***FROM THE DESK OF BOB CENTRELLA, CFA*** **January 8, 2025**

Happy New Year and wishing you and your loved ones a blessed and healthy 2025. Our motto is to thrive in 25! (stole that from my brother). I hope you had a great holiday season to end the year. We ended up on another spur-of-the-moment short trip going to Ireland for a bit to see how they celebrated Christmas. It was a lot of fun, and the Irish people are great to Americans. On the sports front, we are starting the college football "Final-4" playoffs – good luck to Texas, Ohio State, Notre Dame and Penn State. Also, the pro football playoffs start this weekend and congrats to those teams. I'm looking forward to a good year in 2025, now just need this cold blast of weather to move through.

2024 was a heck of a year in many ways including a strong stock market, the continued march of the AI revolution, moderating inflation, a somewhat resilient economy and the election of a new President among the highlights. Coming off a strong 26% year in stock gains in 2023, most market prognosticators thought 2024 could be a positive year but not many predicted another 20%+ market gain. And yet that is what we got. The S&P 500 returned 24.9% and the Equal Weight S&P 100 returned 19.1%. Bond yields declined early in the year but then ended up rising as the year ended. It was also the year of crypto with Bitcoin rising to over $100,000 after the election. So, what does 2025 hold after such a strong 2024? Read on to see where we come out.

First, a quick review of 2024 performance. Below is our table of asset class price returns for the quarter.

| ASSET | % RTN | ASSET | % RTN | ASSET | % RTN |
|---|---|---|---|---|---|
| Cocoa | 178.24% | Hang Seng | 17.67% | I-sh High Yld | 1.63% |
| Bitcoin | 120.1 | IBEX 35 Spain | 14.78 | Nymex Crude | .10 |
| Coffee | 69.81 | Dow Jones Indus | 12.88 | I-Sh Natl Muni | -1.72 |
| Ethereum | 46.2 | FTSE MIB Italy | 12.63 | CAC-40 France | -2.15 |
| Nymex Nat Gas | 44.51 | SP 400 Midcap | 12.20 | Vang Tot Bond | -2.23 |
| Nasdaq Comp | 28.64 | Russell 2000 | 10.02 | I-Sh 7-10 UST | -4.09 |
| Taiwan weighted | 28.47 | US Dollar | 7.22 | Euro | -6.18 |
| Comex Gold | 27.48 | SP 600 Smallcap | 6.82 | Canada Dollar | -7.91 |
| S&P 500 | 23.31 | Euro Stoxx | 6.56 | Japanese Yen | -10.29 |
| Comex Silver | 21.33 | FTSE 100 UK | 5.69 | I-Sh 20+ UST | -11.68 |
| Nikkei 225 Japan | 19.22 | DJ REIT | 4.06 | Mexican Peso | -18.52 |
| DAX Germany | 18.85 | Comex Copper | 2.72 | Soybeans | -22.83 |

Chocolate lovers (me included) were not happy in '24 as Cocoa prices rose 178% to be the biggest gainer. Bitcoin staged a broad rally after Trump won the election and stormed ahead 120% with its cousin Ether up 46%. Coffee lovers also paid up as prices rose 69.8%. Among stocks the Nasdaq rose 28.6%, the S&P 500 climbed 23.3% and the Dow Jones Average rose 12.9%. Internationally the Taiwan index jumped 28.5%, Japan up 19.2%, German +18.9% and the Chinese Hang Seng rose 17.7% among the winners. On the downside, Soybeans dropped 22.8% while other losers were foreign currencies and bonds. The 7-10 yr UST fell -4.09% and the 20+ Yr UST dropped -11.7%.

Among Cap sizes and Styles, Large caps dominated in a repeat of 2023, while Growth beat Value and Large Growth led overall. Midcap outperformed Small for the year while during Q4 mid and small value slightly outperformed growth.

| Index | Q4 % | YTD % | Index | Q4 % | YTD % | Index | Q4 % | YTD % |
|---|---|---|---|---|---|---|---|---|
| S&P 500 Growth | 6.19% | 35.93% | S&P MC 400 Value | 1.57% | 11.53% | S&P SC 600 Value | 1.47 | 7.20 |
| S&P 500 Value | -2.59 | 12.24 | S&P MC 400 Growth | -.92 | 15.62 | S&P SC 600 Growth | -2.65 | 9.04 |
| S&P 500 | 2.49 | 24.88 | S&P MC 400 | 0.44 | 13.72 | S&P SC 600 | -.53 | 8.48 |

On a sector basis, the Mag-7+ large caps drove a 34.06% gain in Tech stocks and 32% gain in Comm Services. The $ Trillion Club was led by Nvidia which rose 171% to over $3 trillion market cap. Apple climbed 30% to $3.7 trillion, Alphabet increased 35.5% to $2.3 trillion. Amazon +44.4% to $2.3 trillion, Meta +65.4% to $1.4 trillion, Tesla +62.5% to $1.25 trillion and Broadcom the latest up 107.7% to $1.06 trillion. Financials climbed 25.6% as banks were in favor after the election on hopes for less regulation. On the downside, materials stocks slumped -7.8% as earnings weakened.

| Sector | % Rtn | Sector | % Rtn |
|---|---|---|---|
| Technology | 34.06% | Industrials | 11.9% |
| Comm Svcs | 32.21 | Energy | 0.86 |
| Financial | 25.63 | Real Estate | 0.68 |
| Cons Cyclical | 21.26 | Healthcare | -.95 |
| Utilities | 19.15 | Materials | -7.82 |
| Consumer Staples | 12.42 | | |

**WHAT WE CAN EXPECT IN 2025**

I think the one thing we should expect in 2025 is the potential for more volatility as we head into some uncertainty with a new President who won in a landslide but with a very narrow Congress who may not make it so easy going to get things done – even though the American people seemed to want that. By year end I come out positive (spoiler alert!) but let's see how to get there. First, we look at the possible keys to a positive upside bias:

1. Moderating inflation – inflation has been consistently declining for the past year and we are now getting closer to the preferred rate of 2%-2.5%. The Fed's preferred measure of inflation, the PCE ended November at 2.8% for the prior 12 mos. It should decline further also as prior months at higher levels fall off the calculation. But it did chill the last few months of 2024 and some unknowns in 2025 include the effect of increased tariffs and tax breaks and the crackdown on illegal immigration on labor. On the positive side, lower inflation will lead to …
2. An accommodative Federal Reserve which lowered rates three times or 100 basis points at the end of 2024. The Fed has indicated further although modest rate cuts in 2025 if inflation stays in check. But they were more cautious in the latest meeting.
3. The Bond yield curve has mostly reverted to normal. The yield curve has been inverted for 628 days but has mostly normalized. I stated in the past that either short rates had to go down or long rates had to rise for the curve to normalize. The latter happened, not preferable but if rates stay below 5%, stocks should be able to deal with that level. See the table following for yields vs one year ago.

| | Today | 1-Year Ago |
|---|---|---|
| 1-Month Yield | 4.304% | 5.54% |
| 1-Year Yield | 4.17% | 4.82% |
| 2-Year Yield | 4.27% | 4.36% |
| 10-Year Yield | 4.69% | 4.01% |
| 30-Year Yield | 4.93% | 4.17% |

4. Less Regulation – The Trump administration is expected to significantly cut government regulation in various areas including banking and finance. This could increase deal activity. Also, the new DOGE group headed by Elon Musk and V Ramaswamy is pledging to significantly reduce government bloat. We shall see…
5. Healthy economy - The US economy seems to be resilient showing GDP growth of around 2.7% in 2024 and above 2% for 8 of the last 9 quarters. Some areas like manufacturing and materials are seeing weakness while technology and consumer spending have been more robust. In Trump's last term his administration was able to produce a strong economy prior to covid. Economic growth of 2.5% or greater should bring …
6. The potential for solid corporate earnings. Corporate profit growth is currently forecasted to be 14.8% in 2025 after a 9.5% rise in 2024. The stock market tends to follow earnings, so solid growth all else equal would be positive for stocks.
7. AI (artificial intelligence) spending and resulting productivity gains – AI spending is still accelerating, and we may only be in the early innings of where this technology can take us and what types of productivity and growth results from it. Right now, it is mostly the infrastructure players that are benefiting, but most companies are spending on AI with the promise of growth as a result.
8. Market diversification over concentration – Stock market gains again in 2024 were skewed to the largest companies in the S&P 500. The so-called Magnificant-7 stocks now comprise over 34% of the index capitalization while accounting for 58% of the gain last year. Nvidia alone was 22% of the gain. During the year, the "other 493" stocks had periods of outperformance but many lagged overall. Better performance from the rest of the market, the "other 493", will be key to further gains in stocks overall.

**KEY RISKS - On the risk front, here are some things to monitor, some the opposite outcome of above**:

1. Inflation could re-rear its ugly head – as mentioned above there are some unknowns such as higher tariffs and what the effect would be on inflation. In general, although inflation has been on the decline, each month brings plenty of angst as we wait for the inflation numbers to be reported. Higher inflation would be viewed negatively by investors and …
2. The Fed may pause or become less accommodative. In December, the Fed indicated a slower pace of easing was likely and markets responded negatively.
3. Bond yields above 5% have historically stifled stocks - higher inflation would lead to higher bond yields and if the 10-year crests above 5% this tends to be negative for stocks.
4. Equity valuations are at the high end – The S&P 500 now trades at 21.4x forward earnings compared to the 10-yr average of 19.7x. But much of the higher valuation comes from the Mag-7 stocks which on average trade at higher multiples. The "other 493" mostly have room for multiples to expand.
5. Earnings can disappoint – we will soon be getting Q4 earnings and outlooks for the first quarter and 2025. With valuations at an elevated level such as they are now, any disappointing earnings can be met with significant selling as we've seen in the past.

6. Can political parties put aside animosity to work for the better of the country? Democrats are upset, they lost big. Republicans control all branches of the government. But all of a sudden, I do not expect a world of cooperating Ds and Rs. Not going to happen. But hopefully there can be some compromise to get things done including a debt-ceiling deal in coming months.
7. Geopolitical Risks remain – There is hope for ending the wars in the Mideast and Ukraine and we shall see if that can happen. We now have changing leaderships across some world economies, and you cannot rule out some unforeseen events in 2025 that could shock.
8. Market corrections happen– Most people may forget that we had 3 market drawdowns in 2024 including -10.9% correction in July. Plan on us getting one or more in 2025. Will it continue to be a buying opportunity and can stocks bounce back?

**OUTLOOK & CONCLUSION**

Back-to-back years of greater than 20% gains are rare, happening only four times since 1935. Results are mixed for the 3rd year so it is tough to draw a conclusion on history. As I discussed at length above, like always there are upside positives and downside risks. In the end one side wins. I will try to tie things together and show why **we remain optimistic and positive on stocks in 2025** and give my outcome probabilities.

In my mind, bond yields and inflation are the biggest risks for 2025. Higher inflation than expected will send long bond yields back above 5% and equity valuations then become more stretched. Am I 100% confident in continuing low inflation? Not really, but I do believe there is a higher probability that inflation remains in check and bond yields settle below 5%. I also feel that although the overall index valuation seems higher than history, the majority of stocks trade below the index average PE multiple which is skewed by the mega caps. For instance, the equal-weighted PE of the S&P is 18.9x trailing earnings compared to 24.8x for the cap-weighted index. Some multiple expansion for these stocks if they play catch-up can help drive gains in the market. I've talked about diversification in the past and am still a believer over the long term. We cannot just depend on a handful of stocks to deliver all the gains.

My **Base Case** assumptions and highest probability for 2025 are as follows:

1. The Fed cuts rates at least 2 more times in 2025 and the yield curve normalizes with the long end around 4.3-4.8% and the 10-year around 4.0-4.25%. Bonds return their coupon in 2025 with a gain of around 4.0-4.5%. Favor short to intermediate bonds 1-5 yrs to be conservative although longer bonds can return more if rates drop but with higher risk if rates rise.
2. Economic growth will be in the 2.5% range for the year with an upside bias. The labor market remains solid with unemployment around 4% or slightly above. Currently it is 4.2%.
3. Corporate profit growth will average around 13-15% for 2025.
4. Stocks gain 10%-12% in 2025 with slight PE multiple compression after 2 big years. Be prepared for a correction during the year as usually happens but use it as a buying opportunity.
5. US stocks outperform international stocks again overall although some countries will beat the US. International developed countries outperform emerging markets. Midcaps outperform small caps, but both produce positive gains. Large caps outperform both again.
6. I assign a 75-80% probability to this scenario.

My **Stable Case** scenario and next highest probability is for stocks to return 2-5% in 2025 but with more volatility as there are fits and starts regarding inflation and the Fed pauses rate cuts. Corporate profit growth is double digits, but PE multiples compress further. I assign a 15-20% probability to this scenario.

My **Bear Case** scenario is for a 10-15% decline as inflation climbs back towards or above 3%, bond yields rise above 5% and the Fed becomes restrictive even talking about raising rates. I still see corporate profit growth of about 10% but stock multiples compress due to the higher rates. I assign a lower 5-10% probability to this scenario.

In conclusion, I continue to recommend a diversified equity portfolio approach to reduce risk with Large Cap stocks getting the highest allocation but exposure to mid and small cap stocks (below 10% of portfolio). Although the US should outperform International, I still recommend a small allocation to this asset class for diversification purposes. I also believe gold should be a part of the portfolio as an inflation hedge. Some institutions now look at bitcoin as another inflation hedge, but I honestly still have a hard time figuring out how to value it.  Individual bonds should be included in balanced portfolios as a preference to bond funds. I expect cash to return 3.5-4.0% in 2025, not great but not bad. So, in conclusion I am optimistic for 2025 overall and forecast a higher finish but with some increased volatility that can be used as buying opportunities.

Peace and have a great 2025. Feel free to email me with comments.

***Bob***