All for One

Weekender

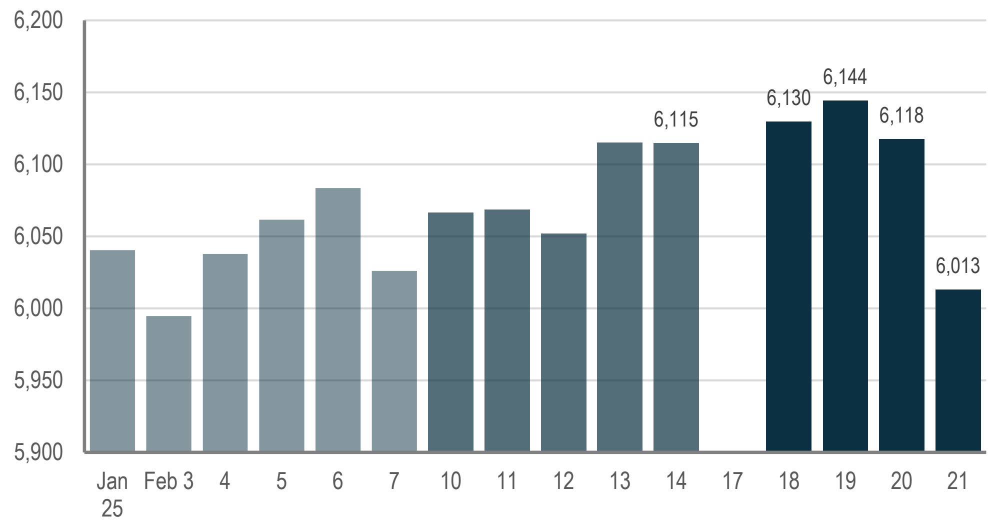
February 22, 2025

Nothing is so firmly believed as that which we least know.

Norman Vincent Peale

Good morning, and welcome to the *Weekender* for Saturday, February 22, 2025. It was a down week for most equity indices in the United States. The S&P 500 was lower by -1.7%, giving up more than last week's gain of +1.5%. Concerns about the US economy's strength were the week's primary drivers.

S&P 500 Index Levels
(Source: Bloomberg)



Interest rates and inflation remain higher than expected even a few months ago. Although much more robust than most economists expected, labor markets are no longer strengthening but beginning to soften. The purchasing manager's index (PMI) was released on Friday, suggesting that manufacturing is growing slowly, but services, which account for the vast majority of US economic output, have begun to contract. Our *House View* has been that the resilient US consumer is running low on fuel. Data being released is consistent with this view.

Walmart released earnings, and most expected them to exceed expectations. They didn't, and as a result, Walmart shares had their worst week in three years. From their earnings release on Thursday to Friday's close, Walmart shares were lower by -8.8%. Approximately 86.0% of the members of the S&P 500 have reported their year-end 2024 profits. In aggregate, it was a great year. Revenues were higher by +4.9%, while profits, driven by expanded margins, were higher by +11.8%. But most earnings reports are accompanied by only modest optimism about 2025 and beyond.

Walmart

Walmart's poor performance this week put markets on notice. As their shares fell, Wall Street analysts elbowed each other to reiterate their buy recommendations and preserve their reputations. While company management continues to expect strong profits in the future, they warned that quarterly earnings in the year ahead would decline for the first time in three years. Forward earnings softness for the company will come from slower margin expansion and conservative accounting for acquisitions, like the smart TV maker Vizio.

Financial markets, in general, and Walmart are priced for perfection. The company's pronouncements were not dire or even concerning, but they did not reflect the perfect world analysts expect and markets have priced in. The result? Markets took the company out to the woodshed.

We believe Walmart's example should be extrapolated more broadly. The company's stock trades at 35.5x the coming year's earnings estimate, almost double their average PE ratio over the past fifteen years. The average PE ratio for the S&P 500 Index from January 6th to Friday is 18.8x the coming year's earnings estimate. Approximately 62.6% of the individual members of the S&P are currently trading at valuations higher than the market average. More worrying, the top 100 most expensive stocks in the index trade at an average of 87.4x the coming year's earnings estimate. Stocks are expensive, and markets anxiously penalize those not meeting lofty expectations.

Walmart PE Ratio

May 22, 2020 - Februar 21, 2025

(Source: Bloomberg)

Sectors

Passive investing has put many individual investors in a precarious position. Indices are overvalued because large, influential securities are expensive while others are not. However, most ETFs do not discriminate on a security-by-security level but indiscriminately buy and sell all names in an index based on the flow of capital into and out of a particular ETF. We believe a passive investment strategy, now used by most financial advisors, will underperform over the coming decade.

Most sector indices are significantly overvalued compared to the more normal average period. Within almost every sector, there are attractive companies with secure growing cash flows that are not overvalued. However, investors relying on passive index diversification will significantly underperform in the coming decade. More on tis next week.

Residential Real Estate

Residential real estate is increasingly concerning. Mortgage rates are currently holding steady at 6.9% on a 30-year fixed. However, mortgages are relatively expensive compared with the recent past and the past since the credit crisis. Persistently high mortgage rates and an evaporating expectation that lower refinancing rates are just over the horizon are cooling off residential real estate, including raw property, building, and home sales. This week, data on housing starts, building permits, and mortgage applications were disappointing.

Debt, Debt, Debt

Household debt in the United States continues to hit new levels. The New York Federal Reserve released its *Quarterly Report on Household Debt and Credit*, suggesting household debt hit a 21-year high at $18.04 trillion at the end of 2024. All non-housing categories of debt, including student loans, credit cards, and auto loans, showed significant increases. While aggregate data suggests households have sufficient income to cover their debt service payments, something doesn't add up.

Delinquency rates are rising. Approximately 11.4% of credit card balances are more than 90 days delinquent. For other loans, 9.2% register the same level of delinquency. We have not seen this level of delinquency since the credit Crisis, during a deep and long-lasting recession. In collecting delinquency data, we have never seen delinquencies near this level. We have not been going into, in the middle of, or coming out of an economic recession.

One More Thing

Our democracy is based upon a fundamental principle, which has flipped upside down over the last decade. By its nature, democracy gives the majority a right to rule through votes and elected representatives. Unfortunately, as majorities rule, minorities may be, at times, ignored, or worse, subject to subjugation, repression, and abuse. The US Constitution contains individual protections for all citizens, whether majority or minority. These protections, many of which are included in a series of amendments called the *Bill of Rights,* enshrine the concept of majority rule with minority rights.

As a country, we seem more divided than ever. While division and disagreement have been both a feature and a bug of democracies worldwide, this time seems different. Minority rights are leading, while majority rule is left in the hedgerows. In short, the tail is wagging the dog.

Conclusion

That's it for this holiday shortened *Weekender*. Have a wonderful week.