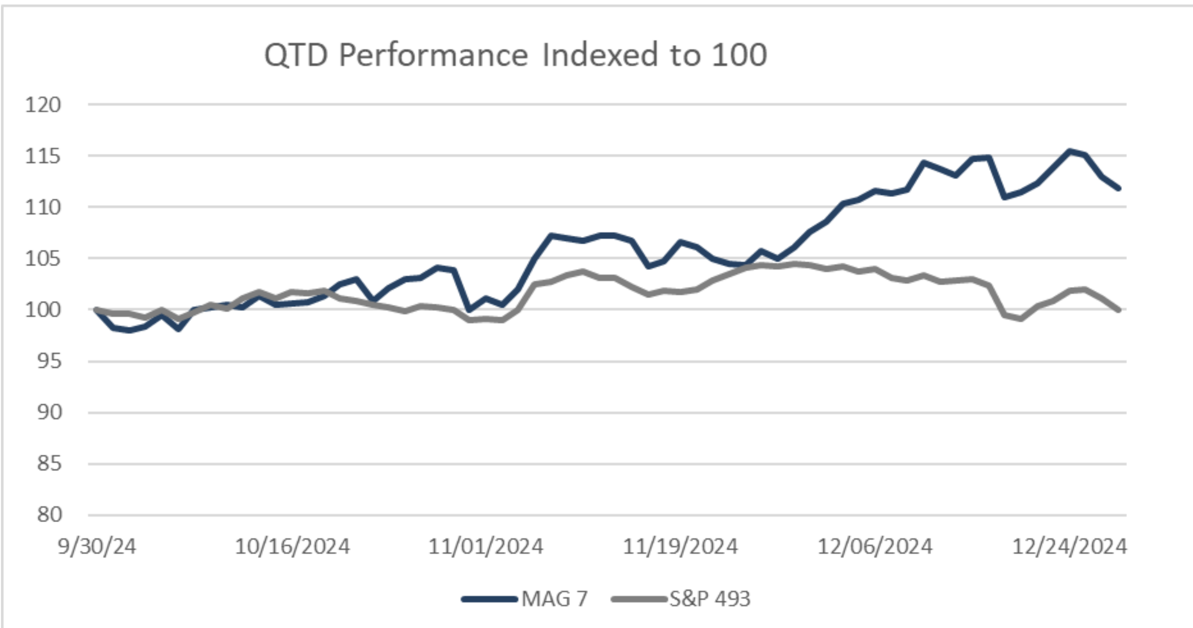
MANAGED ASSET PORTFOLIOS

MAP VIEWS

MAP QUARTERLY COMMENTARY | JANUARY 2025

Stocks posted a second consecutive year of stout advances as the Magnificent Seven (MAG 7) continued to outpace other securities. Equities, however, struggled in December as euphoria following the U.S. election wore off and prospects for lower interest rates in 2025 dimmed. Stocks suffered their largest pullback on December 18th, in response to the announcement that the Federal Reserve (the Fed) cut interest rates by twenty-five basis points and also reduced their forecast for the number of cuts in 2025 from four to two.



Source: Bloomberg

U.S. stocks outperformed their global counterparts throughout 2024 as corporate earnings showed favorable comparisons. This has been driven in large part by valuation expansion. While earnings growth in the U.S. has bested other countries, it is generally being driven by the MAG 7 rather than a full basket of securities. The S&P 500 is trading at 26.6 times earnings on a trailing basis, above the 5 and 10-year averages of 23.5 and 21.5, respectively. Only twice in the past few decades have valuations been higher, once at the peak of the dot-com bubble (we all know how that story ended) and once during the first half of 2020, as earnings collapsed as a result of the COVID-19 pandemic shutdowns. Valuations are not just stretched historically. The S&P 500 trades at a premium valuation to the MSCI ACWI ex-USA. It is also notable that the U.S. is now more expensive than India, a country that is forecast to benefit as companies seek to diversify away from China.

U.S. stocks have historically commanded premium valuations over most other countries for several reasons. The Nation's well-established democracy and rule of law, liquid and transparent markets, and perhaps most importantly, that the U.S. is home to some of the biggest and best companies in the world (particularly in the Artificial Intelligence space), have been key factors that have historically allowed U.S. stocks to command a premium to other countries. We do not see that changing anytime soon; however, we believe the delta between the two has grown too wide.

If inflation were trending to that elusive two percent target and the Fed had a long runway to cut interest rates, an argument could be made for further valuation expansion. However, core inflation remains seemingly stuck around 3%, meaning the likelihood of material interest rate cuts from the Fed is slim. The U.S. economy remains in decent shape. Recent interest rate cuts and pro-growth policies from the new administration will likely keep the economy on track. As discussed in previous thought pieces, recessions begin with unexpected events e.g., COVID-19, the bursting of the housing bubble, the tragedies of 9/11, and the bursting of the dot-com bubble). Eventually, an event will trigger a recession, but until that happens, we believe the economy can continue to chug along.

We do not find the above-mentioned Fed policy reduction from four cuts to two surprising. To be frank, we actually find it surprising that any cuts are on the table for 2025. The Fed has been saying that future actions on interest rates will be “data dependent.” What current data is supportive of lower interest rates? Unemployment numbers are modest at 4.2%. GDP has been surprising to the upside, and inflation remains fairly entrenched at an approximate 3% range. At their most recent meeting, the Fed raised its forecasts for core inflation in 2025 to 2.5% from 2.2% and in 2026 to 2.2% from 2.0% in September. It is now forecasting inflation will not reach its two percent target until 2027, six years after calling the spike in inflation “transitory.” Furthermore, regarding inflation, the Fed has altered its language indicating consumers are suffering from a price problem, not an inflation problem. Yet, prices are where they are because of inflation! In sum, their words do not exactly match their actions.

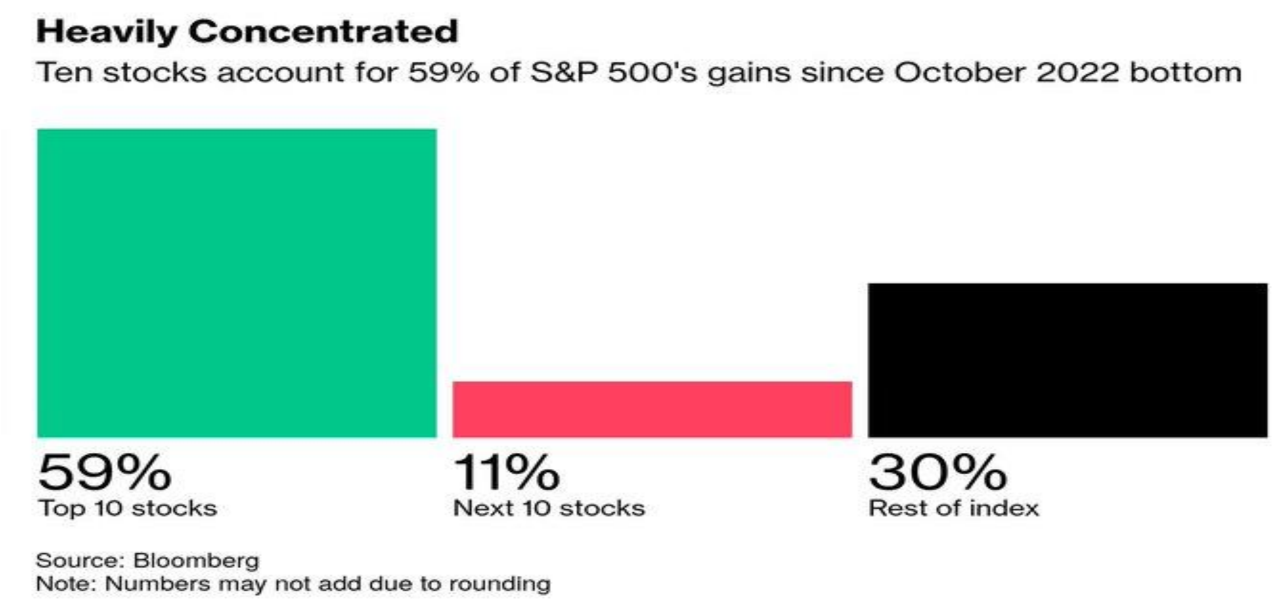
The market is responding in historic measures. The Fed has decreased rates by 100 basis points since September. At the same time, the yield on the 10-year note has increased a similar 100 basis points, increasing to its highest level since May 2024. This is the first time rates have increased following cuts since 2008, and the first time in history they have moved simultaneously. We believe the bond markets are dictating policy rather than the Fed as markets price in the potential for higher inflation and sustained GDP growth. With yields at current levels, we are reminded that this could lead to a pull-back in U.S. equity markets similar to what occurred in 2022, as yields on bonds are more attractive than the average yield on U.S. stocks. As mentioned above, we believe this may be exacerbated by the elevated valuations of the U.S. markets.

We continue to shun longer-dated bonds, as we see more risk than reward at current levels. We also continue to keep maturities relatively short.

Thank you for your enduring trust. We look forward to continuing to work with you to achieve your long-term investment goals as we seek to deliver the best risk-adjusted returns we can achieve.

MANAGED ASSET PORTFOLIOS

Later this year will mark Managed Asset Portfolios' 25th anniversary. During these years, we have seen various market environments and fads. The Fear of Missing Out (FOMO) can be a powerful and insidious force in the investment world. It leads investors to chase hot stocks or trends, often at inflated prices, simply because they fear missing out on potential gains. This emotionally-driven decision-making frequently results in poor investment choices. Instead of conducting thorough due diligence and assessing a company's fundamentals, FOMO-driven investors prioritize the fear of regret over sound investment principles. Unfortunately, we are seeing an abundance of FOMO in the investment world today. And this FOMO is being driven by a concentrated number of stocks. We caution that momentum can act like a drug to the stock market. It can work great – until it doesn't. Think of the stock market as a pendulum on a grandfather clock. When the pendulum is dead center, that represents fair value. The pendulum does not spend much time in the middle, and stocks are often either overvalued or undervalued.



Next month, we will publish a thought piece on passive investing, overviewing some concerns we have about this trend, and discussing some potential implications for the stock market.

We wish everyone a peaceful, healthy, and prosperous New Year!

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