PCM

PEAK CAPITAL MANAGEMENT

Going it Alone

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Brian Lockhart

The global economy entering 2025 seems to be teetering on a precipice with the US storming ahead and posting strong growth while the rest of the world struggles and appear to be accelerating in a downward trend. Forecasting what 2025 will bring to the global economy and markets reminds me of the Eagles classic, Desperado. "Don't your feet get cold in the wintertime? The sky won't snow and the sun won't shine. It's hard to tell the nighttime from the day."

This is what investors are facing after many years of US economic superiority and stock market returns. The chart shows just how much the S&P 500 has outperformed broad European indices. If I included the HSI (Hang Seng Index) it would be even more dramatic as Chinese equities are down more than 26% on a trailing 5-year basis.

Germany has been in a slow economic decline since 3Q2022 and there are concerns that further rate hikes in the EU will result in a full blown recession for the German economy. The entire Eurozone comprises approximately 17% of global GDP but contributed only 3% of global GDP growth in 2024.

China's economic woes are well documented and still deteriorating leading many to expect Beijing to pass a massive stimulus package in 2025. Real GDP grew at a 6% clip in China in 2023 but fell to 3.5% in 2024 and expected to decline further in 2025. Avoiding a global recession largely relies on continued strong economic results in the US.

It is quite likely that the world has become too US-centric for everyone's good. For example, US equities now represent more than 70% of the MSCI World Index, the highest since 1970. US equites are attractive staggering inflows as demonstrated by more than $1 trillion in equity ETF inflows in 2024, basically double the figure from 2023. Popular with retail investors, single stock leveraged ETF's are in vogue. The different ETF's that trade NVDA had over $6 billion in market cap prior the nearly 15% single day decline in late January.

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Valuations and concentrations are alarming. The Magnificent 7 stocks now comprise 33% of the total market cap for the S&P 500. This is double the market cap of the 7 largest stocks from 5 years ago and 50% higher than during the tech/telecom bubble of the late 1990's that peaked at 22%.

There was an 'Emperor is naked' moment for the markets with the news of DeepSeek causing many analysts and investors to questions whether the planned spend on AI is grossly overestimated. Let's briefly look at risks that possibly should be keeping investors awake at night.

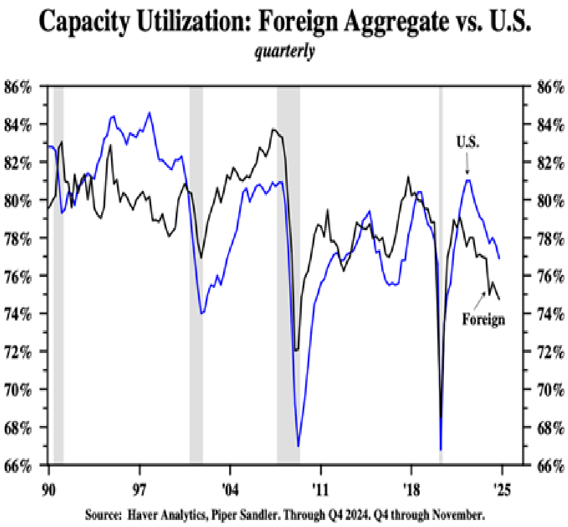
First, complacency. No one seems worried about the ability for the US economy and markets to continue to lead the world to new heights. With so many investors asking the question, "What could go wrong?" we should all be concerned. Today reminds me a bit of the Japanese stock market, the Nikkei 225, in the late 1980's. The surest bet an investor could make was on continued outperformance from Japan until 1990 came along. After hitting a high in November 1989, the Nikkei declined for almost 25 years and only in 2024, 36 years later, returned to 1989 levels. "I know, that could never happen in the US," comes the familiar report from investors, "we are too…" (add whatever metric you prefer, it was likely true for Japan in 1989).

Second, derivatives. Algo trading, Yen carry trade, credit default swaps, and many others have the potential of upending the markets and causing serious harm to investors. There are counter party risks virtually impossible to identify that could cause trillions in losses almost overnight.

Third, policy. On balance, I think policies pursued during Trump's first term in office led to sustained economic growth and rising prosperity across the board. Talk of tariff's being able to replace Federal income taxation scares me and no one can rule out the possible pursuit of economic policies that might create something between disruption and chaos. Trump masterfully uses tariff's in his negotiations but the risk is not zero that his policies could lead to an outright global trade war where everyone loses (especially massively overvalued markets like the US). The US today is the world's consumer making it very likely that other nations will begrudgingly accept what is coming, but the risk of a global meltdown cannot be ignored.

Let's end this Introduction with some good news (maybe). The latest consumer confidence survey from the Conference Board showed more than 60% of investors expect stocks to be higher in 12 months while only 20% expect stocks to fall. The net of 40% is an all-time high and suggests a self-fulfilling prophecy or great disappointment for investors.

CAPU tells the Story



While the world sits on pins and needles waiting for the latest CPI reports in order to anticipate what the Fed will do, there are signs that inflation is not what investors should be concerned about. There is historically a very strong correlation between Capacity Utilization and both employment and inflation. Looking at long-term data sets that go back to 1967, there is a clear pattern of lower highs and lower lows with Capacity Utilization that is leading to many well-respected economists to sound alarm bells. Germany and China each are at Capacity Utilization levels suggesting rising unemployment and recession are imminent as underutilization of resources has typically led to economic contraction. Announcements of factories being idled are at record levels according to World Bank data.

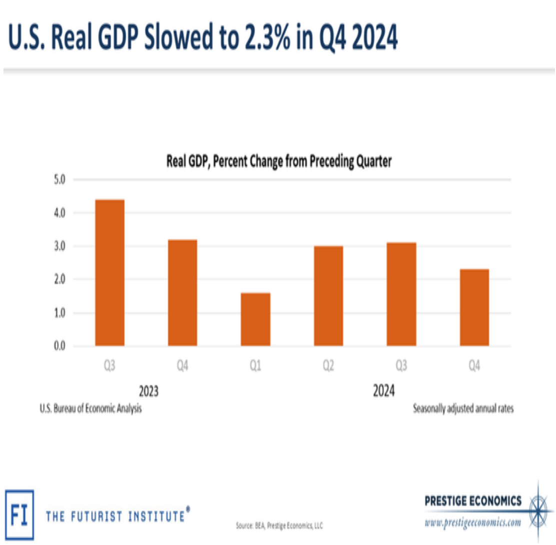
- There have been 8 recessions in the US since 1967 and today's Capacity Utilization reading of 76.9% is lower than at the start of each of the prior recessions.
- China's Capacity Utilization dropped below 75% with rampant reports of factories being filled with goods they cannot sell leading to outright goods deflation.
- Falling Capacity Utilization is associated with falling employment. While US unemployment remains low, it has risen 20% in the last year moving from 3.4% to 4.1%.

Nvidia's Big Move

Holders of Nvidia (Ticker: NVDA) started the week on a sour note as shares of one of the world's largest chip makers tumbled roughly -17% on Monday, January 27th. Shares closed the prior week at roughly $143 per share, representing a year-to-date gain of approximately 7%. The stock closed on Monday at $118 per share. Not only did Monday's decline take out NVDA's yearly gains, but the selloff also pulled shares below both the stock's 200- and 50-day moving averages, as illustrated in the chart to the left. In terms of Nvidia's market capitalization, roughly $600 billion disappeared in one day, or roughly the equivalent size of the TARP bailout of 2008.

- Monday's selloff was sparked by news out of China and DeepSeek's AI platform, which supposedly was developed at a fraction of the cost of models such as ChatGPT that are powered by Nvidia's chips.
- The news sparked concerns about the AI capex spend in the U.S. over the past several years and its potential payoff if DeepSeek (and potentially others) can deliver on a much cheaper model. The selloff's magnitude illustrates how tenuous tech stock valuations have become, and how a snippet of unexpected news can lead to substantial drawdowns.

Growth Slows in Q4 but Remains Resilient



The U.S. economy expanded at an annualized rate of 2.3% in Q4 2024, slightly below expectations and down from 3.1% in Q3. Despite the slowdown, full-year GDP growth remained solid at 2.8%, supported by strong consumer and government spending. Consumer expenditures grew at a robust 4.2%, driving two-thirds of economic activity. However, trade and investment were weak, with exports, imports, and private domestic investment all declining. The Federal Reserve maintained its cautious stance, holding interest rates steady while monitoring inflation, which rose slightly to 2.2%. Additionally, the personal savings rate dropped to 4.1%, the lowest in two years, as consumers tapped into savings to sustain spending.

- Despite persistent inflation, U.S. households continued to spend at a healthy pace, particularly on goods and services. This strength in consumer activity helped offset weaknesses in other areas of the economy.
- Business investment fell by 5.6%, reducing overall GDP growth by more than a full percentage point. Additionally, both imports and exports declined by 0.8%, further dampening economic momentum.

Quinn VandeKoppel

Macro View – Potential US Steel Tariffs Cause Market Disruptions

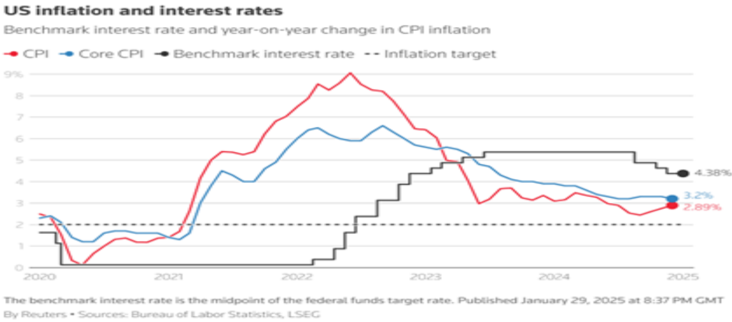
Concerns over potential US tariffs on Canadian and Mexican steel have led some suppliers to halt new orders to the US. Canadian steelmaker Stelco and various Mexico-based suppliers have paused sales quotes, fearing that President Donald Trump will reinstate duties of up to 25% by February 1. Although Canada and Mexico were previously exempt from US steel tariffs, uncertainty is growing over whether they will receive a carve-out this time. Canada and Mexico are key steel suppliers to the US, with imports making up 27% of total US steel consumption in 2023. Industry leaders, including Cleveland-Cliffs CEO Lourenco Goncalves, acknowledge the uncertainty but express willingness to adapt to any new trade policies. The situation has created instability in the North American steel market as companies await official policy decisions.

Taking Stock – Rising Consumer Financial Strains and Debt Pressures

A recent Philadelphia Federal Reserve report highlights increasing financial stress among consumers, with a record-high share of credit card holders making only minimum payments. The percentage of active cardholders meeting just baseline obligations rose to 10.75% in Q3 2024, the highest level in 12 years. Delinquencies have also surged, with balances more than 30 days past due reaching 3.52%, more than double their pandemic-era low. Despite these challenges, consumer spending remains resilient, with inflation-adjusted expenditures growing 2.9% annually in November. However, rising interest rates, now averaging 21.5%, coupled with higher credit balances, pose significant financial risks. Additionally, mortgage originations have dropped to a 12-year low, as high rates deter refinancing. If these trends persist, consumer financial strain could intensify, affecting broader economic stability in 2025.

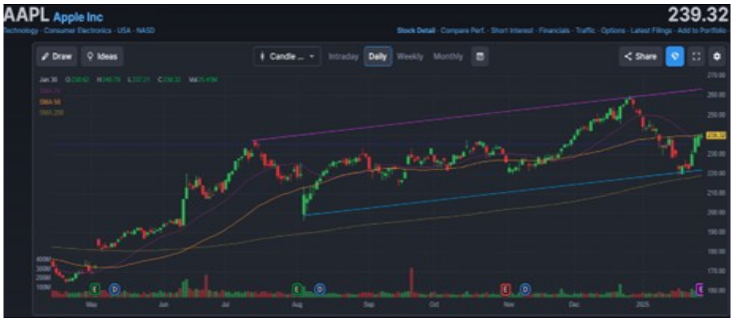
Fixed Income – Federal Reserve Holds Rates Steady

The Federal Reserve maintained interest rates at their current level last Wednesday, with Federal Reserve Chair Jerome Powell emphasizing that there is no rush to cut rates until inflation and labor market data justify such a move. The decision reflects a wait-and-see approach as the central bank monitors economic conditions and potential policy shifts under President Donald Trump's administration. Powell noted that the U.S. economy remains stable, with unemployment holding steady for six months and recent inflation data showing positive trends. However, the Fed remains cautious about possible disruptions from forthcoming policies on tariffs, immigration, and taxes. Powell reiterated that the central bank's actions are guided by economic data, aiming to balance inflation control with employment stability. According to the CME Group's FedWatchTool, the market is predicting that there will likely not be another 25-basis point rate cut until the June FOMC meeting.



Technical – Apple's Rebound

On December 26th, Apple (AAPL) hit a new record high of $260.10. However, over the next 16 trading days, Apple's share price declined by 15.5% to $219.79 after Chinese consumers are increasingly preferring smartphones from rivals such as Huawei but held the 200-day SMA along with the upward trendline. As you can see on the chart below, Apple's shares consolidated for a few days and then immediately rebounded back to the upside. Since rebounding, shares have risen almost 9% but are now facing resistance at the 50-day SMA. With earnings set to report at the end of the trading day on the 30th, direction is largely unknown, but many analysts are forecasting both record earnings and revenue for the fourth quarter. Should the company provide solid earnings and revenue while also providing positive future guidance, shares could re-test the previous highs. However, if there's a earnings miss or poor guidance given, shares could re-test the 200-day SMA.



Technical Analysis - Equities

Clint Pekrul, CFA

As we move into the new year, it is helpful to examine where the major market indices reside within a technical analysis framework. By any measure, the S&P 500 Index has performed remarkedly well. Including dividends, the S&P 500 Index was higher by roughly 57% from 2023 through 2024. Stocks moved higher over this period with relatively low volatility, as measured by the CBOE VIX Index.

The upward momentum for equities in the U.S. has been supported by the MAG 7 and the AI technology theme, although this has recently been tested by news out of China. By comparison, developed market international equities, as measured by the MSCI EAFE Total Return Index, was higher by roughly 22% from 2023 through 2024. The index lost momentum in the fourth quarter of 2024.

Emerging markets, as measured by the MSCI Emerging Markets total Return Index, edged higher by roughly 16% over the period, thus trailing both domestic and developed equity markets.

From a technical standpoint, it is helpful to look at long- and short-term moving averages in relation to current index levels to establish patterns of support and resistance.

U.S. Equities

The chart above illustrates the price movement of SPY along with its 50- and 200-day moving averages going back five years. We remain well above trend today (roughly 31% higher than the 200-day moving average) compared to 2022 when higher rates repriced stocks lower.

However, the rate of change in the 50-day moving average is slowing, which suggests a pause in price momentum. No doubt this is influenced by the Nvidia sell-off, which happens to be the largest holding in the S&P 500. Perhaps it also reflects that investors in general are reevaluating forward earnings in relation to current multiples (can multiple expansion continue if earnings growth doesn't support it).

Emerging Markets

The same analysis on emerging markets reveals a much different pattern compared to U.S. equities. Based on the price action of EEM, the 50- and 200-day moving averages have more-or-less converged to the current price, resulting in a flat-lined trend. Emerging market stocks have not got a bid from investors since the pull back from 2022, largely because earnings growth expectations have not been as compelling relative to the U.S.

Developed Markets

The technical chart for developed markets outside the U.S. isn't much better than for emerging markets. The chart above illustrates the price action of EFA over the past five years. The long-term trend is modestly higher over the period and the current price is roughly 10% above the 200-day moving average. However, like the pattern for SPY, the rate of change in the 50-day moving average has decelerated and is now more-or-less flat.

This year will be pivotal to long-term trends as earnings growth will have to exceed expectations for short-term support to reaccelerate.

Q: How economically disruptive will humanoid robots be?

Extremely disruptive, in both positive and challenging ways. The rapid advancement of AI (artificial intelligence) and ML (machine learning) combined with quantum computing will allow robot to become much more human-like. The changes will not only impact robots' behavior but also their emotions through learned emotional intelligence and language awareness. Robots already exist with amazing levels of fine motor skills and recognition that will become mainstream in everything from manufacturing to domestic help. With the advancements in living skin manufacturing, the day will come when identifying between humans and humanoid robots will be difficult.

The impact economically will be tremendous as robots are utilized for repetitive and dangerous tasks. This will require a massive restructuring of the workforce and is likely to be highly deflationary for wages and product costs. There will be positive aspects of the transformation for individuals and families. CNBC estimates that there will be 40,000 humanoid robots in use by 2030 and an estimated 63 million in use by 2050. It should not take long for the cost of a robot that can perform 100 hours a week of activities (cooking, cleaning, yardwork, bill pay, etc) to fall to around $40,000 or leased for around $700/month. Productivity will skyrocket and while wages will be depressed the costs associated with living will fall. The future will look very different from the present, better to embrace what is coming than fight it.

Quite disruptive. Otherwise, why would we spend the investment capital to develop the technology? Humanoids represent the continuation of automation through technology. For example, Elon Musk's Tesla is slated to begin mass production of its humanoid Optimus in 2025 with 100,000 bots manufactured by 2026. Likewise, China's Huawei is scheduled to roll out its bot Kua Fu this year. Conceptually, these bots are intended to handle mundane, repetitive tasks and it's an extremely competitive industry.

Optimus and Kua Fu are likely the tip of the iceberg when it comes to how humanoids will ultimately impact our economy in ways like the industrial revolution (e.g., the assembly line) or the widespread adoption of the internet. Today, Optimus could mow your lawn but in five years could build your house. As these machines evolve over time with AI, the scope of what they can accomplish will grow exponentially. The promise of this technology is an increase in efficiency and a boost to overall economic productivity compared to human capabilities. Likewise, there will no doubt be the development of new industries because of humanoid technology (e.g., space exploration). The consequence of humanoid advances, however, is the displacement of labor, whereby jobs performed by humans become obsolete.

Q: What is the outlook for energy prices in 2025?

Estimates for energy prices have varied widely since the November election as analysts try to figure out how everything from 'Drill, Baby Drill' to tariffs will change how oil and natural gas is priced. Oil has traded in a remarkably stable trading range from 4Q2022 to today, briefly hitting $90/barrel with a low of $67/barrel while trading in the low $70's at the time of this report. While many speculate about national energy policies and focus, or lack thereof, on renewable energy, the price of oil is almost always going to rely on the fundamentals of supply and demand.

The demand for oil is going to continue moving higher as much of the world is still modernizing and moving towards middle-class living standards that will require higher energy usage. Demand for oil could increase about 1 million barrels per day to 104 million. The supply of oil is estimated to be 104.5 barrels per day in 2025, suggesting oil prices will remain somewhat stable. The more interesting question regarding energy prices is what may disrupt the equilibrium that exists today between demand and supply. Recessions have historically resulted in a 3-4% decline in demand such as what occurred between 4Q2007 and 2Q2009. While recession in 2025 is always a possibility, it is not a base case scenario for the economy so an increase in demand, while modest, should occur. There is a chance of a decline in supply if the Trump administration renews sanctions against other oil producing countries. Supply could easily fall to 101 or 102 million barrels per day that would result in a upward price shock.

Forecasting short-term energy prices is somewhat like throwing a dart at a board. We can create a forecast, but the estimation errors can be quite large. Much of what drives energy demand will be realized GDP growth. According to the Federal Reserve, the economy is projected to grow at 2.1% in 2025. At this rate the probability of a recession is low. Consequently, we might not experience any major imbalances between supply and demand across the energy complex. Furthermore, the continued development of AI technology will be a source of large-scale energy demand.

According to a forecast from the Energy Information Administration (EIA), crude oil prices (brent) are expected to decline somewhat (-8%) in 2025 as production growth will outpace demand. The EIA also predicts that natural gas prices will increase this year. Demand growth for LNG exports will outpace supply growth resulting in lower inventories and higher prices. Electricity consumption is expected to grow by 2% in 2025, matching the growth rate from last year. The EIA also expects that the solar power share of electricity production will increase by 34% in 2025. Meanwhile, the energy demands from AI, as well as data centers and crypto mining, will weigh heavily on current infrastructure, which if not addressed could lead to higher energy prices.

9250 E. Costilla Avenue, Suite 110.

Greenwood Village, CO 80112

Phone: 720.361.4016

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com