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INVESTMENT ADVISORS

We survived yet another election year.

I don't know about you, but I am glad not to see any more political advertisements, at least for a while. Politics is a full-contact sport and not for the faint of heart; mud-slinging both ways comes with the territory. Many sins no longer seem to even raise an eyebrow when in my youth they would have ended a politician's career, but there is one political sin that still seems to stick: If you are interested in politics, then you best not get caught flip-flopping.

I'm not talking about my personal preference for footwear. I grew up in South Florida; who wants to wear shoes when it is always hot? No, I am talking about flip-flopping of political positions to go along with the preference of the day. The examples are too numerous to count, so much so that the "he was for it until he was against it" phrase is now a political cliché.

Flip-Flop

Politics is not the only place where flip-flopping takes place. The market has been flip-flopping for a while now, and while most seem not to notice, I am really getting tired of it. If one pays attention only to the S&P 500 index, then it may not seem like there is any inconsistency. This index, which many use as that proxy for the market, just keeps going up quarter after quarter, or at least it has over the last couple years. However, as I have said more times than I can count, it is what happens underneath the surface that really tells an investor what is happening.

After years of only a handful of technology companies accounting for the vast majority of gains, the market finally broadened out in the last quarter of 2023 and continued that trend in the first quarter of 2024. To break this down, let's look at a better proxy for the entire stock market. Most institutional investors use the Russell indexes as their market proxy. Russell starts with a total market index, which is made up of 3000 of the largest companies whose stock is publicly traded. They break that down into large companies, represented by the largest 1000 of those companies, and small companies, represented by the remaining 2000. These are simply named the Russell 1000 and Russell 2000.

Russell then breaks down these indexes by investing style. There are two broad styles used to select stocks for investment: growth and value. The growth style is about investing in companies that are growing more rapidly than the market average. These investors tend to look for companies that are on the cutting edge and that have compelling stories about how their products will change the world. In theory, these investors will pay any price in order to be part of the cool crowd.

The alternative style would be value. Value investors are bargain shoppers. They have no problem wearing last year's styles if it saves them a few dollars. They want to buy stocks when they are on sale. They tend to invest in older, more stable companies, and may even purchase shares when there is some bad news for the company that they view as temporary.

Institutional investors find this breakdown useful because we can then focus on large growth and value companies, and small growth and value companies. This helps us understand what parts of the market are working and what is not. In the first quarter of 2024, everything worked. Large growth was the best place to be with an 11.4 percent gain, but large value returned 9 percent and small companies were up nicely as well. We had a broad-based market rally.

Then the market flipped. In the second quarter of 2024, the big technology companies in the large growth category were the only stocks that worked. The S&P 500 index was up 4.28 percent that quarter, but when we broke the market down into size and style, large growth was up 8.3 percent and every other category actually lost money. The returns were once again concentrated all in one area.

Then the market flopped. In the third quarter of 2024, the S&P 500 was up 5.89 percent. When we look at the breakdown, small value stocks were the best place to be up 10.2 percent. Small growth stocks were up 8.4 percent and large value stocks were up 9.4 percent. Large growth stocks were still positive, up 3.2 percent, but they shared the glory with the rest of the market and were actually the worst place to be. Once again, we had a broad-based rally in the market.

Then the market flipped. In the final quarter of 2024, large growth finished up 7.07 percent while large value was down 1.98 percent. Small growth was barely positive, finishing up 1.70 percent, and small value finished down 1.06 percent.

Here is where it gets really interesting: It looked nothing like that through the month of November. Through November small companies had been the best place to be while large companies were also up nicely, with growth and value within rounding error of each other. Then December hit and the entire market dropped 7 to 8 percent except for large growth, which was up just under a percent. The market didn't just flip; it flipped out.

Why? To tell the truth I don't really know, but I do have a theory. We will call it the double I theory. Investors are irrational idiots... just kidding. Investors fear inflation and interest rates. Through this period the 10-year Treasury rate climbed from 4.19 percent to 4.58 percent, accompanied by speculation about tariffs and deportations both causing inflationary pressures. These arguments suggest that tariffs will simply make prices go up, which is the very definition of inflation. The deportation argument is that deporting immigrants who are here illegally will cause a labor shortage, meaning companies will have to pay higher wages, which will lead to inflation.

Let's take the tariff argument first. I have said repeatedly over the last several years that I do not know how economics is being taught today. I started that refrain when I read an article suggesting that most schools no longer teach price theory as part of the economics curriculum. If true, this means they are no longer teaching supply and demand, which would be a shame since that is one of the very few economic concepts that actually holds true in real life. Prices are determined by supply and demand. Contrary to popular belief, business owners cannot just raise prices whenever they want. This could be a newsletter unto itself, but for this conversation it suffices to understand that businesses cannot simply pass the tax along to the consumer and expect to sell the same amount of goods. They will pass on what they can, and then eat the rest. They will then attempt to lower costs, primarily by cutting wages, and finally they will accept lower profits. Lower profits are a disincentive, so they will then produce less, at least for the U.S. market. This will cause both a reduction in demand and a reduction in supply. Consumers will also seek substitutes. We wrote in the past how high-fructose corn syrup became a replacement for sugar largely due to sugar tariffs. Those tariffs, which have been in place for decades, did not cause inflation (well, maybe waistline inflation, but not currency inflation).

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REVIEW of ECONOMY

The 3rd quarter 2024 GDP growth came in up 3.1 percent, which was better than we expected. GDPNow shows 2.7 percent growth in the 4th quarter. The economy just keeps rolling along despite all the doomsayers.

The official unemployment rate was 4.1 percent through December. The labor market remains steady. After a slight rise in unemployment the rate came back to the same place we were in September. We are in the middle of the economic cycle and not near the end.

Inflation is 3.3 percent based on the latest consumer price index report. The slowdown has predictably gotten slower, but that is how real-world data works. The producer price index, which tracks wholesale prices, is also up 3.3 percent over the last 12 months. +

REVIEW of MARKETS

The market narrowed once again. For the quarter the S&P 500 finished up 2.41 percent, while small company stocks represented by the Russell 2000 index were up only 0.33 percent. Growth dominated with the Russell 1000 Growth index up 7.07 percent while the value index was down 1.98 percent. For small companies the value index was down 1.06 percent, and the growth index was up 1.70 percent.

Bonds were down after a big up quarter previously. The Bloomberg U.S. Aggregate Bond index ended down 3.06 percent. High yield bonds rose 0.16 percent. Bond yields went from the lows of their range to the highs of their range. Still, they remain range bound in the longer-term.

International stocks were down. The EAFE index finished down 8.06 percent and the MSCI Emerging Markets index ended the quarter down 7.84 percent. +

MARKET forecast

I am aware that we sound like a broken record, but this market keeps acting like a broken record. The market should broaden out and stay that way for a while. It may go in fits and starts, but the valuations tell us we still have a long way to go for the rest of the market to catch up to the large growth stocks.

AI driven technology still has legs, so while tech may underperform it should still deliver positive results. International remains attractive from a valuation standpoint and the dollar is now unsustainably strong. That has hurt international investment, but it will help as it unwinds. We should see outperformance from overseas but caution is in order.

Bond yields ended the quarter near the top of their range. That will likely bode well in the very short-term, but longer-term bonds look fine in this range around 4 percent yield. +

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Tariffs cause all sorts of economic problems, but the suggestion that they drive inflation is intellectually lazy. Tariffs were a significant contributor to the Great Depression and certainly one of the reasons it was a global event. An economic depression is associated with deflation, not inflation. Tariffs and trade wars cause a reduction in both supply and demand, which leads to deflationary pressures.

The deportation causing inflation idea is a bit of a stretch to begin with. There is very little evidence that wage growth leads to inflation, because wage growth is almost always associated with increased productivity. This argument also assumes that the vast majority of immigrants who are here illegally are gainfully employed in jobs that American citizens and immigrants who are here legally would not do for a similar wage. That is a lot of assumptions.

Time will tell what happens on this front. What we do know is that in prior periods when there has been a crackdown on immigration status, including a large number of deportations, it has not triggered inflation. We can look most recently at the Obama administration and their deportation efforts: We had plenty of economic issues in those years, not the least of which was the financial crisis they inherited, but inflation was nowhere to be found.

If I am correct about the lack of inflation triggers from these policies, then why did longer-term interest rates go up? Because the economy is growing at roughly 3 percent, and the belief is that the future will be even better. This should be a bullish phenomenon, not a scare; and that brings us back to our flip-flopping market.

The past 16 years have programed investors to believe that when the economy is bad, we should invest in large high-growth companies because these companies can grow earnings even if the economy as a whole is suffering. Older,

The economy is growing at roughly 3 percent; the belief is that the future will be even better.

more established companies and smaller companies are more dependent on a strong economy to help them grow. When the market broadens out, it reflects a belief that economic conditions will be good for the foreseeable future.

Will the market flop back to broadening out as we enter 2025? That is what should happen, and it should do so for two reasons. First, the market is expensive, and most of that high cost is reflected in the price of those large growth companies. The rest of the market isn't exactly cheap, but the other areas are closer to average valuations, which should lead to better relative results. Secondly and probably more importantly, the economy is doing better than Wall Street wants to admit. Next year earnings estimate for the favored large companies is for 15 percent growth, while Wall Street believes that small companies will grow closer to 3 percent. The former may be a bit of a stretch, but the latter seems overly pessimistic.

All these factors point to the market broadening in 2025. Of course, the market can stay irrational for a long time. That is what keeps us on our toes. Regardless, at least we know there won't be any political ads until 2026, and the only flip-flopping we will have to deal with will be in the markets and on the beach.

Warm Regards,

Chuck Osborne, CFA

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