

## *Client Letter – January 23rd, 2025*

### ***To Whom Much Is Given, Much Is Expected***

Well, that wasn't so bad, was it?! The S&P 500 returned 25% in 2024 after delivering a 26% return in 2023 (the best two year stretch since 1997-98). This was only the fifth historical instance of the Market returning greater than 20% annually in consecutive years, so it has been a very strong run indeed. Readers of these memos know that I have been very cautious about equity return prospects each of the last two calendar years, and my concerns were rooted in two critically important factors: inflation & interest rates. The wage and price spike in 2021 > 2022 necessitated a significant increase in interest rates from 0% to 5% to bring inflation back under control. Given the historical difficulty of taming inflation once it takes root, coupled with the straightforwardly negative affect of rising interest rates on stock valuations and prices, discretion seemed like the better part of valor from my perspective.

From our vantage point at the outset of 2025, the economy and underlying trends in the Market look solid, and the much-anticipated recession expected by many folks since mid-2022 has not yet officially arrived, if it ever will. However, if pressed to identify potential trouble spots ahead I suppose I would start with most recent climb in the 10-year Treasury yield back to nearly 5%, and the steepening of the yield curve in general. Historically, increases in rates tend to cause stress and start “breaking things” in the real economy and not just the financial markets. Over the past 2-3 years we've seen isolated signs of stress related to rising rates (regional bank failures back in 2023, for example) but no widespread corporate defaults and/or consumer balance sheet pain – yet. We shall see if this relatively benign state of affairs continues to hold.

Another area of concern is the S&P 500's valuation of 22x forward (FWD) earnings, which is on the high end of the historical range. And if one drills down even further in search of elevated valuation concerns, it's hard not to fixate on the 35x multiple for the “Magnificent Seven” stocks (AAPL, MSFT, NVDA, AMZN, GOOG, META & TSLA) that have been primarily responsible for much of the Market's total return over the past 5 years. While we all know these are “great companies” that perhaps deserve premium valuations, it does raise the bar on what is expected of them going forward, and the staggering concentration of the S&P 500 in this relative handful of companies raises the stakes for their continued success.

The “Mag 7” have been on such an extended run in recent years that by the end of 2024 they constituted roughly 34% of the total capitalization of the S&P 500 index; if you expand out to the ten largest stocks in the S&P, that grows to 39% of the total. Why this *might* prove to be problematic is that the last time the Market had grown this top heavy was in a prior cycle, when the Top 10 stocks in the index peaked at 27% back in '99/'00. This peak in the Top 10's weighting as a percentage of the S&P was followed by a three year losing streak for the index from 2001 > 2003, and was subsequently followed by a fifteen year lull in which the ten largest Mega Caps ultimately bottomed out at 17% of the index.<sup>1</sup> Much credit has been given to these companies for their tremendous performance in recent years, but now much is expected. One need not be an esteemed Wall Street investor to know that lofty expectations (as expressed by historically high valuations) are often not as easily met as a more modest set: when your C student comes home with a B+ average you might see them grinning ear to ear, but when your 4.0 honors student gets an A- in the

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<sup>1</sup> It was not until 2020 that their weighting returned to that 27% level, per *Strategas*

first semester of their senior year, I've heard tales of tears shed. To put it another way: Happiness = Reality - Expectations.

Legendary investors are indeed making some noises about their valuation concerns. For example, the most recent memo by renowned fixed income investor Howard Marks of Oaktree Capital shared a slide from JP Morgan Asset Management that showed the 10 year forward returns for each month from late 1998 through 2014 -- 327 monthly observations over 27 years. The results were relatively unambiguous: "High starting valuations consistently lead to lower returns, and vice versa; today's 22x P/E ratio is clearly well into the top decile of observation; in that 27-year period, when people bought the S&P at P/E ratios in line with today's multiple of 22, they always earned ten-year returns between plus 2% and minus 2%."<sup>2</sup> Depending on your perspective maybe 2% doesn't sound terrible, but keep in mind that the S&P 500 has delivered an average annual return of 10.13% since 1957 (when adjusted for inflation, the real return drops to 6.37%).<sup>3</sup>

If recent conditions persist in the Equity Markets throughout 2025 (historically high valuation for the S&P 500, which continues to be dominated by the largest 7-10 stocks) you should expect the Hamilton Group to continue reducing our client's exposure to highly-valued Mega Cap stocks by taking profits from that cohort and shifting the proceeds to "cheaper" areas of the market (Healthcare, Consumer Staples, Energy, Small Caps, International Equities) as well as short > intermediate term fixed income & cash. This is not to say that the largest 10 individual equity holdings by market cap in your portfolio will not continue to dominate your overall equity exposure, because they likely will barring a significant decline in that Mega Cap group relative to the rest of the market.

### ***Donald Trump & Elon Musk***

Apparently, many of you would like me to address the re-election of Donald Trump (after his four year "sabbatical") and the still smoldering bromance between Trump & Elon Musk, in terms of how these factors will affect the economy and your investment portfolios. The short answer is that I have no idea, and neither does anyone else. Furthermore, I am loath to get into the predictions business – especially about the future, and most especially about these two highly combustible attention seekers. If you have followed Donald and Elon over the past 10-15 years, you will have noticed that their close friends and confidants come & go... and come again, before perhaps going once more. Given the massive egos and mercurial natures that both men possess, it is impossible to say how long this mutual admiration society will remain intact.

The 'Elon Question' is really a question about Tesla stock (TSLA), as SpaceX and Twitter are both privately held and (technically) distinct entities. With TSLA settling in around \$400, after having rallied from a low around \$240 in early November to a new all-time high of \$480 in mid-December, many clients are wondering what comes next... Sadly, I have been unable to formulate my thoughts on TSLA in a way that passes muster with industry regulations on offering "research opinions" in client communications - as a financial advisor I can speak on industry sectors broadly, but discussing individual equity holdings in an attempt to add value has proven prohibitively difficult. I

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<sup>2</sup> "On Bubble Watch" – Jan 7, 2025 (<https://www.oaktreecapital.com/insights/memo/on-bubble-watch>)

<sup>3</sup> <https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp>

am more than happy to discuss a client's TSLA holdings with them individually if they would like me to address the topic, but opining here has proven to be my first terrible idea of 2025...

As for Donald Trump, I heard from many clients over the past 2-3 months that they were concerned about the coming period of "Trump Chaos" that we as a nation were inevitably re-entering. While I understand the origins of such concerns, I would point out that this is now the second time in the last decade we will be experiencing a four-year Trump administration. What might have felt shocking and unprecedented the first time around now feels, well, far less so: we just did this!

One might even argue, at least with respect to changes in federal tax code, that Trump's reelection could in fact reduce chaos & uncertainty. The Trump 2017 tax cuts were set to expire in the next year, and had the election gone the other way we would be looking at a potentially VERY large increase in corporate tax rates, and potentially an attempt to raise or institute new federal taxes on the wealthy. However, the current corporate tax rate of 21% (vs 35% prior) may now remain in place, which removes a large hindrance to corporate profits. To be fair, it is not clear that this will be good for America's fiscal condition over the medium to long-term (if it leads to systemically higher budget deficits) but in the short-term it would be good for corporate profits & by extension stock prices. You may also see more M&A activity, as the Biden Team was extraordinarily hostile to corporate mergers – for often dubious reasons.

I am not telling anyone who dislikes Trump that they should embrace him (no politics or religion at this dinner party!) I am simply arguing that his reelection in some ways preserves the economic status quo and affords us some continuity. As for other potential changes in store in the second Trump Administration, I am choosing for the next four years to ignore what he says or threatens to do and will instead be waiting to see what *actually happens*, as most of the things that will affect our investment portfolios will require Congressional cooperation & approval. Furthermore, I have heard it argued that when congressional majorities in Washington DC are as minuscule as they are now, it is perhaps not the President but the most moderate senators and congressional representatives who are the most powerful people in the country when it comes to passing laws. For those who are not particularly fond of the extreme elements in either party, this should provide some comfort.

We look forward to catching up with all of you in 2025 if we have not spoken with you already.

Adam Hamilton, on behalf of the Hamilton Group

*Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index. Robert W. Baird & Co. Incorporated.*

Below are some photos of the team at the 2024 holiday party!

