Beginning Again

Weekender

February 15, 2025

Action is a great restorer and builder of confidence.
Inaction is not only the result, but the cause, of fear.
Perhaps the action you take will be successful;
perhaps different action or adjustments will have to follow.
But any action is better than no action at all.

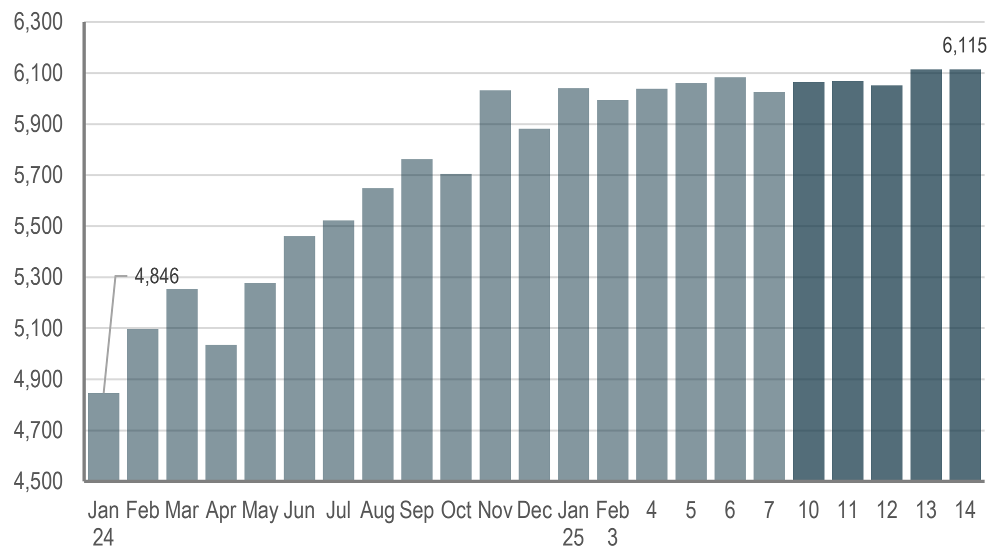
When you are afraid, do the thing you are afraid of and soon
you will lose your fear of it.

Norman Vincent Peale

Good morning, and welcome to the *Weekender* for Saturday, February 15, 2025. Since President Trump took office on January 20, 2025, equity and fixed-income markets have been moving mostly sideways. However, by changing the anchor date to the November 5, 2024 election, equities are up +5.7%. For last week alone, they were higher by +1.5%. The point? Regardless of what you think about his policies, President Trump has been good for financial markets. At least so far.

S&P 500 Index Levels

(Source: Bloomberg)



In this *Weekender,* we summarize financial market moves and provide a more detailed analysis of features we deem critical to our investment positions and allocations. This *Weekender* does not have a one-more-thing segment. That will begin again next week.

Please be sure to consult a qualified financial advisor before making meaningful financial decisions.

From our graph-of-the-week files, we pulled five-year US government bond yields. After a drop into the nether regions prompted by aggressive Federal Reserve rate cuts during the meat of the pandemic, rates rose significantly in response to stimulus-fueled inflation. With inflation now waning from peak levels, yields appear to be upwardly sticky at levels that have not been seen for a generation.

Five-Year Government Bond Yield

January 1, 2019 - February 15, 2025, 2024

(Source: Bloomberg)

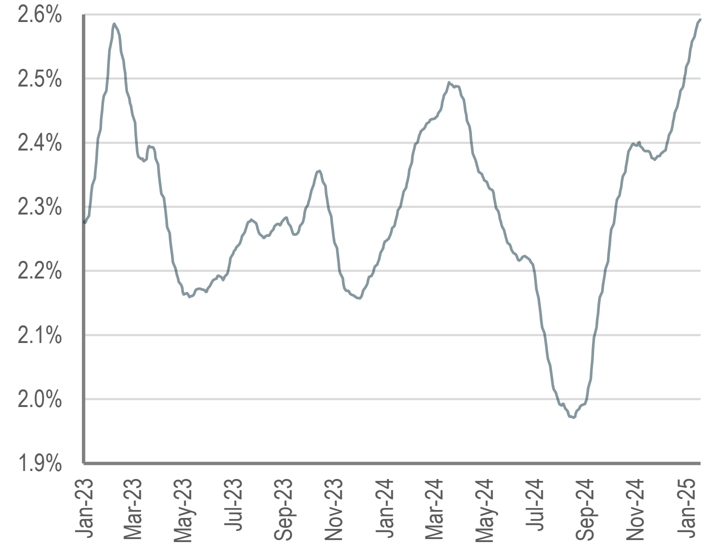
Inflation, as measured by the consumer price index (CPI), is currently at 3.0%, well off pandemic stimulus highs of 9.1% in June 2022 but still a full 1.0% higher than the central bank target of 2.0%. Federal Reserve chair Jerome Powell recently professed that the Fed does not feel an urgency to continue lowering rates given the persistence of inflation and the likelihood that some of President Trump's policies may be inflationary.

As inflation moderates from its 2022 highs and interest rates continue to hold steady, the breakeven, inflation-adjusted rate, for five-year US government bonds has been rising. If sustained, breakeven rates at the current level will negatively impact asset prices, economic expansion, and consumer willingness and ability to spend.

Five-Year Government Bond Breakeven

January 1, 2019 - February 15, 2025

(Source: Bloomberg)



Market Narrative

President Trump has always cut a wide swath in our perpetual news cycle, and his daily reveal of changes to government programs seems to consume all available media oxygen. His proposed changes will undoubtedly impact consumers and investors. But their real impact is months, if not years, away. Markets have been reacting to each "shock and awe" change proposed by the administration.

However, responses are being increasingly muted as the dendrites become less sensitive to the fecund potential of each announcement. As noteworthy announcements give way to the monotonous, slow grind of governing, markets will tune out the noise and focus on the signal within. We expect fundamental factors like economic output, earnings quality, and growth to rise in importance and government pronouncements to fade as the administration hits its 100-day office milestone.

Approximately 76.8% of the S&P 500 member companies have released year-end 2024 profits. So far, sales have increased by 5.1%, while profits are ahead by a healthy 10.4%. Many companies continue to benefit from fatter margins enabled by trillions of dollars in excess liquidity pumped into the economy during the pandemic. Being fully invested, our investment returns have benefitted from this excess liquidity. However, we expect 2025 to mark the end of excess liquidity and the gate to a new normal where the consumer is more constrained, interest rates and inflation perniciously persistent, and a government unable or unwilling to come to the rescue.

As a preview to this new normal, approximately 66% of S&P 500 members releasing earnings have suggested concern about the likelihood that 2025 will meet previously stated expectations. Equity and fixed income prices are determined based upon expectations and valuations, close to the all-time highs of the internet bubble, and are pricing in a very rosy outlook. As softer forward guidance meets with bubble-level valuations in many sectors, we are thinning overweight positions in exchange for higher exposure to resilient, high-quality equities.

We have begun our annual rebalancing in all portfolios. While detailed information is available to subscribers, in almost all accounts, we are inclined to let fixed-income positions in sovereign and high-quality corporate bonds, with yields over 5.6%, continue to do some heavy lifting in most of our portfolios for the coming year.

On the equity side, we are thinning positions where valuations are multiple standard deviations from normal, and fundamentals no longer justify a premium to historical levels.

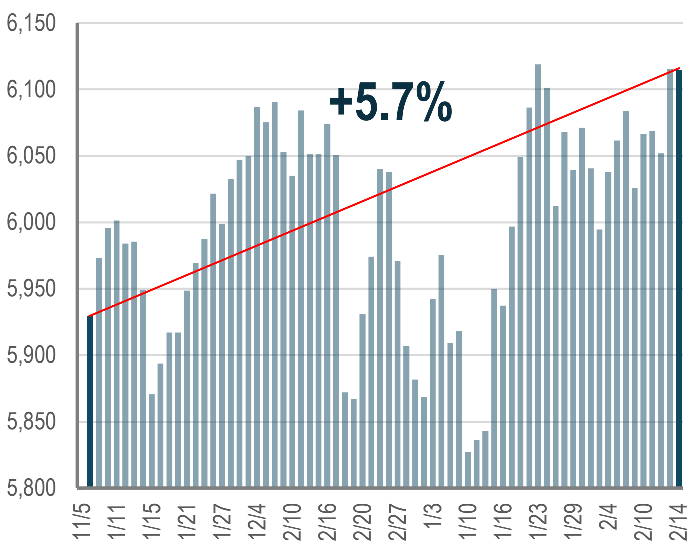
Political

As measured by the S&P 500, equity markets are +5.7% higher as of Friday's close compared to the November 5, 2025, election day. Immediately following Trump's relatively unexpected win, markets levitated. But since Thanksgiving, they have been mostly flat.

S&P 500 Daily Levels

November 5, 2024 - February 15, 2025, 2024

(Source: Bloomberg)



While markets have been relatively sanguine since the election, most news feeds have been aflutter with talking heads decrying the end of democracy in the face of Trump's "Wack-a-Mole" policy rollout. While we attempt to be politically agnostic, the irony of hysterical declarations about the end of democracy, when a new president is pursuing the precise path promised in his campaigns, seems at least disingenuous. Arthur Schlesinger, one of the finest historians of the last century, referred to the increase in power of the president over time as "the imperial presidency." Richard Nixon's administration is considered to have opened the gate to a dramatically more powerful executive branch. Still, every president since Nixon has enjoined and coopted the trend that an increasingly powerful executive branch can use its rule-making powers to legislate and implement its policies.

In substance, Trump is hardly different than previous presidents. In form, he is a force to be reckoned with. Few can or ever will match his odd stagecraft. However, for Trump, this time, this administration is different. The first time he was elected to the highest office in the land, he seemed a bit befuddled by how to operate in an environment that didn't jump to meet his every command. It took him a while to get a cabinet and implement his policies. This time is different. Every day heralds another pronouncement designed to belittle, bemuse, and benefit. It's impressive, if not unnerving, to watch. However, the country, economy, and financial markets are very different today than in 2017, at the beginning of his first term as president. Exactly how different is evident in the table data below from the inauguration day of his first and second terms.

Data Snapshot

	1/20/17	1/20/25
S&P 500 PE	19.6	25.1
Nasdaq PE	25.0	35.9
Nasdaq 100	21.8	33.5
Govt Bond Yield	2.5%	4.6%
Inflation	2.5%	3.0%
Fed Interest Rate	0.8%	4.5%
GDP Growth	3.0%	2.5%
Savings Rate	5.3%	3.8%
Unemployment Rete	4.7%	4.0%

Financial markets are resting at valuations not seen since the internet bubble. That's important because the stock market is one of the measures of Trump's success. Interest rates and inflation are higher than before. Growth is slower, and the consumer, looking for another Trumpian miracle, is stretched. We support the vast majority of Trump's initiatives and policies because we fundamentally believe they support the long-term strength and viability of the country. To fix things, they often need to be broken. This is true with companies, bureaucracies, and human hearts. But we are not naive enough not to expect considerable collateral damage in the process.

Economic

Comparing almost every metric, the US economy is the envy of the world. China and the Asian Tigers are struggling to find firm footing amid a capital hangover perpetuated by decades of spending on real estate projects that are now empty and cannot be sold. Europe's primary economic engine, Germany, is in stall mode and the early stages of recession. Russia is a basket case relying upon its supposedly embargoed oil sales to pay its bills day-to-day. Most advanced economies are domiciled within countries suffering from stifling demographic trends.

From an investment perspective, the eligible global investment destinations are the United States, Australia, and the United Kingdom. However, the future of the land down under is too tightly aligned with China for our comfort, and its capital markets are small and thin. Similarly, Great Britain is too tightly aligned with continental Europe. While America has its problems, it is still the cleanest, dirty shirt among nations. We remain exclusively invested in the United States. Since approximately 40% of the S&P 500 earnings come from outside the United States, our international exposure comes indirectly.

Market

Three critical elements form the basis for our market view going into 2025. We will track them closely and alter our positions as needed. First, equity and fixed-income

Nasdaq Free Cash Flow Yield - US Bond Yield

June 30 2003 - February 15, 2025, 2024

(Source: Bloomberg)

markets are both costly. Second, earnings expectations are based upon continuing record profit margins. Third, continued consumer willingness and ability to spend are baked into market sentiment and earnings. In this *Weekender,* we will focus on valuation among the large technology names.

Almost all valuation metrics are, broadly speaking, not just higher than average but close to or exceeding levels consistent with past investment bubbles. While using multiples to value stocks is common, another approach is to invert the multiples, turning multiples into yields. This is particularly valuable when comparing relative valuation between stocks and bonds. When the yield on the dominant risk-free investment, our government ten-year bond is subtracted from the free cash flow yield of the largest technology stocks in the United States (Nasdaq 100), stocks relative to bonds are the most expensive since the Credit Crisis.

Such extreme overvaluation justifies thinning some positions among high-flying technology stocks, and doing the same math on the S&P 500 yields a similar outcome. However, in this case, the data may be a bit deceiving. At present, the magnificent seven (Apple, Nvidia, Microsoft, Amazon, Alphabet, Meta, and Tesla) account for 62.7% of the total value of the S&P 500. Their weight in valuation is significant. Our research has identified many quality companies as portfolio substitutes for the high-flyers likely to be clocked when broader markets return to trend—a move that has already begun. From the beginning of the year, the magnificent seven are higher by 2.4% while the S&P 500 is up by 4.1%. The magnificent seven have been the motor propelling equity markets for the last two years. Not so for at least the first two months of this year.

We believe equity market valuations warrant extreme caution. The emergence of passive investing as a dominant investment, too, is paradoxically making things worse. Exchange-traded funds are indiscriminate buyers as assets under management rise, fueling overvaluation concerns. Our focus on active management does not fall victim to this overvaluation dilemma. We are reducing exposure to overvalued names in favor of some protection for expected reversion to the mean on valuations. Coincidentally, passive management has left a number of high-quality names under-owned, creating an excellent opportunity to own quality companies at reasonable prices.

Conclusion

That's it for this *Weekender*. Next week, we will examine sector valuations and propose a new allocation in that bucket. We will return to our one more thing segment in the next *Weekender.*

Disclosure Statement

Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors cannot invest directly in an index. Past performance does not guarantee future results. Investing involves risk, including loss of principal.

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