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Economic and Market Outlook

December 31st, 2024

Managing Expectations

Past performance is no guarantee of future results.

- Every securities lawyer who ever lived

Section I. Introduction

The last two years have been good for investing in equities. The S&P 500 gained 24.2% in 2023 and is up another 24.1% as of this writing for 2024. Some may feel that the stock market is on a roll and will continue to deliver outsized gains.

While the last two years have been very profitable, 2022 was down 19.4%. Short term movements in the stock market, up or down, do not have a single cause and cannot be explained by a single narrative. Equity markets swing wildly from day to day, and year to year, on the smallest of news, rally and retreat on sentiment and emotion, and celebrate or vilify the most inane data points. In reality, market prices result from billions of shares being bought or sold in reaction to each investor's perception. It's important not to get caught up in the madness and instead to stay rational and patient.

Unfortunately, there are always reasons stock market investments are risky and you might be tempted to sell your holdings. We continue to advocate for a long term perspective as part of our investment strategy. We manage risk through position size and sector allocation and understand that successful investing is a lifetime endeavor where fear and greed cannot be allowed to affect our decisions.

Section II. The Bull Market

The most basic definition of a bull market is an upward move of 20%. Since the lows of October 2022 through December 20th, 2024, on a closing basis, the S&P was up 65.8%. In addition, the S&P has achieved all-time highs multiple times.

Bull markets do not die of old age. We are approaching 26 months in this bull market. Since World War II there have been 13 bull markets and the average gain was 164% and on average they lasted 57 months. It is also true that recent bull markets have generated higher returns over longer periods of time. On average, the last five bull markets since 1980 have seen stocks advance about 240% over a period of 70 months.

Bull markets end because of Black Swan events or because of recessions in the economy. By definition, Black Swan events cannot be predicted. For reasons cited later in this report, we do not see a recession coming in the near future.

2024 is turned out to be a great year for equity markets. Moving forward, our own internal proprietary model has remained positive for our long term indicators. In the short term the market has gotten a little extended creating some sell off this week.

To be clear, in the short term we fully expect some type of correction or consolidation in the market from time to time. Corrections of less than 10% are part of normal volatility, and are healthy for the market.

Back to back years of 20% gains do not occur very often so there is not much data historically to guide us as to what happens next. Logic would suggest a continued gain next year, but by a lesser magnitude, probably 6% to 9%. Analysts are all over the map, some calling for a decline while others expect robust gains to continue. The average return on the S&P 500 for the last 10 years is around 11%, and over last century the stock market is up on a yearly basis 76% of the time.

The four quarter earnings estimates for 2025 for the S&P rose to $279.74. This is an almost $20 increase from June's $260.60. That equates to a 14.69% annualized return. S&P earnings estimates for 2026 are currently around $307. That represents an additional 9.64% increase.

Despite recent market fluctuations and uncertainties, the momentum behind AI-driven technologies remains strong. As companies across industries continue to embrace AI to drive innovation and efficiency, investors are presented with unique opportunities to capitalize on the transformative power of artificial intelligence. The AI revolution is not just a fleeting trend but rather a fundamental shift that is poised to reshape industries and create new opportunities for growth and innovation. In our view this could be the next economic revolution.

Section III. <u>Inflation</u>

The readings for inflation are proving to be stubborn. Currently the Consumer Price Index (CPI) is up 2.7% on an annual basis, and core CPI, which excludes food and energy, is up 3.3%. Both readings are for November 2024. CPI and core CPI have risen slightly since our last report. While the CPI reading peaked in June of 2023 at 9.1%, the core rate actually peaked in September of 2023 at 6.6%. This is still above the Federal Reserve's 2% target. The move from 3% to 2% is proving to be more difficult.

The source of the stubborn inflation was led by housing costs. While those have started to lessen slightly, the service side of the economy has also become an irritant, as indicated in Chart #1. The biggest year over year components in the service sector are shelter, medical care services and transportation services. Energy is acting as a counter balance.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in November was 2.4% and the core rate was 2.8%. Inflation in the Euro Zone is running at 2.5% on an annual basis in November.

Remember that containing inflation is not about lower prices, but about stable prices. It appears that the Fed's previously aggressive approach has somewhat had its desired effect. The resilient economy continues to mute the effects of restrictive Fed policy.

Wages are starting to moderate as job openings drop and adjustments for increases in the minimum wage start to moderate. Wage increases trail inflation so it is not the problem that many believe. Wages tend to increase in order to keep up with inflation, as opposed to causing inflation.

Section IV. The Federal Reserve and Interest Rates

Because of inflation, the financial media, the Fed and the equity markets have become more focused on interest rates. We were spoiled by ultra-low rates before, during and after the pandemic.

The Federal Reserve continues to alter their previous monetary policy path. After holding rates steady at 9 of 10 meetings, Federal Reserve Chairman Jerome Powell and the committee cut rates at the last 3 meetings, first by 50 basis points in September of this year, and then by 25 basis points in November and December, for a total of 100 basis points. But at the December press conference Powell upset the markets by expressing that there may not be as many rate cuts in the future as the market was expecting.

They also continue to roll off $60 billion of bonds from the Fed balance sheet each month. Shrinking the Fed balance sheet will tighten money supply which once again means lessening consumer demand. This is reflected by the fact that growth in M2 money for August year over year is now only 0.5% (Chart #2).

We expect the Fed will cut interest rates only one time in 2025. Remember that cutting rates is usually a sign that the economy is slowing, which is not the case currently. The economy continues to show strength. The Federal Reserve must remain restrictive until inflation cools further.

Rates in most European 10-year bonds are steady to lower because of a slowing European economy. The U.S. 10-year bond still remains more attractive to international investors for its yield and AA+ credit rating. The U.K. 10-year yields 4.58% (AA), German 10-year yields 2.30% (AAA), France 10-year yields 3.11% (AA), Italian 10-year yields 3.48% (BBB) and Swiss 10-year yields 0.25% (AAA). These compare to our 4.56% 10-year yield.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and tend to happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out or already done with that recession, in other words <u>no predictive value.</u>

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative <u>and</u> the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 4.2% and the 12 month moving average was 4.00%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #3. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. This has strengthened dramatically and currently the reading is 1.04% for November, so this indicator has turned positive.

Indicator number three is represented in Chart #4. This shows the year over year change in Industrial Production. This indicator has turned negative. It currently sits at negative 0.90% for November 2024. This is not surprising given the past strike by Boeing workers and the recent hurricanes.

For indicator number four (Chart #5), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator stands at 1.35% showing the continued strength in employment. Therefore this indicator is positive.

Indicator number five (Chart #6) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is 0.49%, so this indicator has turned positive. This reflects the fact that inflation is proving stubborn and the consumer remains resilient.

Currently three of the five indicators are positive and the S&P 500 Index is 6.92% above its 40-week moving average as of December 20th. With the S&P 500 above its forty week moving average this model is not giving a recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is slightly positive and is at -0.39 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average remained relatively steady at -0.31.

In summary, the two "early warning signs" are not predicting recession at this time. We still believe that in February 2023, when our indicators predicted recession, we may have already experienced the mild recession everyone keeps predicting.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently, 8 out of 12 of our price/volume indicators are positive, which puts us in a good position. The S&P has reached 6000 and keeps making all-time highs. But that doesn't necessarily mean the end of the rally. The market needs corrections from time to time in the short term to stay healthy and growing over the long term.

Our advance/decline line has been positive for the last several weeks but dropped below 50% this week and sits at 48.9%, and is reflecting the recent sell off helping to prevent the market from getting too overheated.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is providing positive signs and our proprietary charting is reflecting a pattern seen during past bull markets as previously sighted in this report.

Chart 1

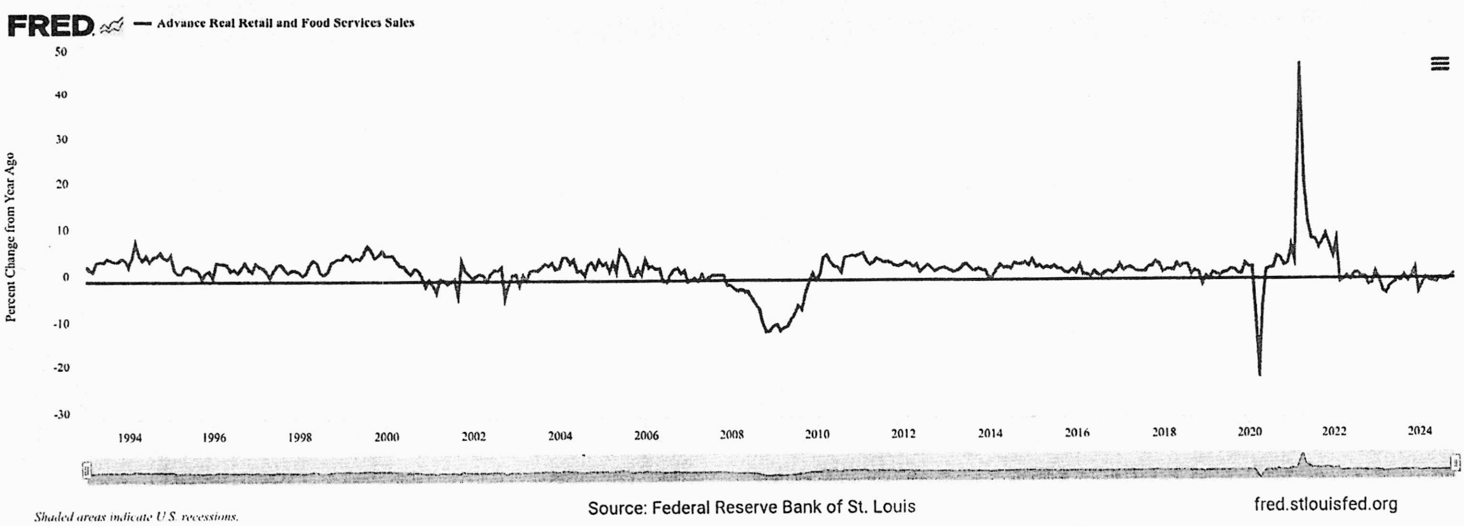
Table A. Percent changes in CPI for All Urban Consumers (CPI-U): U.S. city average

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended Nov. 2024
	May 2024	Jun. 2024	Jul. 2024	Aug. 2024	Sep. 2024	Oct. 2024	Nov. 2024	
All items	0.0	-0.1	0.2	0.2	0.2	0.2	0.3	2.7
Food	0.1	0.2	0.2	0.1	0.4	0.2	0.4	2.4
Food at home	0.0	0.1	0.1	0.0	0.4	0.1	0.5	1.6
Food away from home(1)	0.4	0.4	0.2	0.3	0.3	0.2	0.3	3.6
Energy	-2.0	-2.0	0.0	-0.8	-1.9	0.0	0.2	-3.2
Energy commodities	-3.5	-3.7	0.1	-0.6	-4.0	-1.0	0.5	-8.5
Gasoline (all types)	-3.6	-3.8	0.0	-0.6	-4.1	-0.9	0.6	-8.1
Fuel oil	-0.4	-2.4	0.9	-1.9	-6.0	-4.6	0.6	-19.5
Energy services	-0.2	-0.1	-0.1	-0.9	0.7	1.0	-0.1	2.8
Electricity	0.0	-0.7	0.1	-0.7	0.7	1.2	-0.4	3.1
Utility (piped) gas service	-0.8	2.4	-0.7	-1.9	0.7	0.3	1.0	1.8
All items less food and energy	0.2	0.1	0.2	0.3	0.3	0.3	0.3	3.3
Commodities less food and energy commodities	0.0	-0.1	-0.3	-0.2	0.2	0.0	0.3	-0.6
New vehicles	-0.5	-0.2	-0.2	0.0	0.2	0.0	0.6	-0.7
Used cars and trucks	0.6	-1.5	-2.3	-1.0	0.3	2.7	2.0	-3.4
Apparel	-0.3	0.1	-0.4	0.3	1.1	-1.5	0.2	1.1
Medical care commodities(1)	1.3	0.2	0.2	-0.2	-0.7	-0.2	-0.1	0.4
Services less energy services	0.2	0.1	0.3	0.4	0.4	0.3	0.3	4.6
Shelter	0.4	0.2	0.4	0.5	0.2	0.4	0.3	4.7
Transportation services	-0.5	-0.5	0.4	0.9	1.4	0.4	0.0	7.1
Medical care services	0.3	0.2	-0.3	-0.1	0.7	0.4	0.4	3.7

Footnotes

(1) Not seasonally adjusted.

Chart 2



Source: Federal Reserve Bank of St. Louis

Section VII. The Economy

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index has turned negative unexpectedly. It fell to -16.4 in December of 2024 for the lowest reading of the year. The Empire State Manufacturing Index fell to 0.2 in December, versus expectations of a reading of 6.4. The national ISM manufacturing index improved to 48.4% in November and the ISM services index was 52.1% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect a moderately strong economy and the fact that the Fed may just pull off the goldilocks soft landing scenario.

Multiple Wall Street and Federal Reserve predictions for Gross Domestic Product (GDP) have stayed around 2%. GDP for the third quarter was 3.1%. GDPNow is estimating GDP for the fourth quarter of 2024 will be another 3.1% reading. This shows the economy is still showing resilience.

Section VIII. Conclusion

The fourth quarter has seen a continuation of the market rally that started last year. It has also highlighted short term market volatility. We have sighted many reasons why we believe it is wise to stay invested in the long run.

We continue to be optimistic moving forward. As previously stated we expect a positive, but more muted, return over the next twelve months. Over the short term, directional moves in the stock market are always going to be somewhat unpredictable. Though a correction remains within the realm of possibilities, given what history tells us about market valuations, the historic data on market returns and economic growth it is crystal clear that investing for the long haul is a winning formula.

Happy New Year,

Scott B. Williams, CFA, CFP

Kent Edwin Stone

Chart 3

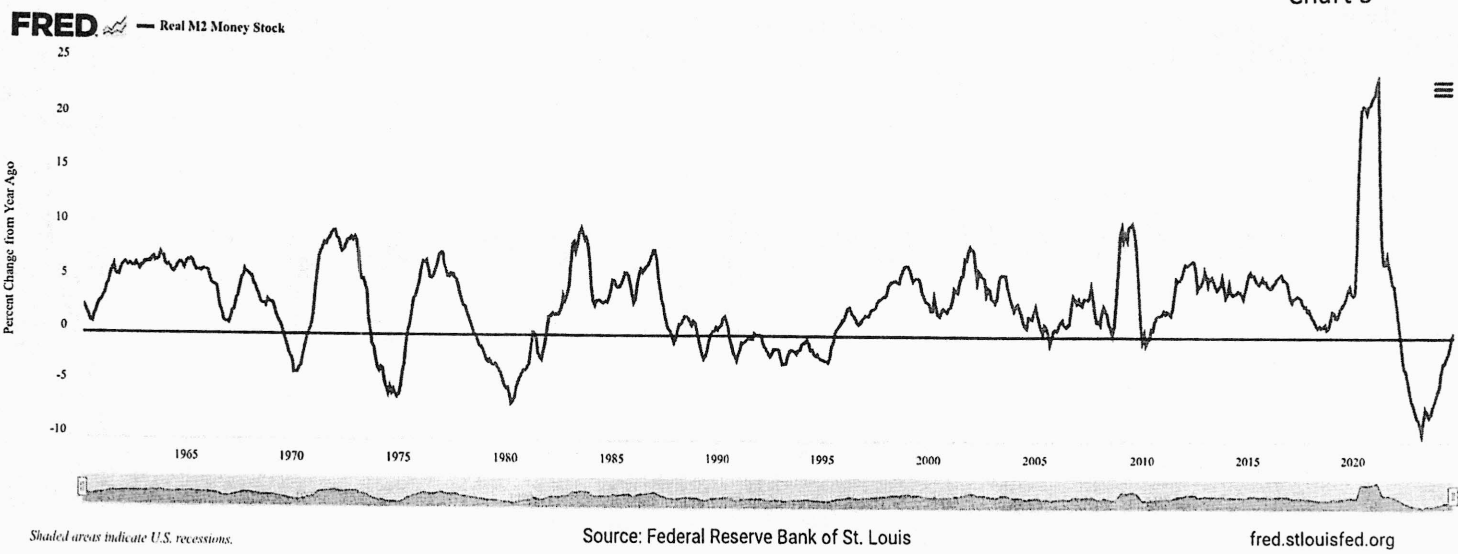


Chart 4

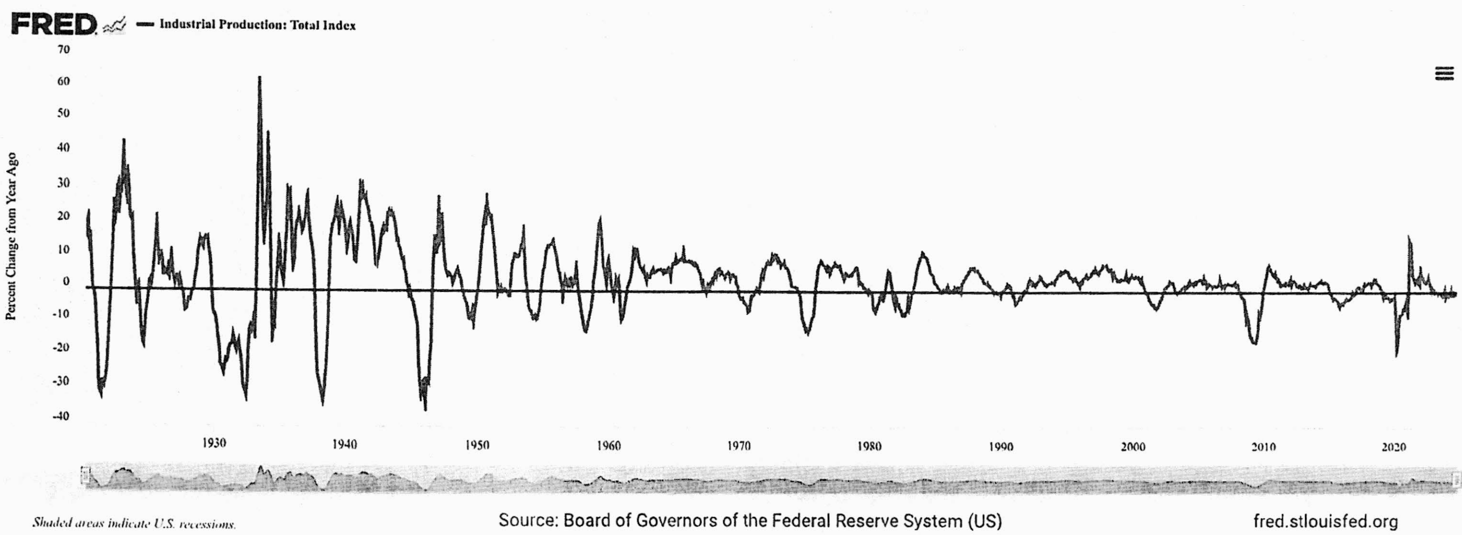
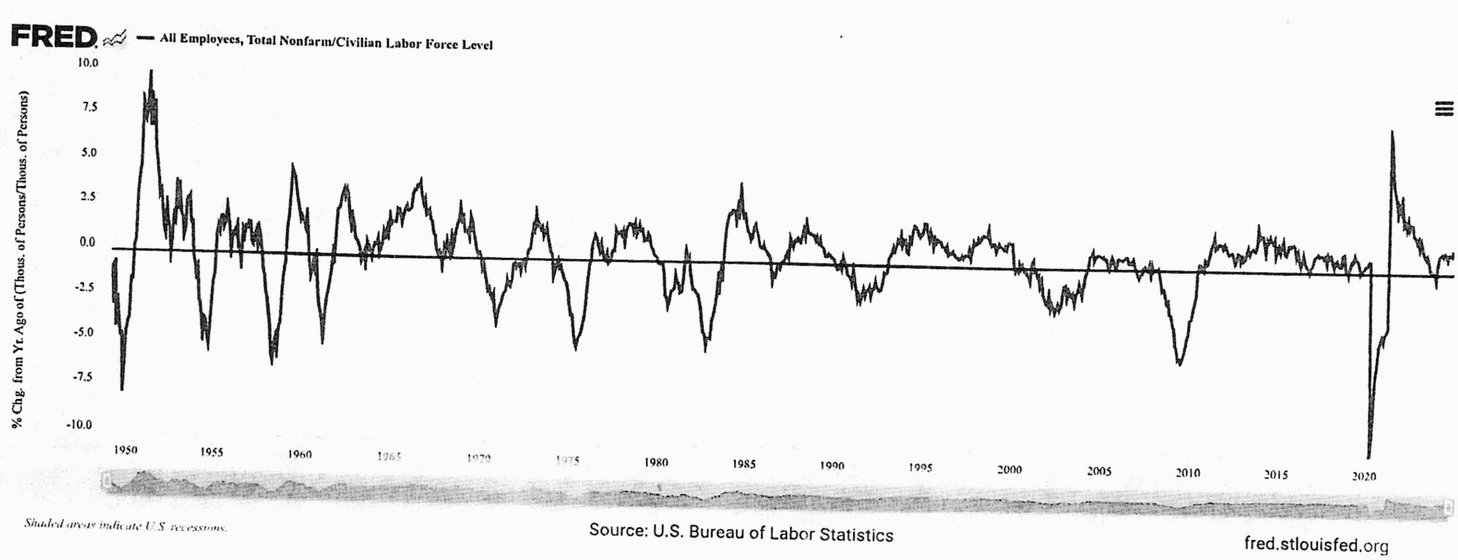
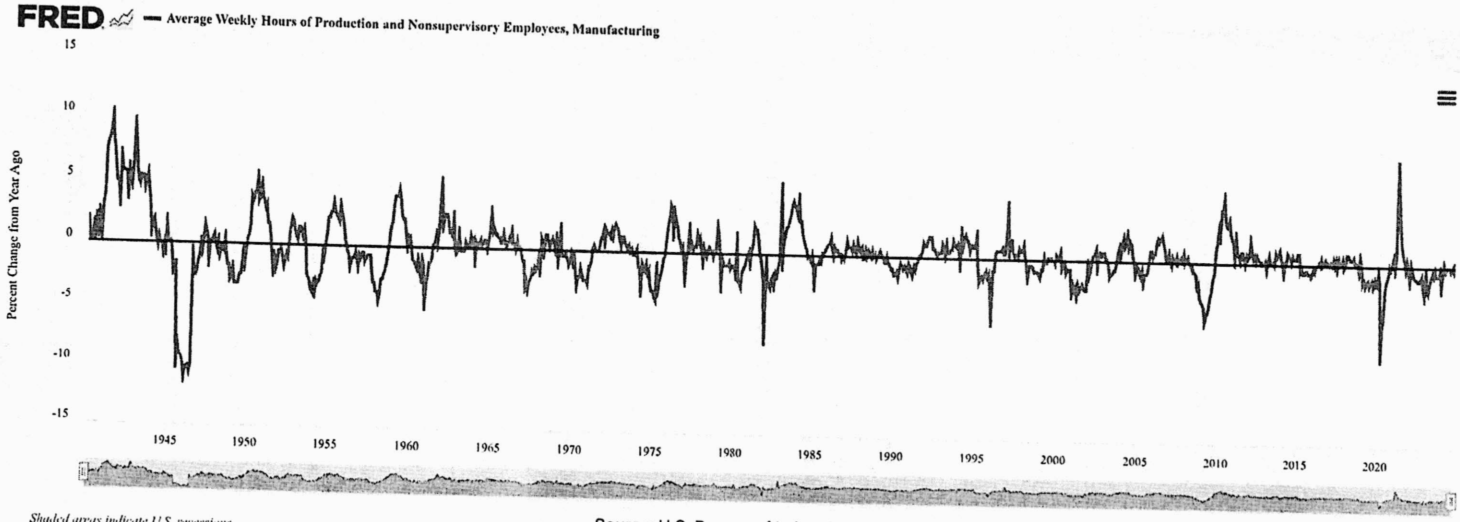


Chart 5





Shaded areas indicate U.S. recessions.

Source: U.S. Bureau of Labor Statistics

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