

New Year's resolutions vs. classic fundamentals: Momentum vs. Valuations



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IN A NUTSHELL

- Our New Year's resolution is to heed momentum and be less tactical, but...
- EPS Tracker (week 1): 4Q24 growth should be an indicator for 2025 excluding tax cuts/tariffs
- Does the S&P's PE matter? Yes, particularly for likely 3-5 year forward returns
- Diversifying from Great Eight: Exceptional enterprises, but record concentration in S&P 500
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Our New Year's resolution is to heed momentum and be less tactical, but...

Upon Trump's victory we figured investor optimism would stay strong through early 2025 provided 10-year Treasury yields don't spoil the mood. We marked inauguration day as being the first possible indication of less-than-ideal news for investors, such as new tariffs. Yet, Trump knows how to keep everyone guessing and the party going. We take no tactical view right now, but we'd be surprised not to see dips or a correction before reaching our 6500 S&P 500 target.

Trump's message was tariffs are coming, but more study and negotiating first. Also coming, less government regulation/ bureaucracy, more U.S. energy, etc. Music to investor ears, but no promises around corporate tax cuts kept the party more like a formal ball than a rave. Corporate leaders surround Trump now, but Trump knows who put him back in office and likely will prioritize low taxes for households. Beyond Trump, the bond market seems more confident recently that the U.S. Federal Reserve (Fed) recognizes the greater deficit and inflation risks and likely will go slowly on further cuts. Earnings season brought great results from banks and upbeat reports from most others so far.

Thus, the beat goes on and we are thinking about the likelihood of a "Great Continuation;" whether that be a long-lasting economic expansion, uninterrupted equity bull market, good conditions in commodities, foreign exchange (FX) markets, bonds, real estate, etc. But the risks include that Trump policies could be more about Americans first, more so than corporate profits first, his penchant for borrowing, a world difficult to discipline even with big sticks, and for equities very demanding U.S. valuations versus bond yields and high expectations for growth from Trump and of course Artificial Intelligence (AI).

EPS Tracker (week 1): 4Q24 growth should be an indicator for 2025 excluding tax cuts/tariffs

Strong start to fourth quarter (4Q) earnings season from large banks delivering big beats with upward net interest income on net interest margin expansion from Fed rate cuts and lower loan loss provisions, also strong investment banking revenue. Loan loss reserves remain steady and low, showing the major banks' confidence in an extended economic cycle. Bottom-up 4Q earnings per share (EPS) climbed to \$62.32. If the rest of companies beat by 5% in aggregate, 4Q EPS should hit our \$65.00 estimate, which suggests \$260 annualized S&P EPS, giving us more confidence in our 2025 estimated EPS of \$275 excluding corporate tax cuts and tariffs. Bottom-up 4Q EPS growth is up 24% year-over-year (y/y) at Great 8 companies. Also encouraging is that the other 492 bottom-up EPS growth still stands at 5.4% y/y. Our standing 2025E S&P EPS assumes mid to upper single-digit growth at S&P 492 companies.

Does the S&P's PE matter? Yes, particularly for likely 3-5 year forward returns

We conducted historical analysis on S&P 500 price-to-earnings (PE) ratio versus subsequent 1-, 3-, 5- and 10-year returns. The relationship is downward sloping, even if excluding the late 1990s bubble and late 1970s high inflation period. So, PE does matter! The empirical analysis supports the idea that high PEs can take 1% off of annualized returns over the next 1 to 5 years. The PE shouldn't say too much about 10-year returns as so much can happen over 10 years: various macro conditions, EPS growth, interest rates, S&P composition, capital gains taxes, etc. The 15-30% R-Squared of observed PE vs. subsequent 5-year returns suggests it's an important consideration, but far from the only one. Given a forward S&P PE of 22, we expect somewhat subpar returns from the S&P 500 over the next 3-5 years. A near 6% annualized total return rather than the 8% we'd consider to be fair right now given yields. Thus, we think the S&P 500 is about 10% too expensive, but this over valuation should only be a small dent to returns over a 3-5 year period. That said, if EPS exceeds our estimates, or 10-year yield falls back to 4%, or the expansion lasts through the decade, then we think the S&P is quite fairly valued. Our intrinsic approach to valuation supports the current PE, but it requires 10% EPS growth (3% above 7%) for a few years beyond 2025.

Diversifying from Great Eight: Exceptional enterprises, but record concentration

Allocating to the Great 8 is becoming a total asset allocation decision, not just an S&P 500 allocation decision. Despite the unique and generally superior operating features of Great 8-10 S&P 500 enterprises, their high PEs and very heavy weights in the index call for new thinking about appropriate strategic allocation. Active managers should seek other stocks that can beat or at least keep up and passive solutions should facilitate Great 8 allocations vs. the rest of the S&P.

Sticking with momentum for now,...but new year's resolutions rarely last for long

Current S&P 500 PE of 22x on 2025E EPS really depends on strong EPS growth for at least a few years. We don't see either elevated cash (M2 money supply) to equity market cap or high household savings rates (albeit healthy) as supporting the PE. Also, household equity allocation is already high. While we think household and corporate savings flows (net buybacks) can keep equity demand healthy, it's ultimately not about equity supply/demand, but rather that future EPS yields are fair versus bond yields. Thus, future S&P returns should be mostly about EPS growth achieved. We expect S&P EPS growth to exceed par (near 7%) by about 3% for the next few years, but as this occurs the observed 22 S&P PE should compress by 3 - 5% each year back toward our estimate of a fair steady state PE of 18.5, which assumes a 4.5% 10-year treasury yield.

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

A **budget deficit** is created whenever the spending in a public budget exceeds the income within a given time period

A **bull market** is a financial market where prices are rising - usually used in the context of equities markets.

A **correction** is a decline in stock market prices.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

A **market** in which **equities** (stocks) are traded. The term can be used to refer to an actual market (e.g. the New York Stock Exchange) or to general trends in equity trading. Equities are securities which certify rights of ownership of (parts of) a company.

FX or **foreign exchange** is the currency — literally foreign money — used in the settlement of international trade between countries.

The **Great 8 companies** refers to AAPL, AMZN, GOOG/GOOGL, META, MSFT, NFLX, NVDA and TSLA.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The **intrinsic value** is the one that comes closest to the value that an objective fundamental analysis would ascribe to an asset.

M2 is a money-supply measure that includes physical money, bank deposits as well as other less liquid funds like savings that can quickly be converted to money.

Momentum refers to the rate of growth of an index or security's price. Momentum investors believe that strong growth is likely to be followed by further gains.

The **par** EPS growth is around 7% year-over-year.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

R-squared, in the context of portfolio management, is a statistic that indicates how closely a fund's performance correlates to the performance of a benchmark.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A **share buyback** involves a company buying back its own shares.

A **tariff** is a tax imposed by one country on the goods and services imported from another country.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

U.S. **Treasury yield** is the annual return investors can expect from holding a U.S. government security with a given maturity.

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as of 1/23/25; 096935_18 (1/2025)

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as of 1/23/25; 104406_1 (1/2025)