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January 6, 2025

With the Presidential Election in the rearview mirror, inflation largely under control, and the prospect of future interest rate cuts paired with strong economic growth in the United States, the final quarter of 2024 was carried, once again, by large domestic stocks. The S&P 500 returned 2.41% for the quarter, raising its yearly tally to 25.02%, but elsewhere returns were not so rosy.[1] The Russell 2000 Total Return index, which includes smaller sized US stocks, managed to squeeze out a small gain for the quarter of 0.33%, but its yearly return of 11.54% lagged its large-cap counterpart significantly. International stocks extended their streak of underperformance relative to US stocks, with the MSCI ACWI Ex-US index losing 7.60% in the quarter, bringing its annual return to a measly (at least in comparison to the S&P 500) 5.53%.

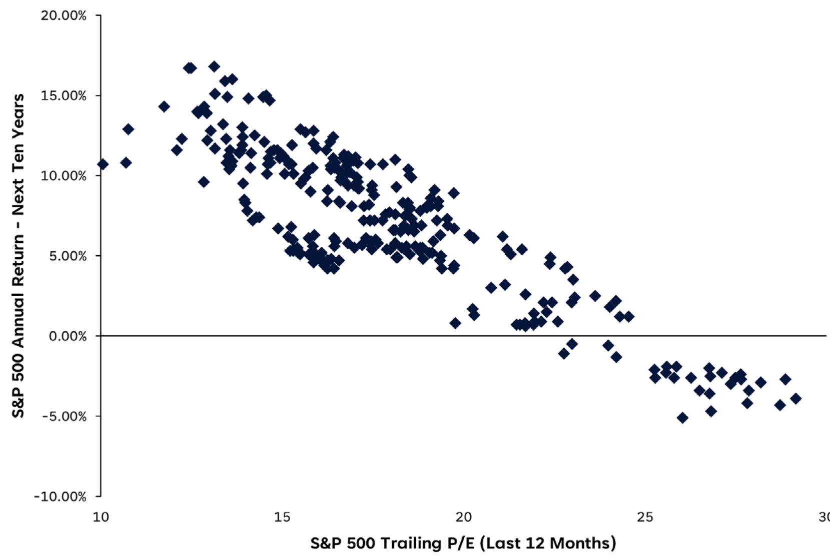
In our last newsletter, we discussed the Federal Reserve's lack of control over interest rates not tied directly to the Federal Funds rate. Last quarter was a perfect illustration. While the Federal Reserve delivered 0.25% rate cuts in both November and December, other interest rates surged. Yields on the 10-year US Treasury (a nice proxy for the overall fixed income markets as well as a common benchmark for mortgage rates) sat at 4.57% at year end after hitting a low of 3.60% in September. Fixed income markets and interest rate sensitive industries including real estate suffered from the rate increases. The Bloomberg US Agg Bond index dropped 3.06% in the quarter, bringing its annual return to just 1.25%, while the S&P 1500 Real Estate Total Return index dropped 7.76% for the quarter to post an annual return of 5.42%.

Valuations and Index Concentration

As fundamental investors, we always keep a close eye on valuations of both individual stocks as well as the overall indexes. The reason we do so is simple: over a long period of time, valuations tend to be correlated with future returns. The following is a scatterplot of Price/Earnings (P/E) ratios and future ten-year returns for the S&P 500[2]:

[1] All index, security, interest rate, and currency data from YCharts

[2] "Do Good Times Make Bad Times? P/E Ratios and Forward Returns", Jeff Buchbinder, LPL Financial, October 29, 2024

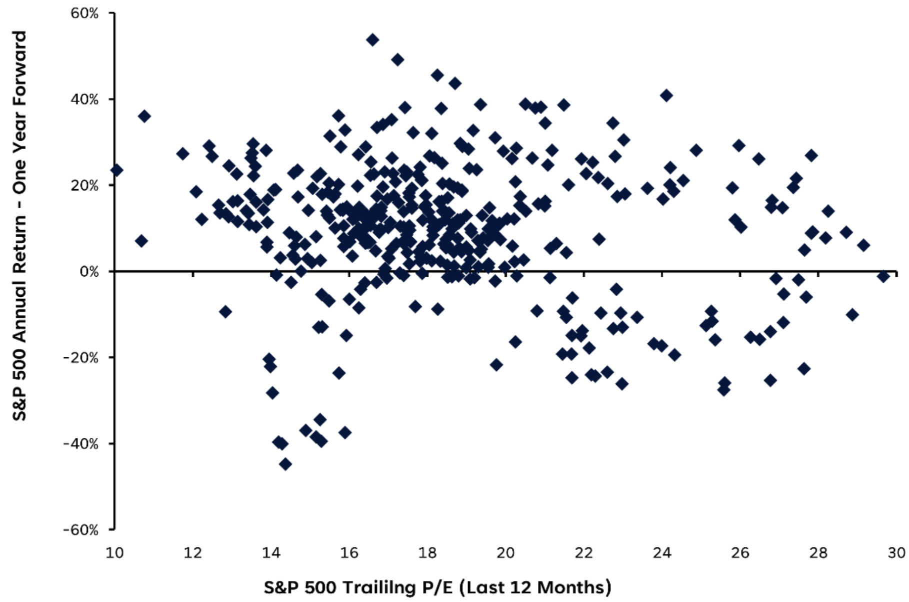


Currently, the S&P 500 has a P/E ratio of nearly 30 (using earnings over the previous 12 months), which implies *negative* annual returns over the next 10 years (at least according to the chart). Of course, there are other valuation measures than P/E, but nearly all measures we are familiar with look stretched[3]:

Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	21.47x	16.86x	1.41
CAPE	Shiller's P/E	37.04x	28.02x	1.48
Div. Yield	Dividend yield	1.33%	1.98%	1.82
P/B	Price to book	4.47x	3.19x	1.52
P/CF	Price to cash flow	16.48x	11.34x	2.17
EY Spread	EY minus Baa yield	-0.85%	0.69%	0.71

Are we suggesting the S&P 500 should be avoided in its entirety? Not exactly. First, valuations are a much less reliable predictor over shorter time periods. The same scatterplot from above altered to one-year returns is far less compelling[4]:

[3] JP Morgan Chase, "Guide to the Markets" 4Q 2024, As of December 31, 2024
[4] "Do Good Times Make Bad Times? P/E Ratios and Forward Returns", Jeff Buchbinder, LPL Financial, October 29, 2024



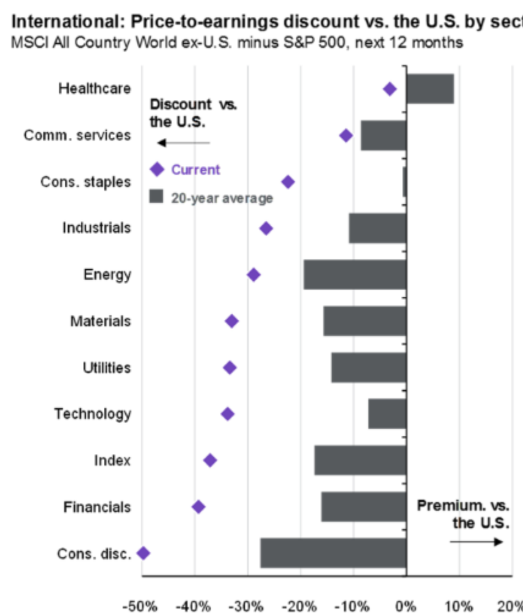
We also think there is at least some justification for higher valuations: earnings growth for 2025 and beyond is expected to be strong and company profit margins will likely benefit from lower corporate tax rates, assuming Republicans and President Trump honor one of their campaign promises. Perhaps a more important factor is the unprecedented index concentration and its impact on valuations. Currently, the weight of the top 10 stocks within the S&P 500 is higher than at any point, going back to at least 1996[5]:

And those high-flying stocks are more expensive compared to the index than they typically are[6]:

[5] JP Morgan Chase, "Guide to the Markets" 4Q 2024, As of December 31, 2024
[6] JP Morgan Chase, "Guide to the Markets" 4Q 2024, As of December 31, 2024

Taken all together, we are concerned about the future prospects of the largest stocks in the index (particularly the so-called Magnificent 7 who trade at even richer valuations), but we feel far more comfortable with the remaining constituents.

In general, we have positioned our portfolios away from the mega-caps that dominate the S&P 500 and shifted more towards small caps, value stocks, and international markets, where we still see reasonable risk/reward trade-offs. International equities look more attractive relative to US equities on a P/E basis than they have in at least 20 years[7]:



[7] JP Morgan Chase, "Guide to the Markets" 4Q 2024, As of December 31, 2024

Of course, reasons abound for these observed valuation differences (anemic growth in Europe, demographic problems in China and Japan, war, less shareholder friendly cultures, etc.), but we are still encouraged by the overall prospects in markets abroad.

What About All the Speculation?

In tandem with the "ready, fire, aim" mindset that we feel has led to the Magnificent 7's disconnect from underlying fundamentals, we have observed certain market pockets blur the line between investing and speculating.

The options market looks likely to have set a record for volume in 2024 after setting records in each of the prior four years. Options volume for the year is over 100% higher than it was in 2019.[8] The surge in options volume coincides with the onset of COVID and is largely driven by retail investors, the "gamification" of investing by apps such as Robinhood, and 0DTE options, which are highly volatile options traded on the same day the option expires. If enough of these options are traded, it can create short-term distortions in market prices, particularly in individual stocks. In 2025, exchanges will look to expand options trading in individual stocks to more trading days (currently options on individual stocks only expire on Fridays).

The price of Bitcoin (BTC) reached all-time highs during the quarter and briefly crossed over the $100k mark before giving back some of those gains. Still, the cryptocurrency returned well over 100% for the year. We will avoid a philosophical debate about the merits of BTC for now, but we cannot avoid the conclusion that a large portion of the activity in BTC and the cryptocurrency world is pure speculation. Dogecoin, for example, which got its start as an internet joke and has since been boosted by mentions from Elon Musk, returned over 250% for the year to bring its market capitalization to just shy of $50B. Does anyone really think Dogecoin will be used to facilitate transactions or represent a long-term store of value?

Why does this all matter? Well, beyond the direct harm that this gambling may cause to people who can't afford it and the inevitable distortions it can cause in markets, we theorize there may be some contrarian signal here. Over the short run, we view stock market returns as largely driven by the marginal investor's willingness to take on risk. When investors are willing to pile on more risk, stocks will likely do quite well and vice versa, regardless of valuations. The speculation we have observed looks to us like significant risk-seeking behavior by investors and market history shows us that that pendulum will eventually swing the other way. We are not calling for an imminent market crash, but a significant correction, particularly in the mega-cap stocks, would not surprise us. We have positioned our portfolios for this possibility.

As always, it is a privilege to manage your accounts, please contact us if you have any questions.

Jack Dukeminier, CPA, CFA

Philip Bagdade, CFA

[8] "2024 was another record-breaking year for options trading. What's on tap for the industry in 2025", Joseph Adinolfi, MarketWatch, December 31, 2024

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Index Definitions:

S&P 500 – A representative sample of 500 leading companies in leading industries of the US economy. The S&P 500 Index focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

MSCI ACWI Ex-US – A market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI). It is designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI ACWI Ex-US includes both developed and emerging markets.

Bloomberg US Agg Bond – A broad-based fixed-income index that includes government Treasury securities, corporate bonds, mortgage-backed securities, asset-backed securities, and Municipal securities to simulate the universe of bonds in the market.

Russell 2000 Total Return – The Russell 2000 tracks the roughly 2000 securities that are considered to be US small cap companies. The Russell 2000 serves as an important benchmark when investors want to track their small cap performances versus other sized companies.

S&P 1500 Real Estate Total Return – Comprises those companies included in the S&P 500 that are classified as members of the GICS® Real Estate sector. The S&P Composite 1500 index (^SPSUPX) includes small cap stocks that may have high growth potential but also meet investability and financial viability criteria.