



Quarterly Recap – December 31st, 2024

The fourth quarter marked the end of an eventful year. Domestic stocks made new all-time highs, and the S&P 500 has notched rare back-to-back 20%+ returns. The bond market struggled to end the year but was still slightly positive overall. The Federal Reserve continued cutting rates, lowering them by half a percent to 4.5%.ⁱ

Equity markets were driven by three narratives during the quarter. Stocks traded dramatically higher following the election, due to policy optimism as well as the successful avoidance of a “worst case” scenario of a contested outcome. Big Tech continued to power higher despite higher interest rates, dragging the indexes with them, but leaving the majority of stocks behind. Finally, a dramatically higher dollar exchange rate hurt foreign stocks, which had already been struggling relative to US stocks.

Bond markets took a puzzling turn to end the year. As the Fed cut rates, yields turned markedly higher and long-term yields are now at their highs for the year. The Fed has cut rates by 1%; meanwhile the ten-year yield has gone 1% higher. It is unusual for rate cuts to result in broadly higher yields.

The developments in the bond market are prompting investors to question the Federal Reserve’s decision to lower interest rates. The first rate cut was half a percent in September, which was in response to perceived deterioration in the labor market. Specifically, the Sahm Rule had been triggered, which historically has portended recessions. The Sahm Rule untriggered in the fourth quarter, and other economic data points indicate broad economic strength. Most importantly, inflation has stabilized higher than the Fed’s 2% target. The bond market seems to be questioning the Fed’s decision and might be indicating that the rate cuts were premature or unneeded.

We remain bullish for both stock and bond markets. The incoming administration promises to be pro-business with the possibility of tax cuts, deregulation, and increased merger activity. Much different from 2016, the new Trump administration has a diverse group of businessmen as advisors. The bond market may remain challenged if the rate-cutting stops, but currently rewards investors with enough yield to happily own them regardless. The economy remains strong and has proven its ability to handle higher interest rates. Risks remain, especially abroad, where the economic picture is less rosy. But despite all-time highs, upside remains for the vast majority of stocks who have not participated in the AI-driven rally. The next few months promise to be interesting.

INDEX RETURNS ⁱⁱ	4 th Qtr	2024	2023
MSCI All Country World	0.4%	19.2%	24.4%
S&P 500	3.0%	25.0%	26.3%
Dow Jones Industrial	0.9%	15.0%	16.2%
Russell 2000	1.5%	11.5%	16.9%
EAFE	-7.6%	4.4%	19.0%
MSCI Emerging Markets	-8.3%	8.0%	10.2%
BC Aggregate Bond Index	-3.4%	1.3%	5.5%

TREASURY RATES	12/31/24
Fed Funds	4.38%
3 Month	4.19%
2 Year	4.24%
5 Year	4.38 %
10 Year	4.57%
20 Year	4.86%
30 Year	4.78%

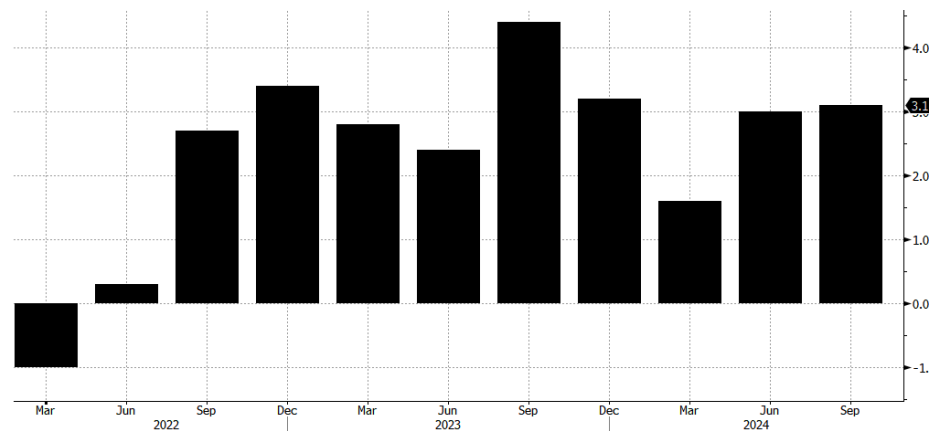
Economic Developments

General economic conditions remain strong in the US. GDP for the fourth quarter is currently projected to be 2.6% by the Atlanta Fed's GDPNow tracker.ⁱⁱⁱ As you can see in the chart below, GDP has been growing at a strong clip for several years now.

While we acknowledge the aggregate economic strength in the data, it's clear that many feel "left behind." Compounding inflation over the last few years is the dominant reason why, leaving prices 22% higher than in February of 2020.^v And while inflation has come down from

its extreme levels, it remains stuck around 3%. The bulk of this inflation is now coming from shelter prices, which continue to rise despite high mortgage rates. A large portion of the country lives paycheck to paycheck and owns few hard assets. A rising stock market, high money market interest rates, and a robust housing market doesn't benefit these people one bit. For this reason, many are referring to the economic strength as a "K-shaped" recovery (some households doing quite well – going up – while others are falling behind – going down).

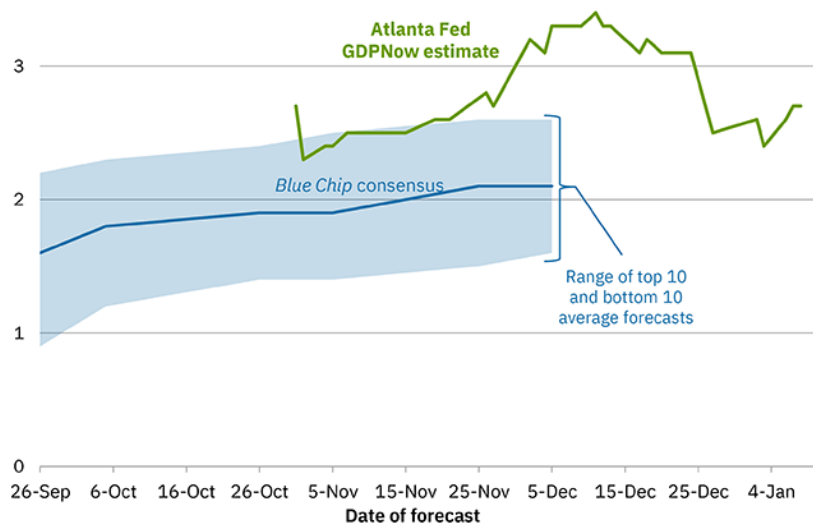
At the end of September there was some concern about the labor market. The Sahm Rule had recently triggered, which had a perfect track record of identifying recessions in their



GDP growth has been around 3% for the past 2 years.^{vi}

would be a red herring, caused by idiosyncrasies from the pandemic reopening and historic levels of immigration rather than inherent weakness. Data since then has shown this to be accurate, as the Sahm rule went back below its threshold and labor markets continue to be strong.

Evolution of Atlanta Fed GDPNow real GDP estimate for 2024: Q4
Quarterly percent change (SAAR)



The Atlanta Fed's GDPNow projects that 2024 wrapped up with another quarter of solid growth.^{iv}

early stages. The rule says that we are in a recession if the three-month moving average of the unemployment rate ticks half a percent above the low from the previous twelve months. Early this year we warned that this would happen and that we thought it

Inflation is still a central concern for consumers and policymakers. Progress has been made in reining in inflation, but it seems to have found a consistent level at roughly 3%, above the Fed's official target of 2%. Inflation break-evens are a good way to gauge general sentiment around inflation. It's a way to calculate inflation expectations based on the price differences between several different types of bonds. This measure shows that investors expect the mildly inflationary environment to persist for at least the next few years.

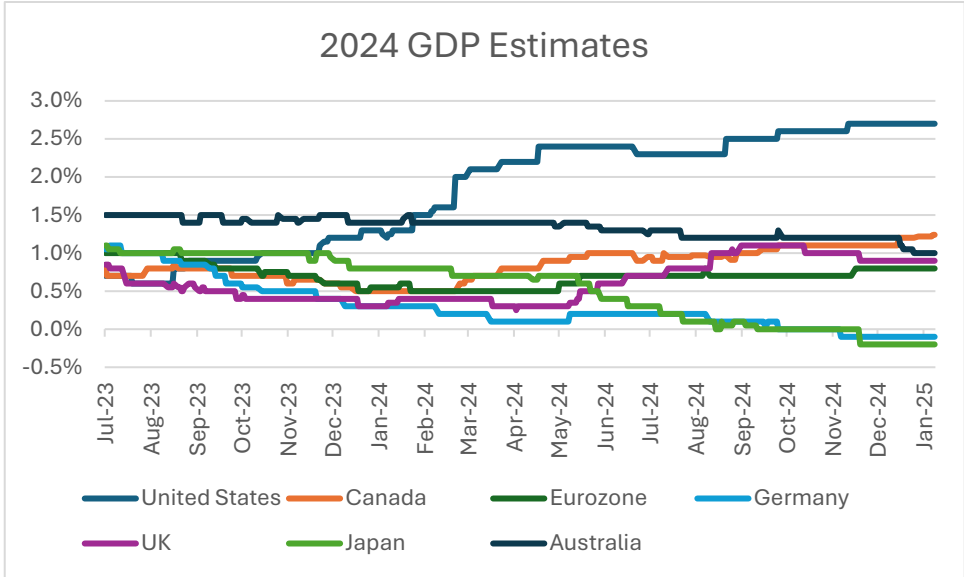


Inflation expectations are lower than 2022, but still elevated from where they were pre-pandemic.^{vii}

We believe the economic impact of elections is often overstated. It's simply very difficult to create meaningful change with the checks and balances that are in place especially with an often-divided and hyper-partisan Congress. The most recent meaningful change might have been as far back as Obama's first term when healthcare was reshaped, requiring enormous amounts of political capital. The incoming Trump administration promises to test whether larger changes to the status quo are possible.

We were dubious that a Trump or Harris win would mean much to markets, but a popular vote win and a sweep of the swing states give Trump a larger mandate than anyone expected, for better or for worse. We are already seeing a dramatically different approach to his inauguration than we did in 2016. World leaders and important executives are treating Mar-a-Lago like the White House, trying to get in his good graces before he starts his term. These same people were openly hostile in 2016. While Canada's Trudeau was looking at embarrassingly low approval numbers already, it's possible that Trump's remarks to the press and social media were what recently caused him to resign, before Trump even took office. With cooperation rather than opposition, a US economy that is vastly outperforming the rest of the world, and a voter mandate for his agenda, Trump is arguably stepping into office as the most powerful person in modern history. With it being his second term, he doesn't even have to worry about reelection.

In 2016 journalist Salena Zito made the prescient observation that one should "take Trump seriously, but not literally."^{viii} You could argue that this message is the major takeaway from his book "Art of the Deal." We have seen him use this messaging countless times already. After all, Mexico never came close to paying for the border wall themselves.



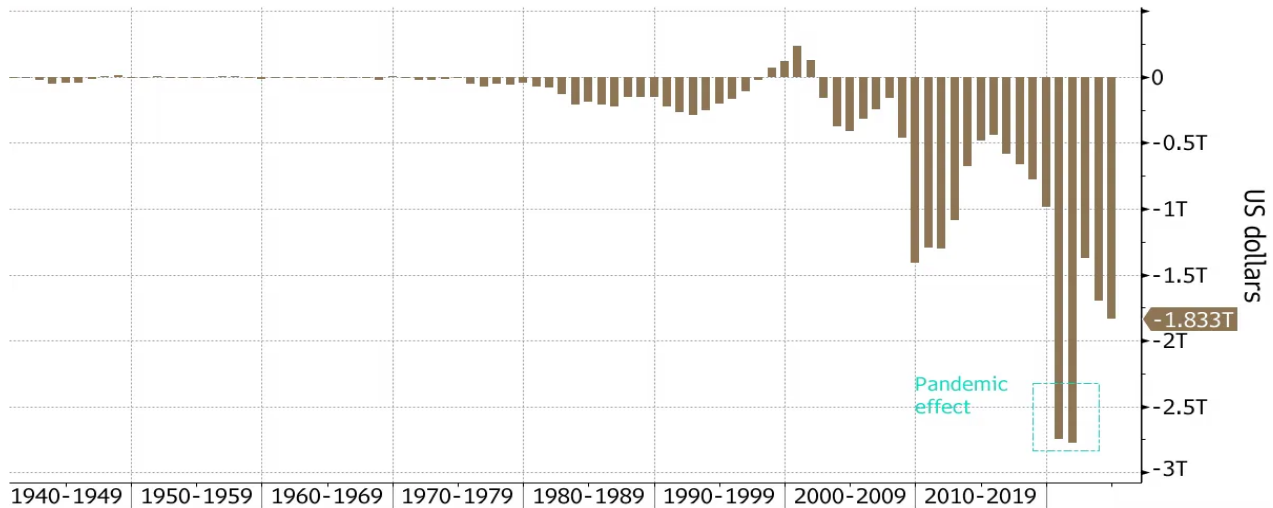
The United States' economy outperformed in 2024, while other developed nations languished or deteriorated.^x

Because Trump's made so many outrageous statements, it is difficult to forecast what will actually come to pass. We are generally reticent to comment much about politics, but many of these policies could have material economic consequences. We will largely have to "wait and see." We believe Trump's ability and willingness to enact parts of his

agenda is undoubtedly a risk for 2025, as he's able to implement changes at home that are dramatically different from the status quo and bully other countries with economic sanctions. Most of the world is in tough economic straits, with China and Germany perhaps the most notable. It might not take much to tip them into recession, which would undoubtedly affect the United States as well.

We will be monitoring the following policy matters, and their likely impact on markets, listed below in no particular order. We've also included our best guess for the outcomes.

- **Tariffs** – Are they a negotiating tool, or a serious threat? We think there will ultimately be some tariffs enacted, but it is mostly a threat used to get policy concessions. Regardless, it's important to know that the media often discusses these in an ignorant and/or dishonest manner. A 25% tariff doesn't mean the consumer pays 25% more. It will probably be much less than that.



The Federal Deficit has ballooned. But neither presidential candidate made it a big campaign issue.^x

- **Immigration** – How much will deportations affect the labor market? We think any talk of “mass deportations” is a pipe dream, as the media would stoke public outrage. It’s much more likely that we see selective deportations of the most obviously undesirable migrants and a closure of the border.
- **The Deficit** – How effective can the Department of Government Efficiency (DOGE) be? We think it’s unrealistic to expect much from this much-needed effort, as it only has an eighteen-month lifespan. We are hopeful that it can bring awareness to government bloat and excesses – awareness that might turn into a longer-term demand for fiscal responsibility. However, a sudden curtailment of government spending is another under-appreciated risk for markets.
- **Business** – How business-friendly will Trump be? We think he’s very likely to extend his tax cuts and continue to generally deregulate. We also think he’ll be more friendly to merger activity – a welcome change for the “tech-right” portion of his contingency.
- **Foreign Policy** – Will Trump be able to end the conflicts in Ukraine and Gaza? We are optimistic that a change in approach will at least bring a brokered resolution to the Ukraine war. He’s also taking a firm stance for Hamas to return the hostages, which could result in escalation. Trump is unlikely to solve either conflict on “Day 1,” but there’s undoubtedly already conversations happening behind the scenes.
- **The Dollar** – How might the above issues contribute to the US Dollar’s strength? The Dollar has already seen a dramatic repricing in the wake of Trump’s electoral win. Economic growth and trade policy decisions could pressure the Dollar higher, while inflation and general uncertainty could have the opposite effect. We expect Dollar strength to continue, but acknowledge substantial uncertainty and possible volatility on this issue.



The Dollar Index relentlessly climbed in value throughout the fourth quarter.^{xi}

Preserve – Interest Rate Commentary

When we last wrote, the Federal Reserve had recently begun the much-anticipated cutting of interest rates to try and get back to a “normalized” level. After more than a year of no movement, they decided to cut fifty basis points in September, a decision that left us scratching our heads because of how aggressive it was. Some investors pointed to the Sahm Rule as the reason. Others thought that it was “catching up” because the Fed didn’t cut in July but had

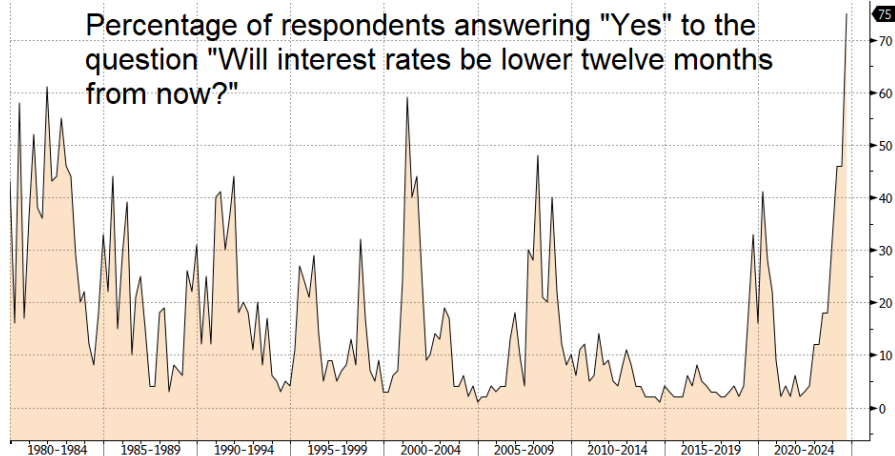
regrets. Our theory is that the Fed was split on whether to cut slightly, or aggressively, and went with the option that would create the fewest dissenting votes. (This was the first time in years that a vote was *not* 12-0, but rather 11-1.)

Regardless of why Powell chose that option, it had an unfortunate second order consequence. Cutting by fifty basis points, signaling two more by year end, and then another four in 2025 is forecasting a lot of policy decisions. If that level of dovishness (willingness to lower interest rates) was not called for, it would take an awful lot of economic data to be able to justify changing the policy.

It's now three months later, and the Fed delivered those two other rate cuts in 2024 The Federal Funds Rate has fallen 1% in just three months. So let's check in on how other interest rates have reacted. You have to imagine investors are happy to get some relief! Right?

Oof. Since the Fed began lowering rates in September, the ten-year yield rallied 1% and the two-year has rallied .65%. The only time rates have rallied *more* than this in response to a rate cut was in 1974.

Investors are trying to figure out how to interpret this contradictory move. The Fed is lowering rates, and in response rates are generally moving higher across the board? The Fed has been asked about this and given largely unsatisfactory explanations. We think (and we are not alone in this assessment) that the market is pushing back against the Fed. The economy doesn't need additional rate cuts; the labor markets bounced back from their summer swoon and inflation is still an issue. If the Fed isn't serious about getting inflation under control when the economy is doing well, why would anyone want to own long-duration bonds? The reaction to the rate cut in December was especially enlightening. The longer Powell took questions and justified the rate cut, the more yields rose. Market analyst Jim Bianco gave perhaps the pithiest summary of the press conference: "The



From last quarter's newsletter: The public was sort of correct, the Fed lowered rates. And this caused all the other interest rates to rise!^{xii}



The ten-year yield has moved higher after the Fed started cutting rates.^{xiv}

The Fed made the case for a rate hike, then they cut.^{xiii}

While the moves have been peculiar, they have brought some semblance of normalcy to the yield curve, which had been inverted for more than two years. (An inverted yield curve is abnormal and results from short-term yields being higher than long-term

yields. It's typically a signal or proximate cause of a recession.) The cut of half of a percent in September resulted in both two-year yields and ten-year yields moving higher. But after the December rate cut, the two-year yield remained where it

“These things (rising ten-year and mortgage rates) don’t really have mainly to do with Fed policy, but [rather] to do with other factors in the economy.”

-Federal Reserve Chairman Jerome Powell, commenting on rising rates in November

was – now essentially inline with where the Fed Funds Rate is – and the ten-year moved even higher. Ten-year yields are now nearly forty basis points higher than two-year yields. This is arguably a good thing, because an “upwards sloping” yield curve could also be a signal of economic strength and has positive effects on the economy. (e.g. It’s now profitable for banks to borrow from the short-term end of the yield curve and lend at the long-term end, which is stimulative to the economy). If inflation does start to move lower again, it’s possible that the Federal Reserve has normalized interest rates and inflation without putting the economy into recession.



The ten-year yield has been lower than the two-year yield since 2022, the longest stretch ever!^{xv}

Fortunately, there’s no evidence that the rise in yields is causing systemic issues – and that makes sense, because rates were at these levels just over a year ago. This isn’t to say that the situation could not change; rates hitting 5.5% or 6% would certainly merit attention. But we think that worries at current levels are not called for, and the Fed still has time to change their approach if rates continue to rise.

When the Fed began cutting rates in September, the “Dot Plot” from their Summary of Economic Projections showed that they expected two more cuts in 2024 and another four in 2025. As they often do, investors took this projection and ran with it, at one point pricing in more than six rate cuts (1.5%) in 2025, which would put the Fed Funds Rate below 3%. The Dot Plot released in December threw cold water on those expectations, with the Fed reducing their expectations to just two rate cuts in 2025. Simultaneously, the Fed raised its projection for 2025 GDP, lowered its projection for the 2025 unemployment rate, increased its projection for inflation, and increased its projection for longer-run interest rates.^{xvi} Everything pointed to a

better economy and more-worrisome inflation, but nevertheless they cut interest rates as they originally forecasted that they would. For an entity that pledges to be “data-dependent,” they consistently find reasons to ignore data that would give them reasons to be hawkish.

With strong economic data continuing to be released,

investors have dramatically curtailed their expectations for rate cuts in 2025. Instead of expecting six cuts in 2025 – a cut at nearly every meeting – investors now expect just one, and probably not until June or later. Pushing back against rate cut expectations has served us well. At one point markets thought we would see as many as eight rate cuts in 2024, and we only got four. And even that might have been too many.

If the strong data continues, it will be difficult to justify cutting any further, especially if the ten-year yield stays elevated. We think it’s very possible that we’ve seen the last of the rate cuts, and the Fed might even start raising rates before the end of 2025. Powell was asked about this possibility during his December press conference and refused to rule it out, though he described it as unlikely. There’s a wide range of possibilities, and the Dot Plot shows that there are a wide range of opinions at the Federal Reserve. Four contributors disagreed with the cut in December. One contributor sees no cuts coming in 2025 while one sees as many as five. And the “longer-run” neutral interest rate could be anywhere from 2.25% to 4% according to different Fed officials. (The “longer-run” interest rate is the theoretical level at which Fed policy is neither stimulative nor restrictive.)^{xvii}

Though he originally appointed Powell, President-elect Donald Trump has been critical of Powell’s decisions during both his own presidency and Biden’s. Trump wanted lower interest rates during his first term, criticized Powell for lowering interest rates before the most recent election, and would like to see interest rates lower than this during his second term. Trump has stated that he will not reappoint Powell when his term is up in May of 2026. Powell has stated he won’t resign, so there is a chance that Trump will nominate his replacement preemptively. If he does, this will further muddy the outlook for interest rates, as any statement by the “shadow chairman” will be scrutinized

for future policy implications.

The position of Federal Reserve Chairman has been growing more politicized over the past decade. An emboldened Trump with a fresh appointee is likely to be more responsive to political demands than anyone ever before.

“We’ve had a year-end projection for inflation and it’s kind of fallen apart.”

“The economy is strong overall... The labor market has cooled from its formerly overheated state and remains solid.”

“Economy activity has continued to expand at a solid pace.”

-Federal Reserve Chairman Jerome Powell, justifying cutting rates in December

“It’s [Fed Chairman] the easiest job in the world. You show up to the office once a month and you say, ‘Let’s see,’ [and] flip a coin. And everybody talks about you like you’re a god. ‘Oh, what will [Powell] do?’”

-President-elect Donald Trump commenting on Federal Reserve Chairman Jerome Powell, October 16th, 2024

Earn – Bond Market Commentary

The bond market performed poorly to close out the year. The Bloomberg Aggregate Index made its high for the year in September, shortly before the Federal Reserve began cutting

rates. As longer-term yields rose through the quarter, bond prices moved lower. The index returned just 1.25% in 2024, worse than a risk-free money market return of ~5%.

It's notable, however, that returns were positive despite the ten-year yield rising more than half a percentage point during the year. Whereas when interest rates rose half a percent for the first time in early 2022, it resulted in a 4% decline. This is the power of having a higher interest rate – it cushions the blow from a rise in interest.

This has been the worst three-year period for the bond market in 180 years. So it's understandable for investors to look skeptically at it going forward. Money market rates are high, and returns from other investments have been impressive. In the typical "60/40 portfolio," bonds are supposed to perform well when stocks fall. This has not been the case in the post-pandemic period, as stocks and bonds have become more correlated. Nevertheless, it's worth considering that 2024 was a "bad year" for bonds but they were still positive for the year. That is not the case for most asset classes during a "bad year." Money markets have been attractive as interest rates rose, but with rates now falling they no longer promise the same generous amount of interest into perpetuity. With an upward-sloping yield curve and the ten-year yield near the highest level since 2008, we think that the prospects for longer-term bonds are positive. It's possible that yields rise further, which would be a mild headwind, but you're now compensated with a generous yield and lower volatility compared to alternatives.

While long-duration bonds with minimal credit risk fared poorly both for the quarter and year, short-duration bonds and those with substantial credit risk did very well. Investments such as high-yield bonds, preferred stock, private credit, and senior loans all benefited from the strong economy and narrowing spreads. Investors have benefited from the high interest rates without suffering many defaults on these investments.



Falling high yield spreads show investors' comfort with credit risk and hunger for yield.^{xviii}

Spreads for both investment-grade and high-yield debt are near the lowest levels since 2019. (The "spread" refers to the difference in yield between Treasuries and another yield-producing asset.) This reflects strong demand and little fear of credit risk. Historically when spreads become tight it can be a warning sign. It's an indication that investors may be complacent and chasing yield, ignoring the risks they are taking. We think the situation right now is a little bit different for a few related reasons:

- Private credit makes the riskier loans, and these are not reflected in the public markets. Because private credit has been growing, the riskier loans are being pulled out of the indexes.
- The loans in the index are rated higher (more creditworthy) than they have been historically. This is true for both investment-grade-rated companies and high-yield-rated companies.
- The US has arguably become less credit-worthy over time as it routinely threatens to breach the debt ceiling and grows the deficit. So the historical comparison is not directly apples-to-apples.

Infrastructure investments continued higher during the quarter, building on what was already an outstanding year. These investments shrugged off changes in interest rates and volatility in oil prices. They powered higher with tailwinds from expectations around Artificial Intelligence (AI) energy needs and shareholder-friendly decisions to return capital to shareholders (share buybacks and high distributions). Closed-end funds (CEF's) holding these investments also benefited from aggressive activism campaigns which aimed to shrink the discounts from as much as 18% to single-digits. These funds had returns as high as 60% for the year.

CEF's mostly had a modestly negative quarter, though returns for the year were still in the double-digits. This was through a combination of rising Net Asset Values (NAVs) and narrowing discounts. Rising interest rates were a headwind during the quarter as they impacted the value of the underlying holdings. But perhaps the greater issue was the changing expectations for rate cuts which has caused discounts to widen moderately. CEFs were poised to benefit as money market yields fell along with the CEFs' leverage costs, a Goldilocks scenario which would encourage investors to buy these funds. Instead, it appears that rates will remain higher than we'd like for a longer period than we expected in September.

Flexible Income Portfolio

The Flexible Income Portfolio (FIP) had a slightly positive quarter. (Though it's worth remembering for all performance commentary that portfolios that arrived at Verismo Financial during different times in the quarter will see a different performance number on the statement. Combined performance between Morgan Stanley and Wells Fargo Advisors Financial Network should be similar). While much of the portfolio was modestly lower during the final three months of 2024, several infrastructure holdings and business development companies more than offset that weakness. The portfolio concludes the 2024 with double-digit gains for a second year in a row, handily beating most fixed income benchmarks.

There have not been many changes to the portfolio recently. We have slightly increased our exposure to longer-term interest rates. We see more upside than downside in these investments and investing in long-duration assets looks attractive with rates where they are now.

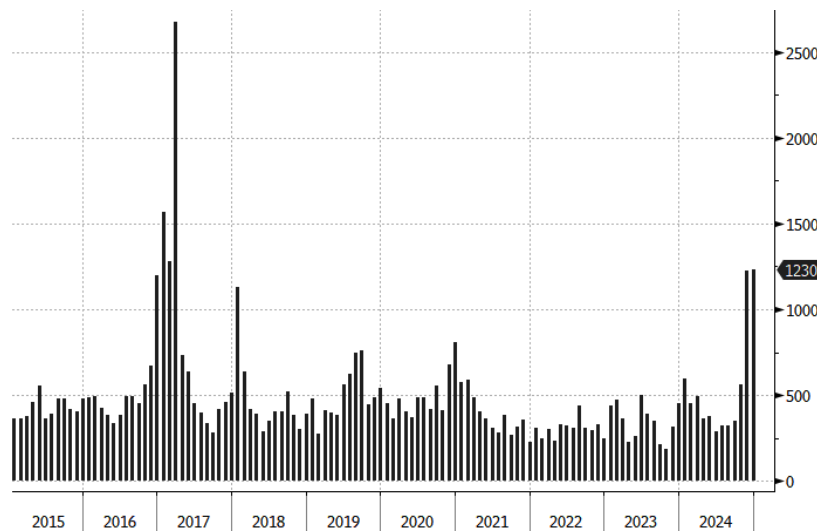
We will be increasing our exposure to Treasury Inflation Protected Securities (TIPS). These bonds pay out more interest when inflation is higher. These bonds seemed like they would be a good investment in 2022, given the sky-high inflation, but were actually punished severely because the Fed was raising rates, and they have a high duration. The current environment is very different; the Fed is lowering rates while inflation is elevated and potentially rising.

We are optimistic about this year's prospects for FIP. We think there is potential upside if rates decrease. We don't see much risk of a damaging credit event as the economy has

remained strong. And we continue to see new opportunities to deploy cash. The portfolio continues to yield approximately 8%, which is comfortably higher than current inflation numbers.

Grow – Stock Market Commentary

The S&P 500 index was higher during the fourth quarter and ended the year near fresh all-time highs. This is the second year in a row with returns of 20% or more, a rare event. (The last time was '98-'99, which capped a five year stretch of 20%+ annual gains.) The contributors to performance continue to be narrow, largely concentrated in select Big Technology stocks with exposure to Artificial Intelligence. Smaller stocks had an eventful quarter but in aggregate didn't move much, while international stocks were beaten down by a variety of macro developments. Three themes drove stocks in different directions during the quarter – the election, interest rates, and the US Dollar.



The media's use of the phrase "animal spirits" spiked after Trump's wins in both 2016 and 2024.^{xix}

Elections are normally not very relevant to markets, but Trump's decisive win certainly caught investors offside. There was fear of another contested election outcome, similar to 2020. With mail-in ballots, we were warned that the result could take weeks to determine. In 2000's "hanging chad" election where Florida needed to do a recount, markets fell by as much as 8% before Gore conceded. An election night victory was unexpected, and Republican control of the House of

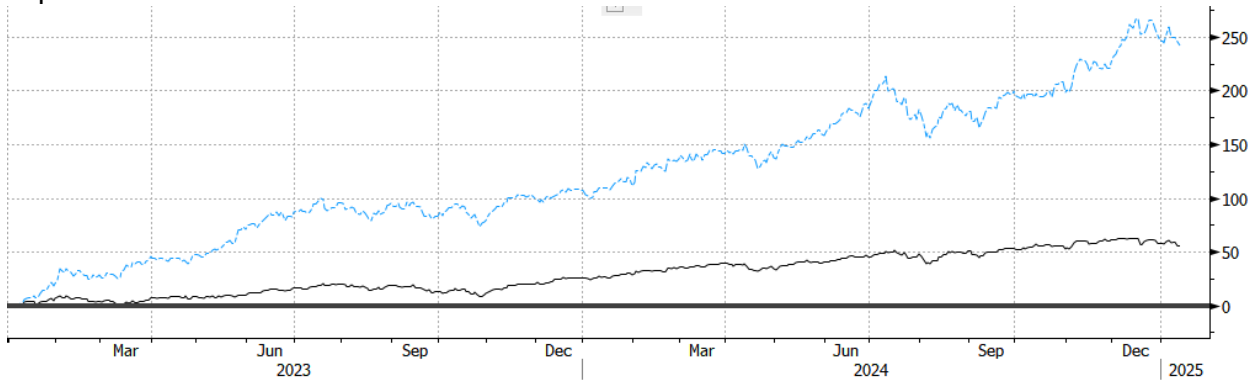
Representatives and the Senate guaranteed that Trump's platform needed to be taken seriously. Banks jumped on hopes of deregulation and increased merger & acquisition activity. Small caps popped on Trump's domestically-focused agenda. The energy sector rallied on promises of a fossil-fuel-friendly administration. Digital currencies cheered the bullish outcome.

Rising interest rates throughout the quarter negatively impacted some stocks, but not others. Interest rates are most important to smaller companies, who have bigger needs for borrowing and who might not be profitable. This persistent headwind took the wind out of smaller companies who otherwise might have gotten more follow-through from the election outcome, while larger companies were largely unaffected.

Finally, the US Dollar (USD) gained value throughout the quarter. It has become increasingly clear that the United States' economy is doing better than other developed nations. Germany is possibly experiencing a recession as we speak, as high energy prices crimp their industrial sector. Europe broadly is struggling to grow. China's all-time low interest rates show that their economy might be in its worst spot in decades. Canada is stuck in neutral. Rising interest rates also help the dollar, as investors trade their currencies for dollars to invest in Treasuries at higher interest rates than other alternatives. Finally, Trump's pro-growth messages resonate with USD bulls and his unapologetic America First rhetoric frightens other countries. A rising Dollar is generally negative for foreign markets just because of the impact of exchange

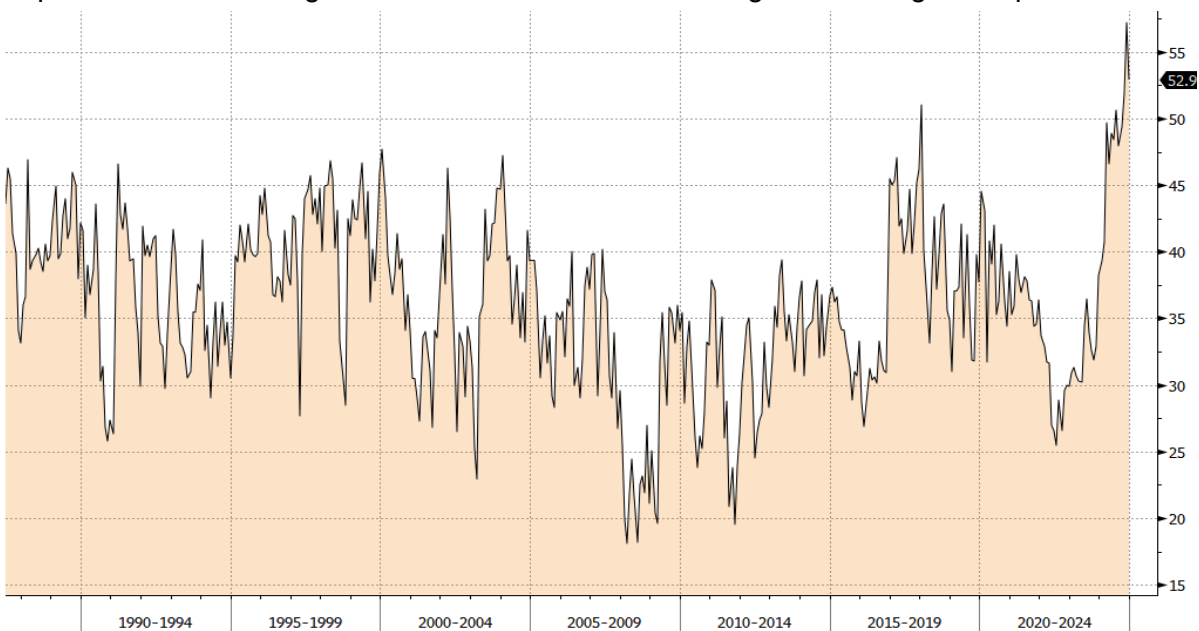
rates. But the geopolitical reasons for the USD's ascent were also negative for the prospects of foreign companies, resulting in even more damage to stock prices.

The S&P 500 as an entity has done well over the last two years. That's largely due to the impact of Big Tech which has stretched their valuations due to the promise of Artificial Intelligence. The number of stocks in the index that are outperforming the S&P 500 is at an all-time low – roughly 15%. That number would be even smaller if it included mid-cap and small-cap stocks.



The Magnificent 7 index (blue) has dramatically outperformed the S&P 500 (black). This divergence is more incredible when you consider that the S&P also benefits from the appreciation of the Mag7!^{xx}

On the one hand, it's hard to be bearish. We have warned about “concentration risk” and the unproven profitability of AI for several quarters now and continue to be frustrated by the narrow rally. It's also possible that these Big Tech winners eventually become competitors in what could be a winner-take-all outcome. That hardly seems to matter right now, as they all tend to rally in tandem. December was most ridiculous, as these stocks continued higher for unclear reasons, possibly because of window-dressing (fund managers want to have “winners” showing on their end-of-year statements), tax reasons (reluctance to realize a big tax gain at year end), and/or momentum chasing (keep buying what's been working). We've discussed momentum in the past – as an investing factor it has zero effect on average, but during some periods it can



This sentiment survey has never seen this level of bullishness from US households. More than 50% expect the stock market to increase next year. (Options are: Increase/Same/Decrease)^{xxi}

become the only factor that matters – in either direction. We recently heard a catchy phrase: “Momentum’s your friend ‘til the bend at the end.”

The Cyclically Adjusted Price to Earnings ratio (CAPE) offers a more somber outlook. The CAPE ratio is price divided by the next ten years of earnings, adjusted for inflation. High scores indicate paying a premium for earnings where expectations for future returns should be muted. CAPE is historically high

at 38 right now, meaning that expected returns over the next few years are low. The only previous instances of a CAPE this high were the late ‘90’s and late 2021. The historical median level is 16. By inverting CAPE we can determine the Earnings Yield, which is the yield of a

“First, it turns out that investing in U.S. equities at a CAPE in the high 30s yet again turned out to be a disappointing exercise... despite continued strong earnings growth, U.S. equities only beat cash by a couple of percent per annum over the whole decade...”

-Investor Cliff Asness, from his work of fiction “2035: An Allocator Looks Back Over the Last 10 Years”

stock’s earnings relative to its stock price. At current levels the Earnings Yield of the S&P 500 is just 1.2% higher than real interest rates (ten-year yield minus expected inflation). This suggests that stocks might still outperform bonds over the next ten years, but only by an expected ~1% per year. (Compare this with the Earnings Yield in the 2010’s of 3-5%.) The CAPE is not a market timing tool, meaning that it shouldn’t be used to predict immediate outcomes. And it’s possible that AI has changed the environment to the extent that such indicators are no longer useful. But at current levels CAPE suggests that investors consider a larger bond allocation in their portfolios.

As we survey the market, we are cognizant of its composition. Any analysis of the indexes necessarily is a judgment mostly on Big Tech, as they have grown to ~35% of the S&P 500 and 22% of the global market. Their stock appreciation has been the momentum, and their valuations are a big portion what’s driving something like the CAPE. At the same time, removing these stocks from consideration is intriguing, but would have caused investors to miss much of the last two years’ gains. Like 2021’s massive speculative rally, the environment has many investors befuddled. 2021 was a great example of economist John Maynard Keynes’s advice that “the market can stay irrational longer than you can stay solvent” as stocks rallied furiously driven by pandemic stimulus and lockdown boredom. It remains to be seen whether the current market is another great example. A reversal or even mild reversion in these important stocks could be extraordinarily detrimental to returns, even if most stocks are completely unaffected.

ETF Portfolio

The ETF portfolio was slightly negative for the quarter, which closes out another overall solid year, though worse than major indexes. While the post-election period was positive, the rapid rise in interest rates was a persistent headwind for the diverse portfolio. The strength in the US Dollar weighed on our international holdings. Our relative lack of exposure to Big Tech was a drag on the portfolio for the second year in a row. We don’t doubt the prospects of Artificial Intelligence. But we don’t think it’s responsible to have such enormous exposure to one theme trading at extremely expensive valuations.

We have made some changes to the portfolio as we react to the Federal Reserve cutting interest rates and the election. We’ve sold our holding in energy producers, instead shifting that allocation into energy services. We think there’s downside risk to oil prices as regulations are lifted and more production comes online, but there is likely to be substantial demand for oilfield

services as a result, allowing these companies to increase prices and utilization. We've also added incrementally to our GARP (Growth at a Reasonable Price) holdings, which are stocks showing potential for high growth, but which aren't trading at sky-high valuations. Finally, we added to our exposure to biotech, expecting benefits from AI capabilities and a busier merger environment.

We remain cautiously bullish overall, as the ETF portfolio has a lower valuation than the major indexes which are flashing warning signs. It's possible, even likely, that major stock indexes will struggle to increase during the year, even if the majority of stocks advance. Indeed, this would even be a welcome event, as it would indicate that parts of the economy other than Artificial Intelligence are doing well.

Best regards,



30 S. Wacker St.
Suite 3910
Chicago, IL 60606
312-763-9662

Frank DeVincentis, CFP
Founder, Managing Partner
Financial Advisor
NMLS # 1255537

Craig Eyler, CFP
Founder, Managing Partner
Financial Advisor
NMLS # 1270172

Molly Girard, CFP
Partner
Financial Advisor
Branch Manager
NMLS # 2359441
312-763-9673

Jennifer Huns, CFP
Group Director
Executive Vice President
Senior Registered Client Administrator
312-763-9602

Scott Tucker, CFA
Chief Investment Officer
Executive Vice President
312-763-9651

Tracy Weidman
Operations Manager
Senior Vice President
Senior Registered Client Analyst
312-763-9652

Yaelle Kimmelman
Marketing Director
Vice President
Senior Registered Client Associate
312-763-9603

Tess Kearns
Branch Administrator
Registered Client Associate
312-763-9605

Sophie Spence
Registered Client Associate
312-763-9604

Wells Fargo Advisors Financial Network did not assist in the preparation of this report, and its accuracy and completeness are not guaranteed. The opinions expressed in this report are those of the author(s) and are not necessarily those of Wells Fargo Advisors Financial Network or its affiliates. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Additional information is available upon request.

Investment products and services are offered through Wells Fargo Advisors Financial Network, LLC (WFAFN), Member SIPC. Verismo Financial, LLC is a separate entity from WFAFN.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The MSCI All Country World Index (ACWI) captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries.

The Dow Jones Industrial Average is a price-weighted index of 30 "blue-chip" industrial U.S. stocks.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of 21 developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 23 emerging markets.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

ⁱ Bloomberg

ⁱⁱ Bloomberg

ⁱⁱⁱ Federal Reserve Bank of Atlanta

^{iv} Federal Reserve Bank of Atlanta

^v <https://www.bankrate.com/banking/federal-reserve/latest-inflation-statistics/>

^{vi} Data from Bloomberg

^{vii} Data from Bloomberg

^{viii} <https://www.theatlantic.com/politics/archive/2016/09/trump-makes-his-case-in-pittsburgh/501335/>

^{ix} Data from Bloomberg

^x Data from Bloomberg

^{xi} Data from Bloomberg

^{xii} Data from Bloomberg

^{xiii} Television appearance, December 19, 2024

^{xiv} Data from Bloomberg

^{xv} Data from Bloomberg

^{xvi} <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20241218.pdf>

^{xvii} <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20241218.pdf>

^{xviii} Data from Bloomberg

^{xix} Data from Bloomberg

^{xx} Data from Bloomberg

^{xxi} Data from Bloomberg