Q4 2024 Commentary

January 2025

"To be true to ourselves, we must be true to others."

President Jimmy Carter

Q4 Market Recap

The S&P 500 reached new highs over 50 times in 2024, largely driven by a small subset of large cap stocks. U.S. small cap stocks also reached a new high in early December but sold off as rates moved higher into the end of the year. The U.S. economy continued to defy expectations and grew faster than many economists predicted. Foreign stocks massively underperformed U.S. stocks by the widest margin in 30 years. Short term bonds again outperformed intermediate to long-term bonds despite the Fed cutting interest rates by 1% in Q4 2024. Investment-grade credit spreads remain near 20-year lows highlighting strong fundamentals for high quality corporate borrowers. Long-term rates remain elevated, indicating that the Federal Reserve may have underestimated the risk of stubborn inflation, while a significant amount of U.S. government debt needs to be issued and/or refinanced in the coming years. Despite a sharp uptick in sentiment surveys post-election, returns were mixed for the quarter.

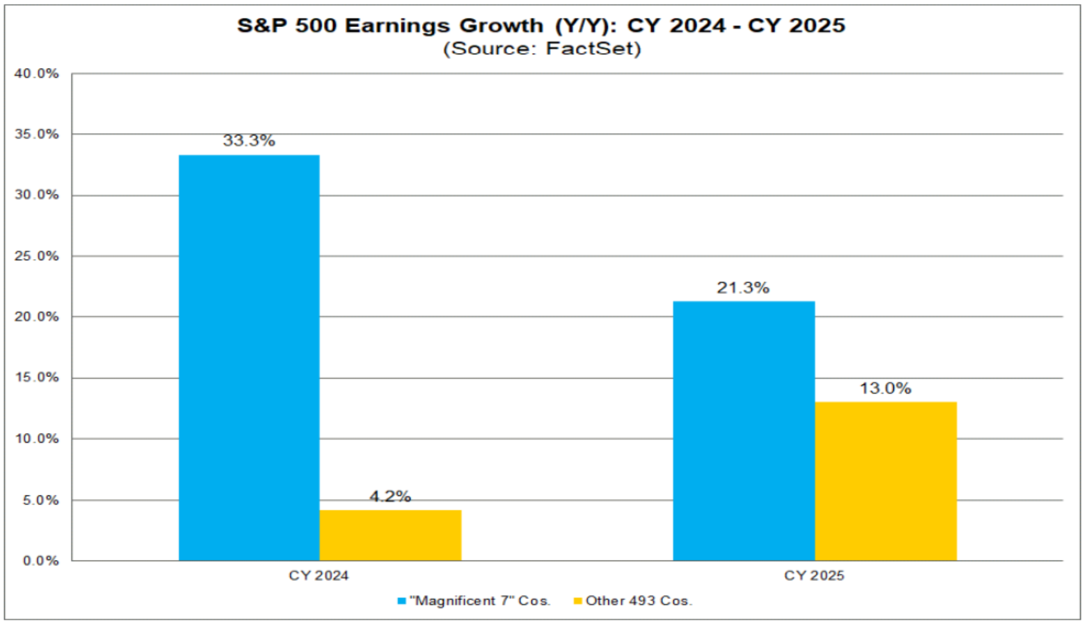
Asset Class	Benchmark	December	Q4 2024	2024
U.S. Large Cap Stocks	S&P 500 TR USD	-2.4	2.4	25.0
U.S. Small & Micro Cap	Russell 2000 TR USD	-8.3	0.3	11.5
Intl Dev Stocks	MSCI EAFE NR USD	-2.3	-8.1	3.8
Emerging Mkt Stocks	MSCI EM NR USD	-0.1	-8.0	7.5
Global Stocks	MSCI ACWI NR USD	-2.4	-1.0	17.5
U.S. Municipal Bonds	Bloomberg Municipal TR USD	-1.5	-1.2	1.1
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	-1.6	-3.1	1.3
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	-0.4	0.2	8.2
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-3.8	-8.2	-6.9
U.S. REITs	MSCI US REIT NR USD	-7.6	-6.4	7.5
Broad Commodity Futures	Bloomberg Commodity TR USD	1.0	-0.4	5.4
Energy Partnerships	Alerian MLP TR USD	-7.2	4.9	24.4
Gold	DJ Cmmdty Gold TR USD	-1.1	-0.5	26.6

Source: Morningstar as of 12/31/2024

2024 marks the second year in a row where the S&P 500 has outperformed most diversified portfolios by a meaningful margin. Many investors are questioning the virtue of diversification, suggesting AI and the expected productivity gains will continue to deliver outsized returns for large-cap technology companies. At the same time, many fixed income investors have grown disillusioned with core bonds, as short-term bonds presently offer slightly higher yields with much less interest rate risk. Using history as a guide, we strongly believe that diversified portfolios are the most valuable when they appear least desirable, i.e. now.

Optimistic for 2025

Large-cap U.S. stocks continue to trade at above average valuations, but there are many reasons investors may want to remain optimistic into 2025. Oil and gas prices are projected to remain low with production gains expected on the horizon. Lower prices at the pump have historically resulted in higher consumer confidence and spending. Analysts expect corporate earnings to grow in 2025 especially for smaller companies which may be underappreciated by the market. As the chart below shows, the earnings growth rate for the S&P 500 ex the Magnificent 7 companies is expected to triple in the coming year.[1] Additionally, profit margins are anticipated to stay near all-time highs, which bodes well for equity investors.



While enthusiasm for President Trump's U.S.-focused, pro-business agenda has spiked, there remains significant uncertainty about what legislation will actually be passed and when. Lower corporate taxes, higher tariffs and tighter labor markets by way of stricter immigration policy are projected to have stimulative and restrictive effects. Following Trump's 2016 tariffs, we saw the U.S. dollar rally versus global currencies. Approximately 40% of the revenue generated by S&P 500 companies comes from overseas.[2] Foreign currency translation for U.S companies could represent a headwind to the rosy earnings growth forecasted this year. We'll be watching closely as policy rhetoric becomes reality in the coming months.

U.S. Equity Dominance

U.S. stock markets have outperformed foreign stocks by a tremendous margin over the past 15 years. While most of these gains can be attributed to the confluence of productivity, innovation, and healthy capital markets here in the U.S., they can also be explained by multiples expansion. Investors are willing to pay a premium for U.S. corporate earnings. This leads to a few interesting observations.

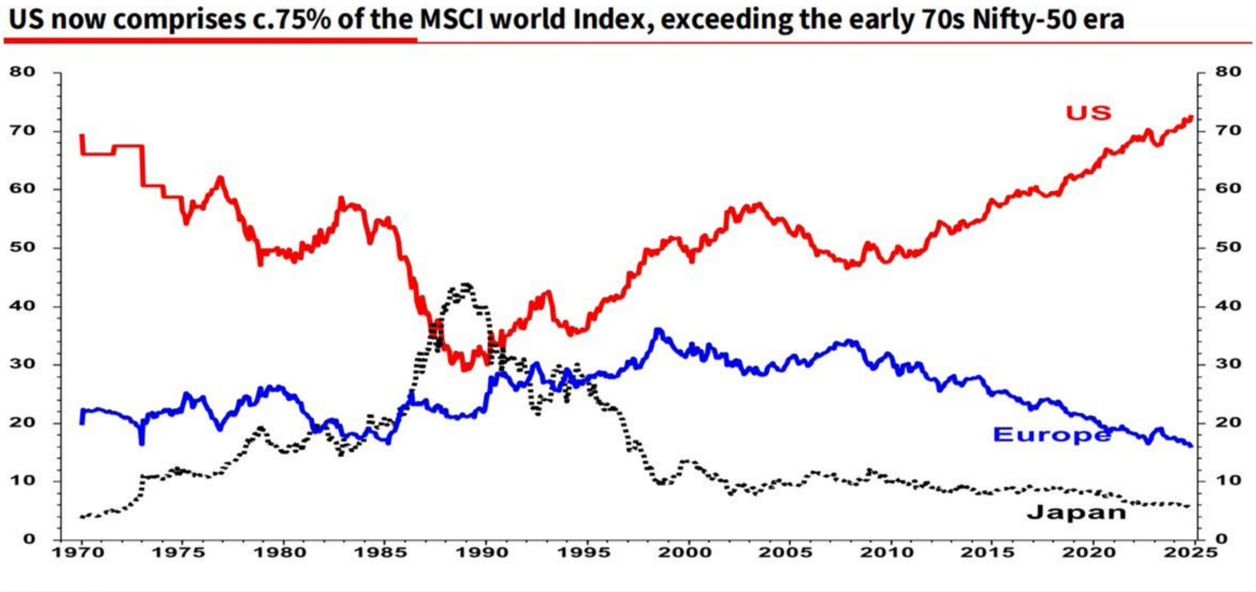
U.S. stock market capitalization relative to GDP has surpassed 200%. This ratio, also known as the Buffett Indicator, may not be perfect, but it can be used to directionally comment on stock valuations relative to economic growth. The ratio's current levels are at an all-time high, slightly higher than the ratio seen during the internet bubble.

U.S stock market dominance can also be seen when analyzing U.S. markets relative to the rest of the developed world. Illustrated by the chart on the next page, U.S. companies now comprise around 75% of the MSCI world index. While the U.S. has arguably led the global economy for at least a generation, one has

[1] Factset as of 1/3/2025. Earnings Insight. https://advantage.factset.com/

[2] Factset Insight. 11/15/2024. https://insight.factset.com/sp-500-companies-with-more-international-exposure-reporting-earnings-growth-above-10

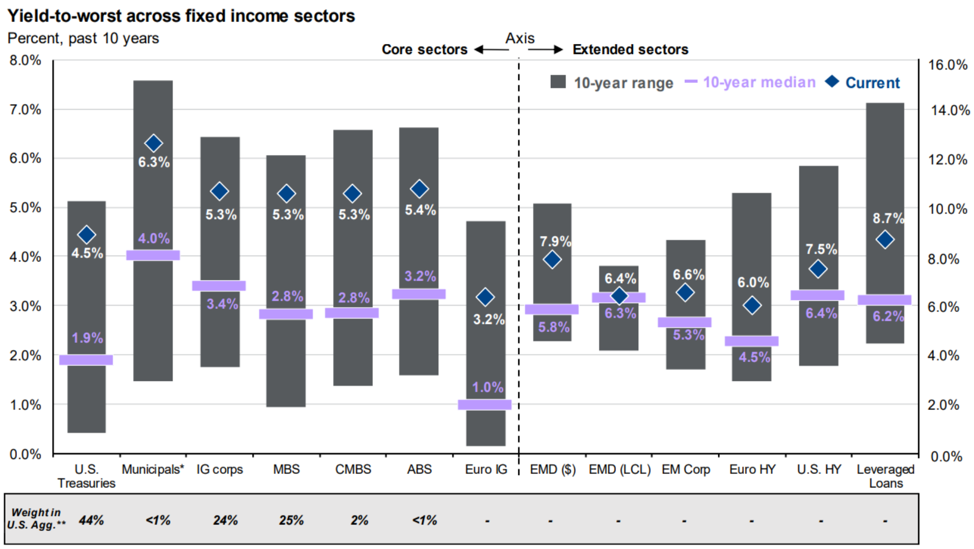
to wonder how long the trend will continue. Tempering expecations for future returns from U.S. stocks at these levels may be warranted.



Source: Datastream

Yield Curve Normalcy Good for Bond Returns

The record-long U.S. yield curve inversion finally ended in September. The Federal Reserve cut short term policy rates three times last quarter citing that significant progress has been made in lowering inflation while prioritizing a healthy labor market. Yet, FOMC members increased their expectation for economic growth and inflation over the next few years, suggesting they predict a 'higher for longer' rate environment to persist. This led to a sharp rise in longer-dated bond yields. To be sure, higher U.S. Treasury yields may also be attributable to worrisome deficit spending and the potential for President Trump's economic agenda to further stoke inflation.



Source: J.P. Morgan Guide to the Markets Q1 2025

Despite the above concerns, bond investors see the potential for positive risk-adjusted returns in core bonds. Total mutual fund bond inflows for 2024 are projected to be around +$190 billion in sharp contrast to the -$38 billion and -$541 billion outflows seen in 2022 and 2023, respectively[3]. As seen on the chart above, yields remain higher than the 10-year median for all fixed income sectors and have the potential to deliver positive real (after inflation) returns in the coming years. Municipal bonds may be appealing

[3] Investment Company Institute. 1/2/2025. https://www.ici.org/research/stats/flows

for high-income taxpayers due to the potential for high tax equivalent yields backed by strong fundamentals for municipal and local government issuers.

Parting Thoughts

As we enter 2025, now is a great time to reach out to your Private Capital Management advisor to review your portfolio and discuss any planning items that are top of mind. We continue to search for attractive risk-adjusted returns while balancing risks in client portfolios. Thank you for your business and continued trust.

Sincerely,
The Private Capital Management Team

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