

Curb Your Enthusiasm?



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A year ago, investors were bracing for potentially one of the most contentious U.S. Presidential elections in modern times while also weighing the investment merits of a U.S. stock market facing three big risks:

1. The possibility of a widely predicted recession,
2. Lofty valuations, and
3. A level of market concentration not seen in decades.

It would have been easy to convince oneself to de-risk portfolios. That **would have been a mistake** as most risky asset classes performed well in 2024. And while recession risks have faded away over the last year, two of those three U.S. stock market risks are still with us, only even more severe - By some measures the S&P 500 is now more richly valued and concentrated in a handful of stocks than at any point in history. On top of this, while election uncertainty has passed, investors must now try to figure how a second Trump presidency and a Republican sweep of Congress will affect consumers, government finances, the economy, and global trade. Despite these risks and uncertainty, **enthusiasm for the economy and the stock market is everywhere**. The question in early 2025 is...is this justified? Or should we all curb our enthusiasm?

It's easy to see why investors are in a good mood - The S&P 500 index set 57 all-time highs in 2024— the sixth most in a year since 1928. The Large Cap stock index gained 25% in 2024, with relatively little volatility – the largest decline in the S&P 500 last year was a mere 8.5% (over the summer). This was the second consecutive year of 20+% gains in the S&P500 - **only the fifth time** that's ever happened. But those large gains were not very widespread. The S&P 500 index was once again driven by the largest and mostly technology-related stocks. An ETF tracking the so-called "Magnificent Seven" stocks gained a whopping 64% last year; the other 493 stocks returned much less on average.

With Small Cap stocks returning 11.5% for the year, the gap between large and small stock performance reached extreme levels – with "Large" outperforming "Small" for the eighth consecutive year – **a record long streak**.

The stocks of foreign developed countries gained only 4.3% - but some of the underperformance was due to a strong U.S. Dollar. In their own local currency terms, non-U.S. stocks gained a much more competitive 11.8%. Emerging Market stocks had a similar return pattern – gaining 13.7% in their local currencies, but only 8.1% for U.S. investors after currency conversions. (Currency fluctuations work both ways and a weaker U.S. Dollar would be a tailwind for U.S. investors in non-U.S. stocks.)

With the Federal Reserve embarking on its well-telegraphed journey to lower interest rates, there was reason for optimism that Core Bonds would provide both a nice coupon yield and higher prices (as yields fell). While the year started well for Core Bonds – up a respectable 4.4% through September 30th - it **ended with a toe stub**. Bond yields spiked in the fourth quarter and Core Bonds declined 3.1% over the last three months, finishing the year with a paltry total return of only 1.2%.



With so much focus on traditional markets, it would be easy to overlook what we view as the third pillar of well-designed portfolios – Alternative Investments. Even though Private Equity, Venture Capital, and Private Real Estate faced headwinds in 2024, limiting the returns for the Alternatives category as a whole, other Alternative investments picked up the slack. Several Private Credit funds posted strong returns while Trend-Following and diversifying strategies also performed well. Importantly, a smartly constructed portfolio of Alternative investments provided not just attractive returns, but also low volatility,

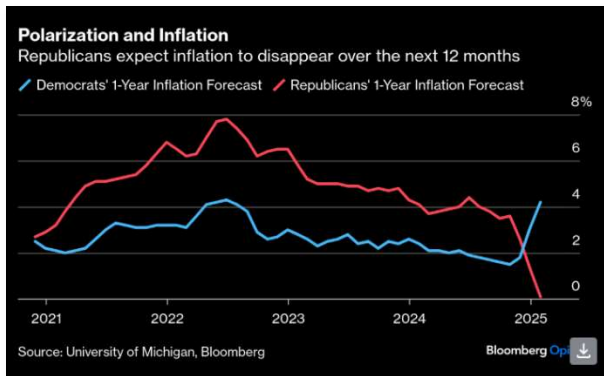
as well as very timely diversification during periods of weakness in stocks and bonds.

Investment Category	Index	4Q 2024	2024	2023	2022	Last 3 Yrs
U.S. Large Cap Stocks	S&P 500	2.40%	25.00%	26.30%	-18.10%	9.00%
U.S. Small/Mid Cap Stocks	Russell 2500	0.60%	12.00%	17.40%	-18.40%	2.40%
Non-U.S. Stocks	ACWI Ex-US	-7.50%	5.80%	16.20%	-16.20%	1.00%
U.S. Core Bonds	Bloomberg Aggregate	-3.10%	1.20%	5.50%	-13.00%	1.20%
Multi-Alternative (Liquid)	Wilshire Liquid Alt's	-1.90%	4.30%	6.30%	-5.60%	1.50%

Overall, as this table clearly illustrates, we think there is an important three-part story to be told about the 4th quarter, 2024 as a whole, and the last three years.

1. The stock market has been bifurcated into two categories – U.S. Large Cap Stocks and “everything else”,
2. The Bond market has provided unusually low returns and unusually high volatility, and
3. Alternative investments helped diversify core assets.

Turning to the present, as much as we’d all prefer to leave politics behind as a 2024 issue, **Washington D.C. remains front and center** as we start the year. Readers are no doubt aware of the policy pillars of the incoming Administration. Whether Americans are optimistic or concerned about these potential policies and the next four years is likely affected by their source of news and their political affiliation. On that subject...we review a lot of charts each day, and this is one of the most striking we’ve ever seen.



The red line (which dives after the election), shows inflation expectations of Republicans the last few years. While the blue line (which spikes up at the end), shows Democrats’ inflation expectations. For the last 3.5 years, Republicans held consistently higher inflation expectations than Democrats and then suddenly, as the intersecting lines show, they quickly flipped viewpoints in the weeks after the election. This chart shows how few can resist the temptation to let politics color their economic expectations – a mistake that needs to be avoided.

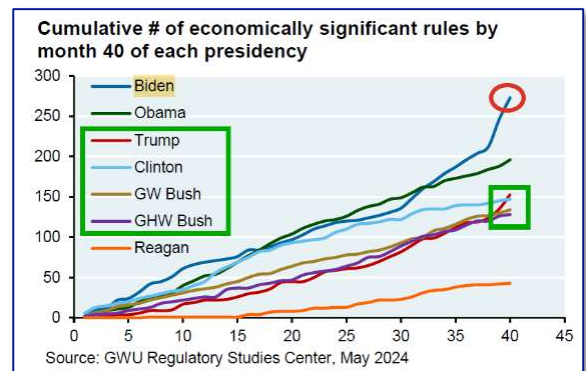
Regarding **tariffs**, many commentators point out that they could be inflationary. We think this is an oversimplification. For one, tariffs might produce a short-term price spike on

some items but are not expected to contribute to continued, sustained inflation. Further, we hope that any large new tariffs will be applied with precision, on products and industries with U.S. based substitutes. We’re also optimistic that foreign companies will ‘eat’ some of the tariffs by lowering their wholesale prices to remain competitive. Finally, like much of what has been coming from Mar-a-Lago lately, we should not forget that rhetoric and a big “first ask” is all part of The Art of the Deal.

Immigration will certainly change over the next few years. There’s inflation risk here too if taken to an extreme level, turning off much new immigration and deporting millions already in the U.S. But here too, we think fears are overblown. For one, this is a complex, multi-factor issue and a smaller labor force, while supporting wages, could relieve inflationary pressures elsewhere (e.g. – housing). We’re also optimistic that overall, immigration reform is accomplished gently with the right balance of compassion and U.S. economic and security priorities.

Then of course, there’s taxes. Trump 2.0 should be **good news on taxes**. Much of the Tax Cuts and Jobs Act (TCJA) passed in 2017 during Mr. Trump’s first term, is set to expire at the end of 2025. With both the Senate and the House on his side, we expect much of the TCJA will be extended for many years. We never thought we’d say that current tax rates are fine, but we honestly don’t think the new Administration should lower taxes any further. Merely stabilizing tax policy at today’s relatively low rates will remove uncertainty and bolster household finances.

A less discussed policy pillar of the new Administration is to **reduce the regulatory burden** on American businesses. This graph, which shows the growth in regulations under each Administration since 1980, paints a clear picture of the extreme regulatory activity of the last few years.



As you can clearly see via the top blue line, the number of regulations propagated in the first 40 months of the Biden Administration has been far greater than the five other administrations since 1990. (That orange line on the

bottom represents regulatory growth during the very pro-business Reagan era.) A significant easing of regulatory burdens may trigger renewed business confidence that fuels the next economic growth spurt. It's no coincidence that The NFIB **Small Business Optimism Index jumped 3.4 points in December** to its highest level since October 2018.

Overall, due in part to having both the Senate and the House on his side, but also due to the fact that he can't run again, Mr. Trump seems intent on trying to "go big" on many issues – immigration, taxes, regulations, and foreign policy for sure. For investors who may be skittish about all this, it's worth noting that after his first Presidential election victory, the U.S. stock market posted positive results for 15 consecutive months. We certainly do not expect the same to happen again, but the S&P 500 rose 2.5% the day after the most recent election –the best return on the day after an election in at least 95 years.

President Trump inherits an economy that is doing well, but which some argue is based on a weak foundation. While GDP growth is still solid and unemployment is low by historical standards, some analysts argue that this has been accomplished thanks to massive U.S. deficit spending. This chart, which goes back to the 1950's, illustrates the Federal Budget Deficit as a % of GDP and the Unemployment Rate combined, to help smooth the line based on the strength of the economy (e.g. – Deficits "should" go up in a recession when unemployment spikes, but should come back down during the good times like today).

While the pandemic was hopefully a "one-off" and the spike a few years ago was arguably justified, that dark blue line should be closer to the long-term average. Yet it's still far above average - **today's deficits are unheard of in light of current economic strength**. Pessimists argue that this cannot continue, and when excessive government spending is curtailed, the economy will stumble. Or that spending will continue and ultimately lead to significant debt and currency issues.

Deficit spending always seems to be a "down the road" issue. On the other hand, inflation is always a "here and now" issue. As inflation cooled in the first half of last year, and as unemployment picked up over the summer, the Federal Reserve began cutting interest rates in September. They've since reduced short-term interest rates by 1.00%.

Investors, homebuyers, and many economists hoped that long-term rates would follow, but **the opposite occurred**. For the first time in history, the Fed reduced short-term rates by 1.00% and the yield on 10-year U.S. Treasury bonds **ROSE 1.00%**. (It's this spike in yields that contributed to the Core Bond market declining 3.0% in the 4th quarter.)

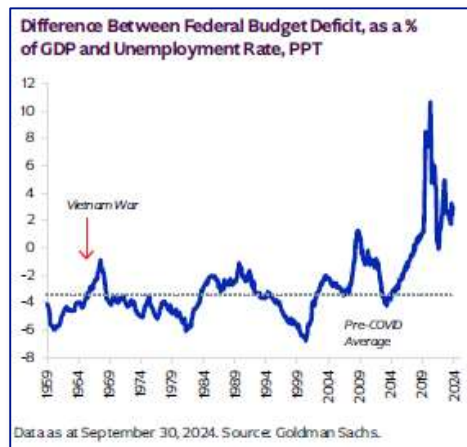
It's tempting to blame this spike in yields simply on inflation, but that may be an error. The difference between yields and reported inflation is now at levels not seen since 2008. Perhaps the bond market is reacting to more than just inflation – maybe the spike in yields is related to our recent fiscal spending deficits as well as the potential policies of the incoming Administration.

While bond-centric investors may welcome higher yields, the recent rise is, on balance, a little alarming. For one, higher U.S. Treasury rates are competition for other investments, making stocks and real estate less attractive compared to bonds. Secondly, the U.S. has about \$3 Trillion of debt maturing in 2025 that will need to be refinanced. In the private sector, higher interest rates make it harder for companies to justify new projects. And of course, mortgage rates remain elevated. Ultimately, the level of yields should eventually be determined mostly by inflation. On that front, there's been some good news in January as a moderate inflation number this month has reversed the rise in yields.

More so than at any time in recent memory – certainly as far back as the late 1990's – **excessive enthusiasm** is a problem for stocks. Why is excessive optimism bad? Because an environment of extreme enthusiasm is ripe for disappointment. And from

simply a supply and demand perspective, extremely positive sentiment means that there is less potential future demand for stocks because once everyone has bought all the stocks they want to buy, who's left to buy more? Here are four examples of excessive optimism in markets today:

- U.S. stock market valuations, by nearly every measure, are at or near all-time highs.
- Relative to their bond and cash allocations, U.S. households have record high exposures to stocks.
- Foreigners and institutions are near record overweight exposure to U.S. stocks.
- Margin debt has jumped and is at a 12-month high.



Perhaps no chart better illustrates investor enthusiasm for stocks than this one, which shows the **% of U.S. households expecting stock prices to be higher** in 12 months.



So, coming off two strong years for U.S. stocks, we think there are **more risks than most investors appreciate**. Risks from extreme enthusiasm that sets the stage for disappointment. Risks from a new Administration intent on making big changes. Risks from a Federal Reserve that has not earned our unabridged trust. Inflation risk. Federal deficit spending threatening our fiscal position. And finally, there are risks in Large Cap indices with high valuations and a dangerous concentration in a handful of stocks.

But that's not to say that it's time to get conservative with portfolios because while a lot can go wrong, **a lot can go right!** The new Administration might succeed at calming geopolitical tensions. The combination of lower taxes, less regulation, and renegotiated trade might have a net result that helps lower inflation. And if we have to choose between business confidence or pessimism, we will take confidence every time. Plus, we haven't even mentioned the potential for continued productivity and profit gains from the Artificial Intelligence (AI) boom. Yes, if a lot of variables fall into place, **2025 could be a goldilocks kind of year** for the economy and many investments with strong returns across Stocks, Bonds and Alternatives.

To us, optimism may be clouding the reality that investors today face a wider than usual range of outcomes. With the

market fluctuating sharply in response to every monthly inflation report, **one or two corrections of 10-15% this year** would not surprise us. While we think it's unlikely, stocks *could* finish the year lower, just like they did in 2022. A surprisingly high inflation spike could also mean more downside for Bonds. (But with income yields around 5.0% on Core Bonds, there's a lot more cushion than in 2022 and a year of negative total returns is unlikely.)

Designing portfolios with so much uncertainty is challenging. Within equities, we continue to think the odds are increasing that we see some rotation of leadership from the largest, most expensive, and most popular stocks to other, smaller large caps, as well as mid-caps. Cutting edge technology stocks are full of opportunity and risks. We remain enthusiastic about the potential contributions from Alternative investments. The sectors that have recently faced headwinds – Private Equity and Venture Capital – could benefit the most from a more business friendly environment with increased Mergers and Acquisitions activity. Private Real Estate has been suppressed for three years now – real estate bear markets rarely last longer. Private Credit should continue to benefit from high interest rates and a solid economy. And liquid, hedge-fund like strategies designed to earn a 4-5% premium over cash are poised to deliver attractive returns in a period when cash yields may plateau around 3.50%.



So, while we do think investors need to curb their enthusiasm just a bit for Large Cap U.S. stocks, the title of this piece also applies to the potentially unsettling ups and downs that we may experience this year. Much like watching a full episode of the TV show *Curb Your Enthusiasm*, with its awkward and at-times cringe humor, we think a year from now investors will be satisfied with their overall experience but will have had to endure some uncomfortable moments along the way.

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