

HISTORY RHYMES

*"HISTORY NEVER
REPEATS ITSELF.
MAN ALWAYS DOES."*
— VOLTAIRE

It has been said, "History may not repeat itself, but it rhymes." While historical events do not occur in the exact same way, human

behavior and its consequences tend to recur throughout history. There are few better examples of this maxim than the stock market.

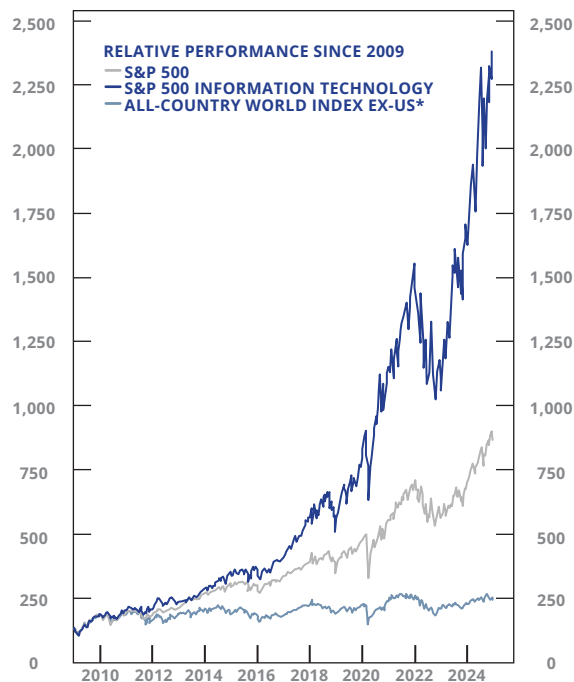
There has always been some "new thing" that elicits speculative interest. Like the irresistible "siren's song" that lured sailors to their doom in Greek mythology, the promise of new paradigms has led many investors to their demise throughout history. In fact, over the last 500 years, humanity has witnessed speculative bubbles involving everything from tulip bulbs to railways, international trade to emerging markets, technology stocks to real estate, and commodities to meme coins. It always starts the same and continues with the uttering of, "This time it is different."

As we welcome the new year, 2024 could be characterized by a historically narrow stock market performance driven by "AI exuberance" against the backdrop of moderate economic growth, massive fiscal support, and simmering inflationary pressures.

Since the pandemic, large-cap technology companies have seen impressive profitability and "limitless" potential give rise to outsized returns. In particular, the Magnificent Seven (Apple, Microsoft, Google, Amazon, Meta, Tesla, and Nvidia) have seen their combined market values increase from less than \$5 trillion at the beginning of 2020 to over \$17 trillion. Over the past four years, not only have these seven companies grown to become 35% of the S&P 500's total market value, but their gains represented 91% of the index's return in 2024.

The Federal Reserve also remains in focus, delivering what could be a final "hawkish cut" in December that has tempered market expectations for further rate reductions in 2025. Fed Chair Jerome Powell's concerns about inflation—due to steady core PCE readings—reinforced a cautious tone. Notably, the 10-year Treasury yield has also risen to an eight-month high of 4.69% to begin the year.

Dominance of US Large-Cap Tech



The current policy stance is a continuation of the Fed's balancing act between supporting economic growth and addressing inflation. After the Fed held rates at 5.5% for over a year, it began cutting the Fed funds rate in September with a 50-basis-point cut. Two more 25-basis-point cuts ensued in the final quarter of the year, but the central bank's reluctance to aggressively cut rates underscores the persistent inability to sustain inflation below 3%.

Modest but stable GDP growth over the past couple of years also provided cover for the Fed to remain patient and not ease monetary further, as the long-anticipated recession never officially transpired. However, questions about sustainable growth loom due to heavy dependence on government spending. At an unprecedented peacetime spending level of 38% of GDP, the federal budget has become increasingly reliant on borrowing to meet obligations. This reliance has long-term implications for fiscal health. Simplistically, ballooning debt, rising interest payments, and mandated transfer payments squeeze discretionary spending. These embedded issues in government finances, that contribute to inflationary pressures, further complicate the Fed's policy decisions.

There was a welcome improvement in Consumer Sentiment during the quarter, with the index reaching its highest level since mid-2021. Other optimistic signs for consumers were steadily growing retail sales, buoyed by holiday shopping, and increased optimism reported among small businesses. However, the broader economic outlook remains uncertain. Manufacturing continues to lag, with industrial production declining for much of the year. The ongoing divergence between a robust services sector and a weakening industrial base highlights the uneven nature of the economy.

As 2025 begins, inflation's trajectory, geopolitical tensions, and fiscal policy debates will play critical roles in shaping both economic and market outcomes. International developments, including the implementation of US tariffs on imports, the impact of a strong US dollar on trade balances, and global liquidity conditions, could also exacerbate domestic challenges. A strong dollar, while beneficial for consumers through lower import costs, pressures exporters and dampens global competitiveness for US firms. These dynamics, combined with political uncertainty and potential regulatory changes, create a shifting environment that the market must navigate.

The persistence of structural economic challenges raises questions about growth prospects. These include high government spending, elevated debt levels, a pause in monetary easing, and rising long-term interest rates. Of course, a richly valued stock market with narrow participation could also create an increase in volatility.

ECONOMIC VIEWPOINT

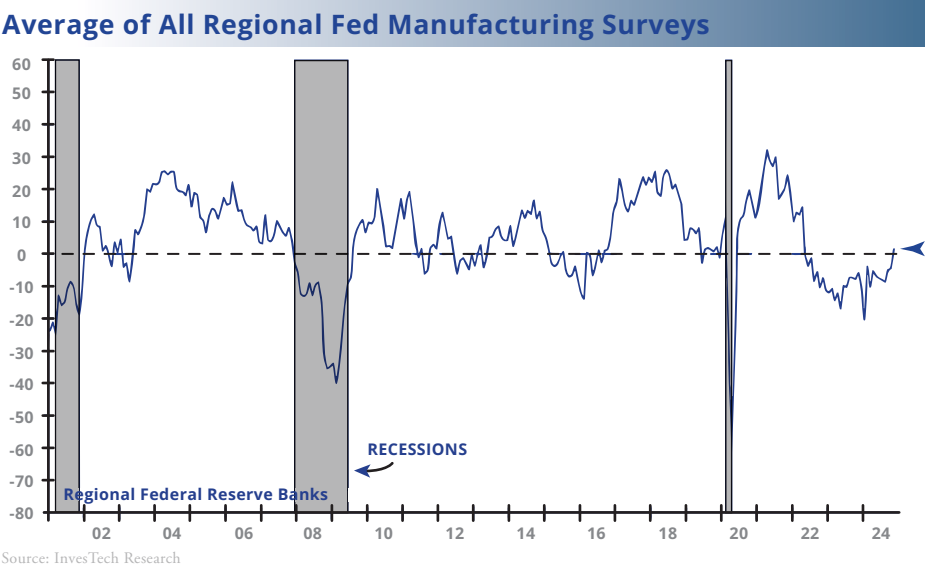
The US economy continued its slow and steady pace through the fourth quarter, with 2024 real GDP growth now projected at 2.63% year-over-year. This marks a deceleration from the previous quarters, but it highlights renewed momentum in consumer spending, a strong services sector, and increasing optimism among small businesses.

Despite broader economic headwinds, US retail spending rose 3.8% for the holiday period, higher than original estimates and the prior year's growth of 3.1%. This growth was supported by improved consumer sentiment, which reached its highest level since June 2021 before pulling back in December over concerns about potential tariffs and inflation.

Headline inflation stood at 2.4% year-over-year, while core inflation—a preferred measure for the Fed—was slightly

higher at 2.8%. These figures underscore persistent inflationary pressures, even as some price measures show moderation.

The services sector surged to its highest readings in two years as industrial production remained subdued. Highlighting a bifurcated economic recovery, manufacturing activity has contracted in four of the past five months. This divergence reflects the varying impacts of economic policies and global trade dynamics across different sectors.



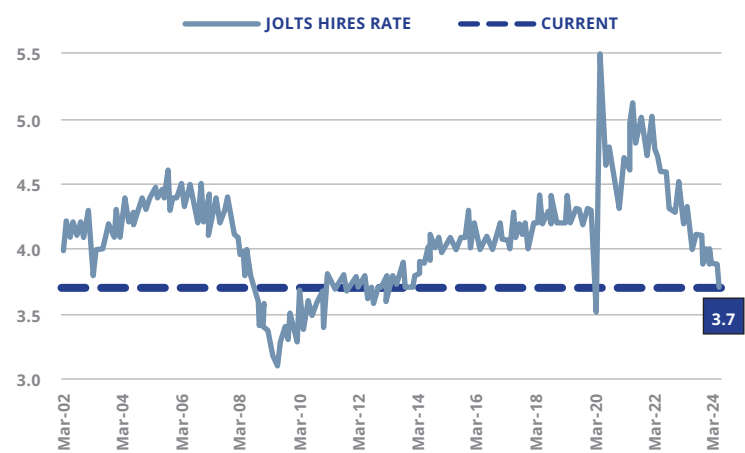
However, US manufacturing moved closer to expansion in December as the ISM PMI reading increased to 49.3, just below the expansion level of 50. In addition, after almost three years of contraction, aggregate data from the Fed's regional surveys suggests expansion may be on the horizon. The combined average of the five regions' manufacturing activity moved into positive territory for the first time since 2022.

Employment data also paints a choppy picture. Initial unemployment claims fell to an eight-month low of 211,000 in the year's final week, but labor remains in a plodding deceleration overall. As of November 2024, the US unemployment rate stood at 4.2%, reflecting an increase from 3.7% over the past year and a 0.9% increase from the trough.

Other notable declines in labor metrics include a fall in overtime hours, temporary staffing, and average weekly hours worked. This reveals a natural progression that ends with a slowdown in hiring rates and job-finding rates. The JOLTS (Job Openings and Labor Turnover Survey) Hire Rate, a key economic indicator that measures the rate at which people are being hired by employers across the US economy, has now fallen to levels typically seen during previous difficult macro-economic conditions or contractions.

Labor market conditions remain a focal point for inflation and economic growth, as they directly impact consumer spending and overall economic stability. While the services sector has shown sustained expansion, the bifurcation from goods and industrial production underscores continued vulnerabilities .

Hiring Activity Continues to Slump



Source: Hedgeye Risk Management LLC

Monetary policy will continue to play a pivotal role in shaping economic expectations. For the first time in more than two years, the yield curve exited its inversion in the final quarter of last year. The Fed’s decision to signal fewer rate cuts in 2025 than previously anticipated reflects its cautious stance regarding inflation, but also acknowledges that long-term interest rates have risen above short-term rates.

The Fed will continue to walk the tightrope between encouraging growth and inflation risks. On the inflation front, a major acceleration is not likely without another substantial fiscal thrust, however disinflation has already slowed or even reversed. To add, there has been much discussion about potential tariff-related inflation risks due to the new administration’s policies. The key takeaway is that the Fed may have to stop lowering interest rates.

Small businesses emerged as a bright spot, with the NFIB Small Business Optimism Index hitting multi-year highs in November. Plans for capital expenditures and hiring also improved, reflecting renewed confidence among entrepreneurs about the future. This is significant because small business represents about half of all private-sector employees and job creation in the US.

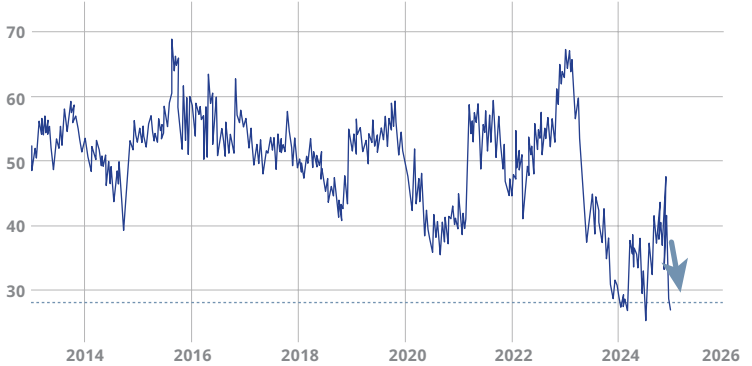
Looking ahead, economic forecasts suggest moderate growth with persistent inflationary pressures. Risks include potential fiscal crises, geopolitical tensions, and structural challenges in manufacturing. Policymakers face a delicate balancing act in addressing these issues while fostering sustainable growth. Monitoring these dynamics will be critical as we navigate the economic environment ahead.

INVESTMENT STRATEGY

The US stock market presents a mixed narrative, with major equity indices ending 2024 on a down note but registering a strong year. The Nasdaq Composite and the S&P500 led the way, while the Dow Jones Industrial Average and the Russell 2000 small-cap index were more subdued. International equities were anemic, and US bond markets struggled as long-term interest rates rose to multi-month highs.

The second-half rally began to lose steam in early December after the S&P 500 peaked at a record high on December 6. From a sentiment perspective, improving stock market breadth in the second half of the year reversed to become narrow again as only a few large-cap tech stocks outperformed. In fact, in December, an all-time low in monthly market breadth was reached, when almost 90% of index constituents underperformed the S&P 500 for the month. As a result, the one-year period market breadth has declined back to the lows seen earlier in 2024. Over the past year, only 30% of S&P 500 constituents performed as well as the index itself, which is often a sign of weakness ahead.

% of Stocks Outperforming the S&P500 (1 Year Periods)



Source: Tier1Alpha.com

From a fundamental perspective, the Nasdaq and the S&P 500 have been buoyed by gains in AI-related and technology stocks, while the Dow Jones saw more tempered growth, reflecting the challenges faced by industrials and value-oriented sectors. Manufacturing weakness, rising long-term interest rates, and geopolitical uncertainties have weighed heavily on investor sentiment.

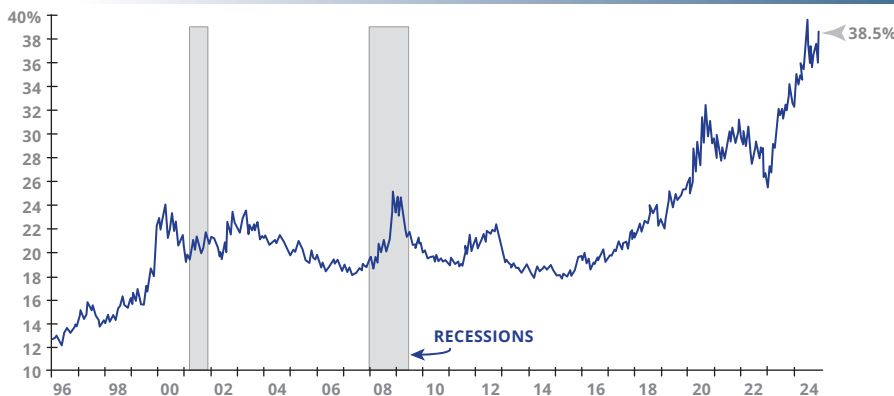
While earnings growth is likely to continue, two pillars underlying the market’s success may be shifting. The Fed may have finished its monetary easing campaign and the prospects for outsized fiscal stimulus like that of the recent past is relatively low. Global liquidity has also played a pivotal role, as the US-Japan real yield differential has emerged as a key driver of equity market valuations. Japan’s negative real yields have amplified

global flows into US assets through a “carry trade” where cheap money is borrowed and invested in US momentum stocks. However, this dynamic has shown fragility as shifts in Japan’s interest rates or policy can induce abrupt unwinding and selling pressure in US markets like experienced in June.

From a valuation perspective, the market value is stretched by virtually all metrics, similar to levels reached in 2021. The S&P 500 ended the quarter trading at 28 times earnings, equivalent to a modest earnings yield of 3.5%, which is lower by comparison to all “risk-free” Treasury yields along the curve. In addition to valuation risk, there is extreme concentration in the stock market. In fact, the combined market value of the largest ten companies in the S&P 500 now account for 38.5% of the entire index’s value .

The dominance of the “Magnificent Seven” stocks underscores extreme concentration risks, drawing parallels to the Nifty Fifty phenomenon of the 1970s and Technology bubble of 2000. This concentration poses significant risks, as the market’s performance remains reliant on a small subset of companies and leaves the major indices susceptible to a sharp sell-off.

10 Largest Stocks % of S&P500 Market Value



While the Magnificent Seven can continue to outperform in the near-term, but broad-based participation of stocks is necessary for the bull market to be sustained. Market breadth could resume in the coming year if the incoming



administration’s policies become clearer and are viewed as bullish.

Sentiment reveals cautious optimism tempered by valuation concerns. The Speculation Indicator surged into “extremely speculative” territory, while technical indicators suggested overbought conditions. Meanwhile, monetary easing by the Fed provided a bullish backdrop during the quarter, albeit one that might not sustain momentum given broader economic constraints.

Utilizing valuations alone, without considering price trends, has proven to be ineffective at predicting market tops. However, solely owning trends without an eye on valuation is equally flawed and can be outright dangerous to portfolios. We have seen this movie before.

Looking ahead, the market faces headwinds, including potential fiscal restraint, tariff uncertainty, overvaluation risks, and shifting Fed policy. Investors should prioritize assets resilient to inflation and have an opportunity for real growth. The guideposts of vigilance, diversification, and a disciplined, long-term approach will be key to navigating uncertainties and positioning for opportunities in 2025.

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