

QUARTERLY MARKET REVIEW

FOURTH QUARTER 2024



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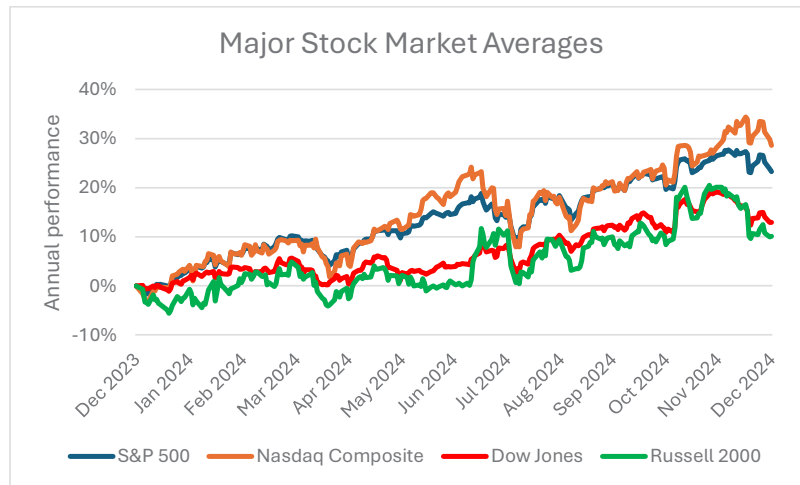
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INVESTMENT GROUP

JANUARY 24, 2025

Dear Investors,

Domestic stock markets experienced another year of positive returns; however, 2024 proved to be anything but a smooth ride. From headline drama surrounding the presidential election campaign, ongoing geopolitical tensions, hedge funds caught up in a yen carry trade unwind, to uncertainty over interest rate cuts, there were plenty of headwinds to navigate. As we have experienced with bull market cycles in the past, stocks climbed the proverbial “wall of worry.” The S&P 500 Index added 25%, the Nasdaq Composite Index gained 29.5%, the Dow Jones Industrial Average rose 14.9%, and the Russell 2000 increased 11.5%. Equity markets weren’t alone as safety assets like bonds and precious metals also posted positive returns. The Bloomberg U.S. Aggregate Bond Index added 1.3%, gold surged 27.5%, and silver jumped 21.3%.ⁱ

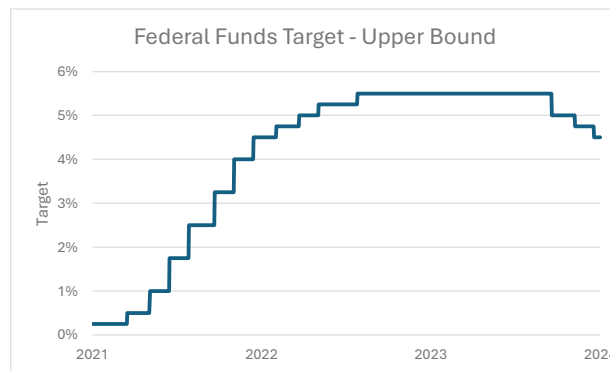


Source: NASDAQ

As we have discussed over the course of this year, a major driver behind these market moves has been investor speculation of when, and by how much, the Federal Reserve would lower interest rates. When we started 2024, it had been five months since our central bank had last raised the federal funds target rate, which stood at 5.4%. However, an important development took place in late December 2023. Chairman Jerome Powell said the Fed was on the verge of preparing to ease borrowing costs. After a slow start to the year, the major market averages rallied into the end of the first quarter of 2024.

The rally proved to be short lived and began to fade following a series of high inflation numbers. From January through April, the U.S. Bureau of Labor Statistics' consumer price index (“CPI”) averaged 0.5% growth on a month-over-month basis, or 6% annualized. Central bank officials said the rebound in price pressures was likely due to seasonality; however, policymakers opted to delay lowering the target Federal Funds rate through the first half of the year. As you’ll notice in the chart above, equity markets reacted negatively as Wall Street worried the above-target inflation numbers could be damaging to the expectation for 100 basis points worth of rate cuts in 2024.

Just as quickly as those fears peaked, they swiftly faded. With the release of May CPI data, the pace of inflation growth rapidly deteriorated. Instead of averaging the 0.5% monthly growth we saw in the first four months of the year, the number dropped to a 0.2% monthly increase. That was more in-line with our central bank's 2% annualized target. Heading into the September meeting of the interest-rate-setting Federal Open Market Committee ("FOMC"), CPI averaged just over 0.1% on a monthly basis since May. The pace of annualized inflation change had dropped from a 3.4% increase in April to just 2.4% by September, marking the lowest rate since inflation peaked at 9.1% in June 2022. At its September 17-18 meeting, the FOMC eased the Federal Funds Target Rate by 50 basis points, marking the first cut in over four years. Even more importantly, policymakers endorsed an additional 150 basis points worth of reductions by the end of 2025, which investors seemed to view as a sign of further growth potential. A lower cost of debt for corporations typically allows for increased spending on new initiatives, and this apparent shift in policy added momentum to the market rally.



Source: Federal Reserve

As mentioned earlier, 2024 was an election year and uncertainty on the outcome began to enter the market leading up to November. Rather than put money at risk ahead of an unknown outcome, institutional money managers tend to hedge their current investments and potentially trim profits. That way, they have dry powder to invest once the associated headline volatility has been removed from markets.

This past year proved no different. After a brief pullback heading into the election, the market rally was revitalized as uncertainty on the election outcome was removed. On November 7th, the FOMC added another tailwind by cutting interest rates an additional 25 basis points. U.S. small cap equities rallied potentially due to the high concentration of their revenue (roughly 80%) earned domestically. The Russell 2000's year-to-date performance had lagged the S&P 500 by about 12% prior to the election, but soon closed the gap to just 5%.

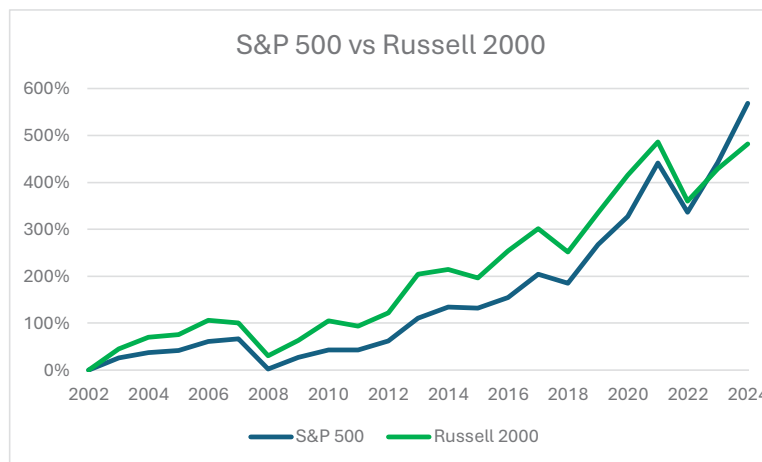
The growth narrative hit another speed bump in mid-December. At the final policy meeting of the year, the Fed surprised Wall Street. The central bank lowered borrowing costs by another 25 basis points to 4.4% while reducing its 2025 rate cut outlook from 100 to 50 basis points. Both of those events were widely anticipated, but it was next year's inflation outlook that caught investors off guard.

As part of their quarterly economic projections, policymakers raised the year-end 2025 outlook for price growth from 2.1% to 2.5%. Powell cited the uncertainty around potential trade policies of the incoming administration of President-elect Donald Trump. He added that Fed officials were planning to take a more conservative outlook until they have more clarity on how the uncertainty around new policies would play out. While 2.5% is just above the 2.4% inflation growth expected for 2024, it was interpreted as a setback compared to the 2% target, and momentum investors unwound trades on interest-rate sensitive assets.

The gap between cash-laden technology giants and more interest-rate sensitive investments like industrials and small caps widened. As we noted earlier this year, the balance sheet strength of the “Magnificent Seven” companies, like Apple (AAPL), Microsoft (MSFT), and Amazon (AMZN), allows them to circumvent higher borrowing costs that may encumber other debt-laden companies. In 2024, the Magnificent Seven are estimated to average 34% earnings growth year-over-year while the other 493 companies in the S&P 500 are on track to average only 3%. When the cost of debt and wages increased over the last two years, many companies’ earnings and profit margins were impacted by the higher cost of those components. Through the 3rd quarter in 2024, the Mag 7 companies had an average profit margin of 23.5% versus the other S&P 500 constituents that averaged 9.3%.ⁱⁱ Many factors play into why profit margins vary across types of companies, but a company’s ability to better control its cost structure is a core catalyst to keeping margins higher.

These differences are exemplified by the annualized performance numbers for the market-cap weighted S&P 500, where the 10 largest companies comprise ~38% of the index, compared to the equal-weighted S&P 500 index where each company has the same percentage representation.ⁱⁱⁱ The market-cap weighted index that we hear about daily, rose 25% while the equal-weighted version gained 13%. The growing concentration of the top 10 largest companies has helped create a significant difference in sector representation with technology being the largest of the market-cap weighted S&P 500 at ~31.7%,^{iv} while industrials is the largest sector weighting in the equal-weighted S&P 500 at 15.6%.^v The Russell 2000 represents a broader swath of the American economy, comparable to the equal-weighted S&P 500, and it suffered a similar setback due to interest rate concerns.

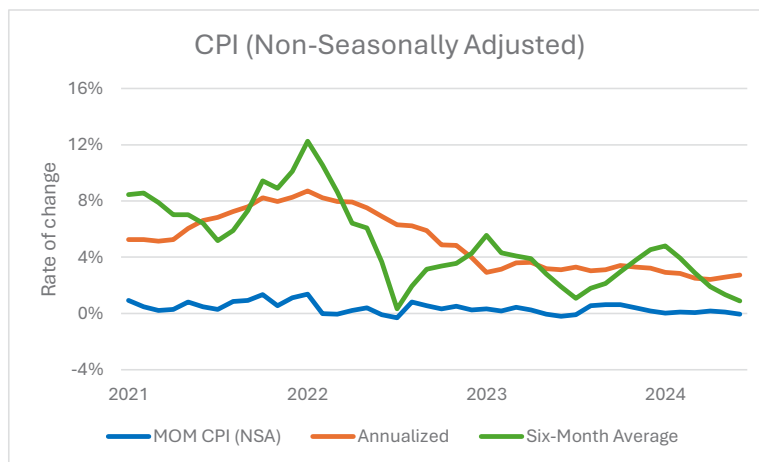
Stepping back from the recent vacuum of rapid interest rate increases, the chart below analyzes the performance numbers of the S&P 500 versus the Russell 2000 going back to 2002. That was following the end of the dotcom bubble burst. Until this year, small cap stocks had outperformed their large cap counterparts over that time period.



Source: NASDAQ

We can understand why Wall Street reacted negatively to the reset in inflation expectations from the Fed, but it is also possible that this is simply a short-term pullback during a bull market. It’s inherent in policymakers’ jobs that they take a conservative approach. They do so because setting lofty expectations on the amount of interest rate cuts would be akin to encouraging speculative investors to take excessive risk. Speculative risk-taking could likely drive the value of the dollar lower and commodity prices up, creating the unwanted inflation growth the central bank has been working to manage. Instead, a careful and modest approach tends to be the best plan to quell inflation.

When we analyze forward-looking indicators of inflation growth, it seems to be steadily slowing. According to the six-month average pace of growth, CPI has cooled to a 0.9% annualized pace. That reading is well below the Fed's 2% target and implies our central bank may be able to continue lowering interest rates without creating upward price pressures.



Source: U.S. Bureau of Labor Statistics

Looking out to 2025, the Fed's decisions on interest rate policy remain a focus as their influence can act either as a tailwind or a headwind for equity and fixed income markets. Despite the headline uncertainty, we continue to see signs that our economy is steadily returning back to normal. Projected earnings growth of S&P 500 companies is estimated to be ~14%, the highest annual percentage increase since 2021. Within those projections, the gap in earnings growth between the "Magnificent Seven" companies and the other 493 S&P 500 companies is anticipated to tighten significantly opening up new potential investment opportunities in equities. Fixed income yields on high quality assets remain attractive on a risk-adjusted basis. All the while, there are many areas of uncertainty ahead of us this year. Through different market environments, we remain focused on investing parallel with your long-term strategic risk allocation, and not diverting during periods of short-term volatility. A well-balanced portfolio should help investors weather unforeseen events that could impact their goal of long-term compounding growth.

As always, we appreciate the trust and confidence that you place in us.

Sincerely,

Your Sargent Investment Group Team

ⁱ Orion Advisor Solutions. *Blended Benchmark Performance*. 31 December 2024.

ⁱⁱ J.P. Morgan Asset Management. *Guide to the Markets: US 1Q2025*. Pg. 12. 31 December 2024.

ⁱⁱⁱ J.P. Morgan Asset Management. *Guide to the Markets: US 1Q2025*. Pg. 11. 31 December 2024.

^{iv} State Street Global Advisors. *SPDR 500 ETF Trust (SPY Factsheet)*. 30 September 2024.

^v Invesco. *Invesco S&P 500 Equal Weight ETF Factsheet: 3Q2024*. 30 September 2024.

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