2024 ANNUAL REVIEW AND 2025 OUTLOOK

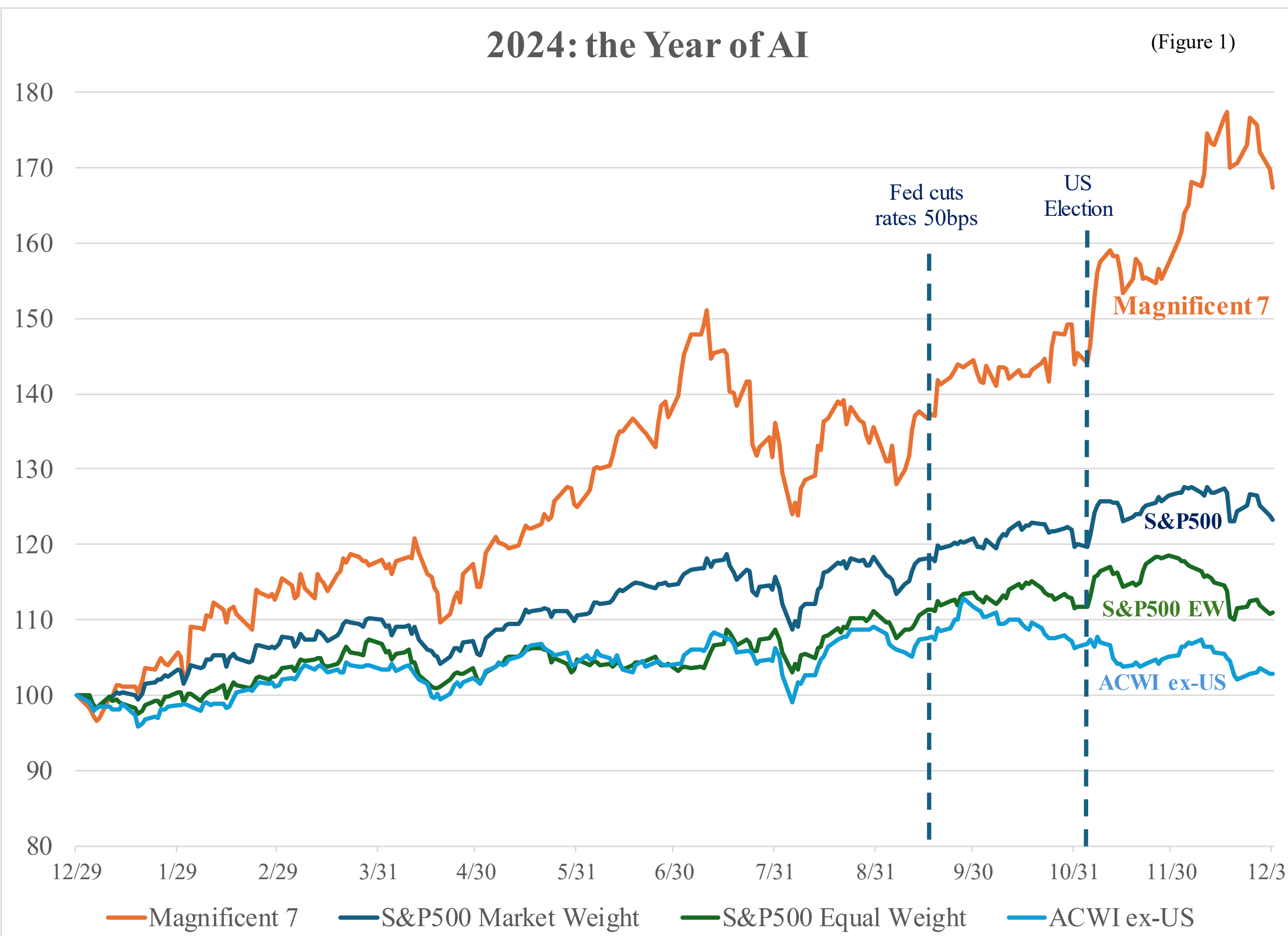
SUMMARY

Global equities reached new highs for the year, driven by enthusiasm for all things AI (Artificial Intelligence). Inflation declined unevenly, allowing the Federal Reserve to cut overnight rates by September. However, long-term rates rose by year-end on renewed inflation fears, partly driven by uncertainty surrounding economic policies by the incoming Republican administration. The U.S. yield curve ended the year steeper as a result. Credit spreads tightened during the year as lower inflation and a dovish Fed spurred risk appetite.

For the year, global equities gained 22.2% while U.S. fixed income rose by 1.3% and broad commodities climbed by 5.4%, driven by gold.

BLOWING BUBBLES

The recurring theme of 2024 was the dominance of artificial intelligence in market performance, almost at the exclusion of anything else. As shown in figure 1, the Bloomberg Magnificent 7 index

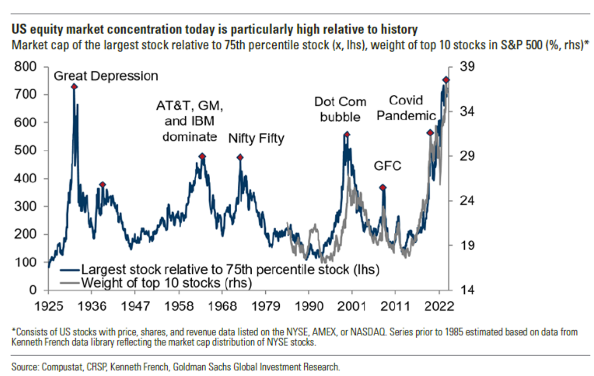


Source: Bloomberg

(consisting of Meta, Amazon, Apple, Alphabet, Tesla, Microsoft and Nvidia) delivered returns of over 67% for the year, vastly outperforming the S&P500 index (+25%). The equal-weighted version of the S&P500 (which gives greater weight to smaller capitalization stocks) produced less spectacular returns of 13%, and foreign equities (proxied by the All Country World Index ex-US) only returned a bit above 6.1%.

Results for the year highlighted the massive outperformance of a handful of equities seen as beneficiaries of the AI revolution, and particularly one stock: Nvidia (+171% for the year). With over a third to the S&P500 concentration in its top 10 stocks, the U.S. equity benchmarks have reached levels typically seen ahead of major corrections (figure 2).

(Figure 2)



Source: Goldman Sachs

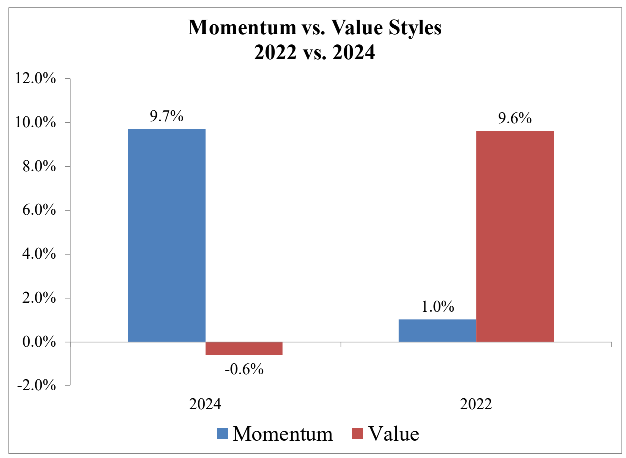
This is because market cap weighted indices like the S&P500 are a momentum machine. Successful stocks represent an ever-greater share of the index and the only way for the index to keep rising is for concentration to increase. Once valuations reach an unsustainable point, a market correction ensues.

Earlier peaks in market concentration included 2008 (financial stocks – great financial crisis), 2000 (technology stocks – dot.com bubble), or 1972 (blue chip stocks – Nifty-Fifty).

Today's market concentration in established and profitable U.S. technology companies eerily resembles the Nifty-Fifty era when Coca-Cola, Disney, Wal-Mart, GE and IBM dominated the index. All these companies still exist today, a testament to their enduring businesses. Yet, the high quality of these companies did not stop the S&P500 from falling 48% between January 1973 and October 1974. The index did not recover until July 1980. Even great companies can fall victim to excessive valuations.

Last year was a great year for momentum investing (a buy the winners strategy, akin to "buy high and hope to sell higher"). As shown in figure 3, the Bloomberg Pure Momentum factor index was up 9.7% in 2024, while the Bloomberg Pure Value factor index was down 0.6%.

(Figure 3)



Source: Bloomberg

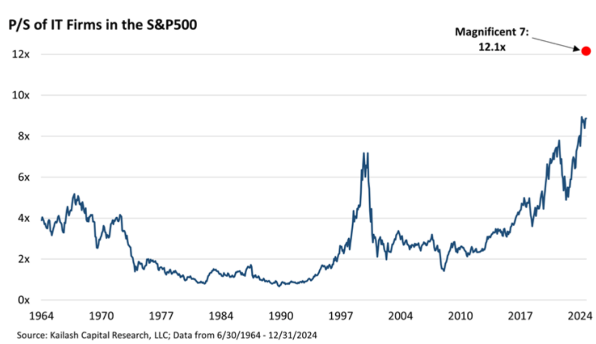
However, consider what happens when market momentum is shaken by an unexpected development, as we experienced in 2022 when interest rates were increased to fight inflation. In that year, the pattern was reversed, with Pure Value up 9.6% and Pure Momentum up 1.0%. Value investing (a "buy low and sell high" strategy) is generally negatively correlated with Momentum and tends to outperform when market cap-weighted indices adjust to proper valuations.

Unfortunately, indiscriminate momentum trading is starting to point to excessive valuations. As shown in figure 4, the Price to Sales ratio of technology firms in the S&P 500 index now exceeds what we experienced in the dot.com bubble. For the Magnificent 7 companies, it is above 12x.

At this point, it is worth quoting Scott McNealy, co-founder of Sun Microsystems, one of the darling technology stocks of the dot.com bubble period:

"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?" Scott McNealy, Business Week, 2002.

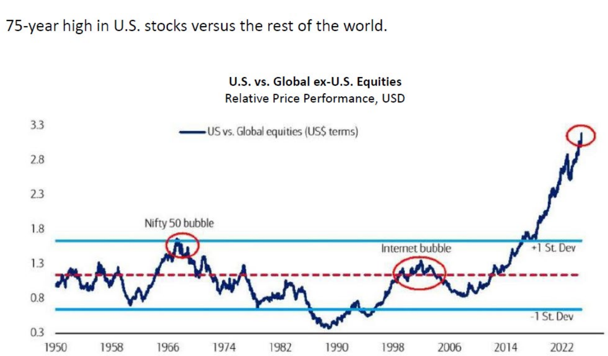
(Figure 4)



Source: Kailash Concepts

The relative performance of U.S. equities vs. global ex-U.S. is now over two standard deviations above long-term averages (going back to 1950). See figure 5.

(Figure 5)



Source: Bank of America

This development is a function of both extreme pessimism regarding foreign equities, as well as exuberant optimism baked into U.S. equity valuations, largely driven by the seeming monopoly of large U.S. technology companies on exciting developments in artificial intelligence.

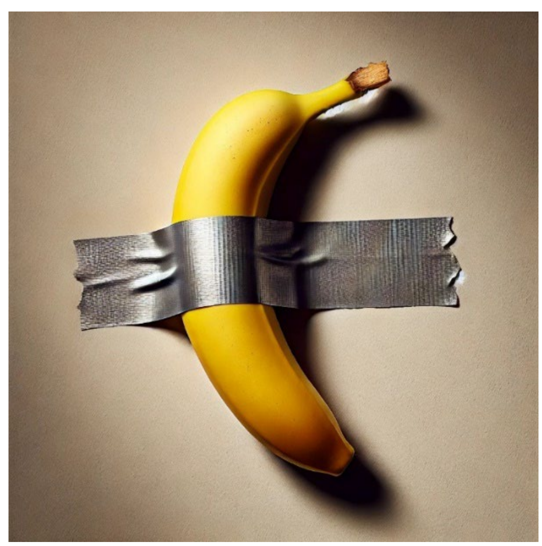
However, the news that DeepSeek, a Chinese AI model, achieved similar performance at a fraction of the costs of U.S. models, highlighted the risk of obsolescence and rising competition for industry leaders. High valuations and high future expectations place the bar high for U.S. technology stocks to continue to drive the market higher and at some point investors will demand a return on investment.

Howard Marks, the legendary investor at Oaktree, shared the four factors that characterize a bubble in his January 2025 client memo "On Bubble Watch:"

- Irrational exuberance,
- Adoration of the companies/assets and a belief that they can't miss,
- Massive fear of missing out ("FOMO"),
- Resulting conviction that "there's no price too high."

In our view, all of these features of current markets, and caution is warranted.

Bubble times: $6.2mm for a banana!

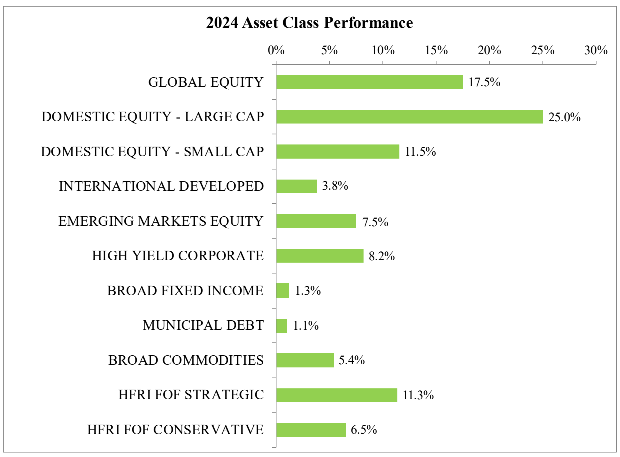


A piece of conceptual art consisting of a banana taped to a wall was sold to a cryptocurrency entrepreneur for $6.2 million in November 2024.

REVIEW OF 2024 MARKETS

For the year, all major indices posted gains across all assets, led by U.S. equities and equity proxies (high yield debt, directional hedge funds). U.S. large cap equities outperformed foreign markets thanks to gains in the Technology sector. High yield credit outperformed investment grade fixed income assets. Directional hedge fund strategies (HFRI FoF Strategic) outperformed defensive strategies (HFRI FoF Conservative, see figure 2).

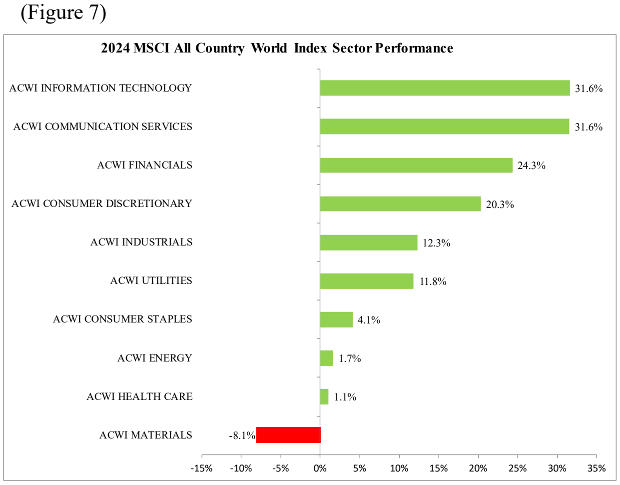
(Figure 6)



Source: Bloomberg

Top-performing global equity sectors in 2024 were Technology and Communication (Magnificent 7). Underperforming sectors included inflation-proof Energy and Materials as well as recession-proof Health Care and Consumer Staples (figure 7).

(Figure 7)



Source: Bloomberg

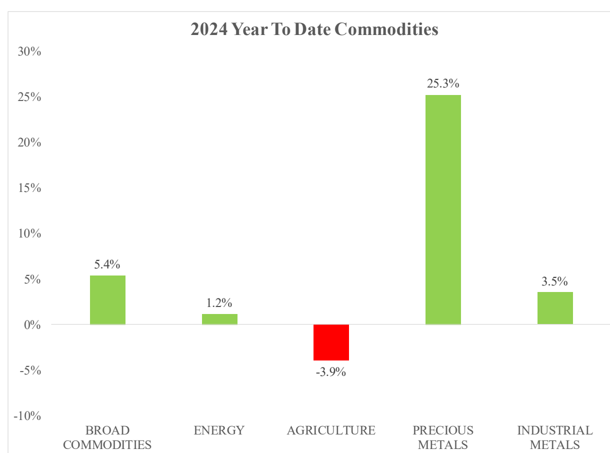
The 10-year U.S. treasury yield rose from 3.9% to 4.7% from January to April as inflation remained sticky. Weakening employment statistics over the summer took yields down to 3.6% by September when the Fed cuts overnight rates by 0.5%. Firming economic statistics and the prospect of tax cuts from a new Republican administration led yields back to 4.6% by year end.

The anticipation of lower U.S. interest rates drove the U.S. Dollar lower against major trading partners through September. Despite the rate cut by the Fed in September, inflation concerns and the risk of trade wars by the new administration caused the U.S. dollar to appreciate through year end (DXY +6.1% for the year).

Equity volatility remained subdued during the first half of the year until August, when a rate increase by the Bank of Japan briefly ignited a reversal of a popular carry trade (funding the purchase of U.S. equity futures with Japanese Yen), highlighting hidden leverage in financial markets. The VIX volatility index averaged under 14 for the first half of the year and over 17 during the second half.

Broad commodities posted gains of 5.4%, mainly driven by Precious Metals (+25.3%). For all the excitement surrounding AI, Gold beat the S&P500 in 2024 (figure 8).

(Figure 8)



Source: Bloomberg

OUTLOOK: THREADING THE NEEDLE

This year is unusual because of the scope and magnitude of proposed policy changes by the incoming Republican administration.

The new administration was elected on a platform of non-inflationary growth. Treasury Secretary Scott Bessent has proposed a 3-3-3 policy of raising GDP growth to 3%, bringing the Federal budget deficit down to 3%, and growing US oil production by an additional 3 million barrels by 2028.

Balancing GDP growth and the budget deficit would allow the debt to GDP ratio to slowly decline. And boosting oil production would promote low energy costs, lowering inflation and allowing interest rates to decline.

But promoting growth without triggering inflation will be a careful balancing act, not unlike threading a needle in a dimly lit room.

As a starting point, the economic picture is quite different today than when the previous Republican administration took over in 2016 (figure 9).

Post-covid, growth is stronger and unemployment is lower, but inflation remains stubbornly high; the budget deficit has grown and so has the total size of the debt relative to Gross Domestic Product (GDP); interest rates are higher and equity valuations are peaking.

(Figure 9)

Now and Then: 2016 vs. 2024

	Q4-2016	Q4-2024
Budget Deficit	-3.05%	-6.92%
GDP Growth	2.20%	2.50%
Net Debt/GDP	76.0%	99.6%
Fed Fund Rate	0.25%	4.25%
Inflation	2.10%	2.90%
Unemployment	4.77%	4.13%
S&P500 Forward P/E	17.1x	22.5x

Source: Bloomberg

U.S. GDP growth has averaged 2.1% year over year since 2000. In order to boost growth to 3%, a Reagan-like mix of tax cuts and deregulation is proposed, which financial markets have cheered. On the other hand, to contain the expansion of the budget deficit implied by tax cuts, the new administration intends to implement a mix of spending cuts and new income from tariffs. Finally, a crackdown on illegal immigration is under way.

As these new policies are still taking shape, it is difficult to assess their eventual impact. However, Figure 10 summarizes the likely effect on growth and inflation of these various policy proposals.

(Figure 10)

Main Proposals	Growth	Inflation
Tariffs / Trade Wars	Lower	Higher
Reduce Immigration	Lower	Higher
Tax Cuts	Higher	Higher
Spending Cuts	Lower	Lower
Deregulation	Higher	Lower

Source: Windrose Advisors

Because the effects of these policies are potentially contradictory, the relative magnitude of each will matter to the eventual macro-economic outcome. So far, markets appear to be discounting an environment of higher growth and higher inflation risk.

BALANCING PORTFOLIOS

The discussion above highlights the complex interplay of issues facing the new administration.

On the one hand, focusing on deficit reduction would improve fiscal sustainability but increase the risk of pushing the U.S. economy into a recession.

On the other hand, pushing too hard on tax cuts could stoke inflation and push up interest rates, potentially triggering a stock market correction.

Wild cards such as tariff and immigration policy, and how these policies might affect interest rates and the currency, make the direction of the economy difficult to evaluate at this stage.

Getting the policy mix just right will require careful consideration. In this light, the administration's step-by-step approach to tariffs makes sense, allowing them to gauge the market reaction before proceeding.

One conclusion that we can draw, however, is that the range of potential outcomes is unusually broad, and that uncertainty (i.e. volatility) will remain elevated.

In that context, the best defense in portfolios remains thorough diversification. Figure 21 shows our subjective assessment of the probabilities of various market scenarios, and the representative portfolios that would tend to outperform in those environments. While we think that a continued expansion/soft landing can be accomplished, the tail risks are too significant to ignore.

(Figure 21)

20%	50%	30%
Surprise Recession	**Expansion / Soft Landing**	**Renewed Inflation**
Bonds	Equities	Cash
Absolute Return	Market Directional	Real Assets, Absolute Return
Private Credit	Private Equity, Private Real Estate, Private Credit	Private Natural Resources, Private Credit

Looking back, 2024 felt reminiscent of the euphoria that preceded earlier market corrections. Single stock ETF's, triple-levered ETF's, one-day options, crypto-currencies… recently the market has been more reminiscent of a casino than the realm of cool-headed financial analysts.

In 2025, macro-economic risk may collide with optimism and high market valuations, suggesting once again that a diversified allocation and defensive posture may reward long-term investors.

Lunar New Year just brought in the year of the wood snake, portending "a year of equilibrium amidst change." This is exactly what Windrose Advisors aims to accomplish for our client portfolios as we enter a period of transformation.

INDEX KEY

Indexes are unmanaged, statistical composites and their returns do not reflect payment of any brokerage commissions or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. The indexes include a different number of securities and have different risk characteristics than the model. Past performance of the indexes and benchmark is no indication of future returns.

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), U.S. Government Debt (Barclays U.S. Treasury), U.S. Inflation-linked (Barclays U.S. Treasury Inflation Notes), U.S. Corporate Debt (Barclays U.S. Corporate), U.S. Securitized Debt (Barclays U.S. Securitized), Emerging Debt U.S. Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Barclays U.S. High Yield), Municipal High Yield (Barclays U.S. Municipal High Yield), Municipal Debt (Barclays U.S. Municipal), Commodities (Bloomberg Commodity Index), Public Real Estate (MSCI U.S. REIT), Global Hedge Funds (HFRI Fund Weighted Composite), Directional Hedge Funds (HFRI Fund of Funds Strategic), Absolute Return Hedge Funds (HFRI Fund of Funds Conservative), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

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