Market Commentary

Fourth Quarter 2024

Thomas J D'Auria, CFA
Managing Partner

Caleb Lennon, CRC
Director

Barbara Tweedy
Wealth Manager

The fourth quarter of 2024 saw increased volatility across both equity and fixed income markets. The benchmark S&P 500 index rose by 2.4% in the three-month period, bringing the full year return to 25.0% and increasing the return from the end of October 2023 to an astonishing 42.6%. This market advance came despite a significant increase in interest rates across most of the maturity spectrum.

Following the Federal Reserve's initial 50 basis point cut in mid-September, the Fed cut rates two more times during the quarter, including a 25-basis point cut in mid-December. This brought the decline in Fed Funds to one full percentage point over the past three months. Despite this meaningful move lower in short-term rates, Treasury yields increased meaningfully in all maturities one year or longer. This divergence in rates tells us that the markets disagree with the Fed regarding the success in slaying inflation and believe rates will stay higher for longer. While we thought short-term rates were too high and needed to come down, the question now is how much further rates need to decline, if at all. We wrote in our last commentary that we felt the Fed wanted to get Fed Funds to their estimated "neutral rate" of about 3.5%. We believe this may be a challenge as stubborn inflation and a healthy labor market continue to defy expectations.

While very short-term yields declined in lockstep with the Fed Funds rate during the quarter, most of the yield curve saw significant increases in rates. The 1-year Treasury bill rose to 4.16% from 4.02% on September 30. The 2-year Treasury note began the quarter yielding 3.66% and increased to 4.25% at the end of 2024. Longer-term maturities saw similar increases. The benchmark 10-year US Treasury note ended the year with a yield of 4.58%, up meaningfully from the 3.81% rate at the end of September. So, despite a full percentage point decrease in the Fed Funds rate over the past three and a half months, borrowing costs - including mortgage rates -rose during the past quarter for many consumers.

Economic and Market Outlook

While there have been many signs of a slowing US economy over several months, it is also evident that economic growth has stayed stronger than most had expected, including the Federal Reserve. A year ago, the Fed projected GDP growth of 1.4% in 2024. It is likely to come in at 2.5%. Conversely, the Fed expected Core PCE inflation for 2024 to register 2.4%, yet the current forecast is for 2.8%. The Fed has 400 PhD economists on staff and still has trouble accurately determining the path of the US economy. We have often said that us mere mortals do not stand a chance out forecasting the Fed and thus do not spend significant time or resources on economic projections.

TANDEM
INVESTMENT PARTNERS

3 Third Street, Suite 215
Bordentown, NJ 08505
Tel 609-452-2100

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628

Oil prices were little changed during the quarter, trading in a tight range of $67-75 a barrel. Thus far, fighting in the Middle East has not had a meaningful effect on energy prices, leaving them subject to supply and demand trends.

The November elections provided plenty of drama but little in the way of surprises. Although Republicans control the Presidency, House, and Senate, it will be challenging keeping the Republican caucus together to pass meaningful legislation. With the race for 2026 mid-terms already under way, we believe President Trump has about 12-18 months to get any meaningful legislation passed. The House and possibly Senate will likely flip to Democratic control in two years, meaning the final two years of the Trump presidency will rely on bipartisanship to get anything accomplished. We believe extending the 2017 tax cuts will be the foremost priority. While there is discussion of a further decrease in the corporate tax rate, budgetary pressures may hinder any additional cuts. Clarifying tax policy for the next decade will help both individuals and corporations better plan.

Earnings estimates for the S&P 500 in 2024 are currently about $240. This would be a gain of approximately 9% from the prior year. Analysts are predicting an even larger gain of 14% in 2025 which would bring earnings to a range of $275-280 next year, with a further increase to $310 projected in 2026. Obviously, there is no economic slowdown factored in these estimates. If these estimates are achieved, the S&P 500 is selling at nearly 25x 2024 estimates and 21.5x 2025 estimates. These are meaningfully above the 30-year average P/E multiple of 16.7x. We can argue that the market make-up has changed for the better over the past 30 years, but it is challenging to rationalize a forward multiple of 21.5x when investors can earn over 4% in far safer Treasuries and money market accounts. Bull markets do not end from high valuations alone, but stretched valuations tend to increase the potential number of catalysts to provoke a downturn.

Portfolio Positioning

Equities completed their second consecutive year with gains of more than 25%. We have not seen this since the streak of four consecutive years during the latter part of the great 1990's bull market. While earnings have been rising, stocks are appreciating much faster than earnings, making them more expensive. Stocks are now more expensive than they were at the end of 2021, a time when the 10-year Treasury yielded a paltry 1.6%.

As we have written for several quarters now, we remain cautious about the potential for further meaningful advances in equity prices. We understand the motivation to buy stocks when prices are rising, but as your risk manager, we are responsible for telling you when markets are showing signs of froth. Asset allocation will continue to drive the bulk of overall portfolio returns and with the ability to safely earn 4%+ in money markets and short-term fixed income, it is prudent to maintain a healthy commitment to fixed income and cash equivalents.

TANDEM
INVESTMENT PARTNERS

3 Third Street, Suite 215
Bordentown, NJ 08505
Tel 609-452-2100

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628

Conclusion

As the calendar turns to 2025, we expect volatility to continue, particularly following the sharp moves in both equity and fixed income markets. Not only was 2024 a strong year for US equities, but the past five years have been quite strong as well. Most would be surprised to learn the S&P 500 has risen an astounding 97% in the past five years. This equates to annualized returns of 14.5%. While remarkable on their own, these returns are even more astonishing when we remind you that this period includes both the entirety of the COVID pandemic (34% decline during Feb-Mar 2020), as well as the 2022 declines due to sharp hikes in interest rates (24% decline during Jan-Sep 2022). So even with two significant downturns, equities have still provided outstanding returns over the past five years. While this does not lessen our concern of high valuations, it does reinforce our disdain for market timing as short-term moves in the markets can negatively affect portfolios that attempt to move in and out of equities for short periods. We counsel maintaining asset allocation with an eye toward defensive stock holdings that should better withstand a downturn.

We hope you and your loved ones had a joyful holiday season. We are here to answer any questions on financial matters that you may have. Please inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

December 31, 2024

TANDEM
INVESTMENT PARTNERS

3 Third Street, Suite 215
Bordentown, NJ 08505
Tel 609-452-2100

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628