AEQUITAS INVESTMENT ADVISORS

QUARTERLY LETTER – DECEMBER 31, 2024

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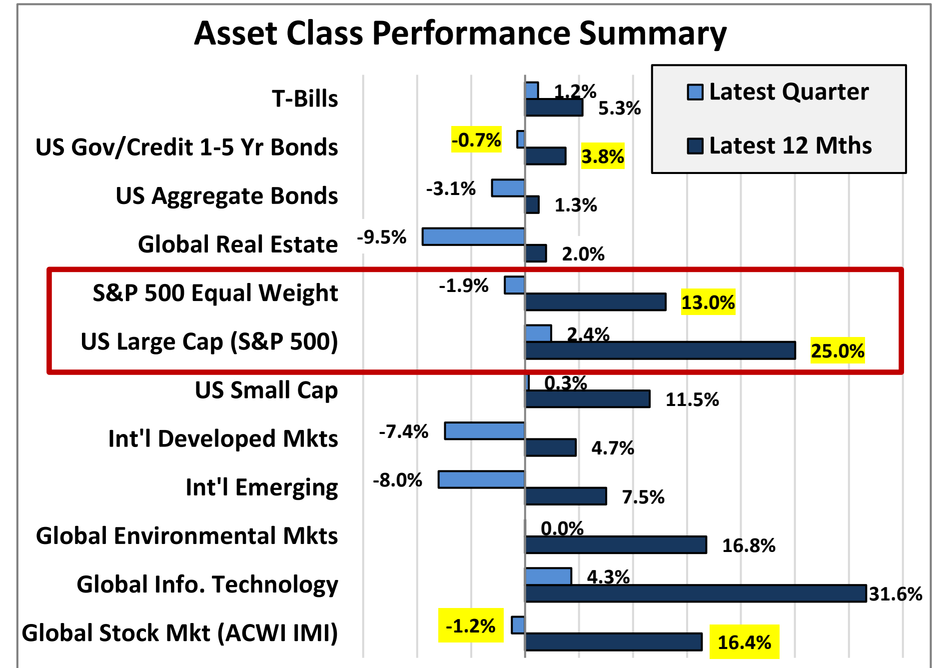
Re: The Case for Paranoid Optimism

Warner & Your Team!

Before delving into the subject matter of this quarterly letter, we would first like to extend our heartfelt sympathy to the victims of the Los Angeles fires. As of this writing, many lives have been lost, more than 200,000 LA residents are or have been under evacuation orders, and more than 12,000 structures have burned to the ground. One of our clients lost their home in the Pacific Palisades fire and many other residents may yet be impacted as the fires are still not contained. Between the hurricanes in the Southeast U.S. this past fall, and now the LA fires, climate-related disasters have taken a heavy toll on human life and property. (For any of our clients who would like to help by donating funds, two organizations worthy of consideration are the California Fire Foundation and the California Community Foundation. World Central Kitchen is another organization providing water and meals to displaced residents as well as the firefighters and other first responders.)

At Least There's Good News on The Economy as We Begin 2025

The December jobs report was surprisingly strong indicating that the U.S. economy is firing on all cylinders. The unemployment rate fell to 4.1%, while inflation continued its downward trend with the most recent Personal Consumption Expenditures Price Index at 2.4% year-over year which is only slightly above the Fed's 2% target. The latest real U.S. Gross Domestic Product (GDP) annualized growth rate came in at 3.1% which exceeded expectations. Small business owners' optimism has surged to a six-year high, and workers' wages are higher than ever even after adjusting for inflation according to the U.S. Department of Labor. Such strong economic signs should boost corporate earnings, as well as capital spending and hiring. Economic growth beyond our shores also appears to be gaining momentum with the fastest growth taking place in Emerging Asia with India leading the way. The Euro Area's economic momentum also appears to be improving, albeit at a rate just slightly above a recessionary level. The International Monetary Fund's most recent report projects that global economic growth will increase from 3.2% to 3.3% in 2025. Their forecast incorporates the potential impact of trade and tariff policy uncertainties which they foresee as temporary, although potentially disruptive in the short term. Oil and gas prices are expected to drift lower as a result of weakening demand and increasing supply (the Trump administration's plan to encourage production may further exacerbate excess supplies for oil and gas producers). Lower energy prices should boost consumer spending in other areas. In sum, as we begin 2025, the global economy appears to be relatively healthy by most measures, although structural challenges, including aging populations and related worker shortages, rising government debt levels, and the economic impact of climate change pose challenges to the long-term outlook.

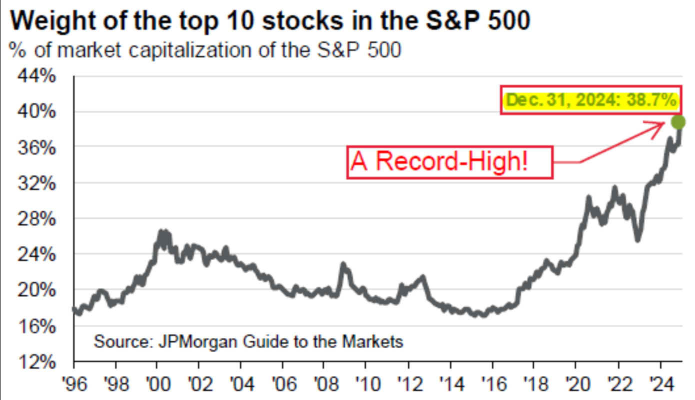


Asset Class Performance Review

In reviewing the Asset Class Performance Summary above, the returns for the trailing 12 months (calendar year 2024) were quite positive across the board with the largest gain in the Global Information Technology sector (+31.6%) which also helped propel the S&P 500 (+25%) to near record-high levels (the technology sector accounts for about 33% of the total market capitalization of the S&P 500). The Global Stock Market gained 16.4%. In other stock market categories, Global Environmental Markets gained 16.8%, followed by U.S. Small Cap stocks (+11.5%), Emerging Markets (+7.5%), International Developed Markets (+1.7%) and Global Real Estate (+2%). Within fixed assets, cash was still the king as represented by U.S. Treasury Bills which gained 5.3% for the trailing 12 months.

U.S. Gov/Credit 1-5 Year Bonds gained 3.8% and the longer-term U.S. Aggregate Bond Index eked out a gain of 1.3%.

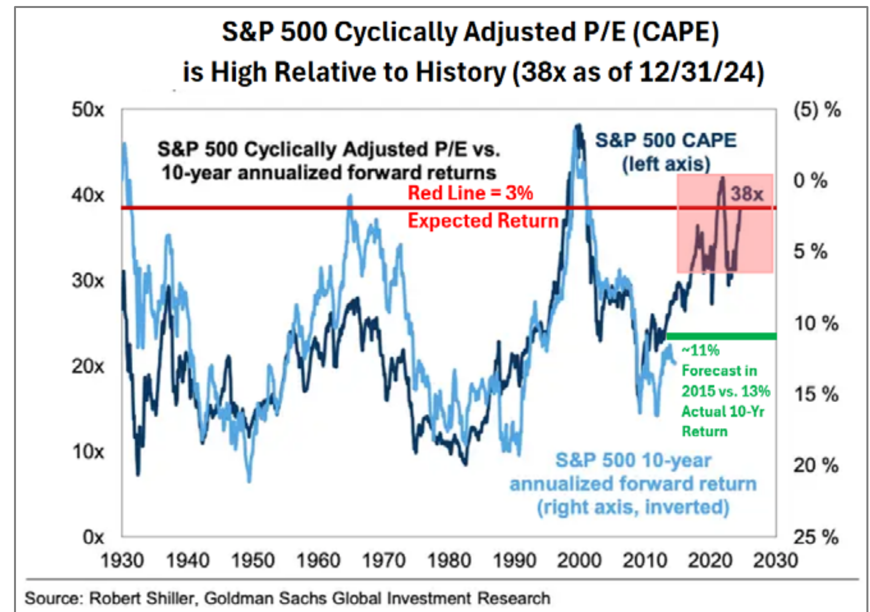
We added the Equal-Weighted S&P 500 Index returns to the summary above to highlight the remarkable impact which the largest ten stocks have had on the S&P 500 Index. The Equal-Weighted Index, as its name implies, equally weights all 500 of the stocks in the S&P 500 Index thus providing an accurate measure of the performance of the *average* stock in the index which was 13% for the trailing 12 months. The S&P 500 Index, on the other hand, is market cap-weighted, meaning that the largest companies represent an outsized portion of the overall index. In fact, the top 10 stocks comprised close to 39% of the entire market capitalization of the S&P 500 at the end of 2024 which was a record high.



For the latest calendar quarter, the returns in the Asset Class Performance Summary were mixed. The Global Stock Market declined by 1.2% with the largest declines in Global Real Estate (-9.5%), followed by Emerging Markets (-8%) and International Developed Markets (-7.4%). The primary reason foreign stocks performed poorly was due to the fact that the U.S. dollar gained 7% against the foreign currencies (for example, in local currencies, Int'l Developed Markets stocks came close to breaking even for the quarter). Elsewhere, the Global Information Technology sector gained 4.3%, the S&P 500 gained 2.4%, and the Global Environmental Markets and U.S. Small Caps were virtually flat. The Equal-Weighted S&P 500 declined by 1.9%. Among the fixed asset indices, U.S. T-Bills gained 1.2% while U.S. Gov/Credit 1-5 Year Bonds declined by 0.7% and US Aggregate Bonds declined by 3.1%. (Yields rose during the fourth quarter on concerns the Fed might delay future interest rate cuts given stronger than expected economic growth as well as the prospect of increased borrowing needs under Trump's tax cut proposals.)

A Lost Decade Ahead for U.S. Large Cap Stocks?

While we've enjoyed above-average stock market returns over the past ten years, and especially the past two years, we should expect lower returns in the future,



particularly for the U.S. Large Cap Growth stock asset class which was trading at a Price-to-Earnings (P/E) multiple that was 50% higher than its average P/E over the past twenty years. The broader S&P 500 Index, which is heavily weighted toward the most expensive top ten stocks, is trading at a P/E level which is 35% higher than its 20-year average. In analyizing these historically high valuation levels, Goldman Sachs and JPMorgan warned of unusually weak returns for the S&P 500 over the next decade. Goldman Sachs forecast an annual return of just 3% for the S&P 500 over the next ten years, while JPMorgan forecast a return of 5.7%. Utilizing the methodology of Robert Shiller's Cyclically Adjusted P/E Ratio (the CAPE Ratio), the ten-year return forecast for the S&P 500 is 3.4% which is close alignment with the Goldman Sachs forecast. The underlying concept when forecasting future returns is to assume that stock prices will eventually revert to their long-term Price-to-Earnings valuation levels. Robert Shiller, Professor of Economics at Yale, was awarded a Noble Prize in Economics in large part for his stock market valuation methodology (i.e., the CAPE Ratio). The CAPE Ratio is regarded as the most accurate means of forecasting future stock market returns over 10-year periods (there are no proven methodologies for predicting short-term stock market returns which is why we focus on the more reliable long-term forecasts when developing asset allocation strategies for our clients).

In the chart above, the black line indicates the CAPE Ratio (the left-hand axis) for the S&P 500 since 1930. The higher the black line, the lower the expected return which is indicated on the inverted axis on the right. The blue line indicates

the actual annualized 10-year return for the S&P 500 (the reason that the blue line ends in 2014 is because it represents the historic 10-year annualized return). Ten years ago, the CAPE Ratio was just over 26.5x which indicated 10-year future return expectation of approximately 11%. The actual 10-year return ended up being 13%. Note how closely aligned the black and blue lines are which illustrates the predictive power of the CAPE Ratio. The essential point is that whenever the CAPE Ratio has been high (as it is now), subsequent 10-year returns have been low, and conversely, whenever the CAPE Ratio has been low (as it was in 2009), subsequent returns have been high.

Fortunately for investors, the S&P 500 represents just one asset class, although it does represent the largest companies in the U.S. by market capitalization. In terms of publicly traded stocks within the investable universe, there are more than 4,000 stocks in the U.S. and another 5,000 stocks overseas. In utilizing the CAPE Ratio methodology for each of the various asset classes within the global stock market, we can identify asset classes which have a higher *probability* of delivering favorable returns. In the table to the bottom left, the highest future return expectations are for non-U.S. stocks in the Developed and Emerging Markets (9.5% and 9.0% respectively). U.S. Small Cap Value stocks have the third highest 10-year expected return (8.2%). A mix of U.S. and foreign stocks (the Global Equities Mix) has an expected return of 6.8%. As mentioned previously, the S&P 500 (i.e., U.S. Large Cap Stocks) has a 10-year expected return of 3.4% which is surprisingly lower than the 5.0% expected return of Diversified Bonds. While there may be a "lost decade" ahead for U.S. Large Cap Stocks as Goldman Sachs and JPMorgan assert, the good news is that by diversifying across a spectrum of asset classes including bonds and stocks with higher expected returns, we believe that it will be possible for Balanced Portfolio investors to achieve favorable returns over the next 10 years.

10-Year Future Annual Rate of Return Forecasts as of 12/31/24

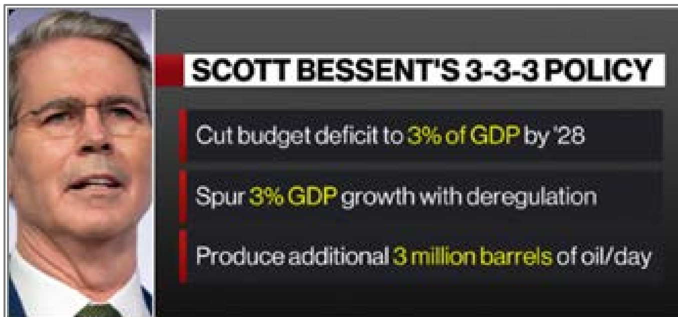
Equities	10 Year "Expected" Return	Risk Level (Standard Deviation)
Non-US Developed Markets	9.5%	16.3%
Emerging Markets	9.0%	19.9%
US Small Cap Value	8.2%	19.6%
Global Equities Mix	**6.8%**	**16.2%**
US Small Cap Growth	6.3%	22.4%
US Large Cap Value	4.1%	15.4%
US Large Cap Stocks	3.4%	15.2%
US Large Cap Growth	2.0%	17.1%
Fixed Assets		
Diversified Bonds	**5.0%**	**2.7%**
Cash (Money Market Funds)	3.6%	0.8%
Balanced Portfolios		
20% Fixed - 80% Equities	6.6%	13.1%
40% Fixed - 60% Equities	6.4%	10.1%
50% Fixed - 50% Equities	6.2%	8.6%
60% Fixed - 40% Equities	6.0%	7.1%
Inflation	2.6%	NA

As was the case in the past and may very be the case today, there is such a thing as too high a price, even for great businesses, and it's up to investors to make the smart decision, writes Noah Solomon. PHOTO BY FRANCESCOCH/GETTY IMAGES ISTOCKPHOTO FILES

Looking Ahead to the New Administration

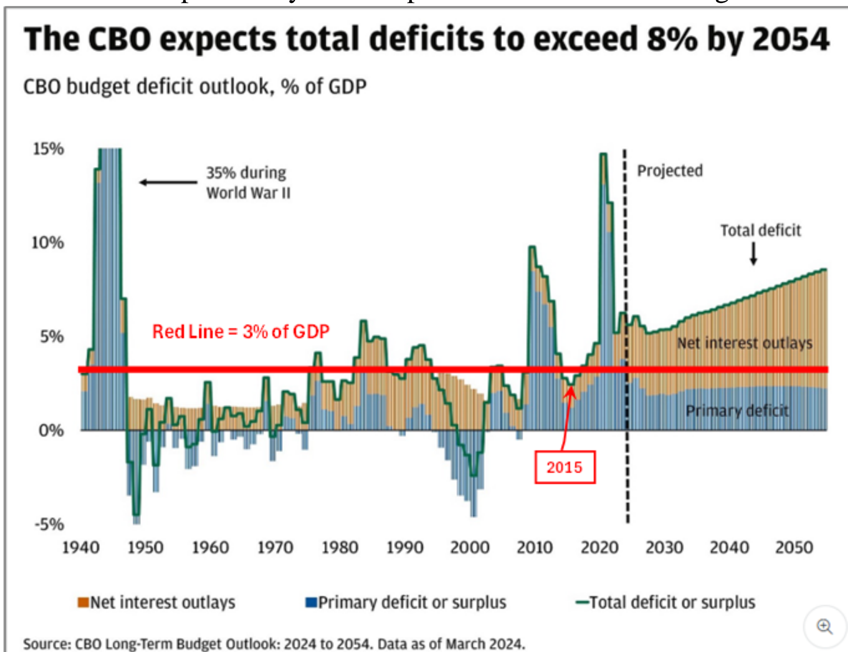
One of the most important cabinet nominations a president can make is for the role of Secretary of the U.S. Treasury. Trump's nominee to replace Janet Yellen in that position is Scott Bessent, a graduate of Yale University and an experienced investor having been a partner at Soros Fund Management and, more recently, the founder of the Key Square Group, a global macro investment firm headquartered in Connecticut. While Bessent lacks the experience and credentials of his predecessor, according to the editorial board of *Bloomberg*, he is viewed by the markets as "capable and qualified" and one who would strive to promote economic growth and maintain stability. Furthermore, Bessent supports Federal Reserve Chairman Jerome Powell serving out the remainder of his term which expires in May of 2026. Powell is widely credited with successfully guiding the economy toward a soft landing by bringing down inflation while also maintaining full employment and strong economic growth. The combination of Bessent serving as Treasury Secretary and Powell serving as the Federal Reserve Chairperson should help maintain stability for the financial markets.

Bessent conveys an optimistic approach to how he might guide the U.S. economy as Treasury Secretary. During the campaign last fall, Bessent promoted what he refers to as *3-3-3 Policy*, an ambitious plan to reduce the federal deficit to 3% of GDP by 2028, increase GDP growth to 3%, and produce an additional 3 million barrels of oil per day. While the second and third goals appear realistic, the first goal of reducing the deficit to 3% of GDP from its current 6.5% level seems



highly unlikely without major cuts to government spending *and* significantly higher tax revenue. On the other hand, lowering the deficit to 3% of GDP is what many economists view as a sustainable long-term level of debt and is clearly a goal which needs to be achieved if we are to avoid dire economic consequences over the long term. The last time the deficit to GDP level was at 3% was in 2015 toward the end of the Obama administration. Since then, the deficit has grown for several reasons, including the loss of tax revenue resulting from the Tax Cuts and Jobs Act under the first Trump administration, the additional fiscal spending and debt accumulation resulting from the COVID pandemic under both the Trump and Biden administrations, and the higher level of interest costs resulting from all of the above (note in the chart below that interest outlays are projected to become the largest component of the deficit between now and 2054).

The good news is that Scott Bessent's *3-3-3 Policy* concept at least opens the door to further dialogue about the need to address our nation's fiscal woes. Perhaps there's now the possibility of a bi-partisan commission being formed to offer solutions (perhaps resulting from Trump's "Department of Government Efficiency" advisory commission). As we've pointed out in prior quarterly letters, there are practical solutions to our nation's deficit. The Congressional Budget Office (CBO) recently published their annual report on the federal government's fiscal outlook entitled *Options for Reducing the Deficit: 2025 to 2034* (www.cbo.gov/publication/60557). The CBO emphasizes that the federal budget is on an unsustainable course and that the deficit as a percentage of GDP would rise to 8% by 2054 unless significant steps are taken to alter the trajectory (note the rise in the total deficit in the chart at the bottom left). The CBO offers 76 specific options for "altering spending or revenues." As one might expect, the options include a combination of substantial spending cuts and revenue increases, none of which would be politically popular, but if the plan is sold as one in which "we're all in this together" and "we must all make sacrifices for the greater good," perhaps there's some hope as naïve as that might sound. Americans have risen to the occasion before, most notably when we were challenged to bring down the national debt following World War II when the tax base was broadened, the highest marginal tax rate for individuals was increased to 90%, and the corporate tax rate was raised to 53%! Note how the deficit plummeted in the chart on the bottom left by the early 1950s. Americans back then viewed paying higher taxes in order to bring down the deficit as an act of patriotism (imagine that!). The good news is that the CBO is not proposing tax increase options of such magnitude, but is offering an array of options where all Americans would need to sacrifice to some meaningful extent through reductions in benefits and/or higher taxes.



In Closing, the Case for Paranoid Optimism

According to Andreas Kluth in his recent *Bloomberg Opinion* column entitled, *The Case for Paranoid Optimism Under Trump 2.0*, "The coming year, 2025, is really like any other, only more so: It deserves to be greeted with what one of my former editors calls *paranoid optimism*. Optimism is in order because the world, chaotic as it currently looks, might get better — and yes, in part because a new American president, Donald Trump, could tackle problems in such mind-bogglingly unorthodox ways that breakthroughs become conceivable." The paranoia, according to Kluth, "...is called for because the world is complicated, with dangerous feedback loops hidden inside today's *polycrisis* [defined as the existence of multiple crises around the world interacting and amplifying each other]. And with a leader as "proudly unpredictable" as Trump according Kluth, the situation might inadvertently become much worse. Yet, let us hope for favorable breakthroughs as we look ahead. And in closing on an optimistic note, perhaps the recently signed Isreal-Hamas cease-fire deal is an important step in the right direction toward creating additional breakthroughs and a more peaceful world.