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2025 Outlook

Executive Summary

- We ended our most recent Q3 note and election note urging investors to stay fully invested. While we are pleased with 2024 results and remain nearly fully invested, we generally grew a bit more cautious at the end of November. We discuss our reasoning below.

Cash and Bonds

While we are not long-term believers in holding significant cash, its attraction relative to other assets has grown recently. Cash invested in 3-month US Treasury bills currently yields just over 4.3%. That stands above various measures of inflation which range from 2.3-3.3%. For most of this century, cash has yielded less than inflation, burning a hole in investors' pockets, especially after taxes. The previous instances where cash yielded more than inflation (2019, 2007, 2000) were all generally opportune times to overweight cash.

This was generally the case as the Federal Reserve intentionally kept rates above inflation to cool the economy and eventually succeeded in doing so with recessions following their restrictive rates. Cash as an asset is further supported by both market and Federal Reserve expectations that future rate cuts will likely slow from here. Both the market and the Fed expected just 1-2 rate cuts in 2025 before January's strong jobs number just pushed expectations down further. This supports the "higher for longer" thesis on cash yields and should curb yield-seeking behavior elsewhere as the Fed attempts to cool inflation.

Investors seeking excess yield over cash or short-term Treasury bills, typically first look to the longer-term Treasury market. 10 and 30-year Treasury bonds yield 4.7% and 4.9% respectively, which sounds attractive relative to cash. The 10-year Treasury is in fact right at its very long-term average yield since our country's inception. This puts the 10-year term premium, or excess yield over short-term bills, near a 10-year high but still below long-term averages. Such yields in the past have typically been tightly associated with 5% per annum nominal returns. So why not lock in these higher yields now?

For one, our government continues to run some of its highest fiscal deficits on record outside of major wars and recessions. While there is some hope that the new Department of Government Efficiency (DOGE) can rein in spending, President Trump's proposed policies on paper are generally expected to widen our deficits further. While his chosen Treasury Secretary, Scott Bessent, has stated he'd like to shrink the deficit to 3% of GDP, he's also stated he'd like to issue less short-term debt and more long-term debt. This all comes at a time when some of the largest historical buyers of longer-term debt (the Fed, China and other foreign countries) have all left the building.

Second, while the Fed has helped bring inflation closer to its 2% target, there are signs and risks that it could in fact move higher from here. Inflation expectations have risen since the election with both the market and the Fed generally expecting President Trump's potential tax cuts, tariffs and immigration policy to push inflation higher. The ISM Services Prices Paid index just jumped beyond expectations to its highest reading in nearly two years in a sign that price pressures may already be building. The Los Angeles wildfires appear to be on track to be the costliest inferno in U.S. history and may lead to higher building material, housing and insurance costs for both LA and America. The bond market has sniffed out these risks and priced a good amount of this in with the 10-year bond yield jumping by over 1% from 3.6%

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in mid-September to 4.6% today. This is highly unusual behavior. Typically, 10-year yields fall when the Fed begins cutting rates as they did before the election. It is reminiscent of the second wave of inflation experienced in the late 1970s and keeps us underweight Treasuries and high-grade bonds.

Stepping out in risk, investors can part with cash and lend to corporations and particularly high yield or junk issuers, but again we see more risk than reward here. High yield spreads, or the excess yield investors receive from lending to corporations versus Uncle Sam, stand near their 21st century lows which we touched just before the Great Financial Crisis (GFC). While it is true that corporations have much stronger balance sheets and credit ratings than in the pre-GFC days, it is also true that bankruptcies in 2024 reached levels not seen since the pandemic and GFC and are inconsistent with today's tight spreads. We prefer the safe bird in hand of 4.3% cash versus other bonds for now.

US Stocks

Turning to US equities, the next step out on the risk spectrum, we've also grown a bit more cautious recently for several reasons. First, valuations are rich across almost every measure, particularly for large cap stocks. The S&P 500 price to book ratio at 5X stands near its all-time highs, which was last reached during the tech bubble. The S&P 500 price to next year's expected earnings ratio is at 21.5X; levels not seen since 2021 and 2000 ahead of two subsequent bear markets. The S&P earnings yield, or the inverse of the price to earnings ratio, relative to 10-Year Treasury yield also just turned negative for the first time since the tech bubble.

These valuations are buoyed currently by a heightened level of enthusiasm which also raises our caution. Baked into the S&P 500's forward earnings projections are analyst expectations that the S&P 500 can grow profits by roughly 14% this year and next while maintaining near-record level profit margins. This type of earnings growth may be possible and certainly has been achieved in the past but would be two times stronger than the average historical earnings growth rate for this century. And while profit margins have indeed expanded significantly this century, much of this came from falling interest rates which seem to be reversing or at least stalling.

Investors are also quite enthusiastic heading into 2025. The median American household has more wealth invested in the stock market than ever before by a wide margin. More investors than ever expect the stock market to be higher by year end. The record growth in zero-day option activity, ETF launches and specifically option-based and leveraged single stock ETFs continue to provide ample speculative opportunities for enthusiastic investors. Investor enthusiasm for Artificial Intelligence (AI) stocks has pushed the weight of the top 10 S&P stocks to levels not seen since the Dot Com bubble. A near record low percentage of S&P 500 stocks outpaced the index in both 2023 and 2024, levels we have not seen since just ahead of the tech bubble in 1998 and 1999.

Given this backdrop, we took a few chips off the table at the end of 2024 but remain just underweight our US equity targets and still do see some reasons and areas for optimism. First, small and mid-cap US shares and even most S&P 500 stocks outside of the largest ten names remain reasonably priced. The equal weighted S&P 500, the mid-cap S&P 400 and the small-cap S&P 600 all trade close to their 20-year averages in terms of price to earnings. Also, after two consecutive years of weak relative earnings growth, small and mid-cap earnings are expected to outgrow large cap earnings in 2025.

Finally, while both potential tariffs and international woes are a concern heading into 2025, small and mid-cap shares generally are more exposed to the US consumer which broadly is in strong shape. The US household debt-to-asset ratio recently touched a 50-year low. The average homeowner still has a 4% mortgage rate. Credit card balances as a share of disposable income also stand near record lows. It is true that some people are struggling. Credit card defaults are approaching GFC levels with the average interest rate on credit cards still near record levels. However, we did just see consumers responding to these rates by paying down credit card balances by $7.5B in November alone.

Supporting the consumer is a strong and potentially accelerating job market. In January 2025 alone, we've seen unemployment decline, job openings jump and the US nonfarm payrolls surprise to the upside. This is at a time where productivity rose 2% in Q3 for the fifth straight quarter of strong 2+% productivity gains. While there is some concern that AI may lead to job destruction, we are seeing the opposite for now. Small business optimism just reached a 7-year high. The share of small business owners that believe it is a good time to expand their business just touched its post-pandemic highs. High-propensity business applications, or applications highly likely to lead to new jobs, also jumped in November to 50% above the levels seen pre-pandemic. Perhaps DOGE and AI will add new jobs.

International Stocks

Turning outside of the US, international stocks and particularly European and Chinese stocks continue to diverge significantly from their US peers. Whereas valuations are on the extreme rich side in America, valuations are roughly average in Europe and well below average in China and the UK. Whereas sentiment is ebullient in the US, sentiment internationally is at levels not seen since the pandemic. While we are typically attracted to cheap valuations and dour sentiment, we remain slightly underweight our international targets as we continue to see these stocks as cheap for good reasons. While the specter of tariffs hangs over international stocks, much of the pain is self-inflicted.

Five US allies representing nearly a third of the international stock market are in crisis mode. South Korea is on edge not just from an increasingly hostile North Korea and a devastating plane crash, but mainly due to internal strife. The country will begin its own impeachment trial of President Yoon Suk Yeol after his failed attempt to declare martial law. Yoon's approval rating was just 25% before he attempted enacting martial law as South Koreans grew frustrated with both inflation and crony capitalism. In Canada, Prime Minister Justin Trudeau announced his resignation as he faced criticism for high inflation and mounting fiscal deficits. The United Kingdom is potentially facing another "Truss moment". Rising inflation and continued fiscal deficits have pushed UK bond yields to multi-decade highs and the pound back toward multi-decade lows against the dollar. France's government similarly lost a no-confidence vote and just ushered in a new government. Again, both voters and investors questioned fiscal deficits and pushed bond yields toward their multi-decade highs. German Chancellor Olaf Scholz also lost a confidence vote with the government collapsing as its economy continues to stagnate. This keeps us underweight international shares and should be a warning for US policymakers. For now, the US remains the cleanest dirty sheet, but we must be vigilant on deficits and cronyism.

Outside of our allies, China the world's second largest economy, is also in crisis mode. Unlike the rest of the world, China has seen declining bond yields with its 30-year bond yield recently dipping below Japan's perennially low yields. China is suffering from many of the afflictions that burst Japan's bubble in the 1980s- demographics, deflation and debt. Whereas Japan had strong allies and a relatively free market to

somewhat lessen the pain of several lost decades, China lacks both. On the international relations front, China faces rising tensions with the US and the specter of tariffs. Meanwhile its relations with Europe have deteriorated as we've seen rising allegations of undersea cable cutting, continued collusion with Russia and a record number of naval exercises around Taiwan. On the economic front, China seems to be stepping further away from open markets- suspending data on external capital flows and sending failed venture capitalists to modern-day version of debtor's prisons. In sum, while we are attracted to low valuations and dour sentiment abroad, we remain underweight here.

Alternative Assets

Wrapping up with alternative assets, we see a mix of risks and opportunities as always.

In the hedge fund space, we've grown a bit more optimistic for the first time in years. While we remain skeptical of the high fees and limited liquidity, we think a highly selective roster of a handful of managers can add value to the asset classes above. The world seems to be coming around to our hedge fund skepticism. In 2024, the fewest number of hedge funds opened this century. This waning appetite leaves more high-quality opportunities available to discerning investors. In a world where there is a strong potential and numerous examples of equities and bonds falling in price together, truly uncorrelated hedge funds that can earn a good premium over cash yields while "making money no matter what" will find their way into our portfolios. On the more directional side, the myopic focus of the markets on a handful of perceived AI winners has left room for long/short equity specialists to find value and add diversity to heavily concentrated liquid portfolios.

In real estate, while we are seeing opportunities, we are proceeding with added caution and selectivity. Liquid real estate stocks, although cheap, have recently traded like bonds on steroids. To wit, in Q3 when the bond market rallied 5%, liquid real estate stocks jumped 16%. In Q4 when the bond market reversed, losing -3%, liquid real estate stocks dropped nearly -10%. That's 3X leverage to bonds and provides little diversification for investors. We've also seen more real estate managers opining on the Federal Reserve and 10-year rates. In our experience this is a difficult to near impossible game to play and we are not interested in hiring real estate investors for their interest rate forecasts. We have, however, studied the booming data center space considerably and made a few investments recently. We've focused on power-secured, pre-specified and pre-leased developments that we expect to complete shortly while demand is still well above supply.

In private equity and venture capital, we expect 2024 to be a largely disappointing year for investors with capital in the ground. Like real estate, we've seen more venture managers than ever forecasting (or perhaps more appropriately hoping) for a return to low interest rates earlier this century. Private equity investors overall missed much of the strong rally we've seen in public markets in 2023 and 2024 with IPOs slowing to a trickle. We expect IPOs, exits and returns to pick up in 2025, but reiterate the importance of patience and discipline in private markets. Private capital has its owns booms and busts. Vintage year diversification, digging holes across time, is key to both limited and general partners. Too many venture capitalists put too much money to work in 2021 and too little to work thereafter. We've also seen AI enthusiasm overwhelm the venture space. AI start ups account for nearly a quarter of first-time venture investments and AI firms are hoovering in the majority of venture capital dollars. We think it will pay to move against the grain here and continue to be patient and disciplined.

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Finishing with real assets, we continue to see strong opportunities. We've heard a lot about the different layers of AI, the search for the killer app, but hear very little about the power needed to run AI. We recently made a targeted investment here and were pleased to see Constellation Energy shares jumping after they announced a similar deal in that space. We continue to hold some gold and see it as a diversifier against rising inflation, deficits and distrust. Commodities were one of the few assets that performed well in 2022 when both bonds and stocks suffered, and we continue to find opportunities.

Conclusion

We enter 2025 just a bit more cautiously than we entered 2024. We are thankful for the strong returns delivered in 2024, but view rich valuations, heightened enthusiasm and rising geopolitical risks with a heightened sense of caution. We are also, as always, thankful for your trust in us to manage your capital. We take our work very seriously and will continue to scour the globe for both risks and opportunities. We wish everyone a prosperous and healthy new year and our thoughts are with LA.

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