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INVESTMENT MANAGEMENT

Equity Market Commentary

SLIMMON'S TAKE | APPLIED EQUITY ADVISORS TEAM | January 2025

The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

AUTHOR

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1 After two years of the S&P 500 index generating over +20% returns annually, I sense much more optimism than I did in 2023 and 2024.[1]

This is a shame since the peak to trough -25% SPX decline in 2022 offered such a great buying opportunity. [2]

2 Given the sense that I am no longer an out-of-consensus bull, it is emotionally tempting to remain contrarian and turn bearish.

3 However, the third year of a bull market, while producing only *a mediocre return* on average, is typically not negative.[3]

In my opinion, it's too early for a down year, considering there still remains too much cash clamoring into equities from the sidelines.

Gone are the days of the consensus skeptics when daily I would hear, "*why would I buy equities when I can get 5% risk-free*." Not anymore.

Instead, now I hear, "*when is the pullback coming to allow cash to be put to work*?" (By the way, we got one on Monday.)

4 Part of me could see a 2025 scenario where:

1. 2025 earnings per share growth exceeds market returns, pulling the market's overall P/E valuation down.
2. With enough negatives out there to cause a subpar year, the recently minted optimists could revert to being skeptics.

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[1] The average strategist 2025 SPX year-end price target projected a +14% return for 2025 versus +4% in 2023 and +2% in 2024. Strategas, January 2025.

[2] From its peak on 1/3/2022 to its trough on 9/30/2022, the SPX declined -25.2%. Bloomberg.

[3] The SPX has averaged a +5% return in the third year of historical bull markets. Paulsen Perspectives, January 2025.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

3. Only to have the market roar again in 2026.
4. Thereby marking 2025 more of a pause year than anything more sinister.

5 However, I concede there could be *a different outcome for 2025*. My confidence in this alternative scenario has been strengthened recently:

1. While back-to-back +20% return years have tended to produce a lackluster third year, the late 1990s were an exception.

2. After two +20% great years in 1995 and 1996, there was no pause. Instead, the S&P roared higher in 1997 (+33%), 1998 (+29%) *and* 1999 (+21%).[4]

6 What was it about the late 1990s that made it the exception to a normal pause in a bull market following two strong years? In my opinion:

The introduction of *the Internet*.

7 While the World Wide Web was introduced in 1993 with the release of the Mosaic browser,[5] it was not until the mid-1990s that the Internet gained *widespread popularity*.

While ultimately the SPX Internet euphoria bubble burst in March of the year 2000, that was only after the S&P 500 had levitated another *+67%* after the two good years of 1995 and 1996.[6]

SPX valuation ultimately peaked at a breathtaking 30.5x forward P/E, far higher than its current 21.9x valuation.[7]

8 Could we be on the cusp of a *huge commercial embrace of artificial intelligence (Ai)*?

We know about the chips and the hyperscalers, but we have heard little discussion of the broader application of these technologies within corporations.

Yet, I am reminded of the *Law of Accelerating Returns*:

> the tendency for technological advances to feed on themselves, increasing the rate of further advance, and pushing well past what one might sensibly project by linear extrapolation of current progress.[8]

An Ai chip might be costly, but it does not have health care costs.

Hence, could the embrace of Ai ultimately be margin/profitability enhancing for a broad swath of companies in many different industries?

9 To be clear, I don't want anyone to assume I am suggesting a +67% return for the S&P 500 over the next three years.

Today the market seems obsessed with trying to figure out the winners and losers amongst the technology stocks providing the picks and shovels.

While important, it seems to me we are not focused yet on the broader application and implications.

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[4] Bloomberg.
[5] Microsoft Copilot.
[6] Bloomberg.
[7] Microsoft Copilot.
[8] Nature.com.

10 So why has my confidence in this alternative scenario risen recently?

Since his inauguration, we have heard a new President who, through significant investment, clearly intends to ensure the US remains the Ai leader. Does the introduction of a Chinese large language model only strengthen his resolve?

11 Most every forecaster I've read suggests that 2025 will be the year the other 493 stocks catch up to the big boys. (SPX equal-weighted outperforms the SPX cap-weighted.)

Clearly a broadly embraced Ai rollout would allow many other companies to financially benefit.

Currently, big tech is heavily owned individually and within the indices. This ultimately can result in big swoons when negative news comes out like it did on Monday.

However, I wouldn't actively bet against the big dogs that comprise the biggest weights in the SPX.

Keep in mind, when the dot.com bubble peaked in 2000, the big titans of that era were—in my opinion--Cisco Systems, Intel and Microsoft. Respectively, they traded at 75x, 50x and 60x forward PE.[9]

Today, except for Tesla, the mega-caps trade at *roughly* a 50% discount to these previous peak multiples.[10]

12 I read two interesting pieces recently which I found entertaining for their juxtapositions:

First, a major financial magazine cast doubt on Elon Musk and his Department of Government Efficiency, suggesting he wouldn't make "*even a dent*" in the deficit.

I have read this view often.

The second was from Goldman Sachs' Dave Kostin who noted that stocks most adversely affected by government spending cuts (due to their high percentage of sales to the federal government) *have persistently performed poorly since the election*.[11]

Who is right?

I would remind you of a famous quip from the legendary Barton Biggs, *"Mr. Market has a sinister way of making the consensus look foolish."*[12]

It seems to me spending cuts plus accelerating growth would have implications for the *deficit* and, hence, the US *dollar*.

Yet this is beyond my equity sphere, so I would simply suggest there are a lot of doubters out there, whereas the market is sending a different signal.

13 While I have articulated our embrace of technology names, Applied Equity Advisors likes more than simply growth stocks.

All three of our active strategies (US Core, Global Core and Global Concentrated) have at least *25% in financials*, the biggest of all sectoral overweights relative to their benchmarks.

Combined with other industrial names, in essence there is a balance between growth and value names.

[9] Microsoft Copilot.

[10] Bloomberg. Based on consensus forward P/E estimates.

[11] GS Weekly Kickstart. January 24, 2025.

[12] The Big Picture. July 2012.

14 So, what stocks do we not like?

I hear plenty of 2024 commentary about "*poor breadth*" and "*low quality*" and how 2025 will be the year for "*quality*" and "*breadth expansion.*"

To be clear, we love highly profitable companies.

Excess cash flow allows companies to buy back stock and invest in their businesses. The *profitability factor* is one of our biggest factor overweights.

But "*quality*" is often used interchangeably with "*defensive.*"

We think it's simply too early to be overweight in recessionary earnings resistant stocks. (A standard measure of defensiveness.)

Especially now, when we have a President who is determined to accelerate GDP, which, at least for the near-term, would make a recession less likely.

15 What about the rest of the world?

I often hear the comment, "*the rest of the world is cheaper,"* and therefore you should seek opportunities outside the US.

Broadly speaking, stocks that have the level of profitability and growth commensurate with those in the US are *NOT* cheaper, in my opinion. Rather, there are *many* less profitable companies.

That's a broad, blanket commentary. Fortunately, because Applied Equity runs global strategies with a limited number of names, we are able to find stock specific opportunities outside the US.

Japanese banks would be one example.

16 Finally for all our advisors and investors in Southern California, our hearts go out to those impacted by the recent fires. I can't imagine the sense of loss. We are thinking of you.

Andrew

Risk Considerations

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