

Valuations Have Richened, But Areas Outside of Large- Caps Remain Attractive



Major Equity Indices See Best Monthly Gain of the Year in November

Amid the results of the US presidential election and resilient economic data, equities were up in November. Both the Dow Jones Industrial Average and S&P 500 indices produced their best monthly returns of 2024, gaining 7.7% and 5.9%, respectively. US small-caps (+10.9%) were among the best performers, followed by US mid-caps (+9.0%) and US growth (+6.1%). Bonds were also up as municipal bonds increased 1.7%, high yield credits gained 1.7%, and investment grade corporates rose 1.6%. Aside from broad-based commodities (+0.1%), silver, gold, and crude oil all produced negative returns, falling 6.3%, 3.1%, and 2.0%, respectively.

Exhibit 1: Trailing Returns as of November 29, 2024

Index/ETF	1-Mo	3-Mo	YTD	1-Y	3-Y	5-Y
Equities						
US Small-Caps (SPSM)	10.94%	9.11%	18.10%	33.58%	5.56%	10.81%
US Mid-Caps (SPMD)	8.95%	9.45%	22.71%	34.09%	8.32%	12.57%
US Growth (SPYG)	6.06%	8.36%	34.90%	40.14%	7.71%	17.52%
US Large-Caps (SPY)	5.96%	7.22%	27.97%	34.26%	10.67%	15.68%
US Value (SPYV)	5.84%	5.69%	20.48%	27.93%	13.41%	12.72%
International Developed Equities (SPDW)	0.39%	-3.61%	7.17%	13.03%	3.04%	6.07%
Broad-based Emerging Markets (SPEM)	-2.01%	2.10%	12.60%	16.71%	1.39%	4.91%
US Fixed Income						
Municipal Bonds (MUB)	1.67%	1.57%	2.63%	4.81%	0.20%	1.34%
High Yield Credit (JNK)	1.66%	2.22%	8.65%	12.08%	3.00%	3.61%
Investment Grade Corporate Bonds (SPBO)	1.57%	0.71%	4.68%	8.55%	-1.32%	0.92%
US Aggregate Bond Index (SPAB)	1.20%	-0.09%	3.10%	6.55%	-1.87%	-0.06%
US Treasury 7-10 Year (IEF)	1.02%	-1.05%	1.66%	4.96%	-3.65%	-1.19%
Treasury Inflation Protected Notes (SPIP)	0.39%	0.13%	4.16%	5.79%	-2.01%	2.08%
Commodities						
Broad-based Commodities (BCI)	0.05%	3.28%	4.24%	0.73%	3.21%	7.08%
Crude Oil (USO)	-2.01%	-3.67%	7.44%	-1.25%	12.59%	-5.08%
Gold (GLD)	-3.12%	6.18%	28.47%	29.50%	13.80%	12.24%
Silver (SLV)	-6.34%	5.96%	28.19%	21.98%	9.68%	11.89%

Source: FactSet. Data as of November 29, 2024. 1Y, 3Y, and 5Y numbers are annualized.

Fed Signals Gradual Easing Ahead

The Federal Reserve decreased interest rates by 25 bps at the November FOMC meeting, dropping the fed funds rate to the 4.50–4.75% range. The move comes on the back of lower but still elevated inflation and a softening labor market, marking the second consecutive meeting in which the Fed eased monetary policy. Fed Chairman Jerome Powell expressed caution regarding the timing of future rate cuts as if rates are reduced too quickly, progress made on inflation could be reversed. “We have to avoid that risk, and to avoid that risk, that means you want to move carefully,” he said. At the same time, if the Fed cuts too slowly, it could raise risks to growth and the labor market. However, FOMC minutes released more recently revealed that officials are less concerned about economic weakness. Policymakers also stated if future data continues to come in favorably, “it would likely be appropriate to move gradually toward a more neutral stance of policy over time.” Currently, a 64% chance for another 25 bps cut to occur in December is priced in per the CME FedWatch Tool.

Will Inflation Reaccelerate?

Inflation via annualized headline CPI, PPI, and PCE prints for October all increased from the previous month. Additionally, recent wage growth data has come in stronger, retail sales beat expectations, consumer spending remains robust, services PMIs lie in expansionary territory, and both GDP and the labor market continue to exhibit a healthy economy. Given this backdrop along with rate cuts and Trump’s anticipated pro-growth and tariff-related policies, will inflation reaccelerate?

Exhibit 2: CPI – Current & 1974 - 1982

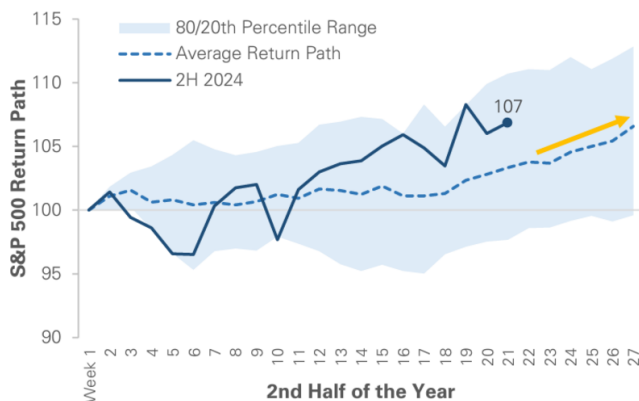


Source: BLS, Apollo Chief Economist

Strong Gains & Supportive Return Path Ahead

According to Goldman Sachs Investment Research, the S&P 500's gain of 28.1% YTD in 2024 puts the index on track for one of its strongest years since 1928. History also suggests its rise can continue through the end of the year. Per MarketDesk, when the S&P 500 returns at least 10% in 1H, its average return path for 2H is supportive, with strong gains seen towards the closing months.

Exhibit 3: 2H Returns of S&P 500 After +10% Gain in 1H



Source: Source: MarketDesk. July 2024 Strategy Snapshot. Second half return path when S&P 500 gains more than +10% in first-half of the year.

Time to Rotate?

The NTM forward P/E ratio of the market cap weighted S&P 500 Index has climbed to 22.5, while that of the S&P 500 Equal Weight Index has increased but remains relatively attractive at 18.2. Additionally, concentration risk is near 100-year highs. Should investors remain overweight US large-cap growth stocks, which have produced attractive returns over the past 10 years, or rotate into equal weight, value, small-caps, mid-caps and cyclicals?

Exhibit 4: NTM P/E Ratio – S&P 500 & S&P 500 Equal Weight



Source: The Daily Shot, Bloomberg Finance L.P.

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Although we were very bullish going into 2024, **we are taking our bullishness down a notch** for 2025. We find ourselves having to go into far corners of the market to produce an asymmetric risk/return (i.e., merger arbitrage, IPOs, spin-offs, banks, cryptos) given how expensive valuations have become in both equities (excluding US value, US SMID, and international) and fixed income. Outside of select pockets of the equity market, there are not many attractive opportunities in the US large-cap space. Hence, history suggests the **market is overdue for a correction**.

As investors who were trained under the creator of the Greenspan Put, we can't help but think **the Trump Put will be deep with wide strikes**. It seems that the cabinet members being elected could potentially radically transfer the legal system resulting in deregulation, creating a boom for the banking system, crypto, merger and acquisition, and the IPO market. Perhaps there should be a new playbook for portfolios in the years to come.

If a recession occurs at some point during Trump's term, the good news is that there is plenty of room for the Fed to cut rates to stimulate the economy. Our bigger concern is how portfolios will deal with the back end of the curve (inflation is ticking higher, the deficit will likely get worse) along with the fact that there are very little bargains in fixed income. Another concern is there is endless money going into passive US large-cap ETFs which creates a **never-ending feedback loop** (money goes into the same stocks, distorts valuations, pushes prices up, forces more people to buy the asset, etc). This is reflexivity at its finest.

Trump's pro-growth policies, tariffs, and protectionism stance coupled with a Fed that wants to lower interest rates could **shift demand curves** and possibly **re-ignite inflation**, leading to rate hikes being priced back into the market. In 2020, we expressed our belief that inflation would be a sticky problem that would last for many years. This is a key reason why we argued investors should own inflation-linked assets. The irony of this call is that inflation-linked assets have a low correlation to US index beta, carry well in a multi-asset portfolio, and trade at a **discount** to the S&P 500 Index.

A new cycle usually signals a change in market leadership. Increase your equity beta, be overweight equities, and tilt away from the Magnificent 7. We believe this late cycle reflation bounce continues in 2025 but shifts to non-Magnificent 7 stocks (specifically US SMID, cyclicals). Inflation expectations are rising, and once the inflation genie comes out of the bottle, it is not trivial to put it back in.

The distribution of outcomes next year is much wider (valuations are expensive in US large-cap index space, fixed income spreads are tight, multiple ongoing wars, strained relations between the two largest economies in the world, etc.). The US economy was improving before Trump's red sweep, so the question now becomes how does the administration shift back to a pro domestic policy without further increasing the deficit, sending bond term premiums higher, and reigniting inflation? It's no small feat and we believe it's easy to see a scenario where left tail risks surface in 2025. For us, **this means portfolios should carry some type of protection strategy beyond real assets.**

Equal weight over market cap weight. It's okay to own the Magnificent 7 stocks, but we advocate reducing one's exposure to these stocks and capping their weights in one's portfolio. Historically, new market cycles have historically corresponded with equal weight outperforming market cap weight. Moreover, there are **plenty of growth opportunities** outside of the Magnificent 7. In fact, out of the S&P 900 Index, over 240 stocks have seen earnings growth greater than 25% over the last twelve months.

Owning small-caps is a once in a decade opportunity. The need to be more tactical is clear with the S&P 500 Index forward P/E at 22, and the index up over 61% from December 30th, 2022, through November 29th, 2024. According to Morgan Stanley Research, small-cap median multiples trade in the bottom 35th percentile, and their earnings are set to surpass large-cap earnings in 2H25. It appears that the stars need to align for large-cap stocks to rally further (i.e. earnings have to deliver). Estimate revisions will likely get revised higher now that election uncertainty is over. Companies have also piled billions into capex to not get behind the artificial intelligence movement, so productivity needs to increase, and margins improve accordingly.

Going into 2024, we did not have high conviction on fixed income ideas. What has the US bond market done in 2024? The Bloomberg US Aggregate Bond Index is up 2.9% YTD through November 29th, 2024. Meanwhile, the S&P 500 Equal Weight Index is up 20.6% over the same period. Spreads are very narrow for corporate credit and high yield bonds, and our view is that the risk vs. reward is unattractive. If there is an asset class you want to be tactical among, it is fixed income. We prefer mortgage-backed securities where at least spreads are attractive, and prepayment risk is low (30-year mortgage back over 7%). We believe there is a high probability that long end rates move higher (inflation and deficit concerns) while the Fed cuts one or two more times, so we expect the curve to steepen.

We are entering into a world of deglobalization, onshoring, and reshoring. In this new environment, investors should own real assets, commodities, and stocks in sectors such as industrials, materials, energy, etc. Inflation-sensitive stocks (i.e. real assets) have demonstrated **asymmetric risk characteristics** for the past three years. They have not gone down as much as the market and have outperformed on the way up (past performance is not indicative of future results). Real assets are not the bargain they were 3 years ago, but many still trade at **30-40% discount** to the S&P 500 Index. In our view, real assets are still worth owning and can potentially benefit from higher real rates from Trump's anticipated pro-growth, tariff, and protectionism policies.

We feel investing is about buying assets below intrinsic value, having a clear catalyst for the market to realize the asset's potential, and then moving on to the next opportunity. Investing is not only about Sharpe Ratio, downside protection, or moving averages. Unfortunately for Non-US stocks, there is not only a missing catalyst, but they face significant headwinds. For instance, China has a non-linear growth policy, Europe's reliance on Russia for gas/energy, a lack of a technology sector, complicated cross border bureaucracy which prohibits some companies from leveraging their neighbors, and a lack of talent to drive shareholder value (many highly educated foreigners want to work in the US). Hence, Europe trades at a lower multiple than the US. There are various value opportunities within the US industrials, materials, energy, and financials space, along with mid-caps and small-caps. Moreover, there is a catalyst for these US segments to have their discount narrow.

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