

# Assessing Both Success and Regress

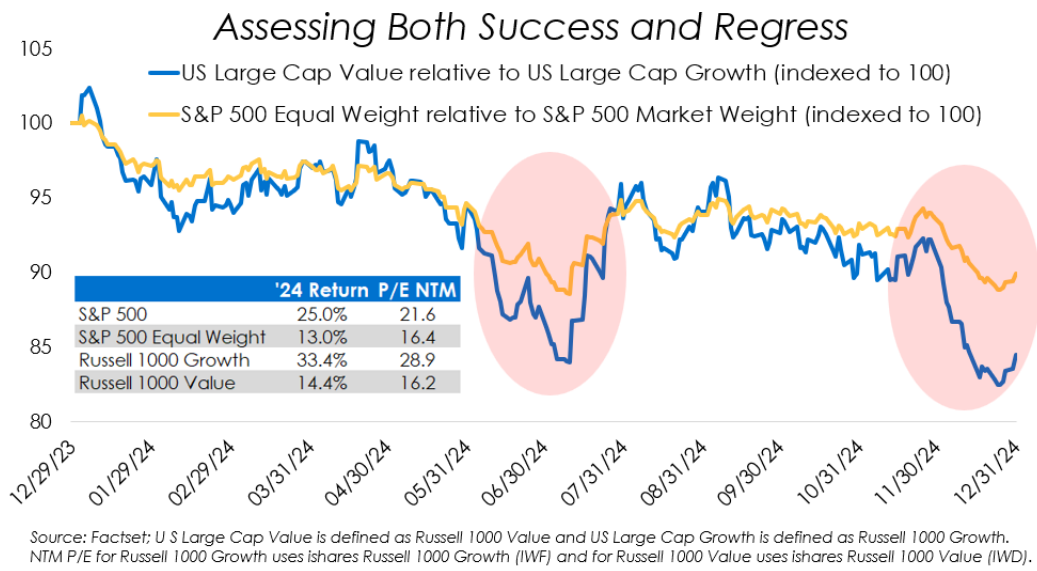
**“Success is peace of mind in knowing you did your best to become the best that you are capable of becoming.”**

– John Wooden (1910-2010)

John Wooden is arguably one of the most successful coaches of all time. In a twelve-year span at UCLA, his basketball teams won ten NCAA championships including a record seven in a row with an incredible eighty-eight consecutive win streak. What makes this more fascinating is that one of the winningest coaches never defined success by winning but rather by striving to be the best version of oneself both individually and collectively.

Investors can have different measures of success. Some investors might be dissatisfied with any stock return less than the 25% that the S&P 500 delivered in 2024. One wonders if those same investors would be less satisfied once realizing the Russell 1000 Growth delivered a 33% return. In contrast, other US Large Cap indices including both the S&P 500 Equal Weight and the Russell 1000 Value generated returns that were

more subdued in comparison. In relative terms, those indices showed a significant degree of regression as can be seen in the chart at right. Both the “average stock” (defined as the S&P 500 Equal Weight) and the “value stock” (defined as the Russell 1000 Value)



underperformed their mega-cap growth brethren resulting in a narrowing of the market that was especially pronounced in both June and December. And yet both of those lagging indices still managed to successfully turn in double digit returns of around 13-14% – numbers that were almost double the consensus of long-term



return expectations for US Large Cap stocks. Some might even argue that generating double digit returns while maintaining a reasonable price to earnings valuation multiple (of around 16X) makes for a much more attractive long-term investment as compared to the more inflated valuations (of nearly 22X and 29X) now represented in the other two Large Cap indices.

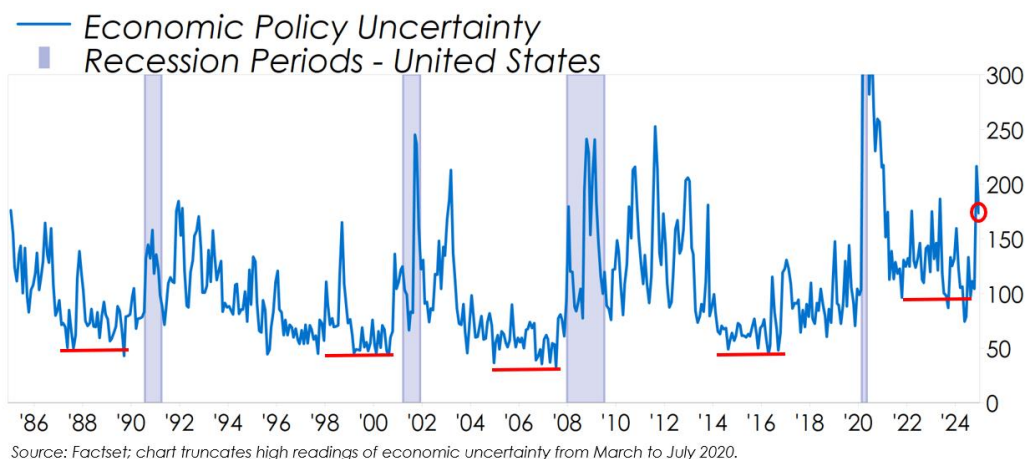
So, is there rationale for behavior that seems to indicate a scarcity of opportunities outside the largest, most popular growth stocks – devoid of valuation or diversification considerations? The answer might be yes and no.

On the one hand, the Fed’s raising of interest rates in ‘22-23 (from roughly 25 bps to 550 bps) has led to a more challenging earnings backdrop (that extended into ‘24) for the smallest sized companies more exposed to the financing disadvantages that this creates. Additionally, some key economic metrics – mostly labor market oriented – suggest that the business cycle continues to mature into its later innings. These dynamics might argue that growth is more difficult to come by outside of the handful of names at the top of the market that benefit from less debt and a high expected return on AI-related CAPEX spend.

And yet at the same time, outside of a softer economic patch that occurred mid-year, real GDP growth has been relatively stable and above average at around 3%. Inflation – while sticky – has come down from its elevated peak. The Fed has cut rates by 100 bps in ‘24. And earnings growth is expected to improve in ‘25 (to double digit territory) – especially down market cap. In short, the profit cycle suggests an earlier inning – and perhaps broadening – backdrop.

If one throws into the mix the potential policy impacts regarding the Fed (inflation, employment and rates) and the new Administration (debt ceiling, tariffs, immigration, deregulation and tax cuts), it’s no wonder that the setup for 2025 is highly uncertain as can be seen in the chart above which illustrates an extended and elevated degree of economic uncertainty.

As a result, this year’s success might be influenced, in part, by how well portfolios are positioned to handle this high degree of uncertainty. We think a greater degree of balance might be the name of the game as we move into 2025.

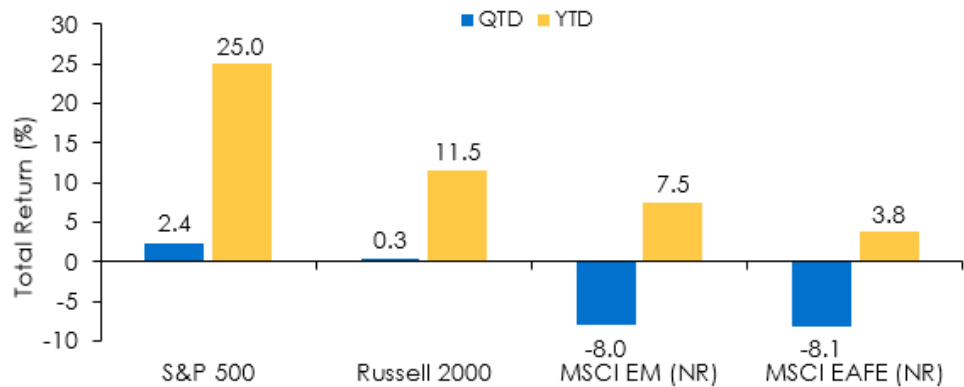


Stocks, Bonds, and REITs all posted negative returns in December as bond yields rose on sticky inflation data leading to the re-emergence of narrowing markets. Full year returns were tiered with Stocks up the most followed by REITs and Commodities and finally by Bonds. The S&P 500 led global equity markets for the year given its growth oriented bias influenced by AI related enthusiasm.

## Stocks

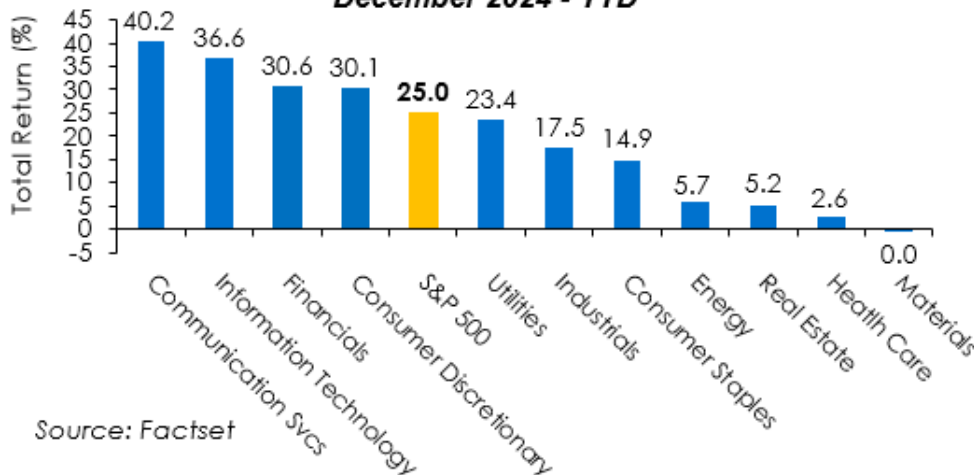
Domestic stocks posted positive returns for the quarter and strong returns for the full year. International markets were negative for the quarter – as the U.S. dollar significantly strengthened into year end – and lagged domestic stocks for the full year. U.S. Large Caps (S&P 500) outperformed and significantly outpaced all other assets classes on the strength of mega cap AI-focused growth companies. US Small Caps (Russell 2000) gave back most of November’s strong gains – as interest rates backed up on sticky inflation data – and ended the year up low double digits. Overseas, full year returns in International Developed Markets (MSCI EAFE) were subdued as money continued to flow into domestic equities. Emerging Markets (MSCI EM) also lagged amid ongoing questions regarding the effectiveness of China’s stimulus programs, the impact that US tariffs might have, and a stronger dollar.

**Global Equity Returns**  
December 2024



Source: Factset

**S&P 500 Sector Returns**  
December 2024 - YTD



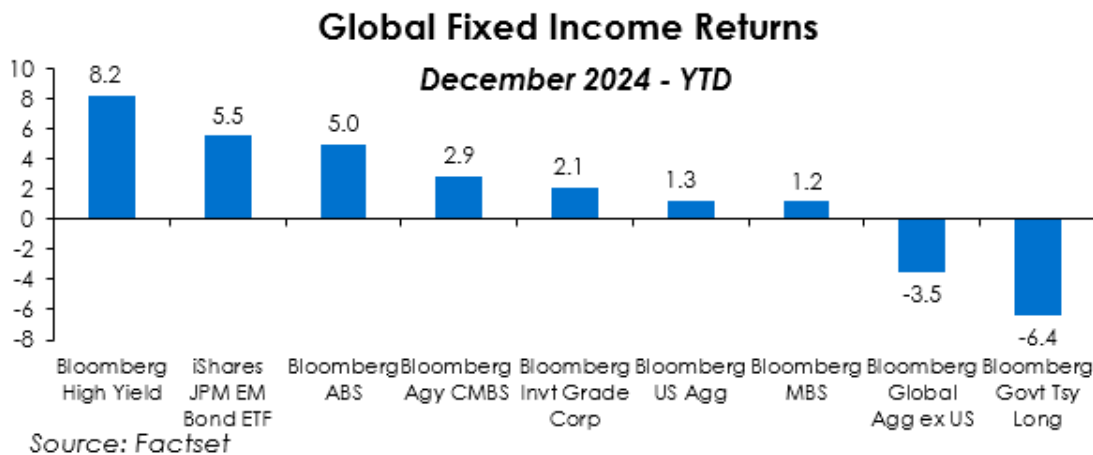
Source: Factset



## Bonds

Despite ongoing balance sheet reduction – policymakers pivoted to an easing bias by reducing the Fed Funds rate by 50 basis points at their September meeting and another 25 basis points each at their November and December meetings (Fed Funds at 4.25-4.50%). While this easing bias is the first in over four years, policymakers recently reduced their number of expected 2025 rate cuts from four to two (25 basis points per

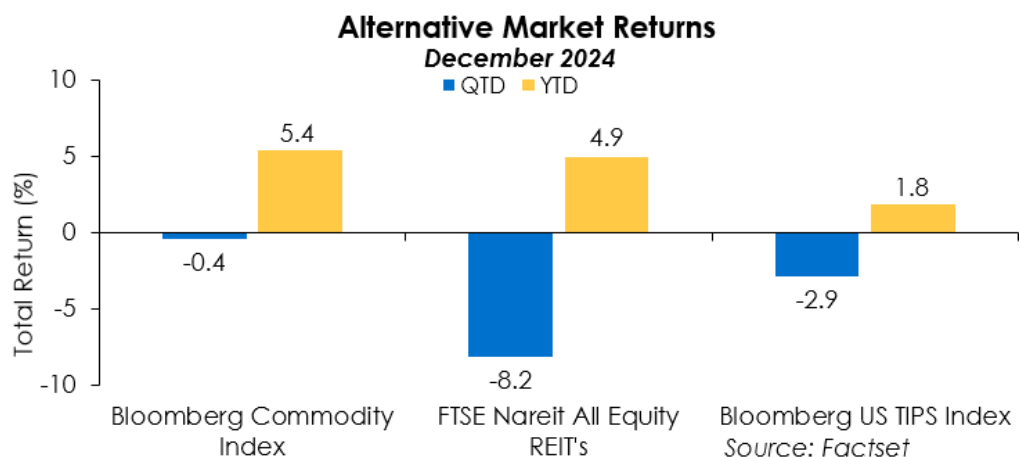
as inflation remains sticky and growth resilient. Bond returns were negative for the month and quarter as interest rates rose considerably during the final three months of the year. Year-to-date, Bond returns



have been modest compared to Stocks – generally in the low-single digits. Credit (High Yield), Emerging Markets (JPM EM), and Asset Backed Securities (Bloomberg ABS) were among the best performing areas for the year. Conversely, long duration Treasuries and the Global Agg ex US lagged on the rate back up (despite the Fed’s back-half rate cut pivot) and stronger dollar.

## Alternatives

Commodities held up best in the final quarter while posting mid-single digit returns for the year – primarily due to the strength of precious metals. Meanwhile, publicly traded Real Estate (REITs) declined in the quarter (mostly December), due to the back up in interest rates, and ended the year up mid-single digits as well. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) outperformed nominal Treasuries amid rising inflation expectations of late.



## Market Outlook

***“It’s Tricky to rock a rhyme, to rock a rhyme that’s right on time.  
It’s Tricky.”***

– Run DMC, *It’s Tricky* (1986)

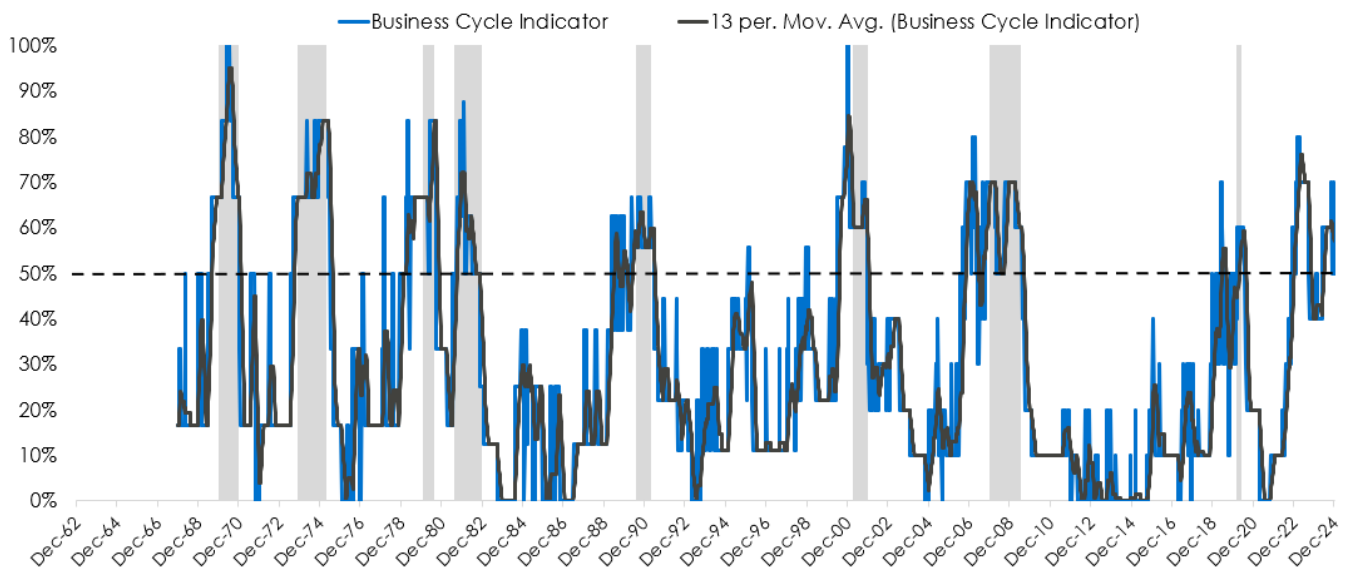
As the page turns to 2025, we’re focused on a “three cycle” framework – one later (Economic Cycle), one earlier (Profit Cycle) and one that runs counter to history (Fed Cycle). This makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and “Head on a Swivel”.

### *It's Tricky*

Cycle	Stage
Economic Cycle	Later
Profit Cycle	Earlier
Fed Cycle	Counter

While only four years removed from the (short) COVID induced recession, we’re more than fifteen years removed from the one prior to that. But its not just the duration that suggests we’re on the later side of the economic cycle. Several fundamental data points including the yield curve, leading economic indicator composites and especially labor market measures suggest a similar conclusion. As can be seen below in our business cycle indicator, an increased percentage of measures being triggered is additional confirmation that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions).

### Business Cycle Indicator

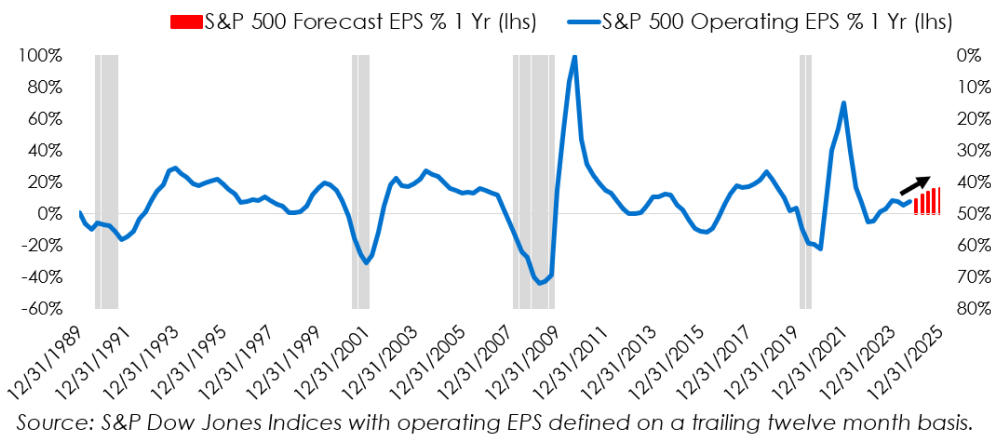


Source: Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.



And yet from a profit cycle perspective, we don't look nearly as late. In fact – as can be seen in the chart below – profit growth continues to ramp off of the earnings recession trough in 2022. As expectations point to an earnings acceleration into 2025, this would argue for being at an earlier respective stage in the profit cycle.

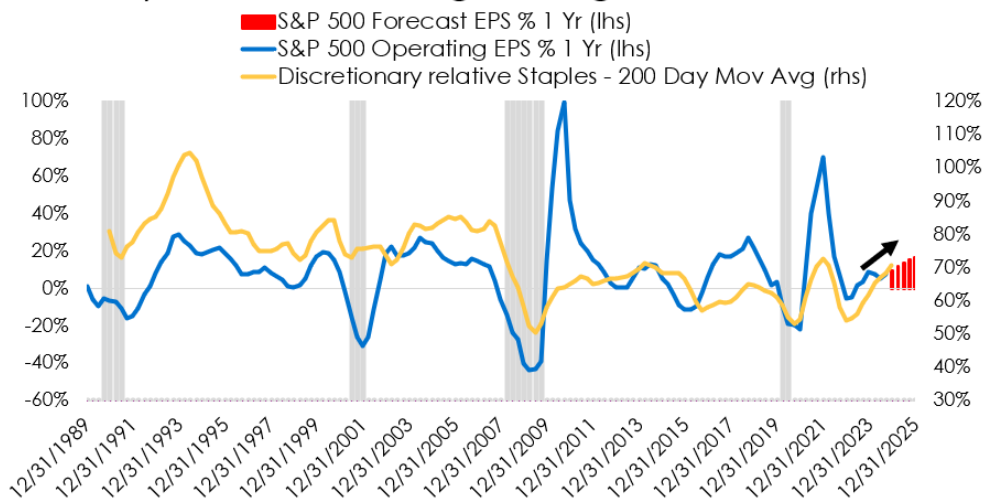
### Earnings Growth Continues to Ramp



As additional evidence, the price action in the equity market seems to be confirming the cyclical improvement in corporate profits. As noted in the chart below, when comparing the Consumer Discretionary sector against the Consumer Staples sector (both on an equal weighted basis

using the relative 200 day moving average), the pro-Discretionary tilt implies a cyclical bias that tends to directionally coincide with an acceleration in earnings growth. The bottom line is that investors continue to favor stocks that benefit consumer wants over needs which seems to be consistent with a broadening growth backdrop as earnings accelerate.

### Cyclicals Confirming Earnings Acceleration



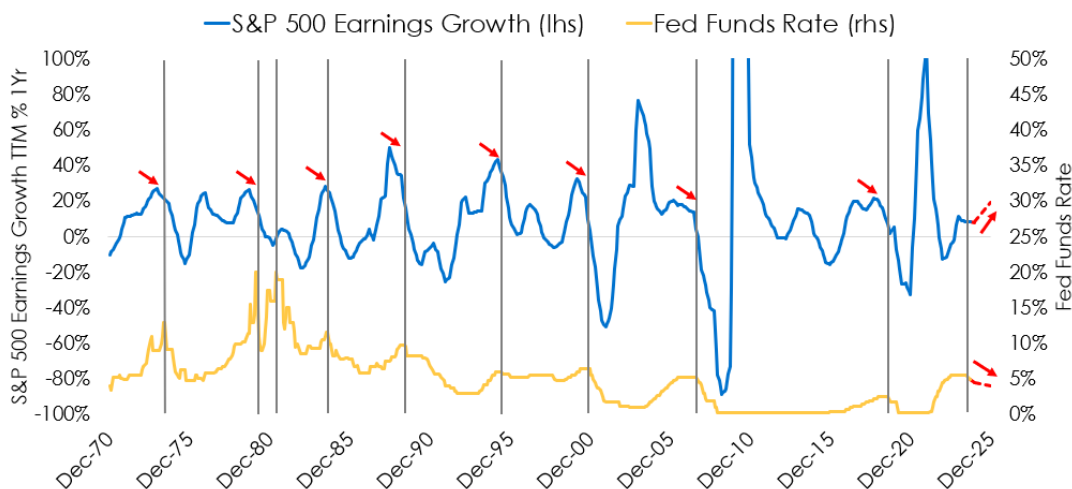
So what do we make of this de-synchronous setup – are we early or are we late? History tells us that the disconnect between the economic cycle and profit cycle tends to be uni-directional. An earnings recession can occur without an



economic recession ('15-16) but generally not vice versa. This implies that the economic state can remain in an extended late cycle position until earnings materially weaken.

Add to that the third leg of the stool – a Fed Cycle that looks counter to history. The chart at right highlights the nine other Fed easing cycles (i.e. cutting rates) over the last half century. Acting as a countercyclical body, the Fed has almost always started its rate

### Fed Easing Cycles vs Earnings Growth



Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; [www.shillerdata.com](http://www.shillerdata.com). Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported earnings using the S&P Dow Jones Indices datasets; [www.wpglobal.com](http://www.wpglobal.com). Next twelve month forecast for Fed Funds rate based on FOMC projection from the September dot plot and forecast exhibits; [www.federalreserve.gov](http://www.federalreserve.gov).

cutting cycle after earnings growth has peaked. Should earnings growth continue to ramp in 2025, such would not be the case in this current Fed cycle. We remain mindful of how such an occurrence might impact both growth and inflation.

To the extent that this aids an accelerating and broadening of the earnings growth backdrop, this could unlock a recalibration of valuations. According to Factset data, consider that since the end of 2009, the “average” stock (as defined by the equal weighted S&P 500) is trading at an almost 25% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 6%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are still rather extreme – not far off from their disparate readings witnessed back in late 2021 and before that, the Tech Bubble peak. The bottom line is that the highest valuations still remain in the hands of the largest and growthier weights in the index. A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with increased concentrations – and with a disregard of building valuation (and mean reversion) risk – at a time when growth might be becoming more balanced.

Conversely, we want to remain on guard for a faster peak in earnings growth that might translate into a changing set of market conditions. Such a set up might occur from the tail risk scenarios of a labor market weakening quicker than anticipated and/or a stickier inflation backdrop that causes the Fed to pivot to more



restrictive policy. Such scenarios might be suggested by the elevated level of economic uncertainty as referenced earlier.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above “Tricky” setup, we continue to emphasize a degree of balance across asset classes and market segments while remaining UW to the most expensive and concentrated areas.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure. Acknowledging the more constructive profit cycle with prospects of a broadening, our bias has generally been to have more exposure to less expensive areas (down market cap vs top). As such, we’ve maintained a larger OW in Cyclical Value and a lesser OW in Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we are longer in duration and have previously repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains OW in portfolios for diversification purposes though we’ve also added to International Fixed Income (EW), where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where spreads remain tight. High Yield corporate bonds tend to benefit from cyclicality though their incredibly tight credit spreads suggests this might already be fully recognized.

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities.

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