January 2025

INVESTMENT PERSPECTIVES

Breadth, Ballots & Bubbles

As we close the books on 2024, U.S. equity markets posted impressive results, with the S&P 500 reaching 57 new record highs despite persistent inflation, shifting Federal Reserve policy, and heightened geopolitical tensions. Yet these headline numbers obscure significant disparities in market performance. A small group of "Magnificent Seven" mega cap stocks accounted for a disproportionate share of the year's gains, a concentration clearly evident when comparing the S&P 500 to its equal-weighted counterpart. Meanwhile, the Federal Reserve began reducing rates in the fall—after maintaining elevated levels for most of the year—lowering the benchmark by 50 basis points in September, followed by two 25-basis-point cuts in November and December. Although inflation moderated from 3.3% in January to 2.7% by November, the Fed signaled a more measured approach to future rate cuts than many had anticipated.

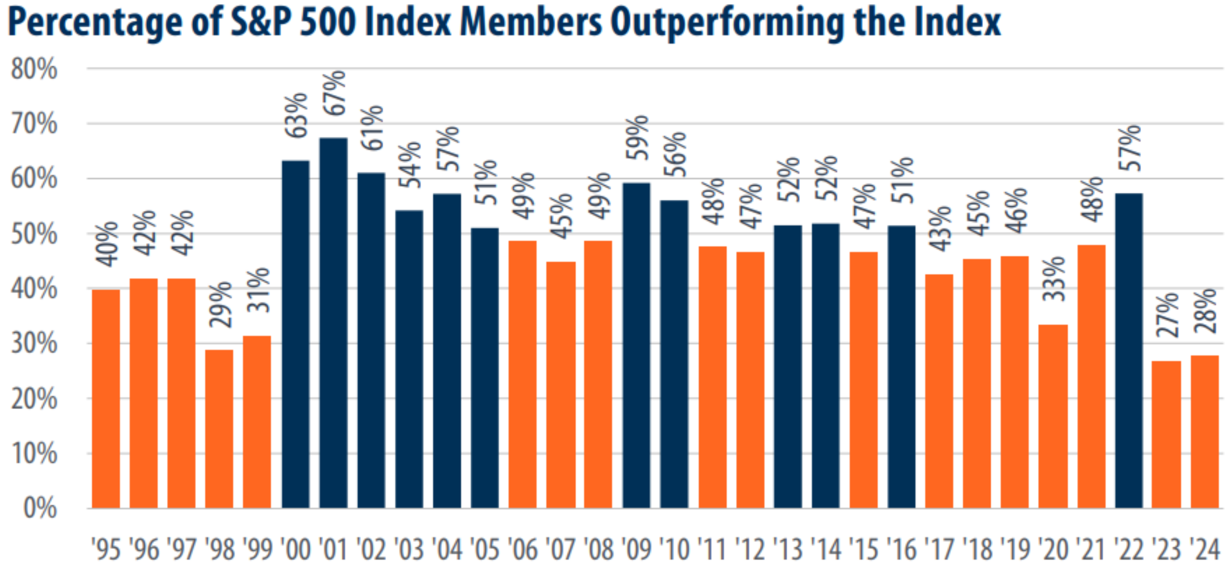
In this quarter's *Investment Perspectives*, we spotlight several themes as we enter 2025. We examine the implications of narrow market breadth for portfolio positioning, analyze how the November presidential election influenced market sentiment, and identify signs of market euphoria that reinforce the importance of disciplined investing. Through all these dynamics, our core philosophy remains unchanged: we seek high-quality businesses trading at reasonable valuations. While a handful of popular stocks have reached frothy valuations, we continue to find compelling opportunities in companies with strong business models, healthy balance sheets, and sustainable competitive advantages.

Market Breadth: A Tale of Market Concentration

The impressive market returns of 2024 hide a critical concern: extremely narrow market leadership. Although the S&P 500 rose 25%, much of that upside was driven by just a few mega-cap technology companies—the so-called "Magnificent Seven." These stocks now account for over 30% of the S&P 500's market capitalization, the highest concentration in the index's history. Collectively, they were responsible for about 55% of global market gains in 2024, surpassing even the late-1990s tech bubble.

The data underscores how exceptional this trend has been. In 2023, only 27% of companies managed to beat the S&P 500—the narrowest margin since at least 1995. That pattern persisted into 2024, when only 28% outperformed the index, making it the second narrowest year in nearly three decades. Such concentration has not been seen since 1998–1999, just before market leadership broadened significantly.

Periods of extreme concentration can present both risks and opportunities. Historically, narrow leadership often precedes a rotation toward undervalued areas of the market, as stretched valuations revert to more sustainable levels. Today, the Magnificent Seven trade at an average forward P/E ratio of 31x, while many high-quality companies in healthcare, industrials, and financials trade at more modest valuations despite robust fundamentals.



Source: First Trust Advisors

These conditions reaffirm our disciplined, value-oriented approach of identifying businesses with solid competitive advantages, healthy balance sheets, and attractive valuations—rather than simply chasing the fastest-rising stocks. Our philosophy emphasizes a diversified portfolio of high-caliber companies purchased at reasonable prices. Although it can be challenging to watch a few names dominate index returns, history shows that maintaining discipline during periods of narrow leadership ultimately pays off. As market attention remains fixed on a handful of stocks, opportunities often emerge to invest in excellent companies at compelling entry points.

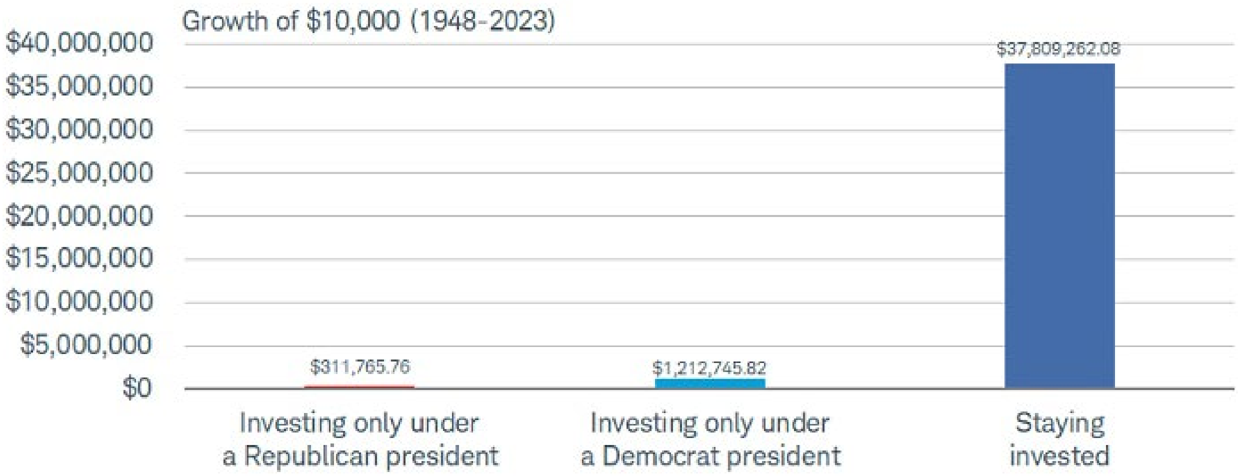
Post-Election Market Dynamics: Looking Beyond the Headlines

November's presidential election had a significant impact on market sentiment and sector performance. Donald Trump's victory triggered immediate rallies in both the S&P 500 and the Russell 2000, which posted their best monthly performances of the year in November. Investors responded favorably to the prospect of tax cuts, deregulation, and a more business-friendly environment, leading small-cap stocks—typically more sensitive to U.S. policy changes—to outperform. Financials gained nearly 7% in the fourth quarter, and energy stocks drew renewed interest, despite lingering commodity price headwinds.

However, a more cautious tone emerged in December, as investors grappled with the practical hurdles of implementing new policies with narrow congressional majorities. Concerns about tariffs stalling inflation progress and immigration restrictions affecting labor markets contributed to more subdued optimism. The Dow Jones Industrial Average recorded its longest losing streak in nearly five decades, falling over 5% during the month. This stark contrast between November's exuberance and December's skepticism illustrates how market reactions to political developments can evolve as policy details come into focus.

Whether under a Republican or Democratic president, the long-term trend for equities has always been upward. While election years can certainly bring more volatility due to the uncertainty they inject, the overall performance of the markets has proven to be less about who wins and more about the broader economic context, corporate fundamentals, and policy impacts that affect businesses. Past performance data illustrate that stock market returns have been favorable under administrations of both parties, and it is not political leadership, but economic fundamentals that drive long-term growth.

Time IN the market



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc.

Looking ahead to 2025, we remain committed to identifying companies with robust fundamentals that can endure various political and economic backdrops. While elections can spark short-term volatility and drive sector rotations, long-term returns hinge on company-specific factors such as competitive positioning, leadership quality, and balance sheet strength. Historically, the first year of a new presidential term often features market turbulence and policy uncertainty. In fact, the S&P 500 declined during the first year of seven of the eleven Republican terms since 1928. Rather than making sweeping portfolio changes based on political developments, we continue to emphasize high-quality businesses trading at rational valuations—a disciplined strategy that has proven successful through multiple election cycles.

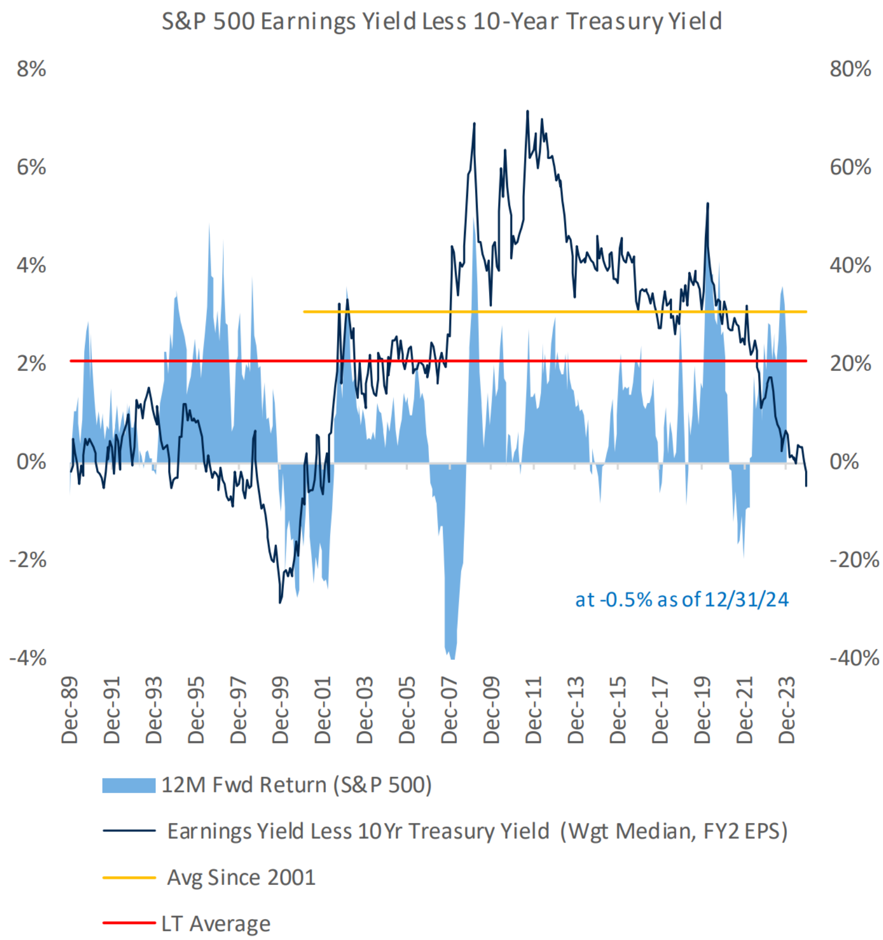
Market Euphoria: Signs of Speculative Excess

As 2024 draws to a close, several indicators point to heightened market euphoria. Margin debt—money borrowed against existing holdings to purchase additional securities, thereby amplifying both gains and losses—has jumped 35% year-over-year to nearly $900 billion, approaching the record levels last seen in October 2021 before the subsequent market downturn. Meanwhile, professional investors have reduced cash holdings to historic lows; Bank of America's global fund manager survey shows the smallest cash allocation since the survey began in 2001, and the Investment Company Institute reports that equity mutual funds' cash-to-assets ratio is at its lowest level in 67 years. These signals suggest increased speculation and diminished capacity to weather volatility.

Although high-profile growth companies often deliver impressive results, history reminds us that stark valuation gaps can precede significant corrections. After the 2000 tech bubble, valuations for many leading growth companies fell sharply—even when the underlying businesses continued to expand. This underscores the importance of balancing business quality with prudent valuations. Our value-oriented philosophy focuses on finding strong companies at sensible prices, providing both upside potential and downside protection across market cycles.

We remain committed to businesses that may not dominate headlines but boast solid fundamentals and enduring competitive advantages. While this market environment can test the patience of value-focused investors, it also creates opportunities to buy excellent companies at lower prices. Time and again, disciplined investing through periods of exuberance has proven rewarding. As Warren Buffett once said, "Price is what you pay, value is what you get"—an insight especially relevant in today's market.

The current market environment presents particular concerns when examining fundamental valuation metrics. The S&P 500's earnings yield (earnings divided by price) has fallen to 4.7%, offering investors only a minimal premium over the 10-year Treasury yield of 4.6% —one of the narrowest spreads in recent history. This minimal premium for taking equity risk, combined with signs of market euphoria suggests increased vulnerability to market corrections. These conditions reinforce our commitment to maintaining investment discipline and focusing on fundamentally sound businesses trading at reasonable valuations.



Source: RBC US Equity Strategy as of 12/31/2024

In Conclusion

As we step into 2025, we are reminded of the timeless principles that guide our investment approach. Although 2024 brought impressive returns, it also highlighted the importance of maintaining a balanced perspective. Short-term market movements are inherently unpredictable, but a steadfast focus on quality and value remains a dependable path to long-term success. We continue to watch macroeconomic trends, market dynamics, and policy developments, all while staying true to your objectives.

Our commitment to identifying high-quality businesses at compelling valuations ensures that your portfolios are equipped to navigate both challenges and opportunities in the year ahead. We thank you for placing your trust in us and encourage you to reach out with any questions or to discuss your financial goals.

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