# QUARTERLY RECAP

## Valued Clients,

### I hope everyone enjoyed the Holiday Season!

Since the stock and bond market crash of 2022, stocks have had a surprisingly strong run, led by a handful of richly valued mega-cap, high momentum stocks. It's historically remarkable that inflation caused interest rates that increased from zero to 5.5% and caused mortgage rates to approximately triple from trough to peak did not cause a recession at any time from 2022-2024 as GDP, employment, and corporate earnings remained resilient in the face of substantially higher costs for everyone.

After two up years where stock prices increased considerably more than company earnings, a more moderate market performance is very likely for 2025.

Interestingly, while the major indexes climbed with just those richly valued Magnificent 7 stocks accounting for 57% of 2024's and 65% of 2023's entire S&P 500 market cap gains, the three-year annual gains were much more modest at 5.4% for the Dow and 7.3% for both the S&P 500, and the Nasdaq according to the Wall Street Journal year-end data in Thursday's edition.

This brings up the value of minimizing those big downturns as we did in 2022. In 2022 both the Nasdaq and the popular Vanguard Growth Indexes (ETF – symbol VUG) both including the Magnificent 7 stocks crashed 33%. So, if a $1 million stock portfolio dropped 33% to $670,000, it had to increase by about 50% ($330,000) just to get back to even. That is why the 3-year annualized performance gives a more realistic overview for this unusual time period.

More fragility and volatility that began with the missed December "Santa Claus Rally" and into the start of January will likely continue in 2025 with a lot of mixed concerns and great opportunities.

# MARKET OPPORTUNITIES

## Interest Rates

- A strong economy with good GDP growth, a healthy employment picture with more people working, higher wages (spending power), reasonable unemployment rates, and most importantly positive earnings growth, could outweigh somewhat higher interest rates and inflation.
- Even though longer rates have risen and may be volatile and unpredictable, as well as short rates likely to decline less than previously thought, the significant decrease in short-term rates bringing down money market, CD, and Treasury Bills to the low 4%s could encourage more dividend focused investing where investors can earn higher income at a lower tax rate with appreciation and income growth potential.

## Business Friendly Policies

- More confidence that tax rates for businesses, individuals, and estates are less likely to go higher and, in some cases, may decline could fuel economic growth.
- More reasonable, less expensive and bureaucratic business regulation could enhance business activity as well as encourage greatly needed home building.
- The rejuvenation of the IPO (initial public offering) and merger and acquisition markets could fuel more economic activity and boost stock prices.

## Diversification from the Magnificent 7

- As a small portion of the U.S. market has gotten so expensive relative to their earnings growth, the market should broaden out to better valuations while lowering the higher market risk from the over-concentration in those expensive stocks.
- While those leading growth stocks are great companies with game-changing technologies, in many cases their valuations have become unsustainable relative to current and future unknown earnings growth.
- Not only can less volatile, less risky growth expand from mega-cap to better valuation large, mid-cap, small-cap stocks, but also to some international and emerging market stocks that may have become very inexpensive relative to the high P/E stocks.
- While earnings growth is very important, I think we will have more attractive opportunities to invest in growth stocks on big pullbacks in 2025.

## Artificial Intelligence (AI)

- While in its relative infancy, AI should give substantial productivity gains as much more work will be accomplished with many fewer person hours and eventually at a much lower cost.
- AI will continue to spur investment activity as research & development into the technology, as well as the data center and energy demands are in the high-growth stage.



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# MARKET RISKS

## Interest Rates

- While short-term, risk-free Interest rates dipped from the mid-5% range in 2023 and early 2024 to the current low 4% area now, longer-term benchmark 10-year Treasury Bond interest rate has spiked up 26% from a September 2024 low of 3.63% to December 31st's closing 4.58%.
- The higher long-term interest rates can slow down economic activity including residential and commercial real-estate, consumer discretionary spending, and business investments.
- As savers can lock into higher interest rate bonds, that leaves less money for stock investments.
- While previous forecasts were for another 4-quarter point, short-term interest rate cuts from the Federal Reserve in 2025, it now looks there may be just two (of course data dependent and subject to change).

## High Stock Prices

- In my opinion it is unrealistic that stocks will continue to rise in value by so much more than company earnings growth.
- Since stocks prices have risen so much more than earnings have gone up, current Price/Earnings ratios that have gotten out of whack are likely to decline going forward by slower share price growth.
- To put the Price Earnings (P/E) ratio into context, with the year-ending Dow at 26.7, the S&P at 25.2, and the Nasdaq at a whopping 33.1 trailing P/E, that is the number of years for each of those indexes to break even at the 2024 earnings level. If you were to buy a business, would you be willing to pay a price that would take 25-33 years just to break even on your initial investment? I don't think so… But the unknown is how fast will future earnings growth make the current high valuations look more reasonable. Of course, over time it should, but there will likely be many bumps along the way.
- While some selling began in December, there could be a lot more profit-taking sales in early 2025 as market anxiety increases and as some investors have delayed capital gain tax obligations from 2024 into 2025.

## Uncertainty

- Tragic, violent terrorist attacks both domestically and internationally are creating more anxiousness, more avoidance of travel and events, and much greater inconvenience, expense, and security needed to function, most notably since the senseless , 9/11 attacks as well as all the horrific, random school and event occurrences that sadly do not seem to be slowing down nor are they fully defensible in the free and open society that most of us cherish.
- Tariffs, while potential negotiating chips as well as domestic job and business protectors will likely cause our prices on goods to increase as consumers will lose some lower cost production country availability. It will also likely cause some retaliatory tariffs or boycotts on American made products, hurting our U.S. companies that rely heavily on sales and earnings from their exports. 28% of S&P revenues in 2023 (we don't have 2024 #s yet) were from exports internationally, and an enormous 59% of technology sector sales (the market golden goose) came from international exports.
- Regardless of your take on environmental issues, there is clearly a rise in weather related damage domestically and internationally.
- There is always a risk of unpredictable one-off, so-called "Black Swan" events that impact both our daily lives as well as business activity whether they be economic, business, political, legal, societal, or climate based.



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While risks always exist, the good news is that following every market downtown, stocks like real estate (overall), no matter how severe the decline, have always recovered and gone higher.

## 2025 STRATEGY

- While growth (vs. value) has become an increasing portion of stock gains, we will continue to be aware of the risk of too much high-valuation momentum and do our best to invest in growth at a reasonable price, especially on pullbacks when the market is temporarily selling off on what usually ends up being short-term events.
- We will continue targeting 6% tax-advantaged (for non-retirement accounts), growing income opportunities with high dividends and covered call strategies plus long-term appreciation. While these investments well out-performed in 2022, and under-performed in 2023/2024, I believe they are poised to do very well in 2025, with much less market risk.
- Our retirement accounts will keep focusing on growth including potential short-term gains and non-tax advantaged income including Real Estate stocks (REITs) with unique tax treatment, high dividends, and fully taxable fixed income opportunities.
- We will continue to monitor sell opportunities as investment valuations get too expensive, risk a decline, or when higher potential investments arise.

**As always, please reach out to me if you have changing objectives, life events, or situations related to your expenses, growth, income, and tax needs going forward.**

**To a happy, healthy, & prosperous New Year.**

– John

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