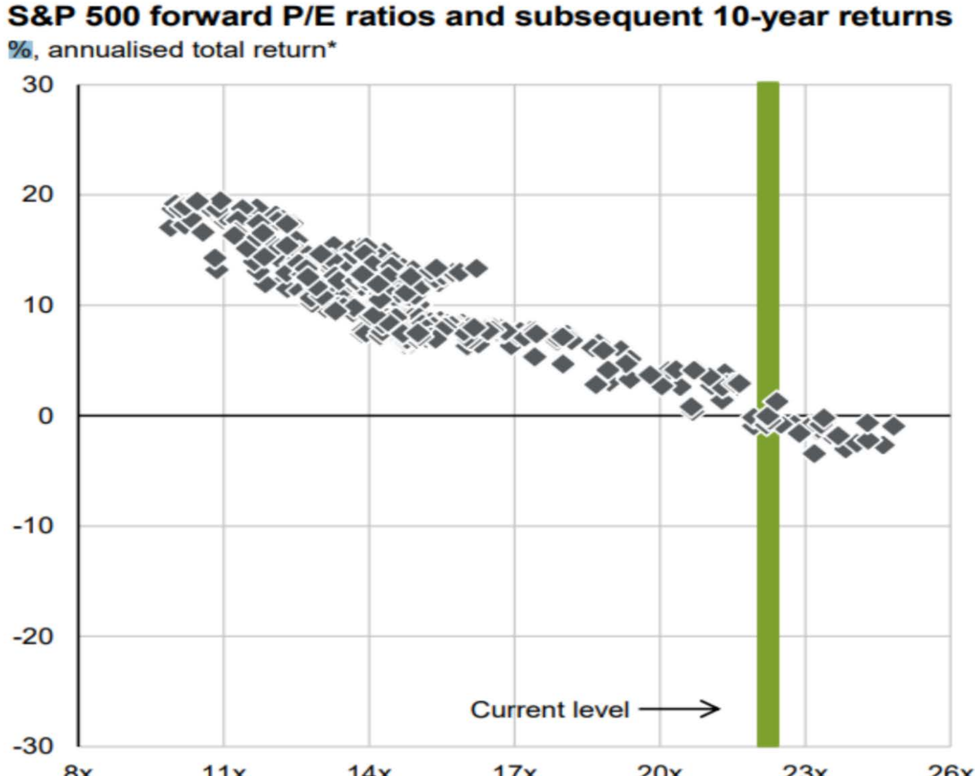
- Our outlook for the economy centers around a more supportive, "pro-growth" environment from Washington, which has fueled the "animal spirits" rally since the election. And yes, there's also $7 trillion in cash sitting on the sidelines that could flow to stocks and other assets, but the story is more complicated. Ironically, too much of a "good thing" could create its own problems. Based on current policy trajectories, we are growing increasingly concerned that inflation could re-ignite, resulting in higher interest rates, and more weakness in the bond market. This sentiment is currently being reflected in prices of 10-year U.S. Treasuries, and the new administration hasn't even taken office. Other uncertainties, particularly around the housing market, trade policies and tariffs, could introduce more volatility in both fixed income and equity markets. Debt markets have already begun to reflect these growing risks resulting in negative Q4 returns as measured by the Aggregate Bond Index and 10-YR Treasury notes of (-3.05%) and (-5.20%) respectively.

- The bearish shift in the U.S. bond market, which we believe is no longer transitory, marks a departure from the bullish trends we experienced between Q4 2023 to the start of Q4 2024. This shift in bond price trajectory presents us with bigger challenges as bonds are experiencing stock-market-like volatility. And while there may be opportunities upcoming, we had to make significant changes to our models in order to reduce interest rate risk, adding our Principal Protected Income as a surrogate to achieve the downside protection and stability our clients require from their bond portfolios. At current levels, we still believe bonds will provide low-to-mid-single digit returns in 2025, we were reminded in Q4 why bonds achieved less than 2% annualized returns in the last ten years.

- Using our targeted, and partially hedged approach, we experienced significant outperformance in our equity portfolios in 2024 and will continue to invest in high quality value, broader cyclical, and certain growth-oriented themes in Smallcap, high quality dividend stocks, artificial intelligence, and targeted Midcap in anticipation of acceleration in GDP and an innovation agenda driven by the new administration.

Q3 Markets Commentary and Outlook

Current Valuations Do NOT Bode Well for Future Returns



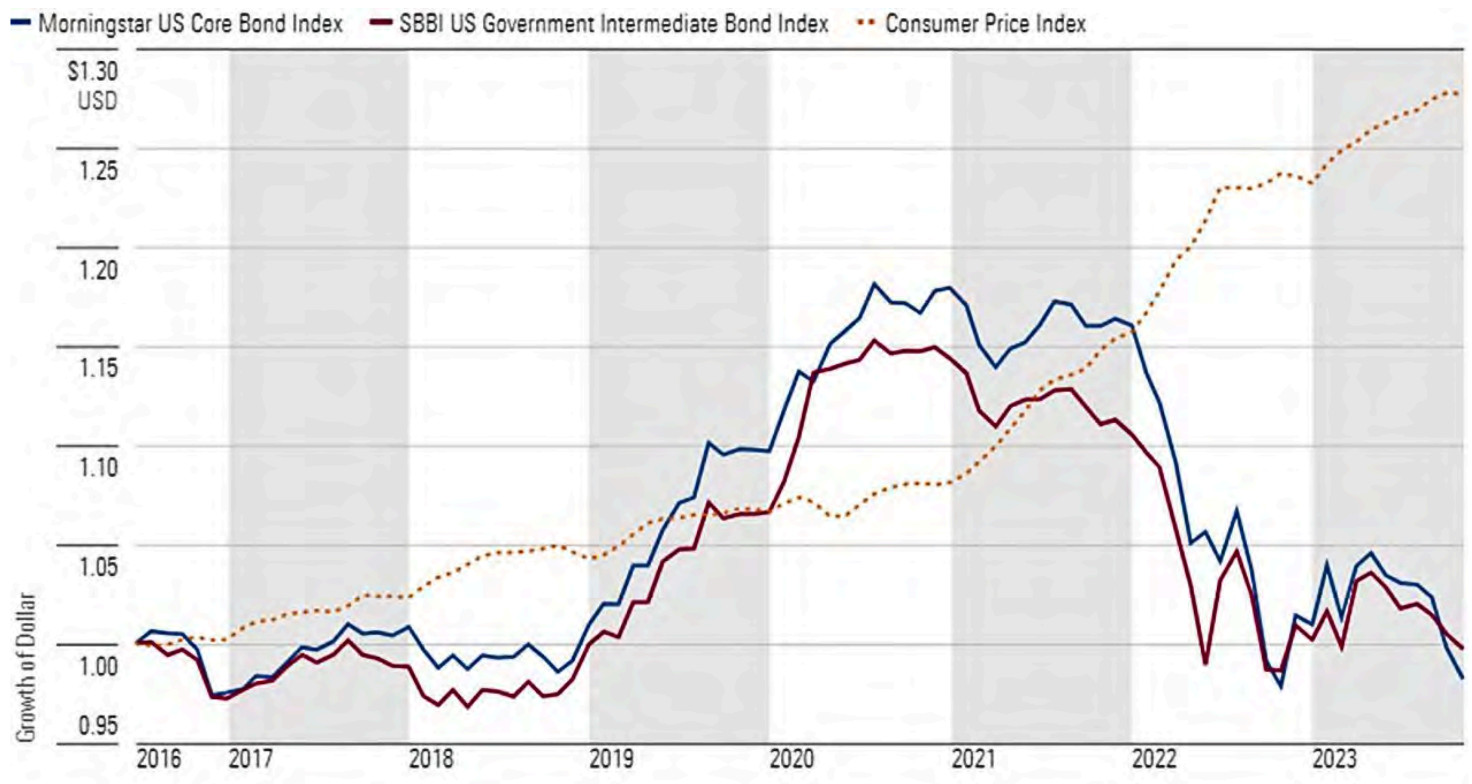
- Stocks are most certainly priced for perfection. Volatility late in the fourth quarter was likely a small peek into what may lie ahead. While we are applying several tactics to gain alpha and minimize draw downs, our portfolios benefited greatly in 2024 from strategic allocations to what we call "Strategic Reserve" themes, including assets such as gold and Bitcoin. We believe these are themes that will help define the investment landscape the next five years as the U.S. approaches $40T in debt, the US Dollar as the reserve currency is questioned, and nation states including the U.S. begin to shore up their reserves with hard assets mentioned above. Gold demonstrated its resilience in the end of the quarter as big tech stocks corrected sharply and the U.S. dollar soared to multi-year highs (gold tends to move inverse to the dollar).

In summary, we expect our All-Weather Investment Approach to maintain an edge in a market that requires more precision and flexibility with a bigger dispersion of winners and losers. Our strategy combines our long-term views, medium term tactical asset allocation, and principal protection strategies to capture upside, while limiting downside exposure as much as possible. We see the U.S. economy producing higher growth, increasingly stubborn inflation, and asset-specific opportunities given a pro-growth agenda and deregulation. Geopolitical uncertainty and tariff details will play a critical role in how America resets trade deals with China and others; all of which will be key determinates of investors' risk appetite.

Portfolio

We made significant changes in our bond portfolios at the end of Q4 to reduce and modify risk and exposure. This was accomplished partially by emphasizing shorter maturity, higher yielding corporate bonds and a 10%-20% cash buffer to improve risk-adjusted returns until interest rates stabilize. We know it is critical for our more conservative clients to maintain their purchasing power and principal stability, and those are an important part of our investment mandate.

Bond Market Longest underperformance Period Vs. Consumer Price Index Inflation



Source: Morningstar, Peak American Investment Advisors 2024

The chart above shows just how tough the bond market has been to navigate in recent years. Just to keep pace with the rising cost of goods and services (as measured by the Consumer Price Index), a conservative bond investor, over the last 9 years, would have needed about 30% more purchasing power to buy what a dollar could in 2016. During that same period, bonds returned about 2% on an annualized basis, failing to cover basic inflation risks, and further proving that this is not our "father's bond market." Today's fixed income portfolio requires more skill, active management, and potential alternatives in order to achieve stable returns versus the traditional methods that were successful in the decades prior.

Portfolio

Modest adjustments were also made to our equity portfolios to better reflect and align with our views on the stock market and slightly augment risk.

- We increased growth exposure in AI (artificial intelligence) & technology post-election to balance our lower-beta value stock exposure in the portfolio. Weightings were adjusted across holdings and high-yield money market exposure was added as we transition to the new administration and a changing risk environment. The post-election crash of 2020 was a recent example of how seemingly unrelenting momentum can come to an abrupt halt.

- We augmented our small position in Bitcoin post-election as we expect Trump and up to 10 U.S. states to create a strategic national reserve policy to buy the asset. Additionally, we are in very early innings predicting nation states, pensions, institutions, advisors, and corporate treasury investors adopting the asset class to hedge inflation and take advantage of finite supply versus "paper" money that continues to decline in value.

- We slightly decreased our gold position after its 40% performance in 2024, and the expectation that digital stores of value may begin to compete with analog versions (such as gold) as digital gains broader acceptance. A strong US Dollar may also be a headwind for the shiny metal.

- We decreased utilities exposure due to increasingly expensive valuations and its stellar outperformance in 2024.

- Thematically, we have increased our exposure to high-quality mega cap value companies, store-of-value, quality Midcap, and remain invested in select Smallcap indexes as consumers should thrive in the near term. That said, we are also keeping our "powder dry" in high-yield money markets as this new administration takes the helm.

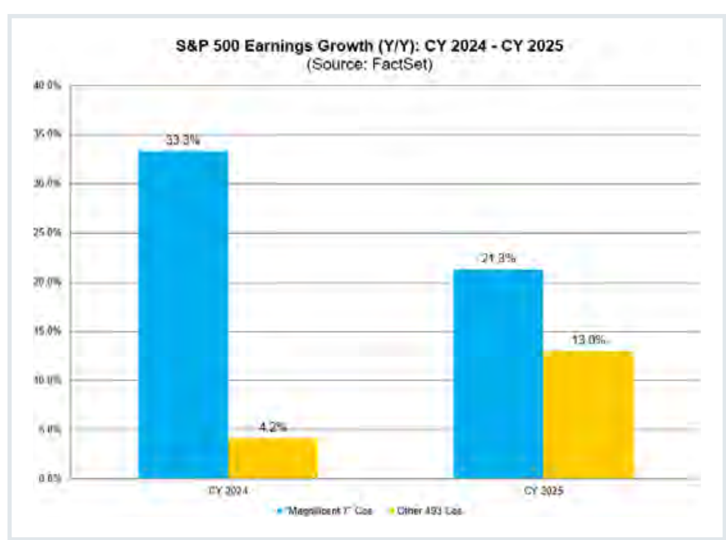
Q4-2024 Portfolio Investment

Asset Class	Investment Theme/View	Portfolio Positioning
Principal Protected Income	Tax deferred yields with zero market risk	Favorable
Cash/Ultra Short Maturity Bonds	Taking advantage of higher yields with minimal risk	Favorable
1–3yr U.S. Treasuries	Likely to experience less volatility	Neutral
7–20yr U.S. Treasuries	Uncompensated risk with higher potential inflation	Unfavorable
Investment Grade Bonds	Shorter maturities preferred, but rewards to risk not optimal	Unfavorable
Short Duration HY Bonds	1–2yr bonds with 6–7% yields offer low relative risk	Favorable
High Yield Bonds	Interest Rates are too low to compensate for credit risk	Neutral
International Bonds	Unfavorable with tariffs and geo-political risk elevated	Unfavorable
Small Caps	Attractive valuations vs. Large Caps with more upside	Favorable
Mid Caps	Will benefit from strong GDP and resurgence in M&A	Favorable
S&P 500	Valuations are stretched, but still acceptable	Neutral
Nasdaq 100	Improving fundamentals but tricky if rates stay high	Neutral
Dividend Aristocrats	Quality-Value is a defensive play with high dividends	Favorable
Large Cap Value	Quality-Value is a defensive play on higher rates and inflation	Favorable
Artificial Intelligence & Big Data	Strong growth potential with global trends	Favorable
Energy	Neutral	Neutral
Utilities	Neutral	Neutral
Gold	Favorable as fiat currency declines and global debt surges	Favorable
Silver	Neutral	Neutral
Bitcoin	Best asymmetric return profile as the asset class emerges	Favorable
Platinum/Palladium	Benefits from new tech economy – volatile at times	Favorable

Favorable | Neutral | Unfavorable

Did You Know?

The last week and first week of trading around the new year has long been an indicator of how the rest of the year will go. While tax-loss harvesting can trigger some selling late in the year, we typically like to see momentum in the final days of trading in order to set the tone for the rest of the year. It has been a while since markets fell consecutively in the final four days of December. The last time was in 1966, and that began one of the longest bear markets in history. From 1966 to 1982 the Dow Jones Industrial Average (DJIA) lost approximately 10% of its value as investors struggled with high interest rates and high inflation. We are not suggesting that is what's to come, but it is certainly an interesting stat to note. Our eyes are laser focused on building inflationary pressures as 2025 kicks off.



Summary

2025 – Outlook

Analysts expect the S&P 500 to report double-digit earnings growth in 2025. The estimated (year-over-year) earnings growth rate for 2025 is 14.8%, which is above the trailing 10-year average (annual) earnings growth rate of 8.0% (2014 – 2023). In other words, expectations are VERY high, but could be achieved as long as aforementioned tail risks do not surface.

We are also hopeful that the administration's tariff threats are more of a negotiating tactic as opposed to a given. Inflation and high rates are the top threats to our bullish thesis. Fed chair Jerome Powell did recently acknowledge that monetary policy remains tight, which implies he may be more inclined to cut than he's letting on. Fed fund futures have just two rate cuts in 2025 as the most likely outcome, greatly reduced from far more dovish outlook just a couple months ago. This low expectation for rate cuts may help the bulls for both stocks and bonds, so long as inflation doesn't spike to an unacceptable level.

With the 10-year Treasury yield back above 4.6%, investors are technically receiving reasonable compensation for taking on interest rate risk. For now, markets expect long-term inflation of about 2.3%, so investors are demanding a 2.3%+ real (after-inflation) return from the 10-year note. This 2.3% real expected return is close to the average from 1999 through 2008, and above the 2.1% median for that same period. But we cannot forget that CPI is currently reflecting 2.7%+ inflation, which must continue to moderate for bonds to rally. We think longer dated bonds are once again *approaching* a "fair purchase point," but we need to see how investors behave in the first 30-60 days of the presidency before any conviction can be established there.

Merger & acquisition volume has been muted for the past few years following record rates post-pandemic. While total global deal volume is up roughly 12% in 2024 compared with the same period in 2023, the number of transactions is lower and volume remains well below the 2021 high, according to Dealogic data. We believe that M&A activities will increase 10-20% in 2025, with stocks in the mid-cap range likely benefitting most.
Most major global economies, apart from China, are expected to grow in 2025, which should help support earnings as nearly 30% of S&P 500 revenues are generated outside the U.S. We are also not as bullish on the global recovery as our peers, which detracts from our bull case.

We believe we are well positioned for the changes that lie ahead and will continue to adjust to market conditions and take advantage of information / market disconnects when and if they occur.

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Disclosures

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