PCM
PEAK CAPITAL MANAGEMENT

A Contrarian's View of the Future

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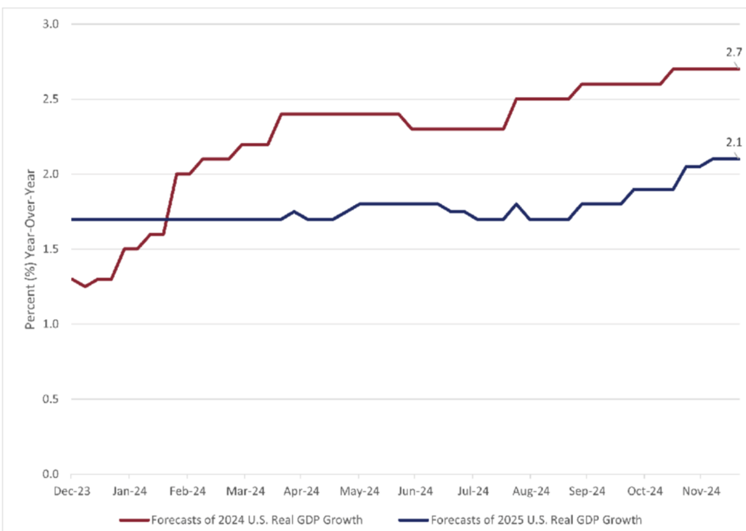
The end of the year is when the analyst community prepares their "House View" of what they expect for the economy and markets in the coming year. These various outlooks are then combined to determine to establish what is referred to as consensus opinion. While there are risks going against the consensus view, it is often necessary to avoid significant losses when markets do not follow expectations.

The consensus outlook will be right about a lot, but identifying where excess risks are being taken with the consensus view is where being a contrarian can be helpful. Let's review some of the important forecasts for 2025 that investors hope to remain on the right side of the trade.

Bond Market

The consensus view is that the Fed will cut rates twice in 2025 and that long-duration bonds will end the year with lower yields than at the start. With equities trading at stretched valuations, many asset allocators are increasing their bond exposure with the expectation of positive returns next year. There are risks to this outlook primarily coming from renewed risks of inflation. First, economic growth (GDP) could to outperform the consensus estimate of 1.9% for 2025. Consumer confidence is at a 2-year high and shows no sign of retreating suggesting spending will remain strong. Second, I expect the Trump Administration to move quickly to reduce or eliminate regulations that are viewed as inhibiting economic growth. If GDP growth exceeds 2.5%, as I believe it might, the Fed will have a difficult time cutting rates and inflation concerns will likely drive yields higher, possibly significantly. Long-duration bonds will hedge risks of a slowing economy but introduce higher volatility if consensus is wrong.



Consensus U.S. GDP Growth Forecasts GLENVIEW TRUST, BLOOMBERG

> **"Identifying where excess risks are being taken with the consensus view is where being a contrarian can be helpful."**

Tariffs

The consensus view is that Trump will aggressively increase tariff's, targeting China and broadly with all trading partners. The impact of tariff's is expected to slow economic growth and result in a modest rise in inflation. I think Trump version 2.0 is going to surprise a lot of people, none greater than what happens with global trade. I believe Trump will focus more on trade agreements that lift all parties and will use higher tariff's only in specific areas he believes abuses are occurring. The public threat of punitive tariff's will bring trading partners to the table with concessions that should increase trade, not reduce it. If trade policy proves to be positive for economic growth, the risk to rising inflation mentioned above will be more acute.

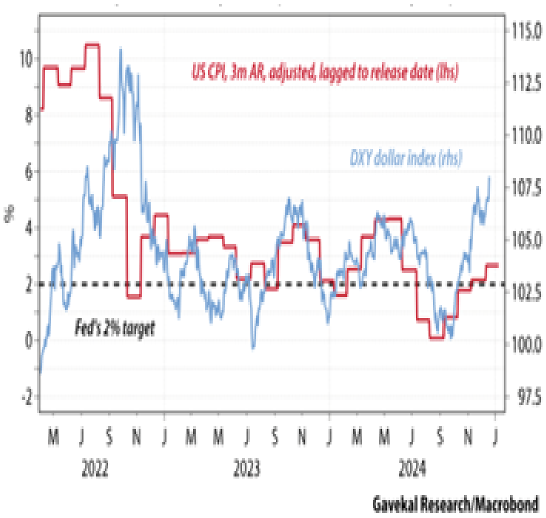
US Outperformance

When comparing rolling 10-year periods, the US has outperformed every other region for 134 consecutive periods according to data from State Street Global Advisors. The 10-year rolling streak is likely to continue in 2025 but the US may not be top dog among stock markets in the coming year. The US markets are priced for perfection at valuations that may require near 20% earnings per share growth (consensus is 9% growth). While US stocks may take a breather in 2025, identifying where outperformance will come from is challenging. Both the Euro-area and Japan are expected to experience GDP growth of 1% or less next year. Consensus for China is dismal as dislocations caused by the property markets intensify. While I expect China's growth to slow, I do not expect the implosion that many are forecasting. The most compelling valuations are found with emerging markets and that may be the asset class that outperforms US equities.

The consensus view on tax cuts is overly optimistic in my opinion. My hope is the Trump team does more than pay lip service to issues surrounding deficits and debt and will only cut taxes that are "paid for". This will likely mean less in tax cuts than the market expects. Energy is expected to experience price declines as supply ramps higher and exceeds demand. I would not be surprised to see energy stocks outperform the broad market next year as earnings exceed estimates.

I forecast inflation running higher than consensus estimates meaning yields are likely to be higher than forecasts that will be a headwind for growth stocks. Look for Wall Street to allocate away from growth and towards value stocks with stable earnings. Small caps have very attractive valuations today but if volatility rises as I expect, any rotation into the more speculative asset class is likely to be modest.

Higher for Longer



Speculation has risen that the Fed's December ¼% rate cut may be the last the market's see for quite a while. With the exception of the DXY dollar index, virtually all asset classes sold off following cautious remarks from Fed Chair Powell on future cuts. Stocks dropped 3-4%, gold fell over 1%, and Bitcoin dropped by 6%. Higher anticipated rates in the US led to the USD surging to the highest level since November 2022. There are market forces that suggest inflation may moderate going into 2025 as US money supply growth remains negative year over year, typical of a disinflationary environment. A wildcard remains how Trump version 2.0 will influence US trade policy (i.e. tariff's) and whether that leads to inflationary pressure.

- Prices of real assets such as equities, gold, bitcoin have risen sharply since the results of November's election were known. Republicans are viewed as favoring policies that benefit asset price inflation.
- If the rally in the USD were to continue higher, it would put pressure on the stocks of multi-national companies who report 40% or more of revenue and profits from exports as their products become less competitive.
- Long-duration market rates moved higher following Powell's comments following the rate cut announcement. If the Fed pauses their easing policy, the 10-year UST is likely to approach the recent high of 4.99%.

The Value Gap Widens

We've written about the value performance gap – or the cumulative return differential between value and growth stocks – in prior months. We mention it again given what has unfolded over the past month, as the gap between value and growth has intensified to close out 2024. The chart to the left illustrates the year-to-date returns for the Russell 1000 Growth and Value Indexes. For much of the year, value and growth moved higher in lockstep with growth rallying in the summer and value providing support during the August drawdown. But December witnessed a breakdown in the value index while growth continued to accelerate.

- Investors collectively sold value stocks (based on the Russell 1000 Value Index) every day for fourteen straight trading sessions beginning on December 2nd. What was noticeable is how abruptly and swiftly investors decided to sell their positions after bidding prices higher for much of the year. The forecast PE ratio for the index is roughly 17x, so valuations remain reasonable.
- Are we setting up a repeat of 2023 or was December simply a temporary pullback? The earnings outlook for the sectors that tend to dominate value – financials, healthcare, industrials – are favorable and the price multiples are in line with historical tendencies. Still, investors may throw caution to the wind and continue to bid mega-cap stocks to nose-bleed highs.

US Markets face Uncertainty at Year-End

With just one trading day left in 2024, US stocks appear poised to close the year on a subdued note as technology stocks led declines. The S&P 500 and Nasdaq Composite have both fallen over 1% in three consecutive sessions, marking a challenging end to the year. Before the December FOMC meeting, markets widely anticipated at least three rate cuts in 2025. However, the Federal Reserve's revised outlook, now projecting only two rate cuts, has fueled investor unease. Despite concerns about the concentrated gains driven by major tech stocks, analysts remain optimistic about the S&P 500's prospects for 2025, citing robust growth potential and positive earnings forecasts.

- Technology stock declines drove the S&P 500 and Nasdaq Composite lower, ending the year on a cautious note. Even with the recent declines both indices will finish the year up more than 20 and 30% respectively, barring any declines on the final day of market trading.
- Treasury yields, which have accelerated higher of late, gained amid weaker economic data, with the 10-year yield around 4.55%, a level we have not seen since May.

Quinn VandeKoppel

Macro View – Inflation Eases Slightly

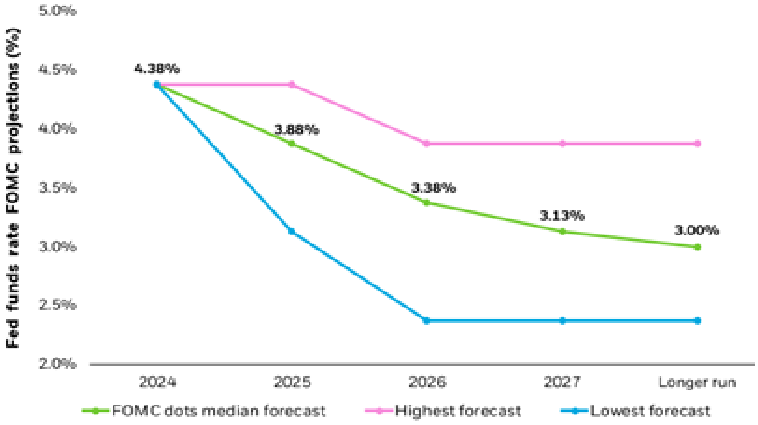
Inflation showed modest signs of easing in November, with the personal consumption expenditures (PCE) price index rising just 0.1% monthly and 2.4% annually, slightly below expectations but still above the Federal Reserve's 2% target. Core PCE, excluding food and energy, also increased 0.1% monthly and 2.8% annually, matching October's rate. Goods prices dropped 0.4% annually, while services rose 3.8%. Housing inflation cooled, rising 0.2%. Personal income grew 0.3%, below forecasts, and spending rose 0.4%. The savings rate fell to 4.4%. Stock futures dipped, and Treasury yields slumped after the report. Fed Chair Jerome Powell noted inflation has moved closer to the Fed's goal, but slower progress and uncertainty may temper rate cuts, aligning with the recent reduction in the projected path of rate reductions for 2025.

Taking Stock – President Carter's Legacy

President Jimmy Carter, who passed away on December 29, 2024, is remembered for a lifetime of public service and humanitarian efforts. Serving as the 39th president of the United States from 1977 to 1981, Carter focused on human rights, environmental initiatives, and diplomacy, including the Camp David Accords, which improved relations in the Middle East. After his presidency, he devoted himself to global causes through the Carter Center, promoting health, democracy, and conflict resolution, and contributing to the near eradication of Guinea worm disease. He also worked with Habitat for Humanity, helping build homes for those in need well into his later years. Known for his dedication to service and community, Carter's contributions extended far beyond his time in office, leaving a lasting impact on countless individuals and communities worldwide.

Fixed Income – 2025 Outlook

At its final meeting of 2024, the Federal Reserve cut interest rates by 25 basis points; the Fed has now cut rates by 100 basis points since September 2024. Looking ahead to 2025, the Federal Reserve is expected to reduce interest rates to around 4%, then pause as inflation and employment data evolve. Core inflation remains above the 2% target, prompting cautious rate adjustments. Geopolitical risks, rising debt, and major economic shifts may sustain higher long-term Treasury yields. The Fed aims to balance inflation control with fostering employment, using interest rates and balance sheet tools. Policy direction will depend on economic data, reflecting the Fed's dual mandate and focus on stability. These factors suggest a measured approach in navigating economic uncertainty.



Technical – Technical Support

After reaching an all-time high on December 6th, the S&P 500, represented by the SPDR S&P 500 ETF Trust (SPY), has pulled back about 2.5%, reflecting some market volatility. On Monday, the ETF tested support near $584.50, aligning with an upward trendline that has previously acted as a key level, notably after the December 20th decline. Should this trendline hold, it could signal renewed momentum for the market heading into the new year, with potential for further gains. Conversely, a break below this support level might trigger a decline toward the $565-$570 range, effectively erasing the post-election rally tied to the outcome of President Trump's victory. This technical setup highlights the market's delicate balance as investors assess the broader economic and geopolitical landscape for 2024 and beyond.

Earnings Overview

Clint Pekrul, CFA

Earlier this year we wrote about current equity valuations in relation to historical measures. Given the cumulative advance of nearly 60% for the S&P 500 Index over the past two years, including dividends, investors are correct to question how much they are paying today for future earnings. More specifically, will future earnings growth support current multiples?

In this section we examine earnings growth estimates over the next two years for each sector and derive the implied price-to-earnings (PE) multiple based on current valuations.

Estimated Earnings Growth

To determine the sector earnings growth forecast, we used the average (consensus) EPS estimate for each stock within the sector over a one- and two-year horizon and derived the annual growth rate. We then weighed each company's growth rate estimate by the stock's capitalization weight within the overall sector. The result is a weighted-average growth rate. The table below illustrates the results:

Sector Earnings Growth Forecast	One Year	Two Year
Technology	12%	17%
Utilities	9%	8%
Energy	8%	16%
Financials	9%	11%
Healthcare	19%	12%
Industrials	15%	13%
Materials	16%	14%
Discretionary	16%	16%
Staples	8%	9%
Telecom Services	9%	11%

Not surprisingly the technology sector is expected to deliver the highest earnings growth rate (17%) over the next two years. However, the sector's two bellwethers – Apple and Nvidia – are expected to deliver flat to decelerating earnings growth rates. The energy sector has a favorable outlook driven by robust earnings estimates in 2026 for both Exxon Mobile and Chevron.

Meanwhile, the outlook for interest rates is more favorable for banks as the yield curve continues to normalize. Earnings growth for the sector is expected to accelerate from 9% to 11%. The outlook for telecom is supported primarily by a modest acceleration in earnings growth for Meta and Google.

Implied PE Multiples

The table below illustrates the implied PE multiple for each sector. The figures are derived by comparing the current price of each stock by sector to its estimated earnings. Each company's PE multiple is then weighted by its market capitalization within the sector.

Implied Sector PE Multiples	One Year	Two Year
Technology	30	26
Utilities	18	16
Energy	15	13
Financials	19	17
Healthcare	20	18
Industrials	23	20
Materials	19	17
Discretionary	21	18
Staples	22	20
Telecom Services	17	15

Investors are paying roughly 26 times forecasted 2026 earnings for the technology sector, which commands the highest PE multiple. In contrast, the energy sector, which is expected to grow earnings by 16% over two years, commands a multiple of only 13 times 2026 earnings. Likewise, discretionary sector earnings, which are expected to grow at 16% over two years, command a multiple of just 18.

On a relative PE basis, the "cheapest" sectors based on 2026 forward earnings are energy, telecom services and utilities. The implied PEs suggest that certain segments of the market remain reasonably priced, considering future earnings growth potential.

Market breadth in 2024, or the overall upside participation across all sectors, has improved compared to 2023. Yet, as we experienced in December, the gap between growth and value stock performance widened considerably to close out the year.

Investors continue to favor technology stocks given their growth prospects. Perhaps 2025 will see some convergence across sector multiples. In other words, we could experience a continuation of the sector rotation that began in 2024. From a valuation standpoint, there are broad segments of the market that don't seem stretched and that could attract further capital allocations.

Q: How is AI being implemented in the markets?

Artificial Intelligence or machine learning is rapidly moving from something that will impact the future to a force of change today. However, it is the convergence of AI and quantum computing that is making AI applications mainstream. Quantum computing is what allows AI and machine learning algorithms to create predictive analytics that identify opportunities and risks.

According to the Hedge Fund Journal, more than 60% of equity trades in the secondary markets are carried out by high frequency trading algorithms using AI. The impact of high frequency trading is still being understood by market participants and regulators, but the emerging consensus is that these programs increase overall market volatility. Forecasts from Bloomberg suggest the need for traders on the floor is dropping dramatically and companies like Vanguard and Fidelity are increasingly turning to AI to provide research and data analytics and will rely less on highly paid analysts.

AI's predictive analytics improvements are driven by the increased availability of quantum computing power. Companies like IBM and Google are essentially leasing quantum computing power while other companies are building machines that are increasingly affordable for large companies. This is dramatically improving fraud detection in the financial sector that should benefit all consumers. It is estimated in a Forbes article from June 2024 that 54% of current finance jobs will be replaced by automation over the next 5 years creating a level of anxiety for those working in New York and London.

It is not uncommon to read articles about how AI can generate outsized returns that beat the overall market such as the S&P 500 Index. Stories of AI driven algorithms that can pick the winners on a consistent basis seem more common now than just one year ago. The popularity of these stories is not surprising, given that AI technology is evolving at a rapid pace and is the driving force that's sending markets to new highs. Yet, it's important to remember two critical points – AI algorithms are not necessarily predictive models, and alpha generation is a zero-sum game. AI models can be trained to synthesize vast amounts of data to solve a problem, but they have no crystal ball to predict the future. Likewise, one investor's alpha is another's underperformance. Competing AI models will create both winners and losers.

AI models can create efficiencies with respect to analyzing data to make investment decisions. Imagine a stock analyst that spends days synthesizing annual reports and income statements to form an opinion on a stock. An AI model could process the same data in a fraction of the time and derive a result that is just as valid. Likewise, AI models can handle the complexity of an econometric problem and perhaps find patterns that humans might not detect. The application of AI in the field of finance looks promising.

Q: What is the outlook for Energy in 2025 under a Trump Administration?

I think the most obvious change will be less emphasis on "green energy" with Trump in the White House and Republicans controlling the House and Senate. The Inflation Reduction Act allocated hundreds of billions for renewable energy that may not be spent given changing priorities. Stocks like First Solar, a leading green energy company, fell nearly 30% in October as traders expect the company to receive far fewer government subsidies.

If you consider the most recent forecasts from the International Energy Agency, the current global demand for oil is 102.8 million barrels per day, an increase of around 950,000 barrels from 2023. That is expected to grow by approximately 1 million barrels per day in 2025. At the end of November, the IEA reported supply of 102.9 million barrels per day and that figure is expected to grow to 104 mbd by the end of 2025. Historically, when the supply of oil exceeds demand, prices fall until production reduces due to lower profitability. There are reasons why excess supply figures may not negatively impact prices as much as expected. The US Strategic Petroleum Reserve (SPR) is at one of the lowest levels in decades with only about 340 million barrels in reserve. The SPR holds a total of 727 million barrels so the Trump Administration could accumulate over 300 million barrels if prices were to fall, essentially eliminating all excess supply.

I expect oil and gas companies to report strong earnings in 2025 and predict the energy sector is likely to be a leading sector next year in the markets.

The Trump narrative during the campaign was one of deregulation. It's very likely that Trump will again withdraw from the Paris climate agreement and pursue an energy policy that's vastly different than Joe Biden's. The shift could be more friendly to carbon-based energy production with less emphasis on renewables, although the clean energy sector's economic footprint is much larger now than when Trump first took office in 2017. Still, it's unlikely that clean energy supply will support overall demand growth in 2025. The continued buildout of data centers to support AI growth will require additional investments in electrical grids and transmission capabilities and will likely be powered by both clean energy and traditional carbon-based sources. Based on analysis from S&P Global, emissions from fossil fuel combustion will reach a new record high in 2025, although increasing at their slowest pace since the pandemic.

Based on analysis from Fidelity, crude oil prices are expected to remain elevated over the next year primarily due to geopolitical risk out of the Middle East and Ukraine and increased overall demand for energy consumption. If true, this outlook suggests higher profits for energy producers and equipment providers and potentially better performance for the sector in 2025 (the S&P Energy Sector Index is higher by just 4% year-to-date). The Trump administration will strive to keep oil prices in a moderate rage that is conducive to both profitability and stable inflation.

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