HORAN Capital Advisors

Quarterly Investor Letter

Winter 2024

"Most investors are primarily oriented toward return, how much they can make, and pay little attention to risk, how much they can lose."
- Seth Klarman

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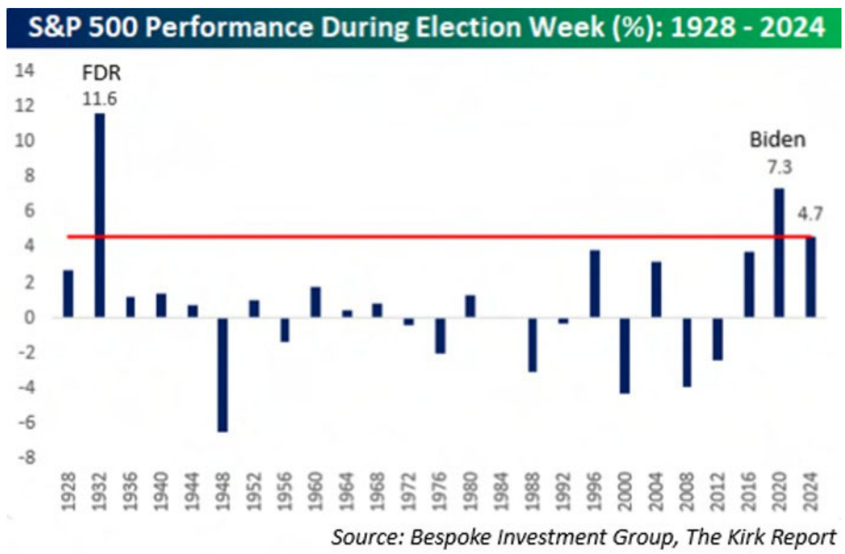
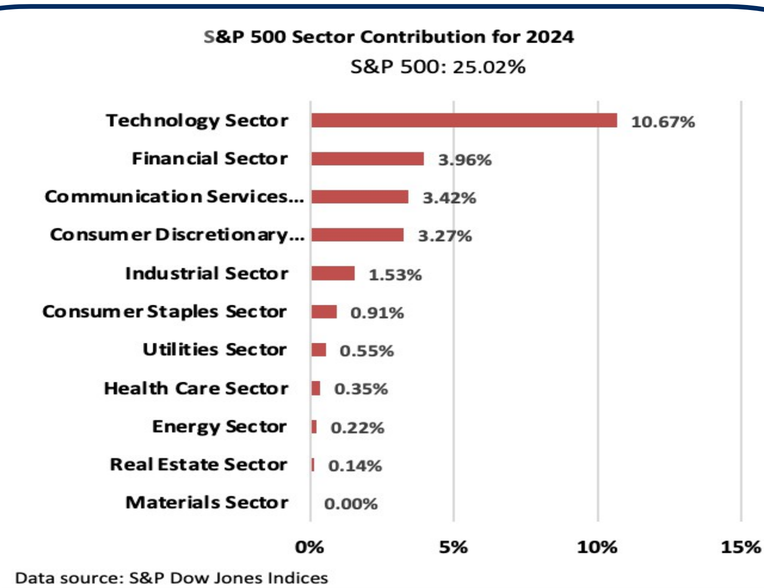
Some Uncertainty Now in Rearview Mirror

With the fourth quarter behind investors, some of the uncertainty that served as a potential headwind for the market is now in the rearview mirror. One of the most discussed issues in the fourth quarter was the November presidential election. Although the election was an important issue for investors to contend with, our Fall Investor Letter did not contain a discussion of the election. The reason for excluding election commentary is the fact the election itself historically has little impact on overall long term equity market returns. What tends to occur following the election is investors adjust to this new environment, shifting their focus to the policies expected to be pursued by the incoming administration. With uncertainty around the election removed, the equity market tends to experience a relief rally. On the day following this year's election, the S&P 500 Index was up 2.5% and up 4.7% for the week. This weekly increase was the third highest election week return since 1928 and pushed the S&P 500 Index over 6,000 for the first time on record.

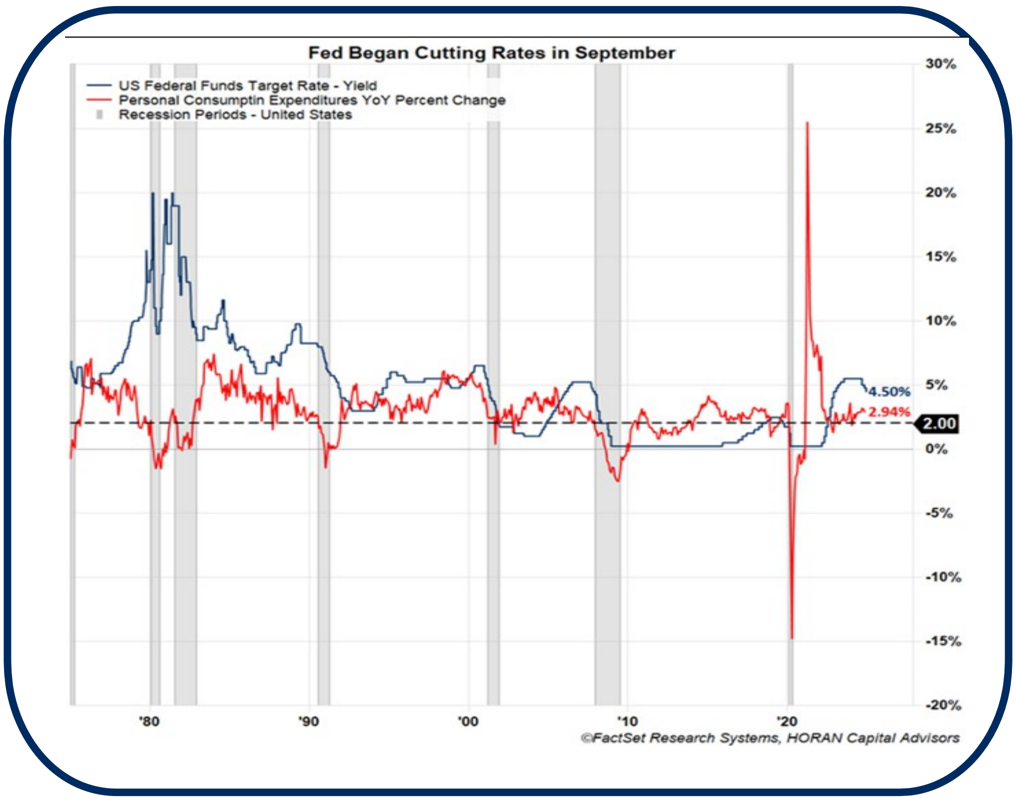
For the entire calendar year of 2024 investors again found the strongest equity market returns in U.S. oriented stocks. Further, the artificial intelligence theme was pervasive for most of the year and led to a group of stocks to become known as the Magnificent 7, i.e., Microsoft, Alphabet, Apple, NVIDIA, Tesla, Amazon and Meta Platforms. These so-called Mag 7 are classified in three sectors as defined by S&P Dow Jones Indices, Information Technology (Microsoft, NVIDIA, Apple), Communication Services (Alphabet, Meta Platforms) and Consumer Discretionary (Amazon, Tesla). For all of 2024 these three sectors accounted for 70% of the S&P 500 Index return of 25.02%. Further, the Mag 7 stocks themselves accounted for just over 50% of the index return in 2024. As noted in earlier newsletters this past year, the market returns have been highly concentrated in just a handful of stocks.





The Fed Changes Course

Following a path of interest rate increases beginning in March of 2022 and ending in July of 2023, the Fed reversed course and began reducing the Fed Funds Target rate in September with a 50-basis point (0.50%) interest rate reduction. In the two subsequent meetings in November and December, the Fed cut another 25 basis points at each of those two meetings. Following the December meeting, Fed chairman Jerome Powell's public comments indicated more caution would be taken by the Federal Open Market Committee (FOMC) in deciding future rate cuts in 2025. Inflation has ticked higher in recent months with the Fed's preferred inflation measure, Personal Consumption Expenditures (PCE), increasing at a year-over-year rate of 2.94% after being below the Fed's preferred target of 2% at the start of 2024. Additionally, although the unemployment rate has trended higher recently, increasing to 4.2%, it remains at a low level as do initial claims for unemployment insurance. The market is now expecting only one 25 basis point cut in 2025, down from an expected four cuts back in September.

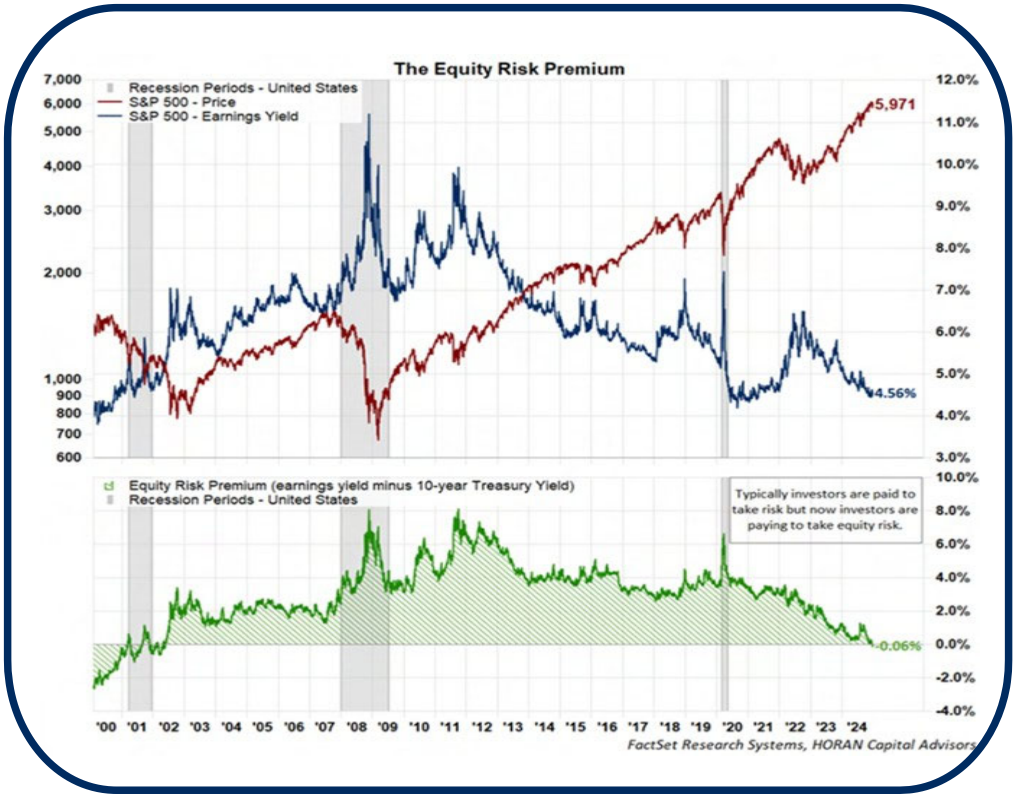


Higher Rates and Asset Allocation

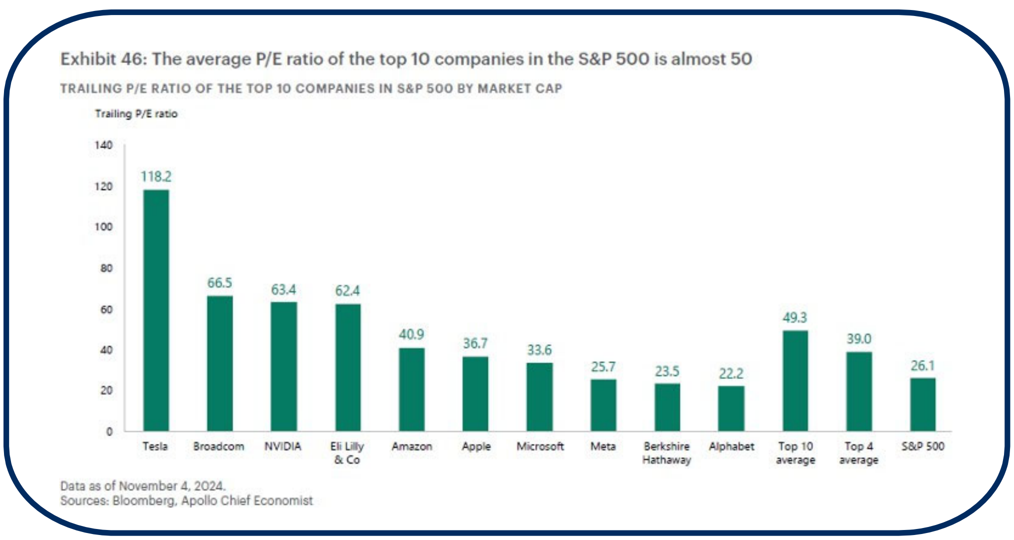
Just as the Fed began lowering short term interest rates, the market started pushing longer term interest rates higher. In mid-September the 10-year Treasury yield equaled 3.61% and has increased to 4.57% at the end of 2024. During September, the treasury yield curve also un-inverted, that is, the 2-Year Treasury yield fell below the 10-Year Treasury yield. The FOMC controls short-term interest rates with their periodic interest rate decisions; however, longer term interest rates are influenced more by market forces. With this move higher in longer term yields, bonds become reasonable competition for stocks.

One way investors can compare the attractiveness of bonds, vis-à-vis, stocks, is to compare the earnings yield for stocks to the bond yield. The earnings yield is simply the inverse of the price/earnings ratio and using 12-month trailing earnings results in an earnings yield for the S&P 500 Index of 3.65%. The difference between the earnings yield for the S&P 500 Index minus the yield on the 10-year U.S. Treasury is known as the Equity Risk Premium (ERP). Since stocks tend to carry more risk, historically the ERP is positive, that is, investors are compensated to own stocks versus bonds. Today the ERP recently turned negative as seen in the near chart; thus, investors are paying to take equity risk.

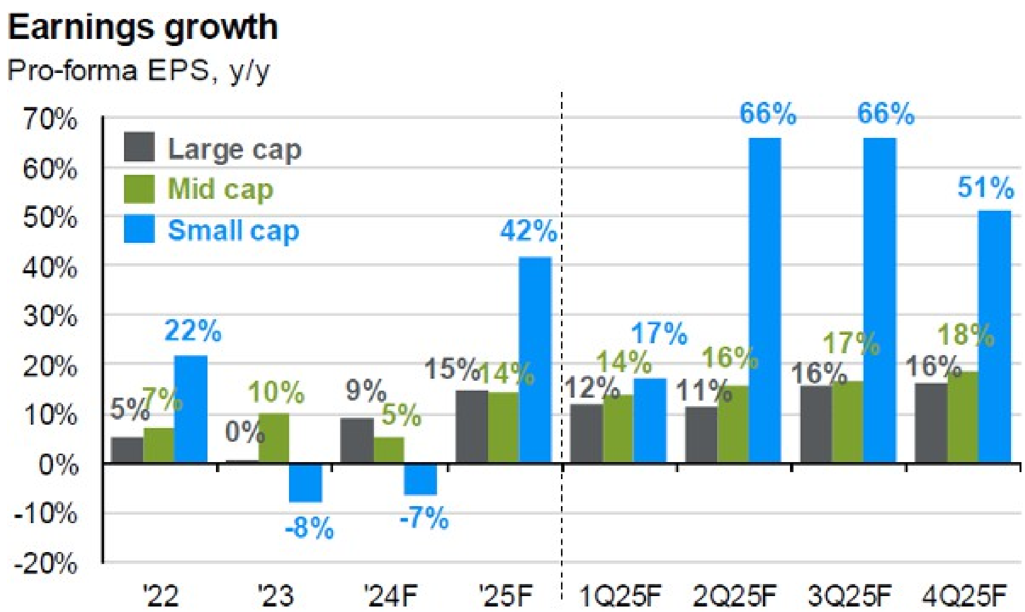
This low or negative ERP is a result of stocks trading at a high valuation relative to bonds. This extended valuation can be isolated to a handful of the megacap stocks, referenced earlier as the Magnificent 7, in the S&P 500 Index. These seven stocks are part of the Top 10 stocks in the S&P 500 Index. As seen in the near chart, the average valuation for these ten stocks equals 49.3 times earnings, while the S&P 500 Index has an overall valuation of 26.1 times its earnings. Excluding the Top 10 stocks, the remaining stocks in the Index have a P/E of 19.6x which equates to an earnings yield of 5.1% and results in a slightly positive ERP. Still a low ERP for the S&P 500 Index, but it is positive, nonetheless.



After two strong returning years for the S&P 500 Index, specifically large company stocks, valuations have become elevated. Investors should keep in mind valuation is not a reliable tool to use in determining if stocks might correct in the short run. However, a higher valuation is an indication that these megacap stocks may lag in some of the future equity market appreciation.



From a somewhat positive perspective is the fact other areas of the equity market do not appear to be extended from a valuation perspective. One area where this is the case is in the small cap stock area. This has been discussed in a few of our earlier newsletters as we began reintroducing small cap stocks to client portfolios in September 2023. As the blue bar in the near chart shows, small company stock earnings are expected to grow by a significant amount in 2025 and far outpace earnings growth for mid cap and large cap stocks. Importantly, small company stock valuations are trading near their long-term valuation levels, unlike large cap stocks that are trading about 35% above their long-term average. Given the fact small company stocks have not keep pace with large cap stocks, they might hold up better in a market pullback.



Source: Compustat, FactSet, FTSE Russell, NBER, J.P. Morgan Asset Management.
The S&P 500 is used for large cap. The Russell Mid Cap is used for mid cap. The Russell 2000 is used for small cap. U.S. Data are as of December 19, 2024.

Stock Prices Follow Earnings

All else being equal, it is fair to say a company's stock price and the market tend to follow a direction that matches its earnings growth rate. The S&P 500 Index companies have seen their collective earnings growth rate increase from 1.7% in 2023 to an expected 9.5% in 2024. Currently, the forward expected growth rate for 2025 is 14.6% and a growth rate of 13.5% is expected in 2026. Worth noting is the fact the earnings growth rate from 2023 to 2025 is accelerating, i.e., a faster growth rate in each year. The strong returns generated by the S&P 500 Index in 2023 and 2024 are reflective of this increasing earnings growth rate. Although 2026 seems distant, the growth rate in earnings of 13.5% is certainly noteworthy; however, this represents a slowing earnings growth rate from the 14.6% in 2025 and it is this fact that may create some additional volatility for stocks in 2025 as stocks trade on future earnings. Importantly, the slowing earnings growth is expected to be centered in the Magnificent 7 stocks while the growth rate in earnings for the remaining stocks in the S&P 500 Index is actually anticipated to accelerate from a YoY growth rate of 8% in Q4 2024 to a YoY rate of 15% in Q4 2025.

Conclusion

All eyes will be on Washington DC and potential changes to economic and fiscal policy as the year progresses and any implications for the markets. One area to note is potential tax law changes. The 2017 tax cuts are set to expire at the end of 2025 which would increase marginal tax rates, reduce the standard deduction, along with various other tax implications. President-elect Donald Trump campaigned on extending many of the 2017 tax cuts that are set to expire and will look to congress to pass legislation in 2025.

Much of the prior commentary on the year's return highlighted the narrow market and the fact the total market return has been driven by a handful of stocks. Over the course of the year there have been short time periods where market breadth had improved, but the concentration of returns seemed to always win out. For the equity market advance to continue in 2025 broader participation in stocks would be beneficial. Given the fact economic data continues surprising to the upside, although by a smaller percentage, favorable economic activity would serve as a tailwind for company earnings and thus stocks. Also, the potential for breadth to expand would likely benefit smaller company stocks and an area where investors can find an opportunity within the stock universe. Of course, after the strong returns in 2023 and 2024, it would not be a surprise to see a market pullback at some point in 2025; however, given anticipated favorable earnings growth in 2025, equity market returns in 2025 are likely to be positive.

Thank you for your continued confidence and support in HORAN Capital Advisors and we are always available to answer your questions and discuss our outlook further. Please be sure to visit us for company news, reports, and our blog at https://horanwealth.com/insights.

Respectfully,

HORAN Capital Advisors