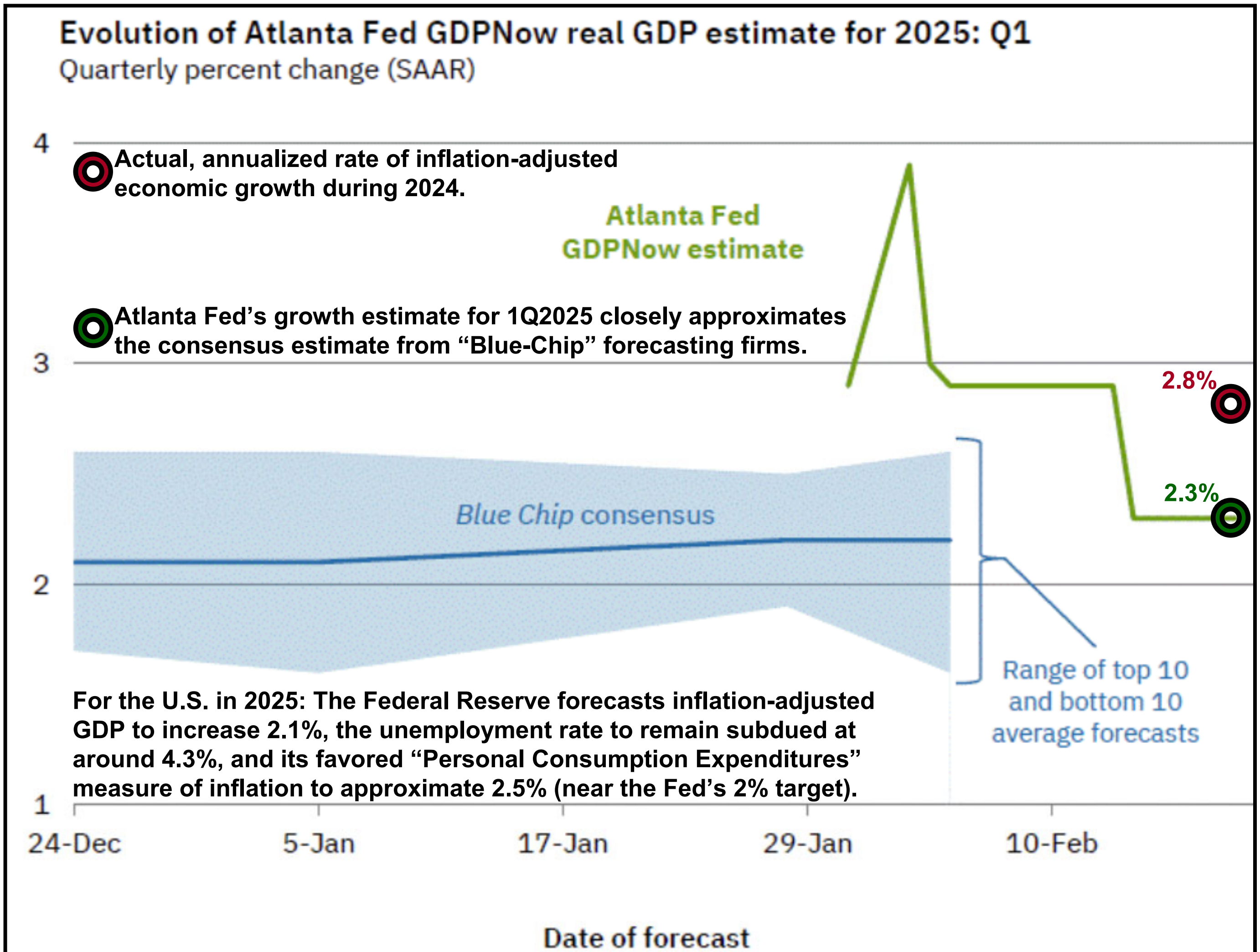
ECONOMY OK, STOCKS PRICEY, JUNK BONDS HEALTHY

U.S. OUTPUT (GDP) EXPECTED TO SLOW SOMEWHAT

The Atlanta branch of our Federal Reserve system estimates U.S. economic growth will slow to an annual, inflation-adjusted ("real") rate of about 2.3% during the first quarter of the year which matches the consensus estimate from other, well regarded ("Blue Chip") forecasters. During 2024, the U.S. economy grew by 2.8% after adjusting for inflation. Economic growth does not correlate perfectly with a rising stock market, but continued economic growth is positively correlated with higher corporate revenues and earnings and earnings certainly do drive stock values. The National Bureau of Economic Research will typically declare a recession only if inflation-adjusted Gross Domestic Product (i.e., "real" GDP) is negative during two consecutive calendar quarters, so **no recession is yet on the horizon**.

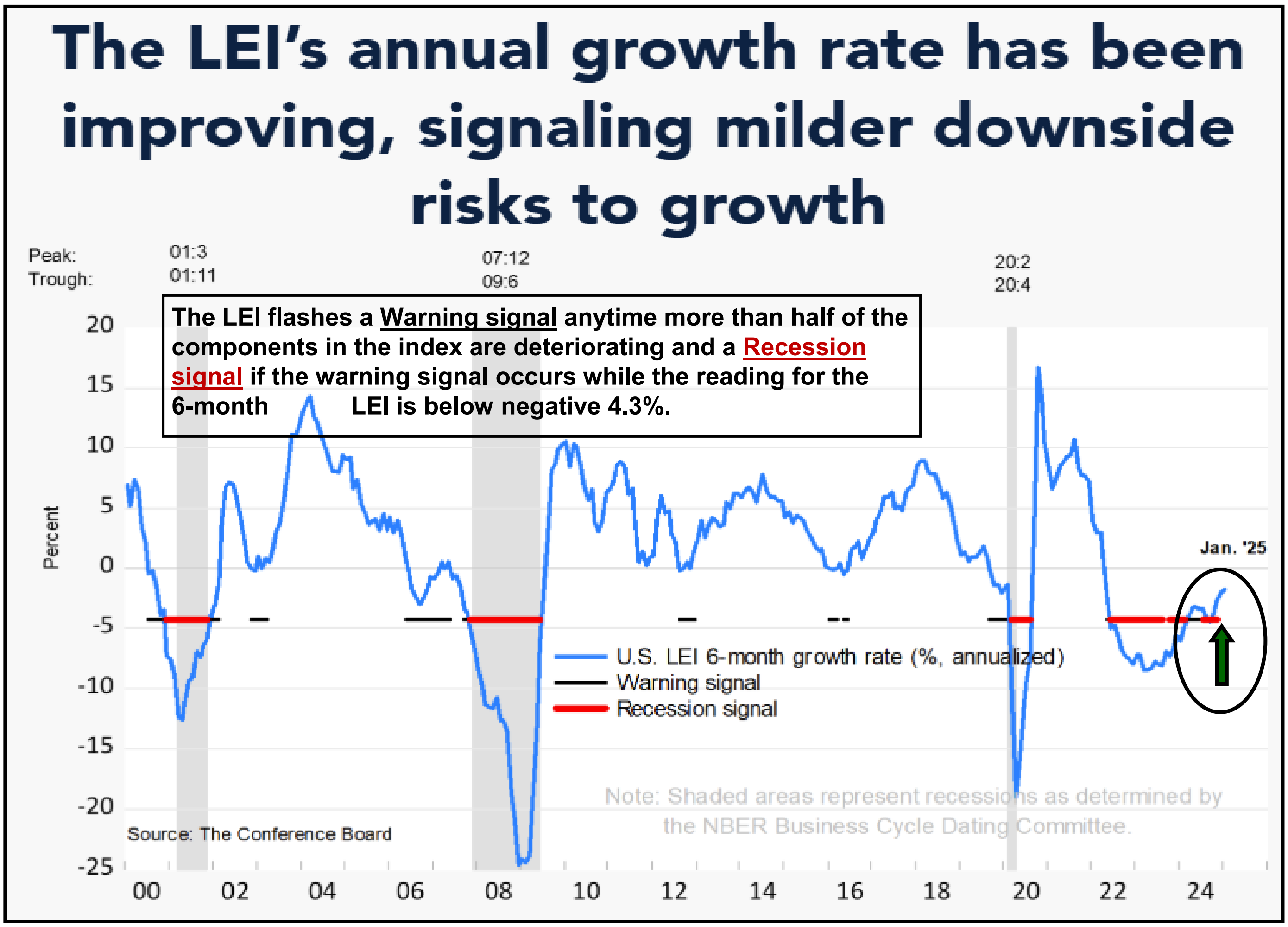


Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

LEADING ECONOMIC INDEX® RECESSION SIGNAL ENDS

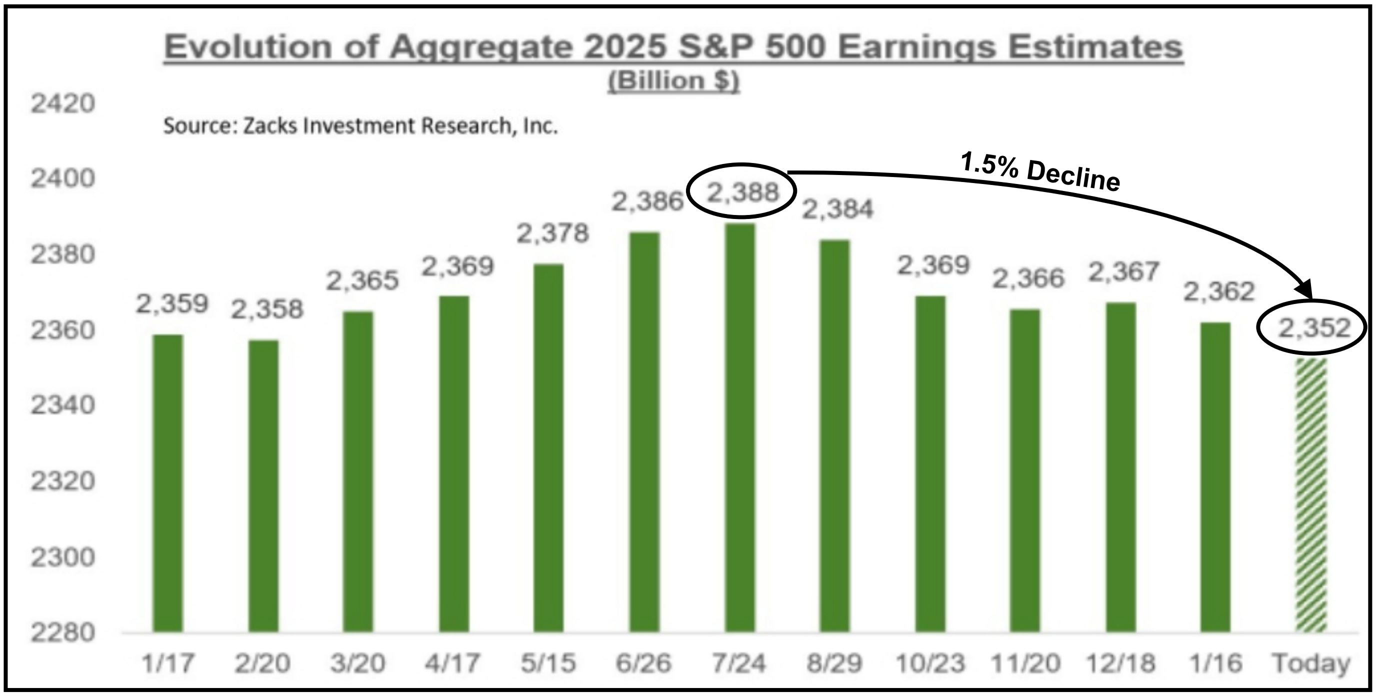
The Conference Board's Leading Economic Index (LEI) provides an early indication of turning points in the business cycle and where the economy is heading in the near term. According to a February 20th press release from the Conference Board, the LEI deteriorated by 0.3% during January, reversing most of the increase that occurred in November and December. However, the **LEI's six-month and annual growth rates trended higher in January** signaling milder obstacles to future U.S. economic activity.

In general, the LEI flashes a warning signal (black lines, below) when most of the components that comprise the LEI are weakening. If that weakening occurs while the LEI's six-month reading falls below -4.3% on the graph, the LEI warns that a recession is *already* underway or imminent (red lines, below). **Because more than half of the LEI's subcomponents began improving during January, the recession signal the LEI had been flashing has ended** (arrow). For 2025, the Conference Board forecasts inflation-adjusted economic growth (real GDP) within the U.S. to be 2.3% which meshes with the estimates discussed on the previous page.

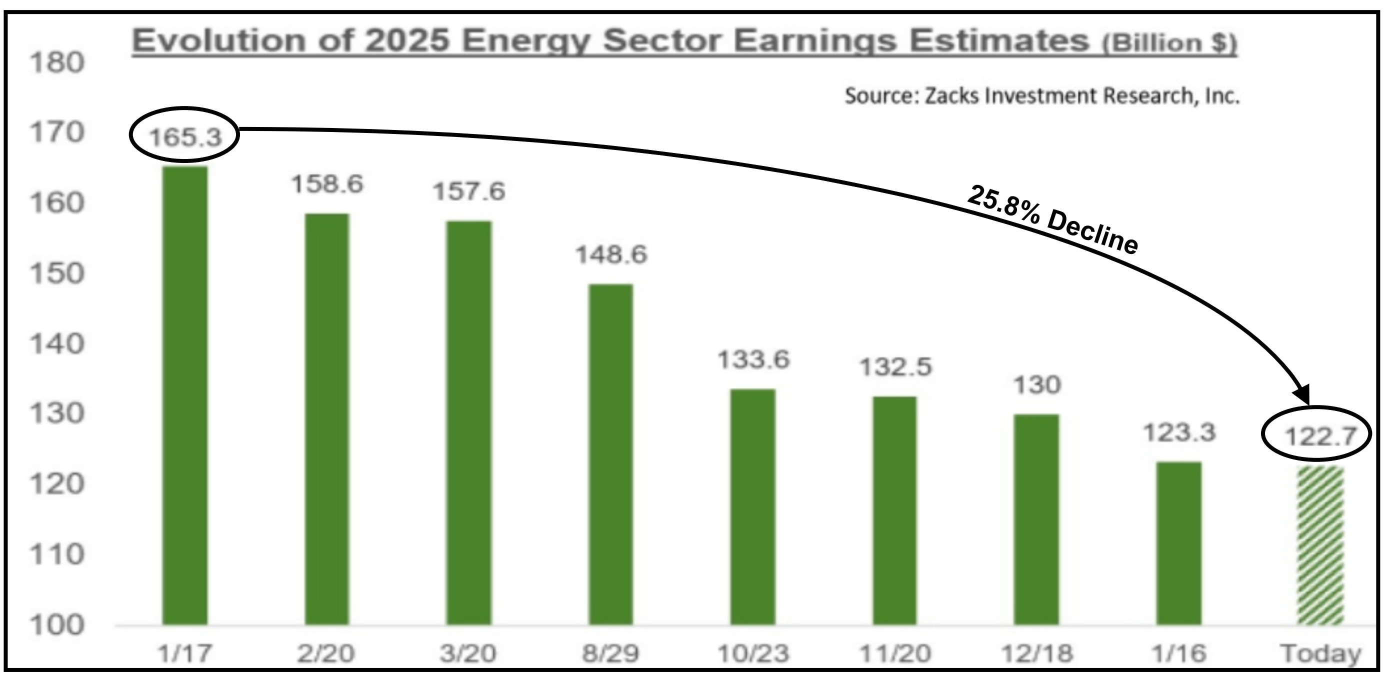


CORPORATE EARNINGS GROWTH PROJECTED TO SLOW

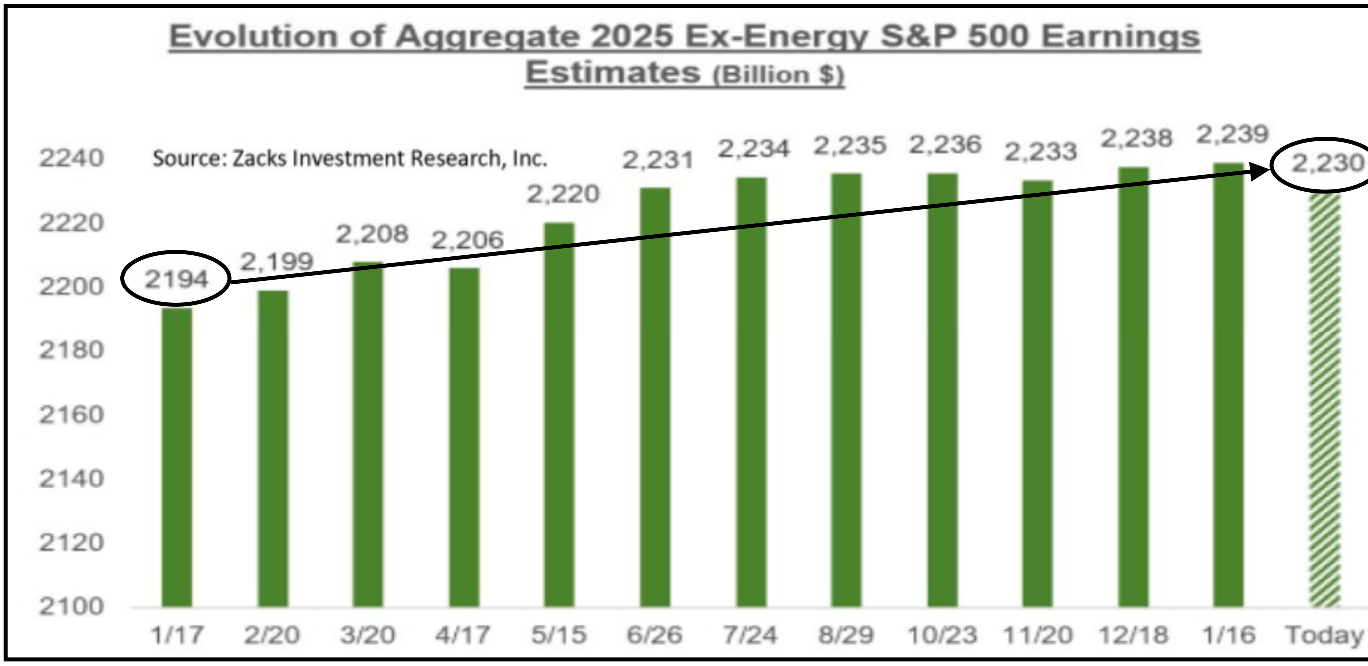
Earnings growth is a primary driver of equity values. With respect to corporate earnings forecasts for 2025, analyst optimism peaked last July when they collectively expected the constituent companies of the S&P 500 to earn $2.388 trillion. Analysts' earnings expectations have since declined by about 1.5%.



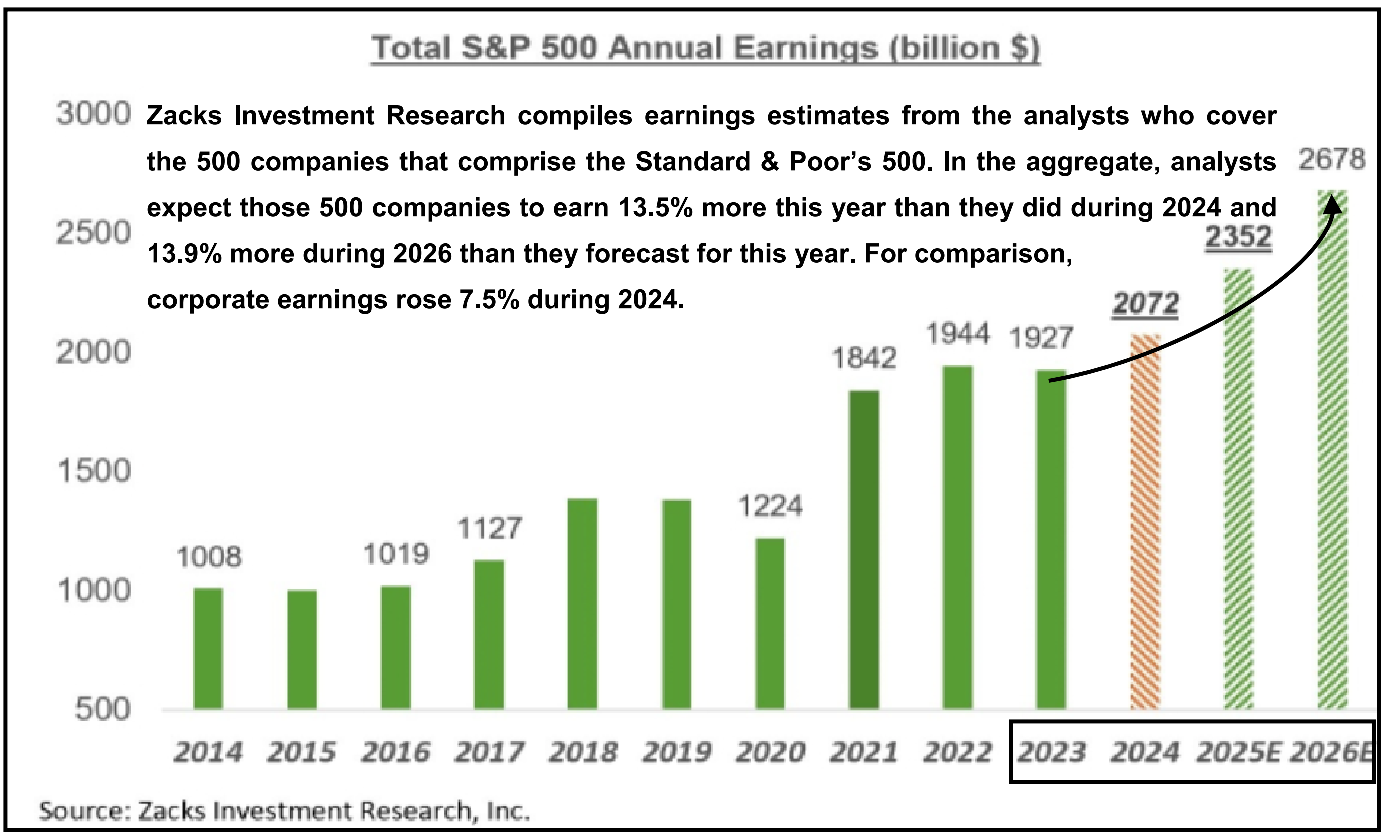
However, most of the deterioration shown above is explained by downward revisions analysts have been making for companies that operate within the energy sector.



Excluding the energy sector's 25 companies from the earnings estimates that appear on the top of the previous page shows that analysts' **earnings estimates for the remaining 10 sectors and 475 companies within the S&P 500 have *increased* slightly *(1.6%)* over the past year**.

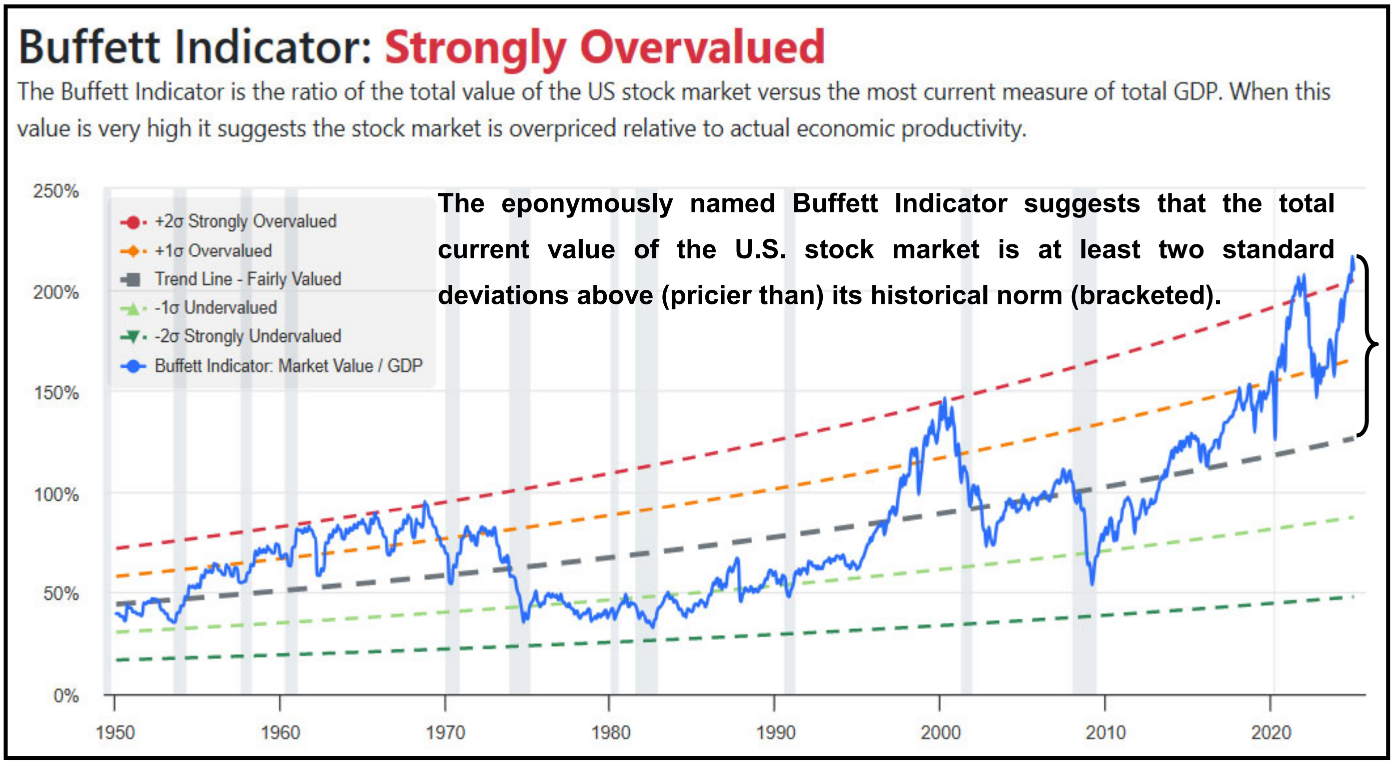


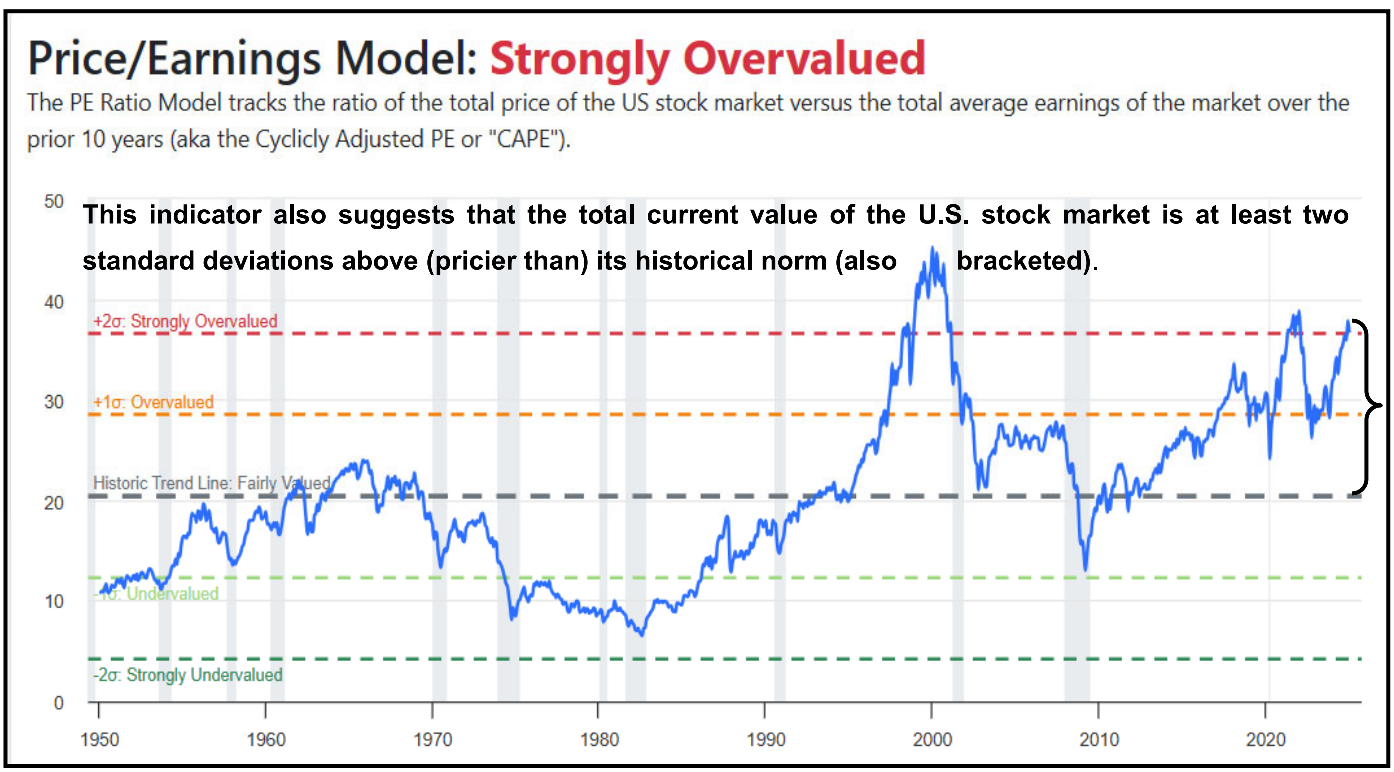
ANALYSTS EXPECT EARNINGS GROWTH TO ACCELERATE



U.S. EQUITIES APPEAR RICHLY VALUED VS GDP & EARNINGS

Although earnings growths estimates for U.S. companies are certainly encouraging, the images that follow suggest that **the robust earnings growth analysts expect may *already* be reflected in current equity valuations**.



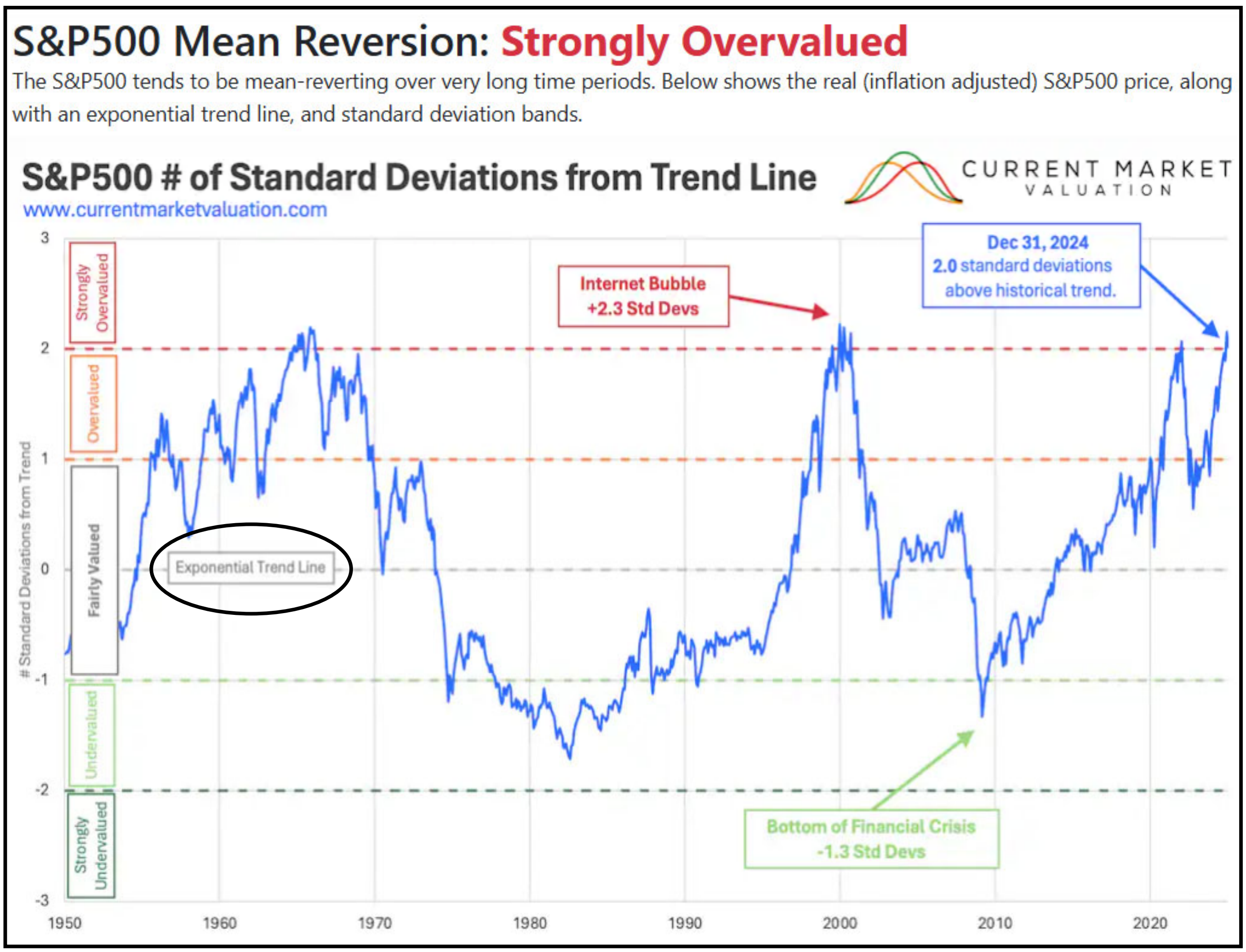


EQUITIES APPEAR PRICEY VS HISTORICAL RETURNS

The next image takes the roughly 10% average annual returns to which equity investors have become accustomed over the past 70+ years and displays those average returns as a flat trend line on the horizontal axis (circled). The image then compares the degree to which the overall value of the stock market has deviated from that long-term trend line.

When the bear market of the 1970's and early '80's is viewed through a long-term lens, equities appear to have been on sale. The same is true for 2008 and 2009 when the world seemed to fall apart. Conversely, the dot.com bubble that occurred during the turn of the century is an example where, retrospectively, equities appear to have been sharply overvalued.

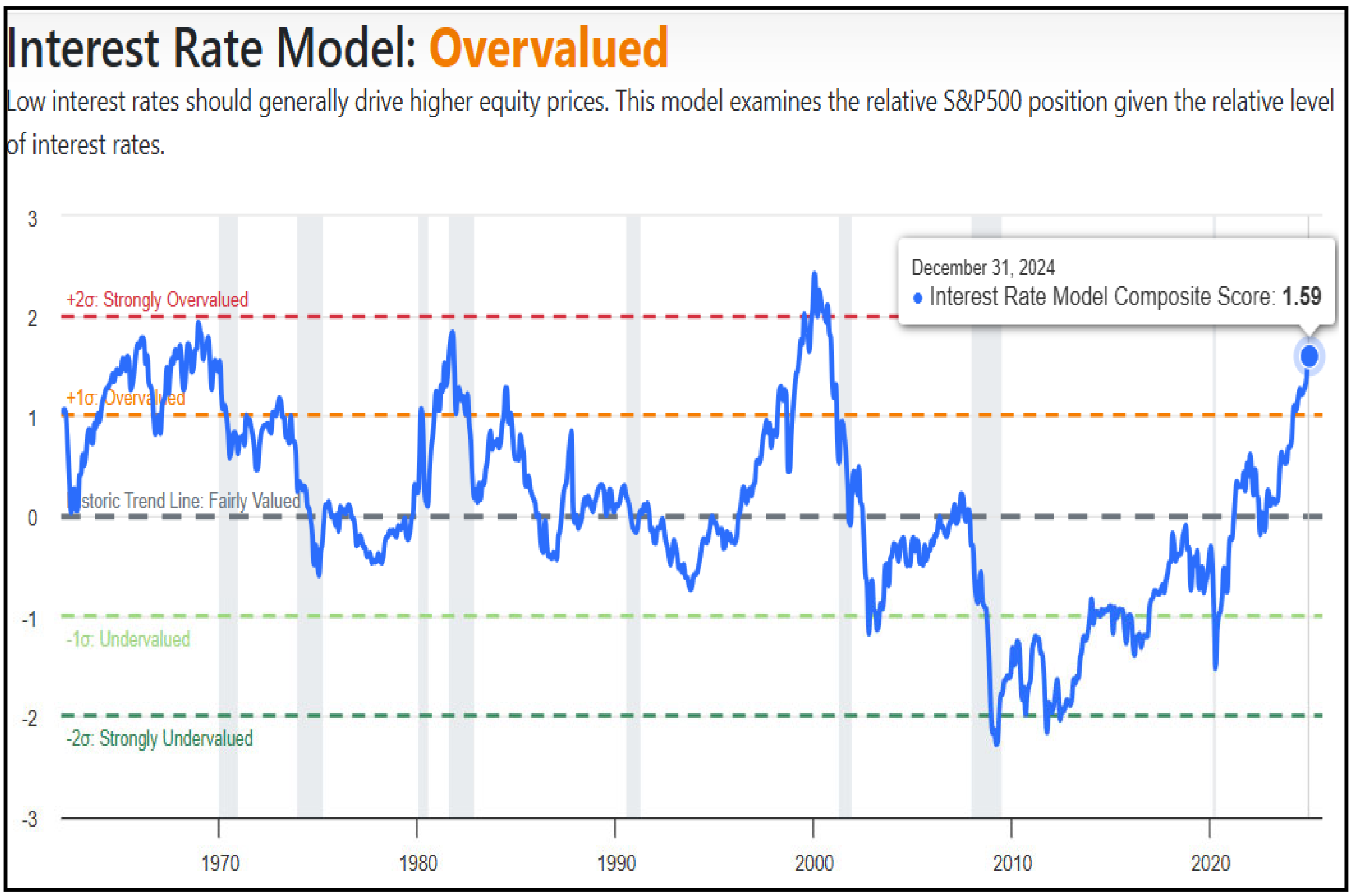
From the beginning of the recovery in 2009 we've enjoyed a bull market in length and scale greater than any other in modern times. Despite the market corrections in 2022, **this metric suggests that equities, once again, appear to be sharply overvalued**.



EQUITIES RICHLY VALUED RELATIVE TO INTEREST RATES

Interest rates influence equity valuations. To the extent interest rates are lower than usual, investors who might otherwise invest in interest-bearing instruments may be induced to purchase dividend-paying stocks. This incremental demand for equities pushes their valuations higher. Lower interest rates also make it less costly for corporations to service their debt. This aids profitability which also tends to drive equity valuations higher.

As shown in the previous panel, the current valuation of the S&P 500 is more than two standard deviations *above* its historical trendline. Although not shown here, the yield on 10-Year Treasury securities is approximately one-half of a standard deviation *below* its historical norm. That is, bond yields are lower than usual. Netting these two components suggests that U.S. **equities are currently valued about 1.59 standard deviations above (pricier than) the level that might be considered to be typical** in the current interest rate environment.



TODAY'S COMPANIES MAY DESERVE HIGHER VALUATIONS

In a podcast recorded January 24, 2025, Lord Abbett Portfolio Manager, Matt DeCicco, outlined why he believes companies today deserve the valuation premiums they're being awarded.

1) MANY MORE "ASSET-LIGHT" COMPANIES EXIST TODAY

In general, he believes that companies today are much better than they were over the previous half century. First, **the number of asset-light businesses has increased dramatically** while the number of manufacturing (asset-intensive) firms has declined. **Today, roughly half of the companies within the S&P 500 are considered to be asset light versus 20% in 1994**. In 1994, manufacturing firms comprised about 45% of the S&P 500 whereas they comprise only about 20% today.

For a given level of revenue, **an asset-light business can be more profitable than an asset-intensive competitor and shareholders will typically award premium market valuations to companies that operate more profitability.**

2) EARNINGS GROWTH NOW EXCEEDS GDP GROWTH

According to Matt DeCicco in that same podcast, **S&P 500 earnings growth was about 2% per year <u>below</u> the rate of GDP growth during the 30 years prior to 1995 and about 4% per year <u>above</u> it since then**. **This, too, will tend to drive valuations higher**, especially when the value of the stock market is being compared to GDP (e.g., the Buffet Indicator).

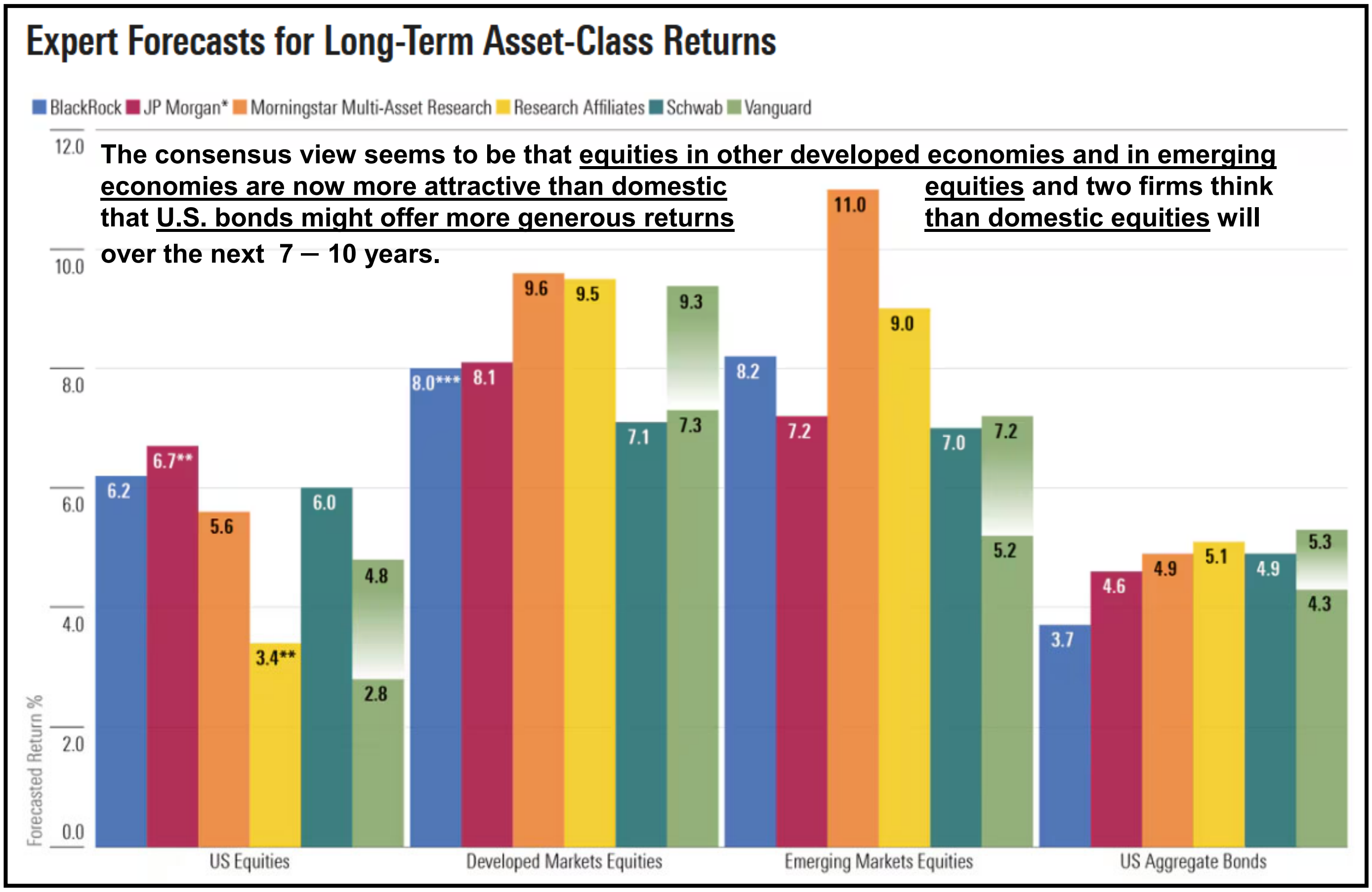
3) RETURN ON EQUITY HAS INCREASE DRAMATICALLY

If a company is able to increase its overall revenues at some rate, it is likely that the returns to shareholders will increase at a significantly greater rate. This is so for a variety of reasons that are beyond the scope of this note. Matt DeCicco estimates **S&P 500 companies generated returns on equity that averaged 12% per year during the 30 years prior to 1995 and 20% since then**. This 30-year compounding advantage also helps explain premium valuations.

BUT LARGE FIRMS STILL FORECAST MUTED EQUITY RETURNS

In January, Morningstar assembled capital markets assumptions that look forward 7 – 10 years from six well-known investment firms (refer to the image on the next page). Notably, **<u>every firm in this survey is expecting higher returns from non-U.S. equities</u> than from domestic ones over the next decade**, and some firms are forecasting higher returns from the bond market than they are from domestic equities.

Of note is that Vanguard (light green bars in the next image) forecasts that average annual returns from domestic equities will fall in a range of 2.8% – 4.8%, down from a range of 4.2% – 6.2% in 2023 and that "value" stocks will substantially outperform "growth" stocks. **Both Vanguard and Research Affiliates (yellow bars) expect an anomaly—i.e., the U.S. bond market (a *<u>safer</u>* place) to produce *<u>higher</u>* returns than domestic equities (a *<u>riskier</u>* one)**.



HIGH-YIELD (LOWER–QUALITY OR "JUNK") BONDS

Most of the six firms that are represented in the image above expect domestic bonds to produce returns that approximate 5% per year over the next 7 – 10 years. However, **lower credit quality bonds that trade within the bond market currently offer a yield advantage of about 1.25% – 2.375% per year over their higher quality counterparts**.

If these firms are correct, that equity returns will be significantly lower over the next 7 – 10 years than they have been in the recent past and that the **returns from lower quality bonds could rival those from domestic equities**, i**t would make sense to continue to lean on lower quality bonds to generate a bit of incremental return as long as repayment of those bonds seems likely**.

The higher yields offered by lower quality bonds are accompanied by a higher risk of default, so prudence requires some sense of the likelihood and severity of any prospective credit losses. After all, chasing an extra couple percent worth of annual return from lower quality bonds could instead end with an issuer default, a material loss of principal, and a dose of regret.

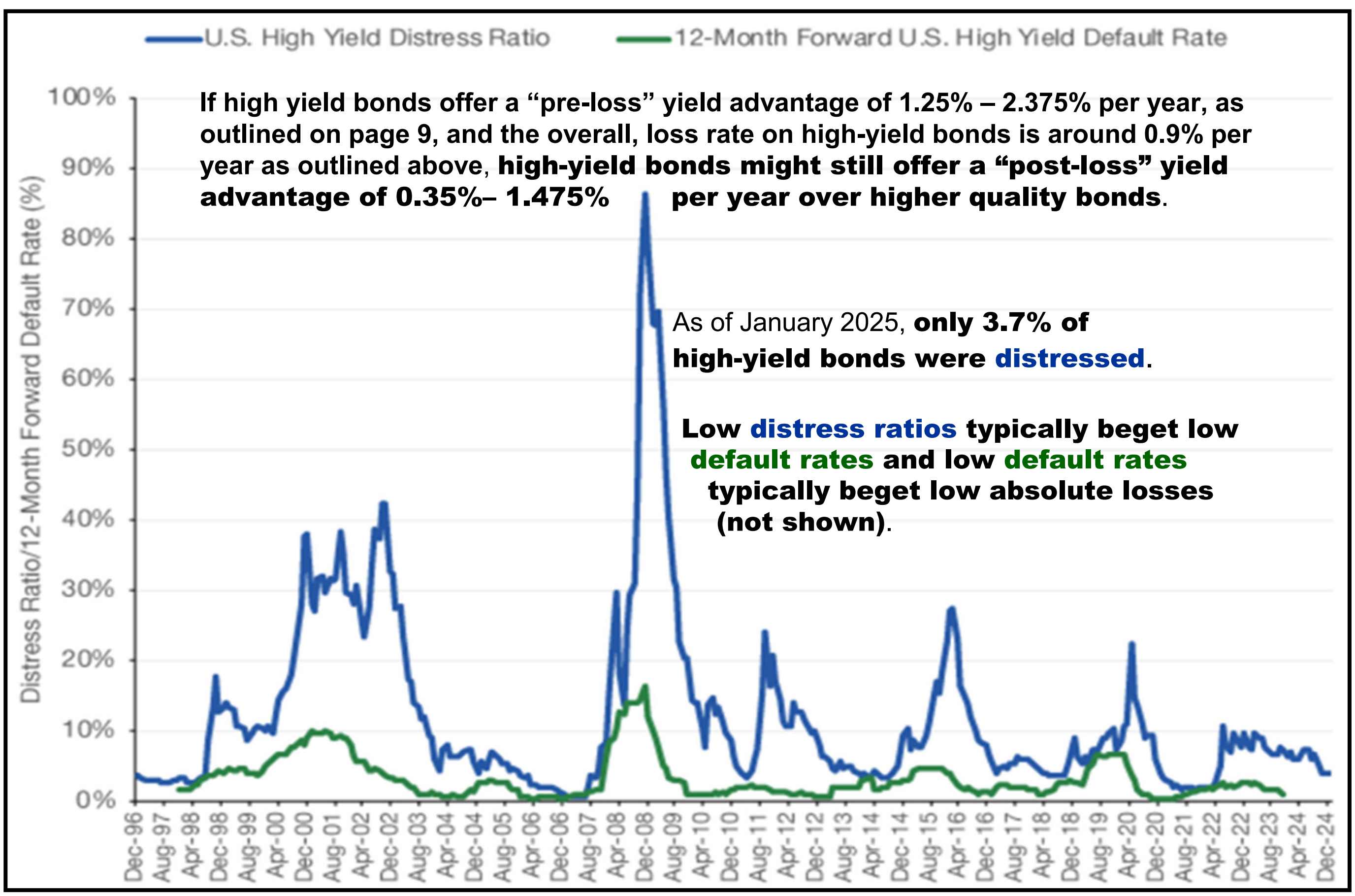
LITTLE DISTRESS IN HIGH-YIELD ("JUNK") BOND MARKET

When holding lower-rated bonds, a primary concern is whether the issuer will pay as agreed and, if not, the extent to which a bondholder can recover his/her investment. In cases where a bond issuer is showing signs of distress, investors will be reluctant to hold its bonds. **As the market values of "distressed" bonds decline, their yields rise, sometimes resulting in yields that are more than 10% higher than offered by Treasury Bonds of similar maturity**.

Bond market gurus track the percentage of high-yield bonds that offer a yield advantage of at least 10% versus their Treasury Bond counterparts and deem them "distressed." **As of January, only 3.7% of all high yield debt was considered to be distressed (blue line, below)**. Historically, 35% – 45% of distressed debt has tended to culminate in default 12 months hence.

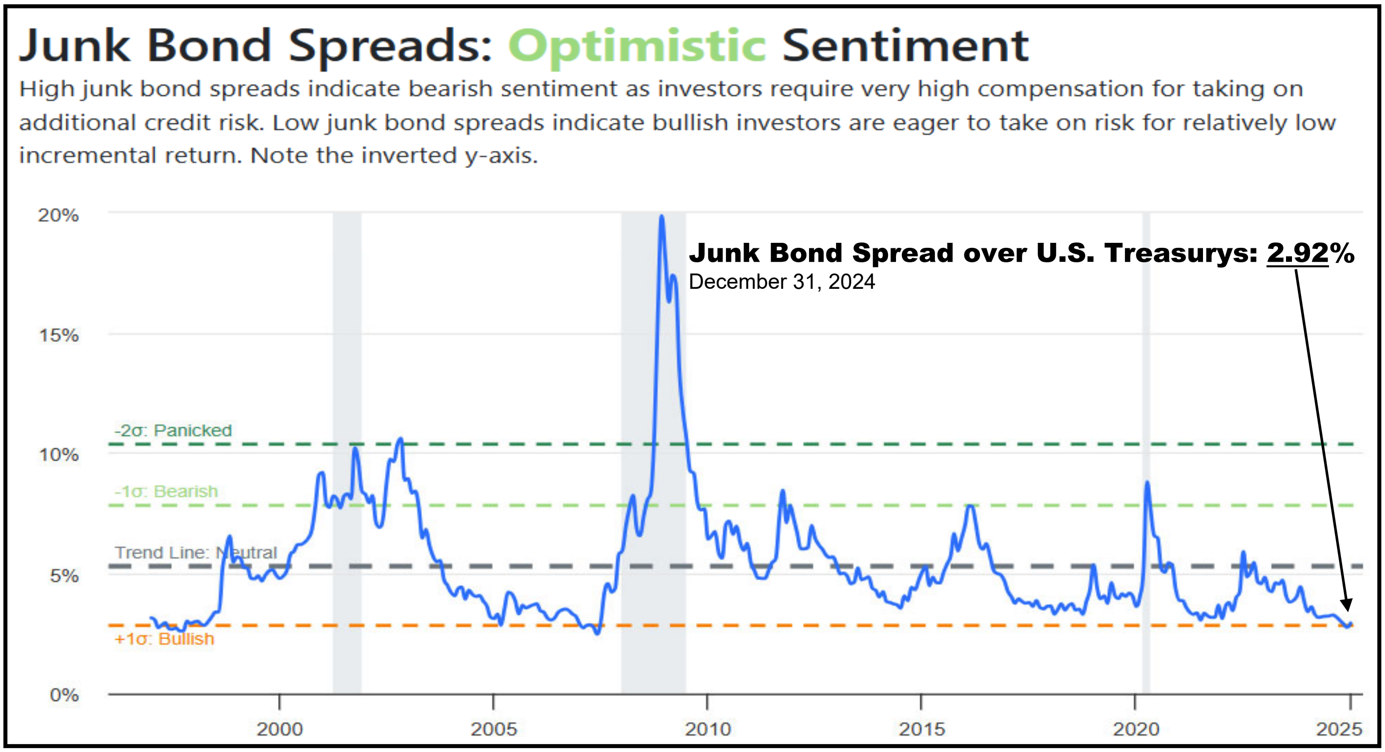
JUNK BOND MATH SUGGESTS THEY ARE ATTRACTIVE

If 3.7% of the high-yield bond market is currently distressed and 40% of those issues actually default, the default rate would then be about 1.5% (3.7% times 40%). If the loss rate on the 1.5% of bonds that actually default is 60%, the all-in loss rate on high-yield bonds would then be in the realm of 0.9% per year.

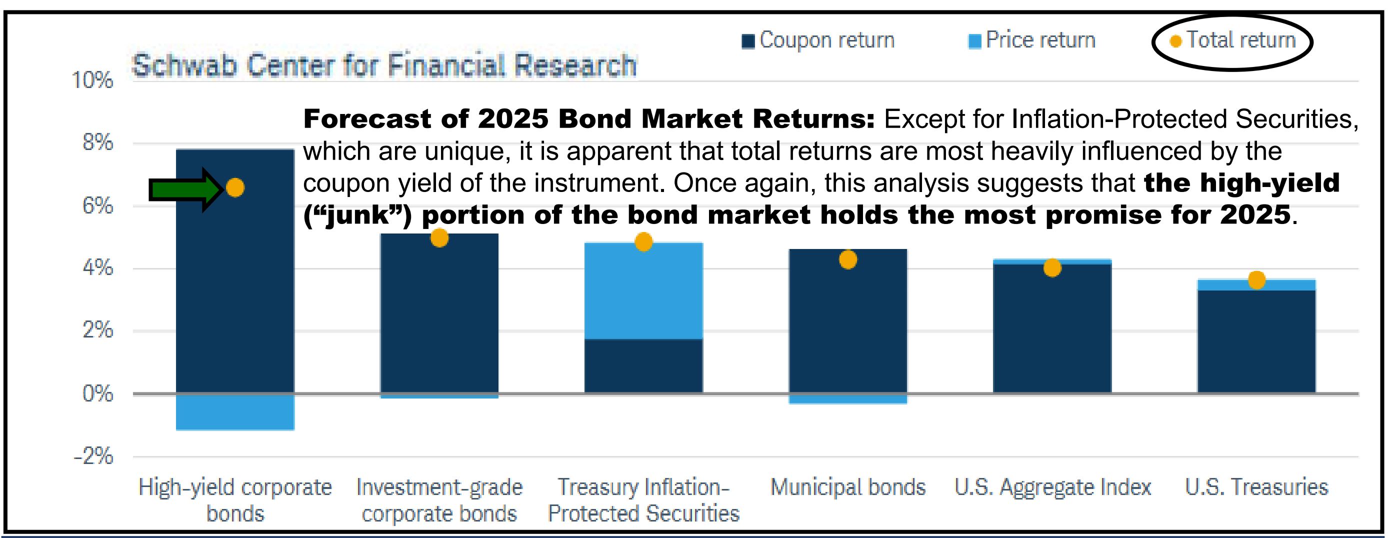


MODEST YIELD ADVANTAGE SUGGESTS JUNK BOND HEALTH

As depicted in the next image, investors were recently demanding a **yield advantage of only 2.92% per year from lower-rated bonds** versus the yields they could obtain from Treasury securities where payment is guaranteed by the full faith and credit of the U.S. Government. This modest yield advantage, referred to as a "spread," leaves very little room for losses that could be incurred as a result of default. Therefore, **this modest yield advantage suggests that investors must not expect losses of any material magnitude to develop within the high-yield ("junk") portion of the bond market** within the foreseeable future.



STARTING YIELDS TEND TO DRIVE BOND RETURNS



VANGUARD'S 12/31/24 VIEW OF THE NEXT DECADE

Over the next decade, Vanguard 50th percentile (median) forecast includes not one double-digit figure. Again, Vanguard expects foreign equities to handily outperform U.S. equities and its meager, 0.6% per year return expectation from U.S. growth stocks implies that Vanguard believes them to either be overvalued, or that the companies that issue them will face an earnings slow-down. As mentioned, Vanguard expects high-yield bonds to be the brightest spot in the bond universe over the coming decade and it expects inflation to settle near the Fed's 2% target.

It's worth noting that various facets of uncertainty are much higher than they were before the election (one example appears below). Uncertainty can result in a reduced appetite for risk and a potential increase in volatility, so unless a given portfolio is earmarked for the next generation, **I prefer to underweight equity exposure** for now.

— Glenn Wessel

Equities　Fixed income　Commodities　Inflation

Asset class	5th percentile	25th percentile	50th percentile	75th percentile	95th percentile	Median Volatility
U.S. equities	–3.2%	1.0%	3.9%	6.7%	11.0%	17.0%
Global equities ex-U.S. (unhedged)	2.0%	5.6%	8.1%	10.6%	14.4%	18.3%
Global ex-U.S. developed markets equities (unhedged)	2.5%	6.1%	8.5%	11.1%	14.7%	16.8%
Emerging markets equities (unhedged)	–2.9%	3.0%	6.6%	10.0%	15.0%	26.0%
U.S. value	–2.8%	2.0%	5.3%	8.8%	13.7%	19.3%
U.S. growth	–6.8%	–2.4%	0.6%	3.6%	8.1%	18.0%
U.S. large-cap	–3.4%	0.9%	3.7%	6.4%	10.8%	16.7%
U.S. small-cap	–3.6%	1.9%	5.5%	9.1%	14.6%	22.6%
U.S. REITs	–3.3%	1.7%	5.1%	8.6%	13.8%	20.2%
U.S. aggregate bonds	3.5%	4.5%	5.2%	5.9%	7.0%	5.8%
Global bonds ex-U.S. (hedged)	3.1%	4.2%	5.1%	6.0%	7.3%	4.5%
U.S. Treasury bonds	3.1%	4.2%	4.9%	5.7%	6.9%	6.0%
U.S. intermediate credit	3.7%	4.7%	5.5%	6.2%	7.3%	5.3%
U.S. high-yield corporate	3.8%	5.3%	6.2%	7.2%	8.6%	10.3%
Emerging markets sovereign	3.2%	4.8%	5.8%	6.7%	8.0%	10.0%
U.S. TIPS	1.7%	3.1%	4.2%	5.4%	7.3%	5.2%
U.S. cash	1.7%	3.0%	3.9%	4.8%	6.1%	1.4%
U.S. mortgage-backed securities	3.5%	4.8%	5.5%	6.2%	7.0%	4.9%
Commodities	–2.1%	3.5%	7.5%	11.5%	17.3%	16.8%
U.S. inflation	0.3%	1.6%	2.4%	3.3%	4.6%	2.4%