

Quarter-In-Review – The markets closed out 2024 on something of a mixed note. Bonds struggled, particularly after election day, and outside of the top large-cap names, most stocks were flat to down for the quarter. For example, the capitalization weighted S&P 500 was up +2.4% for the last three months of the year while the equal weighted S&P 500 index lost -1.9% and the universe of small-cap stocks was essentially flat. The international markets were particularly weak in the final three months of the year, with the international developed index falling over -8% while emerging market stocks were down -5.5%.

Despite the mixed results for the quarter, it proved to be another positive year for most equity sectors. Global stocks finished up +16.5% in 2024 after a +22.0% gain in 2023. But as noted earlier, the big story in the equity markets in 2024 was the small number of stocks (the so-called ‘Magnificent Seven’) becoming ever and ever more important both in terms of market performance and weighting in the capitalization weighted indexes. As you can see from the chart below, at the depths of the bear market in 2022 the ten largest stocks in the S&P 500 comprised less than 20% of the index. By the end of 2024 this had increased to close to 40%, the highest level of concentration in modern history. What this means in practice is that the Mag-7’s performance drove the index returns. As noted earlier, the cap-weighted S&P 500 index far outperformed its equal-weighted version for the full year (+24.8% versus +12.8%). If you look at the NASDAQ 100 where the top ten comprise 55% of this index, the performance differential versus the equal weighted version was even more pronounced (+27.7% versus +8.4%). Few diversified investors kept up with the cap-weighted U.S. indexes in 2024.

In the world of fixed income, it proved to be another tricky year. Despite the Federal Reserve cutting their policy rate by a full 1%, long-term interest rates actually increased, with the yield on the 10-year Treasury moving from 3.88% to 4.57%. Interestingly, 2-year bond yields were unchanged over the twelve months, so it was another year of disparate returns depending on where you were invested in the bond market. Intermediate-term government bonds closed down

Market Benchmarks			
Market Indices	4Q24	YTD	3-Yr An
Global Equities	-1.1%	+16.5%	+5.2%
S&P 500 Index	+2.4%	+24.8%	+8.8%
Russell 2000	+0.3%	+11.4%	+1.2%
Int’l Index (EAFE)	-8.4%	+3.5%	+1.6%
Emerging Mkts	-5.5%	+10.8%	-0.3%
Other Indicators	12/31/24	9/30/24	12/31/23
Fed Funds Rate	4.25%-4.50%	4.75%-5.0%	5.25%-5.5%
2-Year Treasury	4.24%	3.64%	4.25%
10-Year Treasury	4.57%	3.79%	3.88%
S&P 500 P/E Ratio*	21.5	21.5	19.5
Crude Oil	\$71.72	\$68.30	\$71.31
Core Inflation	2.8%	2.6%	3.2%
*Forward 12-month operating earnings per S&P			

-0.6% in 2024 while short-term Treasuries gained +3.9%. The real pain was felt in long-term bonds – the ETF comprised of Treasuries with maturities beyond twenty years lost -8.1%, its third annual loss in the last four years. Corporate bonds and mortgage-related securities generally increased slightly in value during the year, but in general it paid to concentrate on short maturity bonds or high-yielding money funds in 2024.

Earnings Have Been Key – Looking back over the last twelve months, probably the biggest surprise for most people is how unphased the stock market was by the various economic and political crosscurrents throughout the year. The bearish narrative coming into 2024 was that a probable recession would crimp corporate profits, and that political instability combined with geopolitical turmoil would dent investor sentiment. While we experienced our fair share of both geopolitical and political surprises, the

stock market in the U.S. largely ignored it. At the end of the day equity prices followed earnings growth once again. In January 2023 the consensus view was that 2024’s earnings for the S&P 500 would come in at \$225 per share. By January 2024 this estimate had increased to \$243, and it’s looking like the final number could be closer to \$270. But we would be negligent if we didn’t note that expanding valuations have also played a part in the solid returns of the last few years. For example, between 2020 and 2024, the U.S. stock market has



roughly doubled. Earnings growth accounts for approximately 60% of the gain, higher price-earnings multiples 25%, and dividends 15%. As such, U.S. large-cap stocks, in particular, are pushing valuation boundaries we've rarely seen before. More on this later.

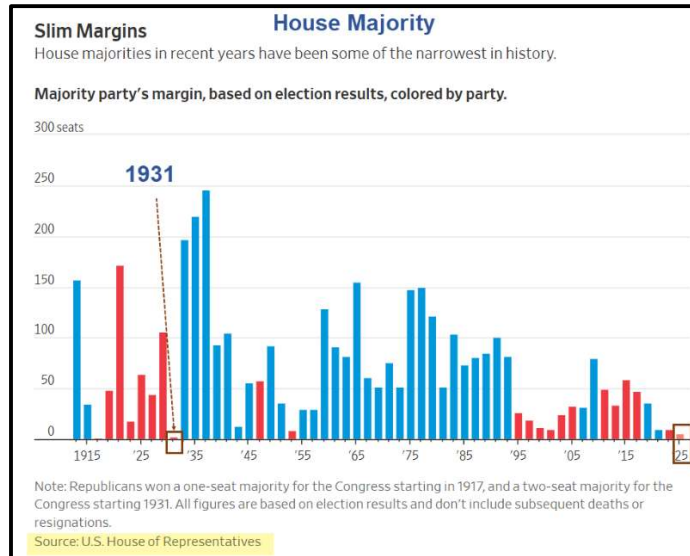
Thinking About Possible Paths Forward

- As always, in the battle between greed and fear, the fear component gets the most attention, or at least makes for better copy in the press. Much is being written about the overvalued U.S. market, but adding to the uncertainty are questions about what the 'red sweep' will mean for policy after inauguration day. Invariably, when it comes to politics, there are two narratives about the path the economy could take. One view sees tax cuts and deregulation unleashing animal spirits, thereby boosting productivity growth while keeping inflation well-contained. The other foresees policy uncertainty hindering growth, while trade and immigration restrictions impart a stagflationary bias.

In reality, the incoming administration already has a built-in tension within its myriad economic policy plans because tariffs are not friendly to interest rates, mass deportation is not friendly to the economy, and debt reduction is not friendly to growth. Something will have to give, but it's too soon to handicap the legislative agenda, especially when we consider that the Republicans have one of the slimmest House majorities in history (see chart above). Granted, no one knows the future, but let's speculate for a moment and outline three possible scenarios for the U.S. economic backdrop in 2025.

1. The Productivity Renaissance

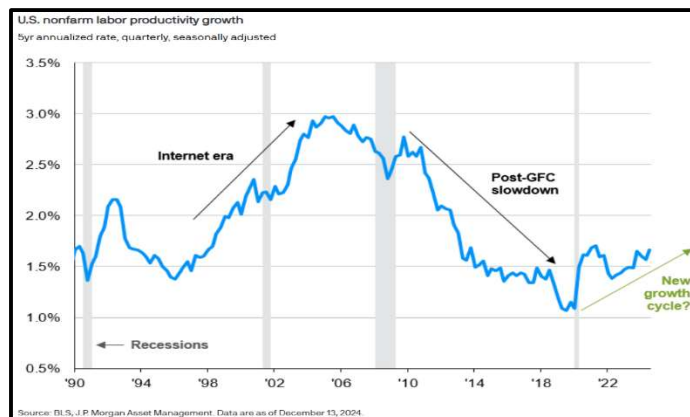
The idea of worker productivity is a straightforward concept, but it's often ignored when looking at the macro picture. Any business motivated by profit would love to generate the same output with fewer inputs, or more stuff with the same inputs. What works at the individual business level also works in aggregate. The chart to the right shows productivity growth in the U.S. from 1990. Clearly it moves in waves, and what drives these waves is a topic of continued study and much dispute. The first tech boom in the 1990's is thought to have driven the first upward wave in



productivity growth. Businesses were able to do more with less by rolling out various technology solutions that we are all very familiar with - internet browsers, fiber optic cables, networking...the list goes on and on. Obviously, productivity growth is good for earnings (you are making more with less after all), but it's also good when looking at the growth/inflation tradeoff. An economy with high productivity growth can generate higher incomes for workers and businesses without taking inflationary risks. This means central banks can keep rates lower than otherwise would be the case.

What's less understood is why productivity growth then stagnated in the mid-2000's up until relatively recently. A whole host of factors are blamed - the easy gains from the tech revolution had already been captured, the impact of the financial crisis, and greater market concentration with fewer competitive pressures are top of the list. In real terms, though, the slowdown in productivity growth contributed to stagnant wage growth for many segments of the workforce.

But as the chart below hints at, productivity growth has picked up of late. Again, the tailwinds are debated. The go-to explanation is technological advancements, especially in AI. But economists have only a vague notion of how AI is in fact helping production (although to be fair, they will probably be the last ones to figure it out). Others contend that a hybrid model of work is helping, others think that tight labor markets are forcing firms to innovate. All factors probably play a role. But the key is that if this trend continues, the U.S. economy in the second half of the 2020's could experience robust growth without the inflationary tradeoffs. The incoming administration's policies might accentuate this trend, but it's really too soon to say.



This is a bullish scenario for the markets. It would mean that the moderating inflation trend we've experienced over the last couple of years continues (see the chart at the top of the next page). Bond yields wouldn't have to increase much beyond today's levels, the Fed almost certainly wouldn't have to reverse policy in 2025 and

hike rates, and profit growth could persist.

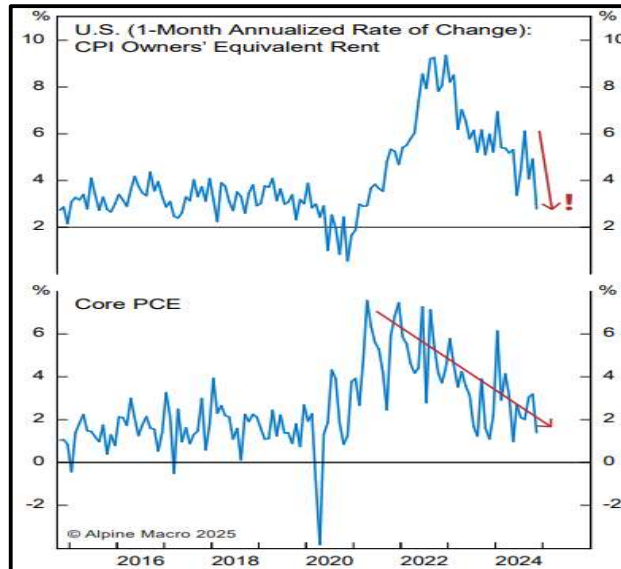
2. The Ship Springs a Leak

This is the recession scenario where something goes wrong, growth contracts, and unemployment shoots higher. One problem with this scenario is that identifying the catalyst for the recession is getting harder and harder in the U.S. As the Fed was hiking interest rates, the most common fear was they would hike too far and tank the economy, as they had in the past. But continued robust growth has brought home the fact that the U.S. economy is nowhere near as rate-sensitive as it has been in the past. In both the late 90's and mid-00's rate hikes directly increased consumer and corporate debt payments, contributing ultimately to a recession. But this hasn't been the case this cycle (outside of commercial real estate), largely because existing homeowners and businesses were able to lock in their liabilities at low long-term rates. So, if higher rates haven't triggered a recession, what will? There was some thought that an oil shock tied to instability in Eastern Europe or the Middle East might do it, but that worry has proven to be misplaced. The new fear is that a misstep on trade policy by the incoming administration could be the cause, and that is certainly possible. But until we know the details of the legislative agenda it is tough to make that call.

3. Inflation – Revenge of the 1970's

The final scenario is the one getting all the press. The rise in longer-term yields after November 5th is taken by many as a clear sign that the Trump administration will be inflationary. The possible extension of the Tax Cuts and Jobs Act combined with new tax cuts and large tariffs are all thrown into the cauldron of inflationary jitters. The threat of mass deportations and saber-rattling against Iran only add to the mix. We'd also add, although it is less talked about, the Fed's pivot to easier policy. It's less than clear that the last 100bps of rate cuts can be justified given the sticky inflation data.

These are all valid concerns and we won't underplay the risks. A misstep on the trade front, in particular, could lead to an inflationary outcome at the same time growth suffers. But as you can see from the chart to the right, it's hard to know what exactly is going to happen, and the range of outcomes goes from a modest increase in tariffs to the highest since 1900. In reality,



the incoming administration probably doesn't know themselves what they are going to focus on post-inauguration day and how much of the rhetoric is a negotiating tactic.

So which path is the most likely? So far, we think the recession scenario is the low odds bet in the U.S. (10% or less). To trigger a contraction would require a drastic change on the legislative front or a big exogenous shock. Europe, the U.K., and parts of the emerging world are much more at risk of contraction in 2025.

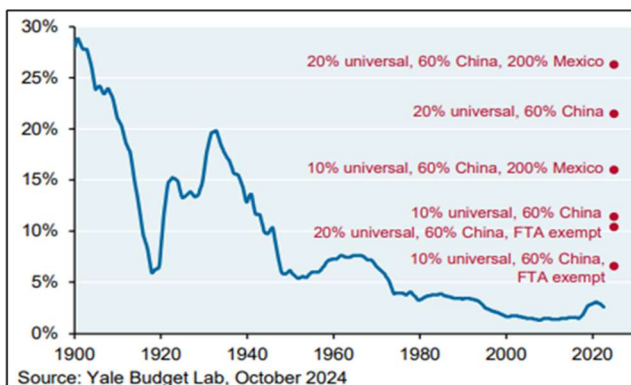
In our mind, the inflationary scenario is possible (one in three chance), but it would require policy missteps that haven't occurred yet. We think the productivity-led growth scenario is much more likely because this trend is already underway and the economy remains relatively resilient to both today's interest rate levels and any energy shock emanating out of the Middle East.

That being said, we suspect this year will play out in waves. We've half-joked in the past that the market can really only focus on one thing at a time. That was true last year and probably will be this year. We could go a few weeks, or even a couple of months, obsessing about bond yields, and this narrative could lead to a correction in stock and bond prices. But then the focus could switch to something else like robust corporate earnings growth or moderating price pressures, and prices rebound. It's quite possible that the economic story of 2025 is very similar to that of 2024, but that the market gyrations are hypersensitive to small changes in the fundamentals.

What About Stretched Valuations? – No matter how optimistic you might be about the economy, it's hard to deny that the U.S. market is on the pricey side. The chart at the top of the next page shows the price-to-sales ratio for the information technology sector going back to 1995 and the Magnificent Seven from 2015. This isn't a cheap market by any stretch.

What the lines on the chart obviously miss are the dramatic sales and earnings growth numbers for the Mag-7 stocks in particular, and the fact that all seven throw off massive amounts of free cash flow (unlike many tech stocks in 1999). But how big of a headwind are current valuations?

It's worth stating up front that current valuations are a very



poor predictor of future market performance over the next year or two based on the historical record. Earnings trends are much more predictive, and on this score, the fundamentals still look decent. Granted, earnings projections are always a fraught number, but generally they point to between 10% and 15% growth in S&P 500 earnings in 2025 after roughly 10% growth in 2024. If the estimates are even close to being accurate, valuations shouldn't preclude further market gains unless interest rates increase dramatically, like they did in 2022.

But we think high valuations imply a couple of things. First, it makes the market much more susceptible to a correction. If we go through a period where the market is worried about rising inflation and the 10-year yield is pushing towards 5%, it's quite likely that the broad market indexes could correct sharply – say between 10% and 20% - with some of the very expensive stocks getting hit even harder. This was the experience in 1998 and 1999 when the NASDAQ swooned significantly a number of times while staying in a bull trend. It's easy to say that you shouldn't let the volatility shake you out of your portfolio, but every correction feels like 'it's the one.' Maybe take your RMD early in 2025, and almost certainly top up your cash reserves to help ride through any volatility.

The second implication is a longer-term issue. At least historically, low valuations imply higher future returns, while high valuations imply the opposite, at least over long periods (say more than five years). Based on historical parallels, the S&P 500 is priced to yield subpar returns over the next ten years given current valuation metrics. Conversely, international stocks are as cheap relative to U.S. stocks as they have ever been which should mean they are priced to outperform.

Does this imply we should be buying more international stocks today? We think it is too soon to make that call. We've been maximum underweight the international markets for some time because we've been concerned about the economic prospects in Europe and parts of the



emerging world, and so far these worries haven't abated. Granted, the bearish story on Europe and China in particular is deeply consensus, but we don't see a catalyst to turn around the growth story this year. Furthermore, if the productivity-led growth scenario we outlined earlier proves to be the case, already expensive U.S. stocks could get more so.

The biggest known risk at this time for the most expensive parts of the market is the inflationary scenario noted previously. In 2022 tech stocks took it on the chin as inflation percolated and the Fed was forced to raise rates dramatically. While not our base case, renewed monetary tightening in the second half of the year is probably the biggest risk for the high multiple growth stocks. We wouldn't chase the Mag-7 at these levels and are roughly equal weighted between growth and value stocks today.

Final Thoughts – A chapter closes on another profitable year for investors, and as always, another year starts with questions and concerns. Obviously, the new legislative agenda will be a big focus early in the year, as will trends in both inflation and interest rates. Add in a seemingly overvalued equity market, and there's plenty of scope to worry if you are so inclined. Our crystal ball is as cloudy as anyone's, but our take is that economic fundamentals could be just fine in 2025 based on what we know right now. The markets could gyrate significantly more than they did in 2024 as emotions swing between fear and greed, but the surprise over the coming few months could be how little fundamentally changes. We still think there is a decent chance stocks beat bonds in 2025 as long as earnings continue to grow, and that bond investors will be rewarded once again for not taking duration risk. But much could change as the year progresses due to policy decisions, so we will have to remain flexible to the evolving situation. Finally, we wish everyone all the best for the coming year.

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