December 2024

From the front page of Tuesday's WSJ:

Stocks Set for Best 2 Years Since ’90s

Interest-rate levels create doubts that market can maintain sizzling pace of 2024

BY KAREN LANGLEY

U.S. stocks roared to another blockbuster showing in 2024. ...

The S&P 500 has climbed 24%, notching 57 record closes as the economy remained healthy, inflation ticked lower and an AI-fueled rally in big tech stocks powered on. Even with a stumble in the last few trading days, the broad U.S. stock index is on pace for its best consecutive years since 1997 and 1998, according to Dow Jones Market Data, during the lead-up to the bursting of the dot-com bubble.

The rally has created millionaires and turned professional investors increasingly bullish: In December, the Bank of America Global Fund Manager Survey found record enthusiasm for U.S. stocks, as measured by the net share of respondents favoring the group. The payoffs haven’t been limited to the equity market: Gold is on pace for its best year since 2010, while bitcoin more than doubled, vaulting above $100,000 for the first time before slipping below that mark. ...

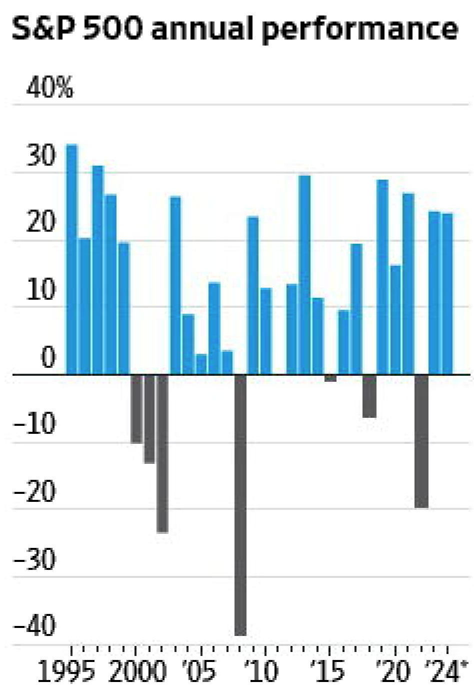
For one thing, interest rates may remain higher than anticipated, affecting borrowing costs and potentially giving investors lower-risk alternatives to the stock market. The Fed recently signaled doubt over how much more it will cut rates. Benchmark Treasury yields had been rising even before that.

For another: The powerful rally has left stocks looking increasingly expensive.

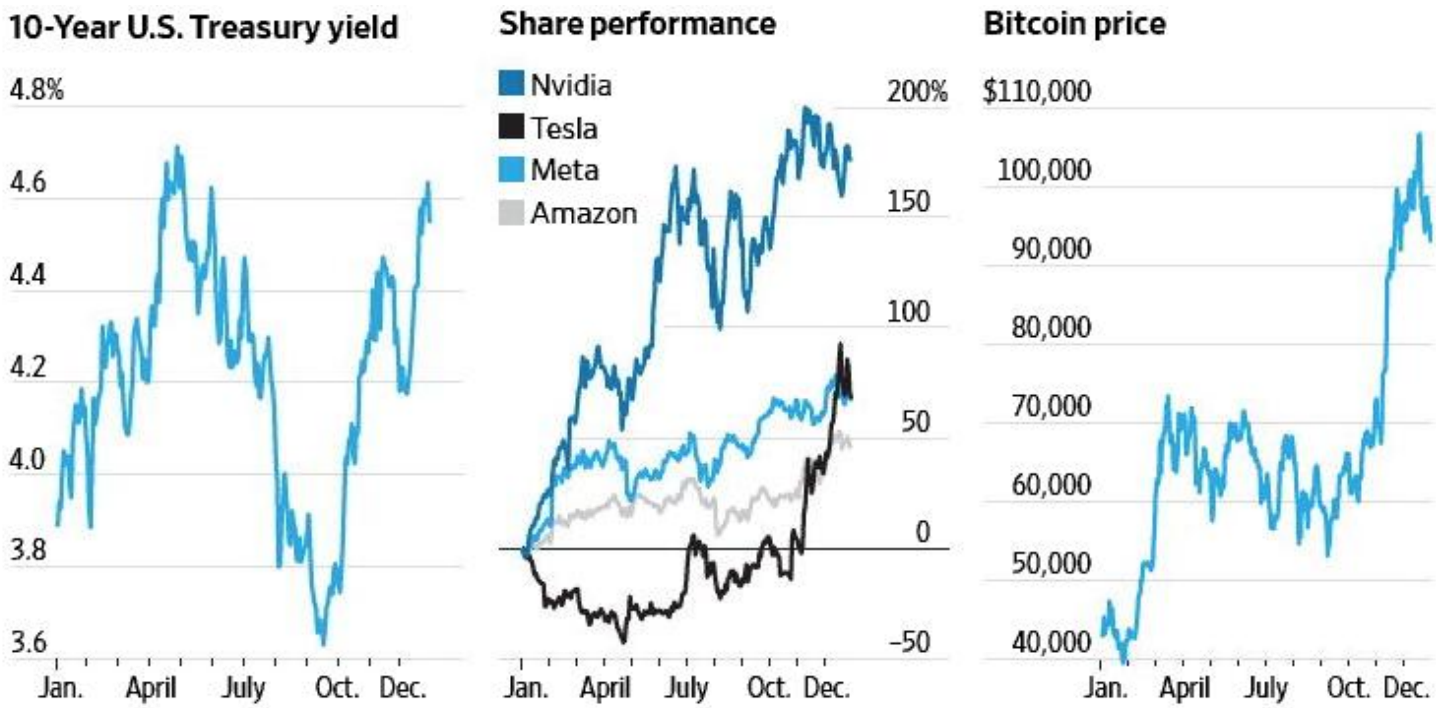
The S&P 500 traded late last week at 21.9 times its projected earnings over the next 12 months, according to Fact-Set, above a 10-year average of 18.5 times. ...

Wall Street analysts expect profits from companies in the S&P 500 to grow by 15% in 2025 from a projected 9.5% for 2024, according to FactSet. ...

Over the past year, investors began to turn a more skeptical eye to the question of when companies’ spending on artificial intelligence will turn into profits. Shares of Google parent Alphabet and Amazon.com stumbled when



*Through Dec. 30
Source: FactSet



Sources: Tullett Prebon (10-year note); FactSet (share performance); Kraken (Bitcoin)

investors looked askance at a pairing of heavy spending with signs of disappointing sales growth.

Even so, the biggest tech stocks continued to do much of the work of powering the S&P 500 higher. Through Dec. 24, the Magnificent Seven—Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla—accounted for more than 53% of the stock index's total return, including dividends, according to S&P Dow Jones Indices. Nvidia alone made up 21% of the return, as the maker of artificial-intelligence chips saw its market value leap past $3 trillion. ...

One beaten-down corner of the market that many investors are talking about: small capitalization stocks. The Russell 2000 benchmark is 8.8% off its record close from November 2021, while the S&P 500 has risen 26% over that time. ...

Analysts expect small-caps to benefit as the Fed lowers interest rates. The group tends to issue more floating-rate debt than do larger companies, so its borrowing costs should fall if the central bank eases monetary policy.

Still, there are reasons for concern. The Fed jolted markets in December when it reduced rates but signaled just two additional cuts next year, suggesting borrowing costs may settle at a higher level than investors expected.

The Russell 2000 slumped 4.4% on the news in its worst day in 2½ years, while the Dow Jones Industrial Average dropped more than 1,100 points, its 10th consecutive day lower. The blue chip average's losing streak was its longest since 1974.

Even as the Fed began cutting rates, the yield on the 10year U.S. Treasury note has ticked higher. The yield on the benchmark government bond settled Monday at 4.546%, up from 3.860% at the end of last year and 3.685% on the day the central bank announced its first rate cut in September.

Uncertainty abounds on the political front. Stocks rallied when Republicans swept the November elections, raising hopes that business will benefit from tax cuts and looser regulation. But President-elect Donald Trump has also proposed sweeping tariffs as well as mass deportations, policies that could add to inflation if enacted. ...

From December 12th's Global Investment Strategy:

Dispatches From The Future (January 2, 2026): The 2025 Recession

The Consensus: Wrong As Usual

It is amazing how much can change in 12 months. In mid-December 2024, the S&P 500 was above 6000. The Wall Street consensus was that the index would rise another 10% or so in 2025.

Fast forward to the start of 2026, and the index stands at 4452, after having fallen to a low of 4197 in early November.

The hoped-for soft landing never arrived in 2025. Although it was not obvious at the time, the NBER now believes that the US entered a recession in May of that year.

Most strategists blame the trade war and the turmoil in bond markets for the recession. There is no doubt that both factors contributed to the downturn, but the reality is that the global economy was already skating on thin ice in late 2024.

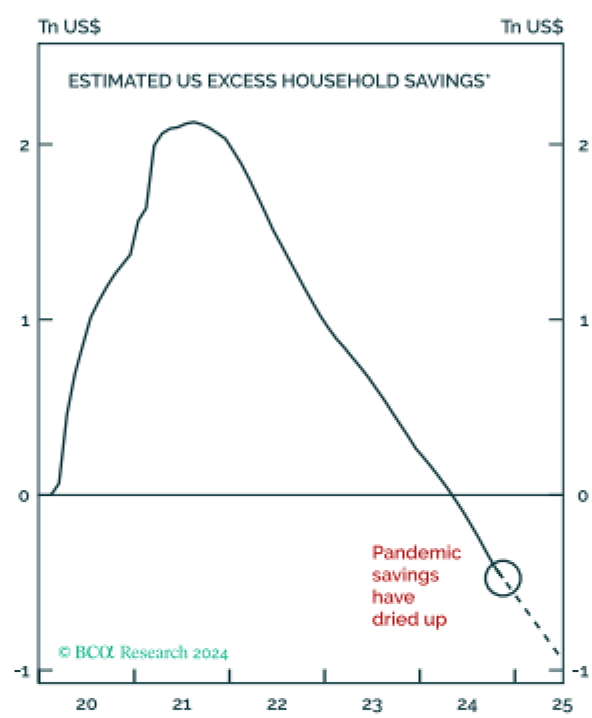
Cracks in the US Labor

Market Back in 2022, when we were out-of-consensus in arguing that a US recession was NOT imminent, we noted that the extremely high level of job openings insulated the labor market. Almost anyone who lost their job back then could simply walk across the street to find new work. This prevented unemployment from rising.

By the second half of 2024, job openings had retreated close to pre-pandemic levels. The official job openings rate stood at 4.6% in October. This was near the rate of 4.5% that Fed Governor Christopher Waller had identified as marking ... the point at which any further decline in openings would trigger a self-reinforcing cycle of rising unemployment.

As job openings trended down and the hiring rate hit an 11-year low, it became increasingly difficult for unemployed workers to find jobs. The number of so-called “permanent job losers” – people who were unemployed because they lost a permanent job – was 48% higher in November 2024 than on the eve of the pandemic. The median length of unemployment climbed to 10.5 weeks. The number of people collecting unemployment benefits

CHART 5
A Depletion Of Excess Pandemic Savings



* SOURCE: "DATA REVISIONS AND PANDEMIC-ERA EXCESS SAVINGS", H. ABDELRAHMAN AND L. OLIVEIRA, FEDERAL RESERVE BANK OF SAN FRANCISCO, NOVEMBER 8, 2023.

in mid-December 2024 was 14% higher than at the same time of the year in 2018/19. Employment at temporary help agencies – a classic leading indicator for the labor market – continued to sink.

Among those who were still employed, a growing number were working part-time for economic reasons. As usually happens in the lead-up to recessions, the fraction of the working-age population with a full-time job declined. It was nearly a percentage point lower in November 2024 than in April 2023. On an unrounded basis, the headline unemployment rate rose to 4.246% in November 2024, just a whisker below the prior peak of 4.253% reached in July 2024.

The US Consumer Finally Buckles

Spending drives employment and employment drives spending. The feedback loop between the two underpins the business cycle.

Going into 2025, most strategists expected US consumer spending to hold up well. They were wrong.

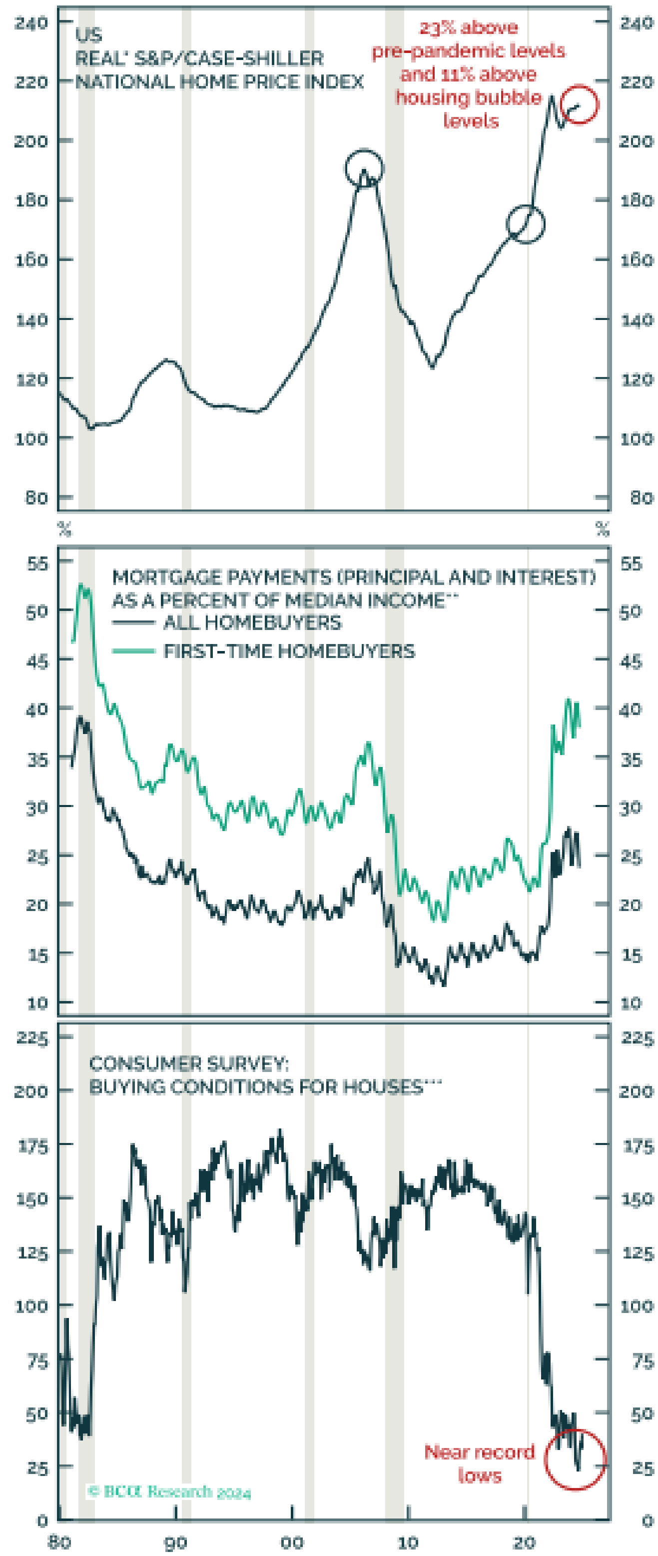
In early 2022, US households held over $2 trillion in excess pandemic savings (**Chart 5**). By late 2024, those savings were gone, removing a key source of spending power from the economy.

The depletion of pandemic savings and a weakening labor market added to stresses at the bottom end of the income distribution. In 2024, credit card and auto loan delinquency rates reached their highest levels since 2011 – a year in which the unemployment rate stood at nearly 9%.

Although credit card delinquency rates temporarily ticked down in the second half of 2024, this mainly reflected the tightening in lending standards that took place over the preceding two years. As credit card interest rates hit record highs, credit card debt growth slowed further in 2025 while delinquency rates rose anew.

Higher up along the income distribution, the copious amount of home equity that many households held going into 2025 proved to be less stimulative for consumption than many economists had predicted. Unlike during the 2000s housing boom, banks remained cautious about

CHART 9
Homes Became Unaffordable



* DEFLATED BY HEADLINE CPI AND REBASED TO JANUARY 1975 = 100.
** SOURCE: NATIONAL ASSOCIATION OF REALTORS.
*** QUESTION POSED: GENERALLY SPEAKING, DO YOU THINK NOW IS A GOOD TIME OR A BAD TIME TO BUY A HOUSE? SOURCE: UNIVERSITY OF MICHIGAN, SURVEY OF CONSUMERS.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

extending home equity lines of credit (HELOCs). HELOC debt stood at 1.3% of GDP in late 2024, a fraction of the peak of 5% of GDP reached in 2009.

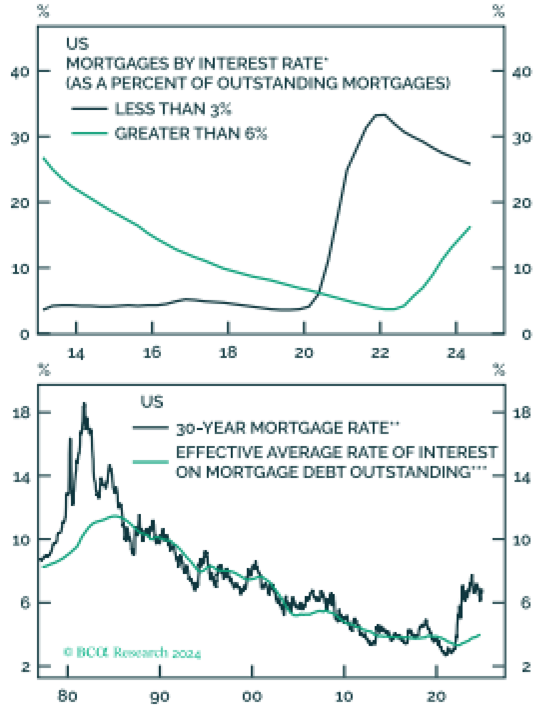
Housing Blues

Meanwhile, homeownership remained a pipe dream for many younger people. While mortgage rates in 2024 were similar to those during the 1990s, real home prices were twice as high (**Chart 9**). As a result, new homebuyers in 2024 had to devote a similar share of their income to servicing their mortgages as they did in the early 1980s. But unlike back then, new homeowners in 2024 could not reasonably expect real home prices to rise significantly over time.

In early 2022, less than 4% of US mortgages carried a rate above 6%, whereas one-third carried a rate below 3%. By mid-2024, 16% of mortgages had a rate above 6%, whereas one-quarter had a rate below 3%. At the end of 2025, the shares were nearly identical, something that could have been easily predicted a year earlier (**Chart 10**). Rising mortgage interest payments squeezed spending on other things, contributing to weaker consumption.

CHART 10

Rising Mortgage Interest Payments Squeezed Spending



* SOURCE: FHFA NATIONAL MORTGAGE DATABASE, OUTSTANDING RESIDENTIAL MORTGAGE STATISTICS.
** SOURCE: FREDDIE MAC.
*** SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

In 2007, Ed Leamer famously delivered a paper at Jackson Hole entitled "Housing IS the Business Cycle". Leamer made the same point as shown in **Table 1**, which is that residential investment is the only component of GDP that reliably shrinks in the lead-up to recessions.

In October 2024, the number of housing units under construction in the US was down 13% from December 2023 **(Chart 11)**. Nationwide, there were nearly 50% more newly built homes for sale than in 2019. Investors simply chose to ignore the warning signs coming from this leading sector of the economy.

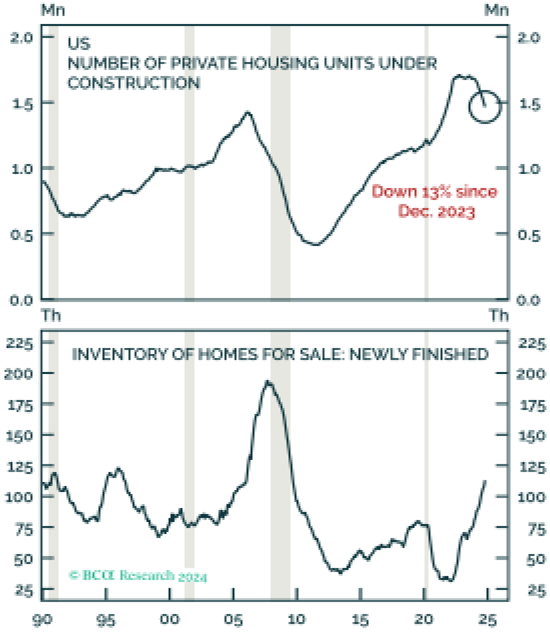
TABLE 1

Residential Investment Is The Only Component Of GDP That Reliably Shrinks In The Lead-Up To Recessions

	MEDIAN CONTRIBUTION TO REAL GDP GROWTH (PERCENT, ANNUALIZED)	
	Non-Recessionary Quarters Q2 1947 - Q3 2024	4 Quarters Prior To Recession Q2 1947 - Q3 2024
REAL GDP GROWTH	3.50	2.69
PERSONAL CONSUMPTION EXPENDITURE	2.29	1.75
SERVICES	1.24	1.03
GROSS PRIVATE DOMESTIC INVESTMENT	1.17	0.18
FIXED INVESTMENT	1.01	0.34
NONRESIDENTIAL	0.83	0.63
RESIDENTIAL	0.20	-0.34
CHANGE IN PRIVATE INVENTORIES	0.19	0.03
NET EXPORTS	-0.22	0.20
GOVERNMENT	0.35	0.50

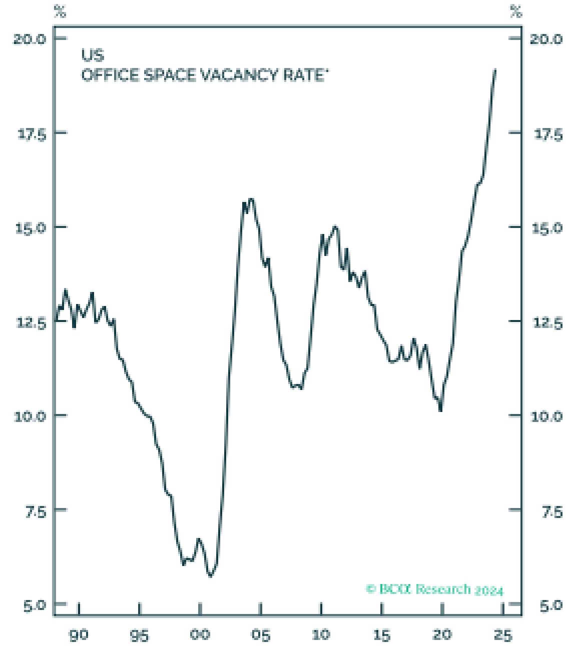
SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

CHART 11
Housing Construction Declined In 2024



NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 12
The Office Vacancy Rate Kept Climbing



* SOURCE: NCREIF.

CRE Deteriorates Further

As problematic as the situation in residential real estate was, the situation in commercial real estate was even worse. The office sector vacancy rate climbed to record highs over the course of 2024 (**Chart 12**). Not only did delinquencies on office-linked loans soar, but delinquencies on other types of CRE loans – from apartments and

TABLE 2
CRE Delinquencies Spread Beyond Offices

CRED iQ OVERALL DISTRESSED RATES BY PROPERTY TYPE* *DELINQUENT AND / OR SPECIALLY SERVICED LOANS*						
MONTH	OFFICE	MULTIFAMILY	RETAIL	HOTEL	INDUSTRIAL	SELF STORAGE
Jun-23	8.4%	4.5%	11.2%	6.5%	0.5%	0.0%
Jul-23	7.9%	4.7%	10.7%	7.7%	0.5%	0.0%
Aug-23	9.4%	5.0%	10.7%	7.7%	0.4%	0.0%
Sep-23	10.8%	4.7%	11.2%	8.3%	0.7%	0.1%
Oct-23	10.5%	5.1%	9.5%	8.9%	1.8%	1.3%
Nov-23	6.8%	2.9%	6.6%	6.4%	4.4%	1.3%
Dec-23	9.9%	4.0%	8.4%	8.0%	0.6%	1.1%
Jan-24	10.5%	2.6%	8.0%	6.7%	0.3%	14.4%
Feb-24	11.0%	3.4%	8.4%	6.9%	1.3%	0.1%
Mar-24	11.4%	3.7%	9.5%	7.7%	0.6%	0.1%
Apr-24	11.7%	7.2%	11.9%	8.7%	0.4%	0.1%
May-24	11.1%	7.1%	11.3%	9.4%	0.5%	0.1%
Jun-24	11.5%	7.4%	11.7%	8.1%	1.0%	0.1%
Jul-24	12.2%	8.4%	11.8%	7.8%	0.8%	0.2%
Aug-24	13.0%	11.0%	10.6%	8.4%	4.6%	0.1%
Sep-24	14.8%	11.2%	11.4%	8.6%	0.6%	2.4%
Oct-24	14.8%	11.0%	11.7%	9.0%	1.2%	3.6%
Nov-24	15.5%	11.2%	11.5%	8.6%	0.6%	1.7%

* AS OF NOVEMBER 30, 2024.
SOURCE: CRED iQ.

shopping malls to hotels – rose to cycle highs (**Table 2**).

By late 2024, most investors had forgotten about the regional banks and their hefty exposure to the CRE sector, as well as their large mark-to-market losses on Treasury and MBS holdings. In 2025, rising loan losses amid a weakening economic backdrop brought those concerns back to the fore. The resulting wave of bank failures reinforced the slowing trend in credit growth that was already visible in 2024 (**Chart 14**).

CHART 14
Credit Growth Slowed In 2024

SOURCE: FEDERAL RESERVE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

The Trade War Begins

In an interview with Meet the Press in December 2024, President-elect Trump said that “tariffs are the most beautiful word.” He also lamented that he “never really got the chance to go all out” on tariffs because of the pandemic.

In 2025, he got his chance again. The first salvo of the trade war began when Trump raised tariffs by 10% on China in March. Among other things, Trump criticized China for “unfairly” weakening its currency to gain a competitive advantage over the US.

Since Trump’s first term in office, China had moved aggressively to diversify its exports away from the US and other developed economies. Nevertheless, the US still imported $520 billion in goods and services from China in 2024 while China imported only $160 billion from the US.

Thus, as retaliation, the Chinese authorities announced that they would subject US companies with operations in China to export taxes. They also pledged to reduce exports of key rare earth minerals to the US. Both announcements spooked markets.

Not fazed by China’s retaliatory actions, Trump proceeded to slap a 5% tariff on all automobile imports entering the US. He also threatened an across-the-board tariff of 20% on any country running a trade surplus with the US.

In November 2024, the US Trade Policy Uncertainty Index compiled by Baker, Bloom, and Davis hit a record high, surpassing even the levels reached during Trump’s first trade war. As the IMF had already pointed out months earlier, when companies are gripped by uncertainty, they tend to sit on their hands. This, in turn, depresses business investment.

Capex intentions were already soft going into 2025, while real core capital goods orders were trending lower. Manufacturing construction was showing signs of peaking. The spectre of higher tariffs only added to the strains facing the US corporate sector.

The Fed Gets Cold Feet

Although the US economy was already slowing in the first quarter of 2025, clear-cut signs of a recession had yet to emerge.

Inflation rose modestly towards the end of 2024 and remained sticky into early 2025. Against this backdrop – as well as the potential inflationary consequences of higher tariffs and the yet unknown impact of President Trump's initiatives to reduce immigration – the Fed began to signal a more circumspect view towards further rate cuts. The term "Fed pause" entered the market narrative.

This did not go down well with President Trump, who claimed the Federal Reserve was trying to undermine him by not cutting rates. In what would be the first of many occasions, Trump stated his intention to fire Jay Powell. In the end, he never did, partly because having Powell at the helm of the Fed gave Trump a convenient foil to blame for the bad economy.

The Bond Market Says "No"

Without a doubt, the greatest irony of 2025 was that the tax cuts that investors so eagerly anticipated ended up sinking the stock market.

In retrospect, it should have been obvious that President Trump would test the bond market to see how much he could get away with in his efforts to further slash taxes.

Although Republicans in Congress had originally planned to pass Trump's tax cuts in a reconciliation bill in late 2025, this did not stop Trump from routinely claiming in the weeks following his inauguration that he was going to extend all the expiring tax cuts in the 2017 Tax Cuts and Jobs Act (TCJA); further lower corporate tax rates; increase the SALT deduction; and eliminate taxes on tips, overtime pay, and social security benefits. Taken together, Trump's proposed tax measures were set to add more than $7.75 trillion to the federal debt over the subsequent ten years (**Table 3**).

TABLE 3

Trump's Proposed Fiscal Policies Would Increase The Budget Deficit

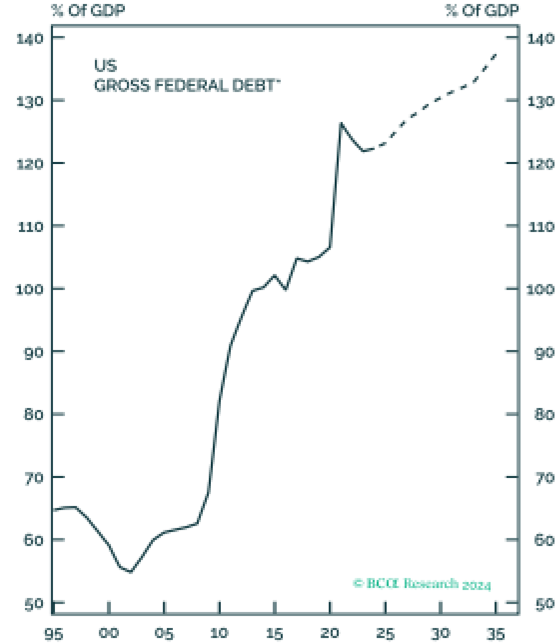
Summary of Trump Plan, Savings/Costs(-) (billions, 2026-2035)			
Policy Proposals	**Low**	**Central**	**High**
Extend and Modify the Tax Cuts & Jobs Act (TCJA)	-$4,600	**-$5,350**	-$5,950
Exempt Overtime Income from Taxes	-$500	**-$2,000**	-$3,000
End Taxation of Social Security Benefits	-$1,200	**-$1,300**	-$1,450
Exempt Tip Income from Taxes	-$100	**-$300**	-$550
Lower Corporate Tax Rate to 15% for Domestic Manufacturers	-$150	**-$200**	-$600
Enact or Expand Other Individual and Small Business Tax Breaks	-$150	**-$200**	-$350
Strengthen and Modernize the Military	-$100	**-$400**	-$2,450
Secure the Border and Deport Unauthorized Immigrants	$0	**-$350**	-$1,000
Enact Housing Reforms, Including Credits for First-Time Homebuyers	-$100	**-$150**	-$350
Boost Support for Health Care, Long-Term Care, and Caregiving	-$50	**-$150**	-$300
Subtotal, Tax Cuts and Spending Increases	**-$6,950**	**-$10,400**	**-$16,000**
Establish a Universal Baseline Tariff and Additional Tariffs*	$4,300	**$2,700**	$2,000
Reverse Current Energy/Environment Policies and Expand Production	$750	**$700**	$550
Reduce Waste, Fraud, and Abuse	$250	**$100**	$0
End the Department of Education and Support School Choice	$200	**$200**	$0
Subtotal, Revenue Increases and Spending Reductions	**$5,500**	**$3,700**	**$2,550**
Net Interest	**-$200**	**-$1,050**	**-$2,100**
Total, Net Deficit Impact	**-$1,650**	**-$7,750**	**-$15,550**

* THE UNIVERSAL BASELINE TARIFF IS ASSUMED TO BE 20% IN THE LOW-COST ESTIMATE, AND 10% IN BOTH THE CENTRAL AND HIGH-COST ESTIMATE. THE CHINESE TARIFF IS ASSUMED TO BE 60% IN ALL SCENARIOS. THE HIGH-COST ESTIMATE ALSO INCORPORATES REVENUE LOSS FROM POTENTIAL DYNAMIC EFFECTS, SUCH AS A REDUCTION IN GDP.
SOURCE: COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET.
NOTE: FIGURES ROUNDED TO THE NEAREST $50 BILLION.

During Trump's first term in office, the bond market was largely indifferent to higher budget deficits. In 2016, however, the federal budget deficit stood at 3.1% of GDP. By 2024, it had more than doubled to 6.4% of GDP – an extremely high number for an economy that was operating near full employment. Real bond yields were close to 2% in late 2024, compared to around zero when Trump first took office in 2017. Meanwhile, the debt-to-GDP ratio stood at 123%, up from 105% in 2016 (**Chart 21**).

Interest payments on federal government debt rose to 3.1% of GDP in 2024, up from 1.3% of GDP in 2016. The Congressional Budget Office reckoned that interest payments would increase to a record 4.1% of GDP over the subsequent decade (**Chart 22**). And that assumed that the expiring tax provisions of the TJCA would not be extended, and that the 10-year Treasury yield would be around 3.7% in 2028 – 75 bps lower than what markets were expecting in December 2024.

CHART 21
Unsustainable Fiscal Dynamics (II)



* SOURCE: US CONGRESSIONAL BUDGET OFFICE.

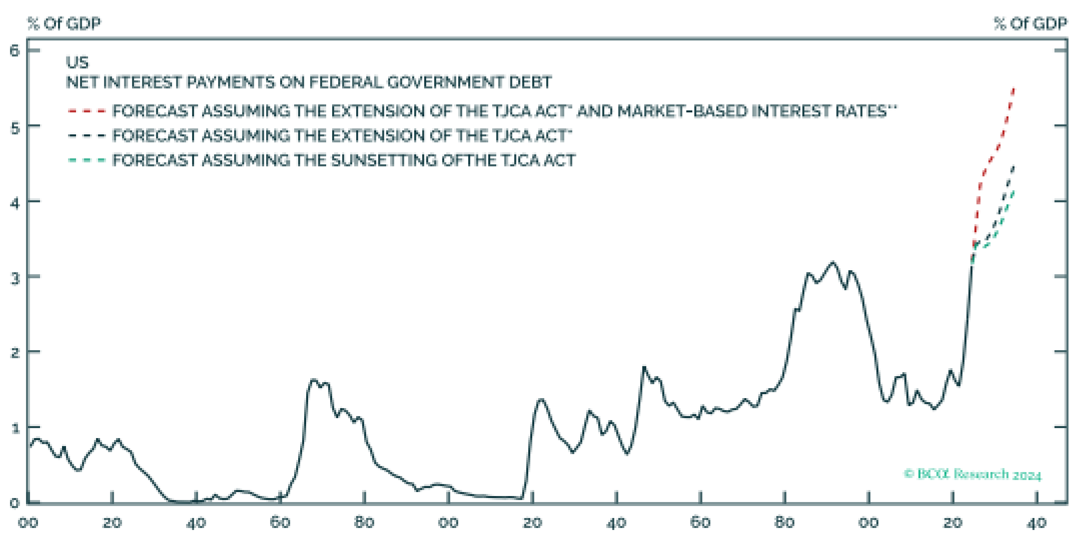
Dogeball

The lack of any concrete progress on the spending front did not help matters. Trump continued to insist that he would neither cut defense spending nor touch Medicare or Social Security, the two biggest entitlement programs. This just left discretionary federal spending, which had already shrunk from 37% of overall federal government spending in 2011 to 26% in 2024 (Chart 24).

Trump's promise to compensate farmers and others who had been affected by retaliatory tariffs only worsened the budget outlook.

Meanwhile, just like Ronald Reagan's Grace Commission, efforts by the newly created Department of Government Efficiency (DOGE) to eliminate waste bore little fruit.

CHART 22
Soaring Interest Costs On The Federal Debt Caused A Market Riot



* CALCULATIONS USING THE CBO'S ESTIMATES OF BUDGETARY EFFECTS OF SELECTED ALTERNATIVE ASSUMPTIONS ABOUT REVENUE POLICIES RELATED TO THE 2017 TAX ACT (MAY 2024) AND THE CBO'S 10-YEAR BUDGET PROJECTIONS (JUNE 2024).
** CALCULATIONS BASED ON THE FUTURE PATH OF 10-YEAR TREASURY YIELDS IMPLIED BY THE FORWARD CURVE.
SOURCE: US CONGRESSIONAL BUDGET OFFICE, OFFICE OF MANAGEMENT AND BUDGET, IMF, AND BLOOMBERG FINANCE L.P.

Federal employment had barely changed in 80 years, so there were not that many bureaucrats to cut to begin with. DOGE did make a variety of recommendations to reduce fraud, but notably left out the biggest source: tax evasion.

Unwilling to wait for another budget-busting reconciliation bill to be signed, markets began to revolt in April 2025. The 10-year yield jumped to 4.9%, causing mortgage rates to rise further into punitive territory. For the bond market, this time truly was different.

Trump Doubles Down

If there had been any hope of avoiding a recession at this point, President Trump's next few actions obliterated it.

Infuriated by the Fed's seeming inaction, Trump took to social media to announce he would use his superior negotiating skills to bring yields back down. Although Scott Bessent was quick to point out that Trump was not threatening to default on the debt, Bessent's words were undermined by the fact that he himself lacked any credible plan to reduce the budget deficit.

With bond yields continuing to grind higher, Trump then announced that he was ordering the Fed to buy government bonds. The Fed immediately issued a press release stating that it had no intention of doing so, noting that debt monetization would "undermine its legal obligation to maintain low and stable inflation over time."

Chaos in the Bond Market

With the Fed no longer providing an unconditional backstop to the Treasury market, chaos erupted. The 10-year yield surged to 5.9%.

Treasuries are not like Italian bonds. They are the main source of collateral for the global financial system. Global equities plummeted. The S&P 500 dropped below 5000 for the first time since April 2024.

In less than five days, the Fed reversed its earlier stance. Citing "unusual and exigent circumstances," it said that it would begin buying Treasury bonds. However, the Fed made it clear that this would be a temporary measure, contingent on "meaningful steps being taken to redress fiscal imbalances."

From Fiscal Easing to Fiscal Tightening

The Fed's call to arms forced Congress to push forward budget negotiations. Although it took nearly a month, in a bipartisan effort, Congress ultimately passed a budget resolution in June that extended only the personal income tax cuts in the TCJA for lower- and middle-class workers and froze defense and discretionary spending. None of Trump's campaign tax promises – from eliminating taxes on tips to further cutting corporate tax rates – saw the light of day. Taxes on higher income earners went up.

Fiscal policy, rather than loosening as most investors had expected in late 2024, tightened at the federal level in 2025.

At the state and local government level, fiscal policy also turned contractionary. This was partly because a weaker economy led to lower tax receipts. It was also because state and local government spending had been artificially inflated during the pandemic thanks to generous transfers from Washington. As the National

Association of State Budget Officers predicted in 2024 even before the recession began, this forced a retrenchment in state spending.

The World in Recession

Although the passage of a budget resolution helped calm market nerves, it happened too late to save the economy. By June, the US unemployment rate had already hit 5% on the back of an 80K contraction in payrolls during that month. It would ultimately rise to 6% by the end of 2025.

Falling employment led to less spending, leading to even lower employment. Despite hopes to the contrary, it turned out that the usual feedback loops that drive economies had not been abolished.

The rest of the world arguably fared even worse than the US. Canada was the first G7 economy to succumb to a recession in November 2024 when the unemployment rate reached 6.8% – two percentage points higher than in July 2022. In an interview on December 3 2024, former Bank of Canada governor Stephen Poloz admitted as much, saying that “We’re in a recession. I wouldn’t even call it a technical one.”

The euro area, which was already close to stall speed in late 2024, soon followed suit. Higher US tariffs on European automotive exports and contagion from the US fiscal crisis to the Italian and French bond markets pushed the region into a recession. The only solace came in the form of a ceasefire in the Russia-Ukraine war.

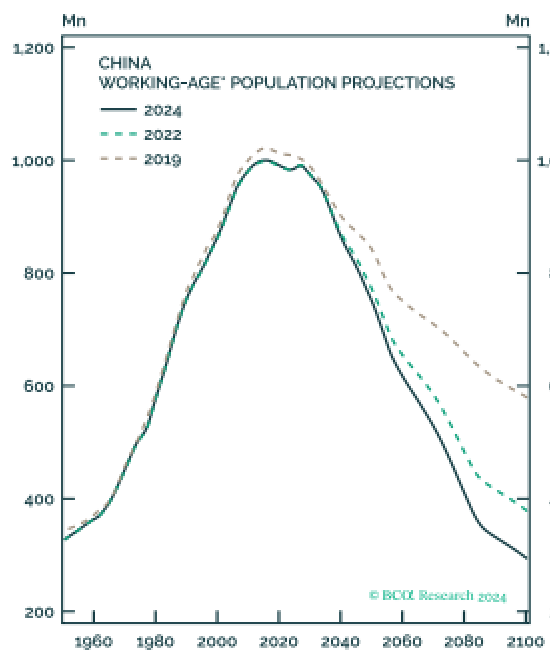
Chinese Stimulus: Too Little, Too Late

Despite piecemeal stimulus measures, China’s economy weakened further in 2025.

Following a temporary jump in export growth due to efforts by importers to front run Trump’s tariffs, Chinese manufacturing activity slowed over the course of the year.

Making matters worse, the Chinese housing market continued to flounder. By late 2024, housing starts were down two-thirds from their peak. While home sales and prices rebounded slightly in early 2025, this was mainly because local governments – with financial assistance from Beijing – were buying unsold apartments. These purchases provided financially strapped property developers with enough cash to keep building. Given that China already had 20 million excess homes at the time, not to mention a shrinking population, this proved to be a case of “short-term gain for long-term pain” (**Chart 31**).

CHART 31
China: A Shrinking Population



* ESTIMATED POPULATION BETWEEN 15-AND-64 YEARS OF AGE.
SOURCE: UN POPULATION DIVISION.

Falling interest rates failed to generate much traction. China was in a liquidity trap. Telling banks to lend more does not help when households and businesses do not want to borrow more. What China needed was more consumer-focused stimulus. Although the Chinese authorities did provide some of that over the course of 2025, their actions were reactive rather than proactive.

The Greenback’s Wild Ride

The US dollar began 2025 on a firm footing. Stronger growth in the US than in the rest of the world, coupled with Trump's sabre-rattling over tariffs, put downward pressure on most global currencies, benefiting the greenback in the process.

The bond market riot in the spring unwound some of the dollar rally. Unlike during previous episodes of financial turmoil, the US dollar weakened as investors became worried about unsustainable fiscal dynamics.

The passage of a budget resolution to curb the flow of red ink helped stabilize the dollar. However, the ensuing Fed rate cuts – which ultimately brought the fed funds rate to 2% and the 10-year Treasury yield to 3.25% by year end – kept a lid on dollar strength. While the trade-weighted dollar ultimately finished the year slightly stronger than where it started, it was unable to reclaim the peak reached before the bond market riot. ...

The S&P 500: The Path to 4197

Stocks rallied in late 2008 after the most intense phase of the global financial crisis ended. However, they then fell to fresh lows in March 2009, as the full extent of the economic fallout became visible, and analysts slashed earnings estimates.

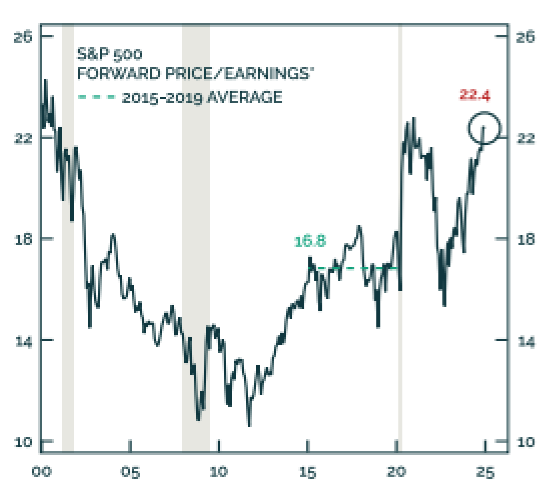
The 2025 equity bear market followed a similar script: Stocks weakened modestly in the first quarter as the trade war erupted. Equities then plunged in the second quarter due to the fiscal crisis. Stocks then retraced some of their losses at the start of Q3 as fiscal stresses abated and bond yields came back down. However, equities then started to slide anew, with the S&P 500 dropping to a low of 4197 in early November before recovering to close the year at 4452 as the economy began to show signs of stabilization.

The fact that the S&P 500 experienced a peak-to-trough decline of 31% came as a shock to both investors and the analyst community. It should not have. The S&P was trading at 22.4-times forward earnings in December 2024, 33% above the average that prevailed between 2015 and 2019 (a period which encompassed most of Trump's first term) (**Chart 35**).

Earnings Disappoint

The fact that earnings estimates were unrealistically optimistic did not help matters. In mid-December 2024, analysts expected S&P 500 companies to generate earnings of $275 per share in 2025. This represented a 13% increase over 2024 – off peak profit margins no less.

CHART 35
An Elevated P/E For The S&P 500



It now appears that S&P 500 companies generated earnings of only $240 per share in 2025. Despite the drop in stock prices, the trailing P/E ratio for the S&P 500 stood at 18.5 at the end of 2025. This was slightly higher than the post-2000 average, a testament to how incredibly expensive stocks were in late 2024.

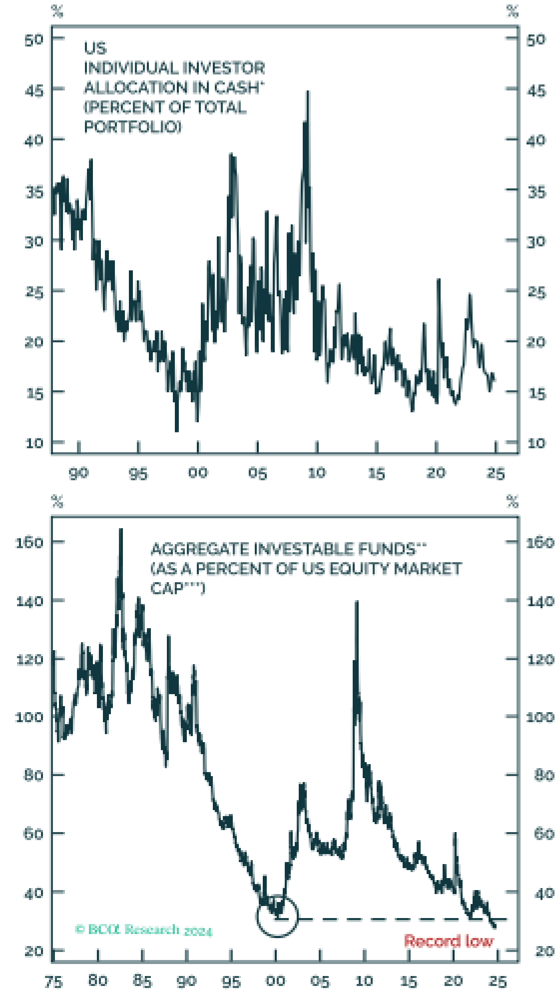
So Much For All That "Cash on the Sidelines"

Reassurances made in 2024 that stocks, no matter what, would be buttressed by a bounty of cash that investors were allegedly holding rang hollow. This, too, should have been predictable.

According to the AAII's monthly Asset Allocation Survey, investors had only 16% of their portfolios in cash in November

2024, below the post-1990 average of 21% (**Chart 37**). Likewise, Bank of America reported in December 2024 that cash in its wealth and brokerage accounts, as a share of AUM, stood near record-low levels. This conclusion was supported by BCA's own broad measure of cash on the sidelines, which hit a record low in late 2024.

CHART 37
Not That Much Cash On The Sidelines



* SOURCE: AMERICAN ASSOCIATION OF INDIVIDUAL INVESTORS.
** INCLUDING MONEY MARKET FUNDS, TIME AND SAVING DEPOSITS OF HOUSEHOLD AND INVESTMENT ORGANIZATIONS, AND CHECKABLE DEPOSITS OF INVESTMENT ORGANIZATIONS. SOURCE: BCA CALCULATIONS.
*** WILSHIRE 5000 MARKET CAP.

Defensive Sectors Outperform

Considering the decline in stock prices in 2025, it is not surprising that safer companies outperformed riskier ones. Most notably, high-quality companies with strong balance sheets fared much better than low-quality companies.

Small caps tend to be of lower quality than large caps, as evidenced by the fact that more than half of the smallest US listed companies were unprofitable in late 2024.

The earnings of non-US companies are generally more cyclical and more exposed to global trade than their US peers. Thus, despite the US being the source of much of the stresses in the global economy in 2025, the S&P 500 still managed to slightly outperform non-US bourses in common-currency terms.

Globally, the top-performing sector was consumer staples, followed by health care and utilities.

The worst-performing sectors were consumer discretionary, financials, industrials, real estate, energy, and materials. The latter two sectors were dragged down by lower oil and metals prices. Brent crude oil fell to a low of $45/barrel while copper dropped to a low of $3/pound.

AI Euphoria Abates

IT and the tech-heavy communication services sectors fell broadly in line with the overall market in 2025.

While advances in artificial intelligence continued, investors began to worry that broad-based profits from the AI revolution would not appear for many years.

In many ways, investor concerns over AI paralleled the dotcom experience. In 1987, Robert Solow famously quipped that "you can see the computer age everywhere but in the productivity statistics." In the mid-1990s, however, productivity growth rose by about one percentage point and remained elevated until the mid-2000s (Chart 40).

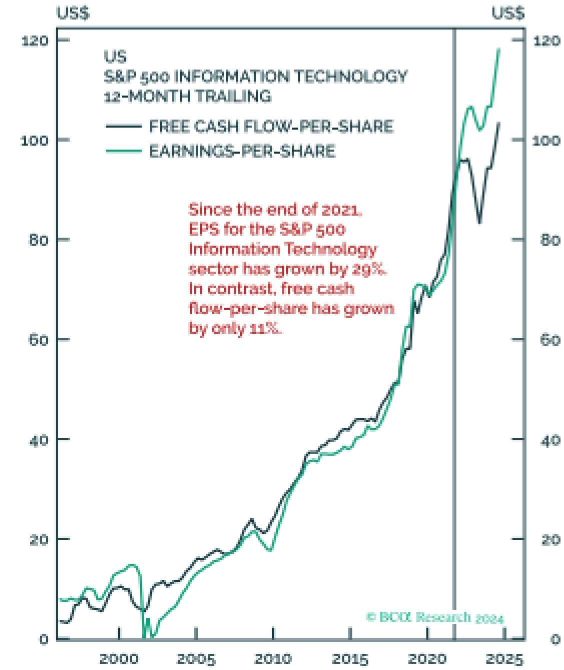
Ironically, it was only in the mid-2000s that tech companies finally figured out how to make serious money off the internet. And those profits largely came from exploiting network effects: People used Facebook, for example, because everyone else was using Facebook.

In 2025, investors increasingly began to worry that large language models were less like social media platforms and more like, say, internet browsers. Although they are indispensable, nobody pays for an internet browser because they are fairly interchangeable. Likewise, because large language models were designed using broadly the same neural net/transformer architecture and relied on similar training sets, they seemed largely indistinguishable from one another.

Worried that they would not be able to fully monetize their investments, buyers of Nvidia chips and other AI-related hardware scaled back capex and, in some cases, wrote off earlier purchases. Similar to what transpired during the dotcom bust, tech EPS – which had been running well ahead of free cash flow – tumbled (**Chart 41**). ...

CHART 41

Tech Free Cash Flow Grew More Slowly Than Reported Earnings



SOURCE: BLOOMBERG FINANCE L.P.
NOTE: VERTICAL LINE DENOTES DECEMBER 31, 2021.

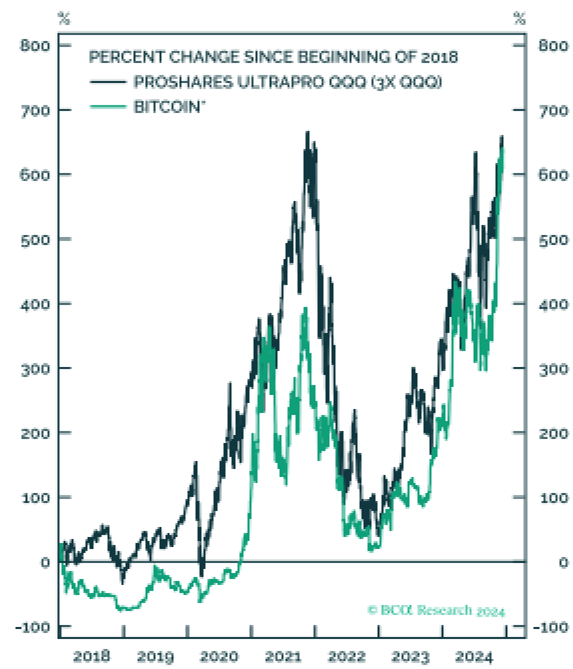
Gold Beat Bitcoin

Bitcoin's supporters had hoped that fiscal instability would cause money to flow into the crypto space. It did not. As it turned out, Bitcoin was just a high-beta play on stocks (**Chart 43**). As stocks swooned, so did Bitcoin. The virtual currency finished the year at $45,000.

Gold fared much better, ending the year 10% higher. The yellow metal rose during the debt crisis and then received a tailwind from falling interest rates during the remainder of 2025. It also continued to benefit from EM central bank purchases.

CHART 43

Bitcoin: A High-Beta Play On Tech Stocks



* US DOLLAR TO BITCOIN. SOURCE: MACROBOND FINANCIAL AB.

Investment Conclusions

Our decision to shift to an underweight on stocks at the end of June 2024 was clearly premature. However, the motivation for our decision was sound, as the events of 2025 bore out. ...

Four from the WSJ:

You’re Invited to Wall Street’s Private Party. Say You’re Busy.

Small-time investors may soon gain easier access to so-called private markets. That usually means higher fees, greater risk, more conflicts of interest and a harder time selling.

By Jason Zweig
Dec. 20, 2024

Hold on to your wallet. Wall Street is gearing up for a sales push that could enrich the middlemen and impoverish you.

I’m talking about private or alternative assets—investments outside the public stock and bond markets. In the right hands, these assets work wonders. In the wrong hands, they wreak havoc.

This coming year, with Wall Street and Washington likely opening the floodgates in unison, your financial adviser may inundate you with pitches to buy private assets. You should evaluate them with more skepticism than ever.

Hedge funds, venture capital, private-equity funds, nontraded real estate, private credit and other alternatives hold out the hope of better diversification and higher returns. All too often, those potential virtues come at the cost of higher fees, greater risk, more conflicts of interest and less disclosure. And you can generally sell only at certain times, not whenever you feel like it.

That’s why access to alternatives has long been restricted to big institutions and wealthy individuals, who can afford to lose most or all of an investment without going broke.

A few great investors, led by the late David Swensen of Yale University, have used alternatives to drive impressive outperformance. Often, however, these investments have been a costly path to mediocrity for even the world’s biggest investors.

As the managers of alternative funds have struggled to resell a glut of overpriced assets, they’ve also been stymied trying to convince big clients to add more money.

No wonder there’s an intensifying push to strip away the traditional protections for smaller investors.

A bill pending in the U.S. Senate would allow anyone who can pass an exam about “the risks and opportunities of investing in securities” to purchase alternatives.

Project 2025—the policy blueprint that President-elect Donald Trump has said he partly disagrees with—calls for loosening the regulatory restraints on who can invest in private assets. (As of now, purchases are often restricted to investors with at least $200,000 of income and $1 million in net worth, not counting their home.)

And the managers of private assets that may not trade for years at a time are stuffing them into exchange-traded funds, which trade all the time.

Financial advisers might tell you that you need to buy alternative assets because public stocks and bonds are overpriced and doomed to provide years of poor returns.

What they won’t tell you is that they need to *sell* you alternative assets, because otherwise their own firms will be doomed to years of poor returns.

Wall Street's traditional sources of vigorish—the cut it takes as the middleman—have withered away. Many mutual funds used to charge 1% and up in annual expenses; now you can buy ETFs for 0.1% or less. Stock commissions, once 1% or more, have gone the way of the dodo.

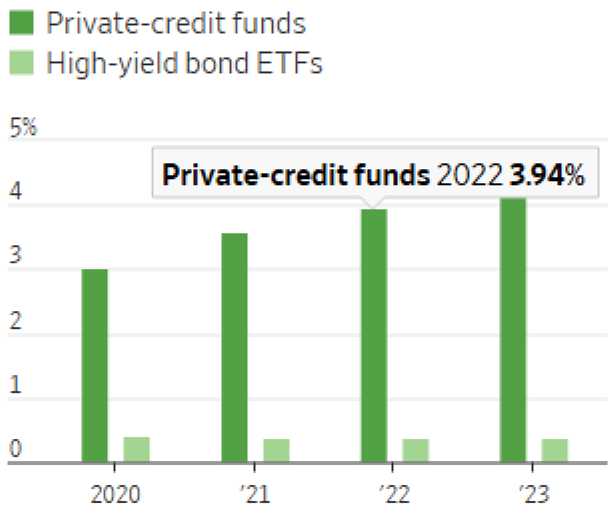
On the other hand, expenses on alternative funds, often 2% annually, can range up to 6% or more. Commissions, often 2% to 5%, can sometimes even exceed 10%.

And no matter how private assets are repackaged, they have drawbacks that are hard to paper over.

Because the underlying holdings don't trade publicly, valuing them is a mix of art and sorcery, with some managers booking one-day gains of 1,000% or more.

Private-equity and private-credit funds use lots of borrowed money to focus on smaller companies. "You're adding a high-risk thing to your portfolio with a lot of the same exposures as public markets," says Daniel Rasmussen, founder of Verdad Advisers and author of the forthcoming book "The Humble Investor."

Total annual expenses



Notes: Private-credit fund expenses are simple averages gathered in fourth quarter of each year. High-yield ETF expenses are year-end averages, weighted by size of funds.
Sources: Cliffwater (private funds); Morningstar (high-yield ETFs)

While some managers of alternative assets deliver superior returns, most don't—and getting access to the few outperformers is all but impossible for most investors.

When it comes to the opacity and complexity of alternative assets, some financial advisers know what they're doing. Others might not even know what they don't know.

A recent survey of more than 500 advisers who use alternatives, conducted by private-asset specialist CAIS and the consulting firm Mercer, asked what their top challenges were.

The greatest number of respondents, 48%, named "high levels of administration and paperwork."

Only 36% cited the lack of liquidity; a mere 26% said fees and expenses were too high; only 10% doubted they could get access to superior managers; and a piddling 4% said alternatives are "too risky."

These advisers didn't merely drink the Kool-Aid; they're drunk.

In the past couple of years, I've reported on a series of quirks, mysteries, bad deals and outright rip-offs among alternative assets:

- investments with "guaranteed" yields of 15% or more that evaporated, now being investigated by federal and state authorities;
- "interval funds" that charge lavish fees but let you take money out only a few times a year;
- illiquid portfolios that sometimes do change hands—for 75% or less of their reported value;
- funds purporting to offer high returns at impossibly low risk;
- nontraded companies that don't even exist claiming to have sold more than $344 billion in imaginary shares;
- brokers hawking illiquid shares and debt in companies they control, without disclosing their conflicts of interest;

- private real-estate funds that lock money up and open the door for only a fraction of investors to sell at a time.

Jonathan Treussard of Treussard Capital Management, an investment manager in Newport Beach, Calif., suggests telling your adviser: “If you can’t explain the strategy well enough for me to understand it, you have no business encouraging me to get in there.”

Unless your adviser has extraordinary expertise, I’d suggest an even shorter response: “No thanks.”

The Intelligent Investor

Bubble Spotting

By Jason Zweig

Fellow investors,

When it comes to recognizing the extreme market overvaluations that everyone calls "bubbles," most people are wrong most of the time.

Most predictions about bubbles turn out to be either Type 1 (false positive) or Type 2 (false negative) errors.

I still remember an off-the-record dinner I went to in early 2010 with several of the world's most-respected bond investors and analysts. The question on all their minds was the same: Is the bond market in a bubble?

Their answers ranged from "probably" to "definitely." No one expressed any significant doubts that the bond market was dangerously overvalued.

That was a Type 1 error -- the false negative of predicting a bubble that didn't materialize. Over the next decade, fixed-income investors did just fine, earning close to 4% annually, not much below the long-term average return on bonds.

Type 2 errors -- false negatives, or missing a bubble that later seems obvious -- are at least as common.

In 1841, Charles Mackay published the classic book *Extraordinary Popular Delusions and the Madness of Crowds.* (Required reading in my Advanced Topics in Investing, which I taught for 6 years at OU.)

Only three years later, he became a booster for one of the worst market manias ever to infect British investors: wildly overvalued railroad stocks.

As I've written, "The most famous critic of bubbles who ever lived fell like a chump for a craze that was unfolding before his very eyes."

I'm telling you all this because, like my colleague James Mackintosh (see below), I'm finding it hard to resist the intuition that we're in a market bubble right now.

Last Thursday, on its earnings conference call, Broadcom's CEO declared that the company's opportunity in artificial intelligence over the next three years is "massive."

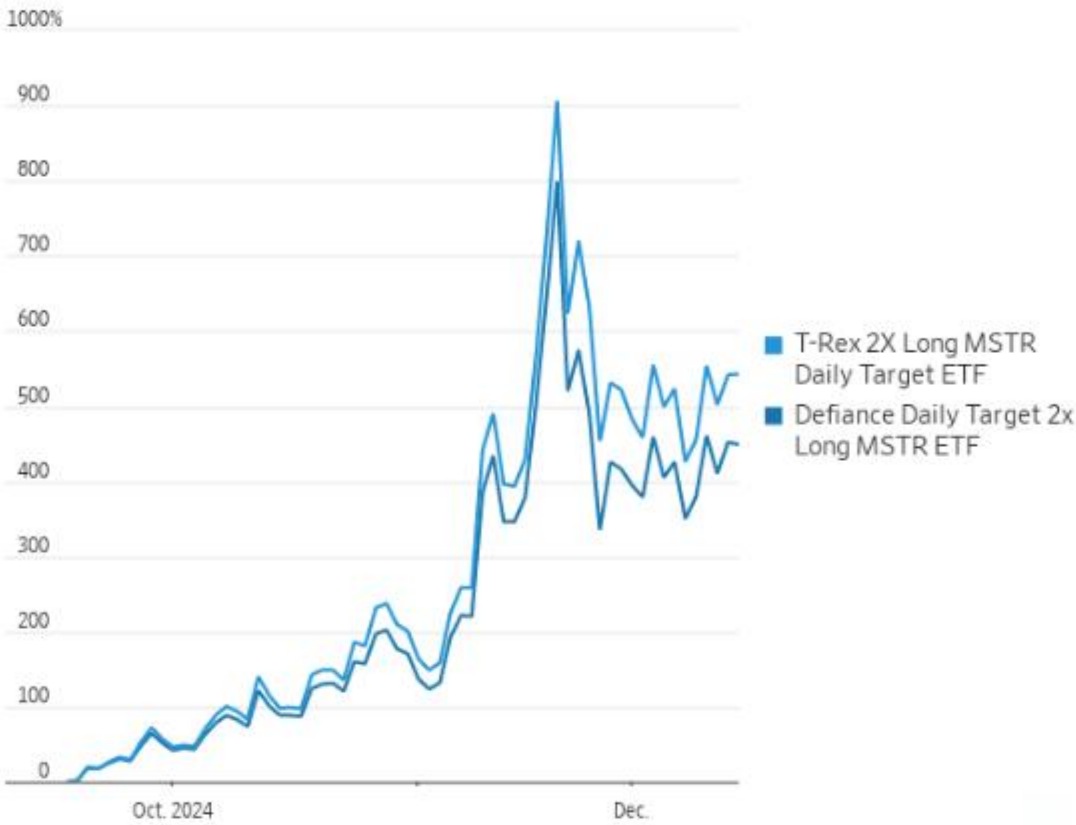
The stock -- whose market value already exceeded $800 billion -- surged 24% the next day to a new all-time high:

Tesla's stock has doubled in the past two months alone:

And what about MicroStrategy, the software company that has amassed [an immense trove of bitcoin]? Its stock, valued at [three or four times] the market price of MicroStrategy's bitcoin holdings, is up well over 500% this year.

That's nothing, though.

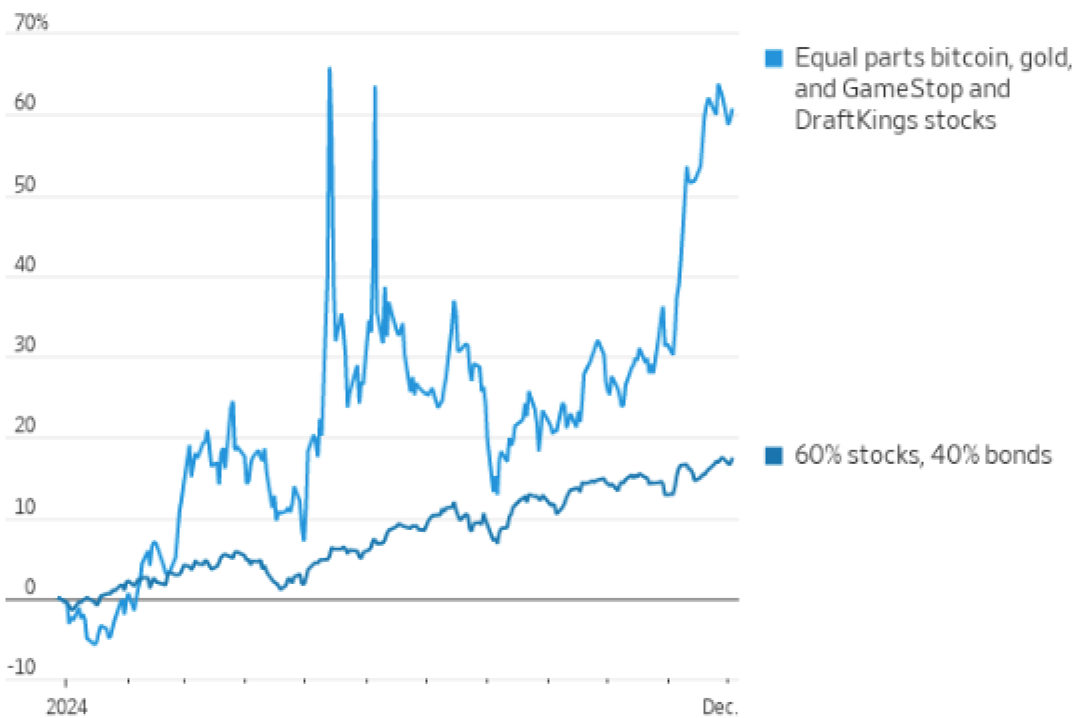
[Two ETFs] that seek to double MicroStrategy's daily return are each up more than 440% in *the past three months:*



Source: FactSet

And many [young people are going for broke](), loading up on risky assets as radically as they did in 2021 (or, for that matter, as different generations did back in 1999 -- or 1929!):

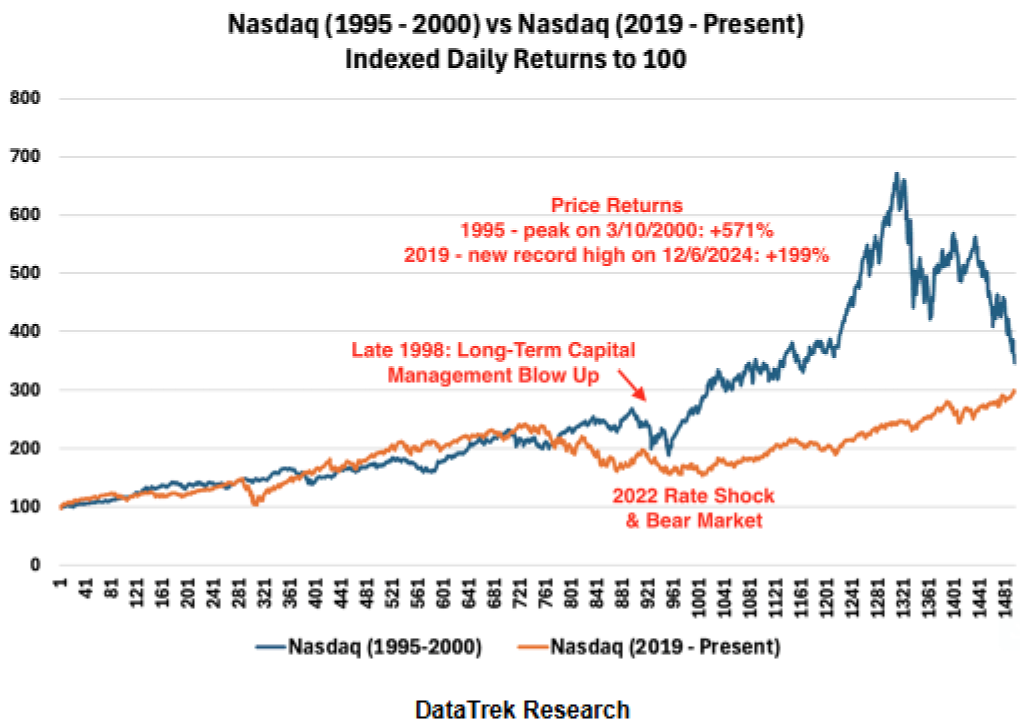
A portfolio of risky assets is far out-earning a more traditional portfolio.



Note: Stocks are represented by the S&P 500 and bonds by 10-year Treasurys. Returns are cumulative since end of 2023.
Sources: Leuthold Group, FactSet

Of course, if anyone could objectively identify a bubble as it is forming, then bubbles would never form. People would see them coming and step aside, enabling markets to recover their equilibrium before things reached the danger point.

As Jessica Rabe of DataTrek Research recentlly pointed out, today's market (below, in orange) probably isn't yet as overheated as it was at the end of the 1990 (in blue). The horizontal axis shows the number of days from the beginning of each of the two market periods:



So I'm not here to tell you we're definitely in a bubble. But I am certain this is a time to be much more cautious than usual.

Market manias can go on for an amazingly long time. But they can't go on forever. I don't know when this will end, but I'm quite sure it will end badly -- especially for those who think they have discovered how to get rich quick.

That thought brings back another memory. In January 2000, I interviewed Warren Buffett. The craze for internet stocks was near its peak, and many market pundits had declared that Buffett was a dinosaur. I asked him how he felt about what was going on.

He replied with two calm, simple sentences I've never forgotten: "I know what will happen. I just don't know when."

When everyone is embracing risk, you should be extra careful. ...

Why This Frothy Market Has Me Scared

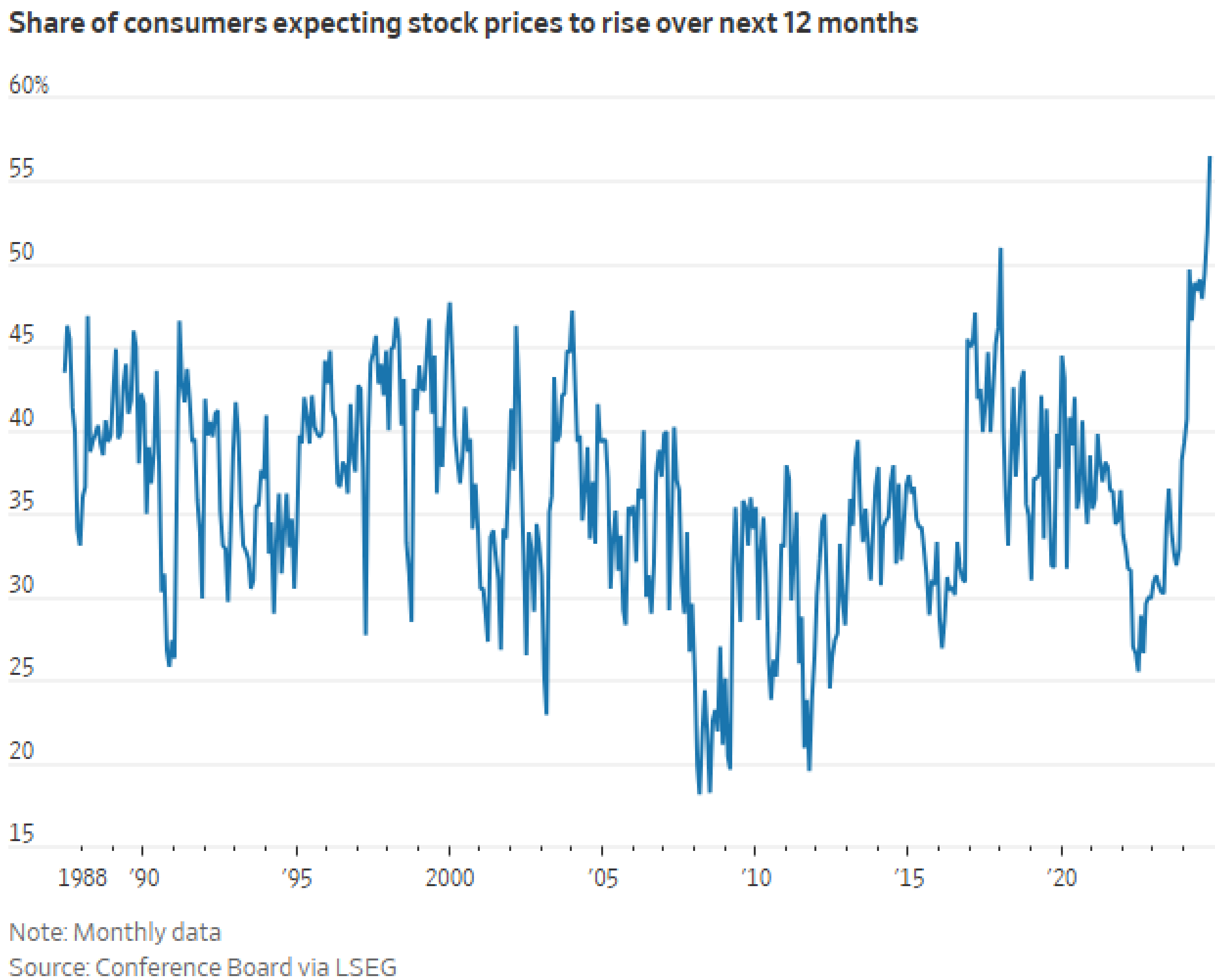
When investors are wildly optimistic, it is much harder for the market to rise and much easier for it to fall on any hint that they might be wrong

By James Mackintosh
Dec. 17, 2024

The market feels toppy. There is no science to this and readers will have to judge for themselves. But here are a bunch of things that make me think trouble might be imminent for stocks—perhaps a correction, perhaps the start of something bigger, but at least a bump in the road.

Bulls are everywhere. Bears are hard to find. This shows up in sentiment, in surveys and in the capitulation of the permabears.

Sentiment is euphoric, according to Citigroup's Levkovich indicator. This index combines lots of measures and suggests investors have only been more positive twice, in the postpandemic SPAC/cannabis/green bubble and in the dot-com bubble of 1999-2000.

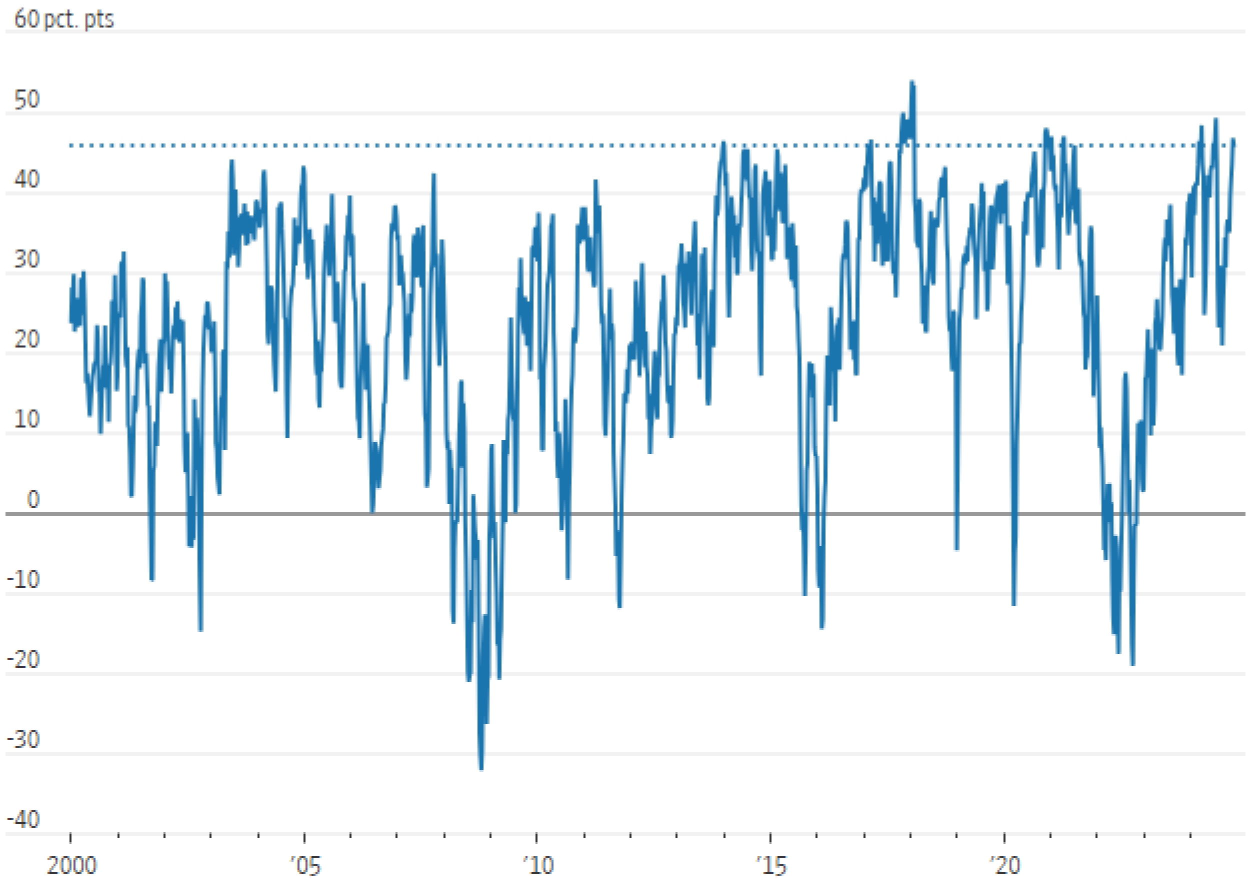


When investors are wildly optimistic, it is much harder for the market to rise—everyone's already got a lot of stocks—and much easier for it to fall on any hint that they might be wrong. I don't know what the trigger might be, but it doesn't need to be much.

Other signs of optimism. Investment newsletter writers have rarely been more bullish or less bearish, according to the weekly survey by Investors Intelligence. Households have never been so confident that stocks will rise over the next year, according to the Conference Board's monthly survey.

And fund managers shifted after the election to be more overweight U.S. stocks than any time since 2013, pretty much as all-in on the U.S. as they have ever been, according to Bank of America's survey. Money is pouring into funds at an exceptionally high rate too, close to new highs.

Investors Intelligence survey bullish-bearish (dotted line shows latest point)



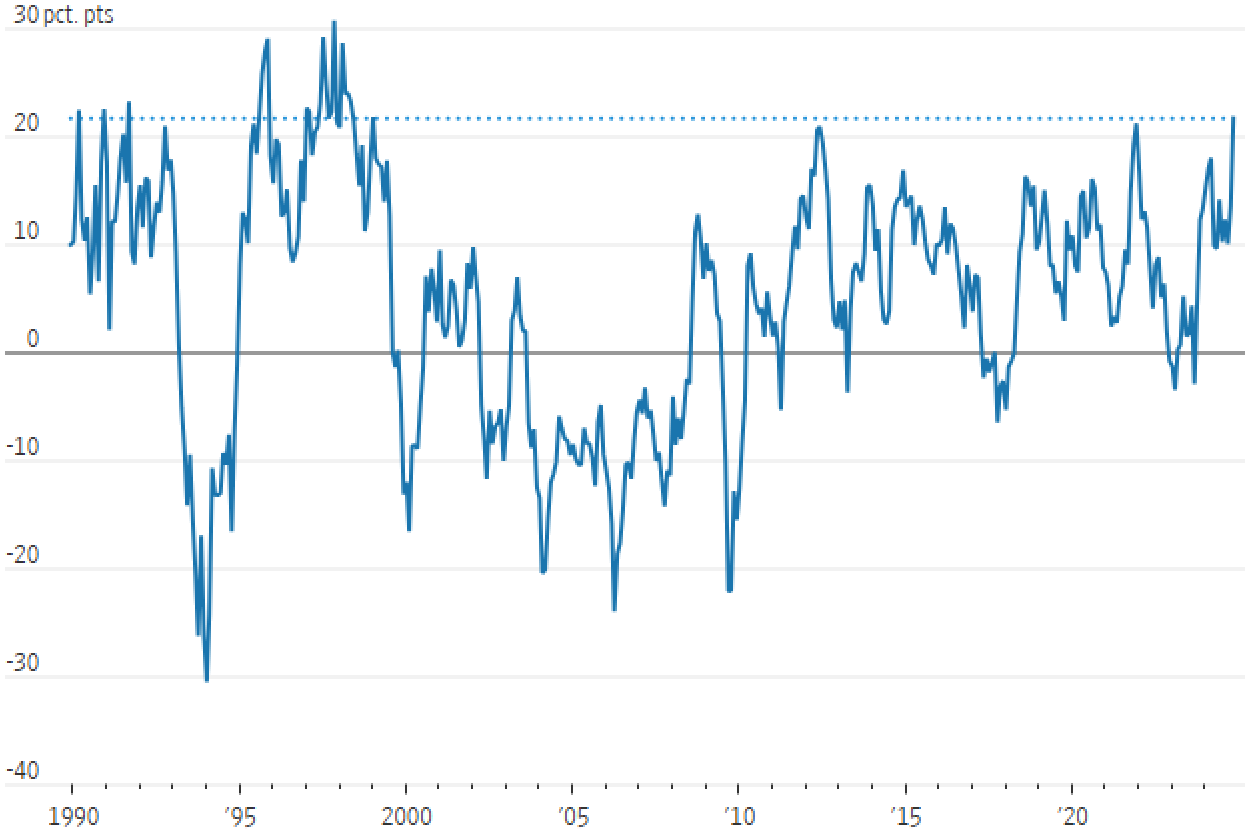
Source: LSEG

Some of the best-known bears have given up. Economist and fund manager Nouriel Roubini used to revel in the moniker of "Dr. Doom," but he told Bloomberg TV "I'm not Dr. Doom, I'm Dr. Realist," while talking up the prospects for the U.S. economy. David Rosenberg of Rosenberg Research didn't actually say the fateful words "this time is different" but he did write that "traditional valuations, at the least, are not that helpful right now."

This time will be different. Rosenberg thinks investors have shifted away from the standard metric of price against one-year forward earnings to look further out, because of the prospects for an AI-driven productivity boom. Even those who think markets will eventually return to something like normal, such as Goldman Sachs, don't expect issues soon.

Almost everyone agrees AI and the U.S. economy are great. Wei Li, chief investment strategist of the BlackRock Investment Institute, says spending on artificial intelligence will be "of a magnitude similar to previous industrial revolutions, but happening so much faster." She argues that "U.S. exceptionalism has been years in the making."

U.S. 11-month performance vs. rest of the world* (dotted line is latest)



*MSCI U.S.A. % price change minus All Country World %; monthly data through November
Source: LSEG

The widespread agreement shows up in prices. The biggest AI-linked stocks dominated the market this year, while the U.S. market outperformed the rest of the world by almost 22 percentage points in the year to the end of November, the most over an 11-month period since 1998.

No one cares about valuation. It isn't just that people think AI and the U.S. will do well. They don't seem to care about the price, even though price is the starting point for future returns. Cheap, or value, stocks have been underperforming for years, but just had their longest-ever consecutive daily decline, falling every day for the past 11 days. These are almost by definition bad companies, but the disconnect from the excitement about growth stocks is extreme.

The same goes for stocks against bonds, with the earnings yield—the inverse of the PE ratio—barely above the 10-year Treasury yield, the lowest reward on this measure for the risk of holding stocks since the aftermath of the dot-com bubble. It isn't just that people want to buy good companies, they seem to want them at any price.

Inside trades. The one group not buying into the story are corporate executives, who ought to be best-placed to see the potential for a new golden era for American profits. They have been selling more stock than they buy, according to regulatory filings, suggesting they think prices are too high.

None of these points are proof that the market must fall, let alone that it will happen soon. None have a perfect record and on some measures—such as the American Association of Individual Investors's survey—things aren't so extreme. But I don't want to be part of a crowd buying into a narrow story when prices, valuations and hope are already extremely high, and insiders aren't willing to back it with their money.

This feels like a good time to take some money off the table (we agree).

Something old, something new from Wall Street will likely make you blue.

How Booming Leveraged Funds Can Incinerate Your Money

Variants soon might include long-short funds resembling steel-cage matches

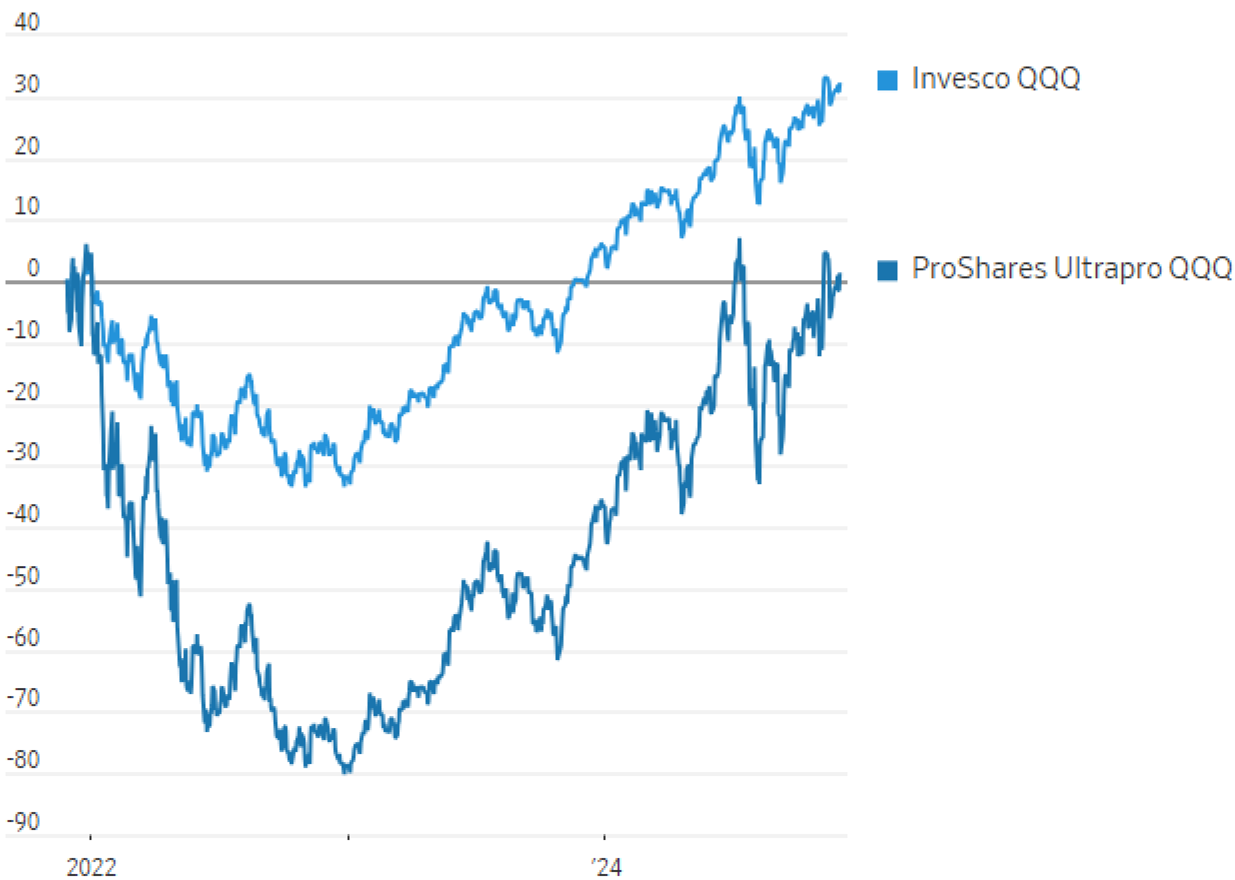
By Jonathan Weil
Dec. 11, 2024

There is great appeal in the notion of a simple investment product that can reliably provide double or triple the returns of a popular stock or index. The results have been disappointing, vaporizing billions of dollars, but Wall Street keeps finding plenty of eager buyers.

Leveraged exchange-traded funds are having a moment about two years after the first leveraged single-stock ETFs were introduced in the U.S. They typically use derivatives to seek magnified gains. That also will magnify losses. Through November, the size of these funds in the U.S. grew 46% this year to about $137 billion, according to Morningstar Direct. About $20 billion of them were single-stock funds, up 11-fold year to date.

The biggest leveraged ETF, at $25 billion, is the ProShares UltraPro QQQ. The fund's manager says it seeks

Performance of Nasdaq 100 ETF and 3x leveraged version through November



Source: FactSet

"daily investment results, before fees and expenses, that correspond to three times (3x) the daily performance of the Nasdaq-100 Index."

The crucial word there is "daily." An investor who naively skipped over that nuance and held the fund for longer may have been disappointed with its relative performance. Through last month, the Nasdaq-100 gained 32% during the previous three years. But the fund was up only 1%.

The daily results often don't go according to plan, either. On many days this year, the fund's performance has been significantly less than or greater than three times the index's move. The reason: Nobody's perfect. Every day the fund's holdings go up or down in value, while the fund's managers must keep its daily leverage at a constant level. This requires lots of complex trading, buying more when the index goes up and selling when it goes down.

Leveraged ETFs aren't new, and their foibles are well known to old hands. The noted fund manager Ted Seides in a 2010 paper, titled "The Surprising Cost of Volatility," highlighted the performance during the financial crisis of two leveraged ETFs tied to the Russell 2000 index of small stocks.

The Russell 2000 fell 16% from the start of 2008 to the end of 2009. One might think someone who was betting the index would go down during that same period would have profited nicely. Yet investors in a leveraged ETF called the Russell 2000 Ultra Short 2x *lost* 51%. That was almost as bad as the Russell 2000 Ultra Long 2x, which fell 53%, or more than triple the index's decline.

The drag mainly was due to the underlying holdings' volatility. "In markets that are more volatile than directional, the repeated process of rebalancing the ETF follows a pattern of buying high and selling low that takes a toll on asset value over time," Seides wrote.

The appetite for leveraged ETFs has grown nonetheless. Popular single-stock leveraged ETFs include two funds targeting 2x daily returns in the bitcoin buying machine MicroStrategy. After investors noticed they frequently were missing their daily targets, the funds' managers explained they couldn't get enough swap contracts from their prime brokers and had turned to less effective ways of getting daily leverage, including the options market. Skeptics have pointed out that a 51% one-day drop in MicroStrategy's stock price could wipe out the funds.

In a research note last month, Victor Haghani and James White of the investment firm Elm Wealth wrote that "even with the fullest disclosure possible, we struggle to find cases where these ETFs, particularly those based on single stocks, would make sense as investment vehicles for investors with typical risk preferences."

A jump-the-shark moment for the ETF industry could be approaching. Like a pro-wrestling promoter pairing a heel or a good guy against a jabroni in a steel-cage match, Tidal Investments has filed plans with the Securities and Exchange Commission for a lineup of eight leveraged ETFs called Battleshares, each pitting a popular disrupter against a company it is disrupting. One fund would have a leveraged-long position in Tesla about twice as big as a short position in Ford. Another would be long Amazon and short Macy's in the same way. And so on.

Unlike other leveraged ETFs, the proposed Battleshares funds make no pretense of seeking "daily" performance, stating instead that each ETF "seeks long-term capital appreciation." As with other leveraged ETFs, the constant rebalancing required as the stocks go up or down is likely to drag on returns.

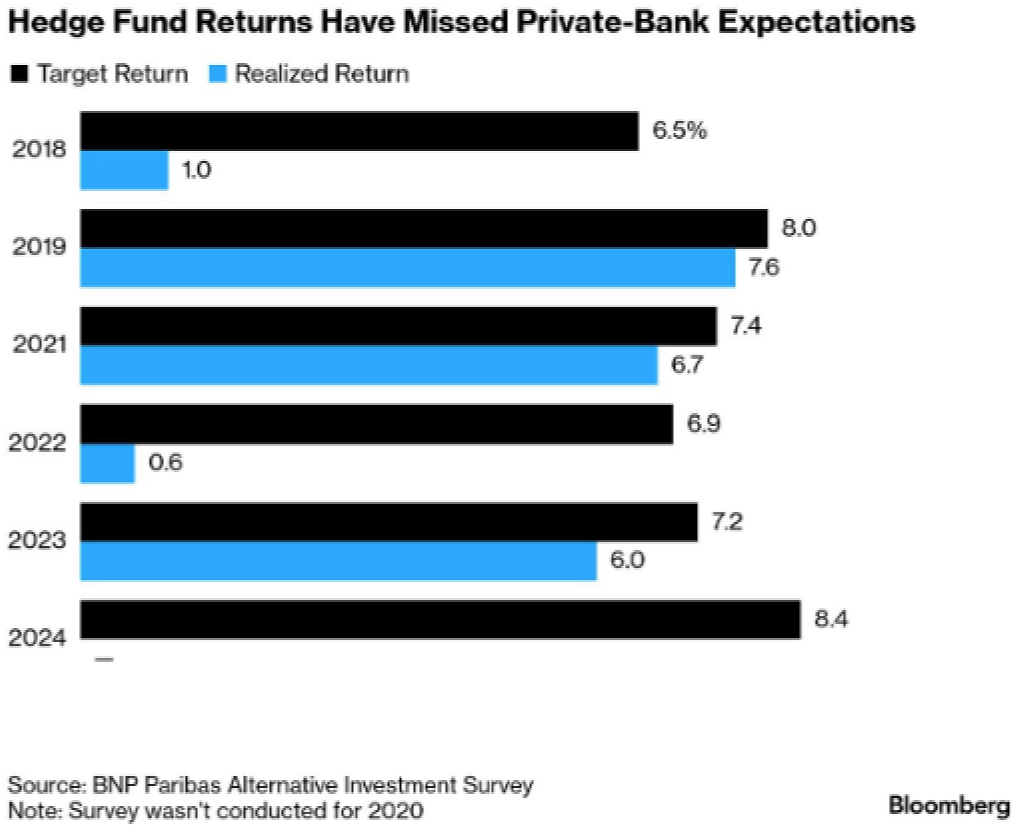
White, the chief executive of Elm Wealth, at The Wall Street Journal's request estimated how the proposed Battleshares pairings would have performed if they had maintained 2x daily leverage over time.

For the three years through Nov. 30, one might naively have expected a 26% compounded annual return simply by netting Amazon's 2x long performance against Macy's 1x short performance. (On a compounded basis, Amazon grew 6% a year, while Macy's fell 14% a year). However, in a leveraged ETF structure, White estimated the trade would have lost 5% a year, including management fees and finance costs. That mainly was because of the stocks' volatility and the constant rebalancing needed to maintain the 2x daily leverage.

Likewise, over the same period, netting Tesla's performance against Ford's would have suggested a possible compounded annual return of 4%. In a 2x leveraged ETF structure, White estimated the pairs trade would have lost 28% a year.

While it may be brilliant marketing, these aren't investments for the serious-minded. They likely will be more fun to watch than to own.

From December 10th's Evening Briefing:



Follow-ups

Three from the WSJ:

For Small-Cap Stocks, Look Past the 'Trump Trade'

Tariff and rate-cut expectations have boosted shares of smaller companies, but investors should focus on long-term appeal

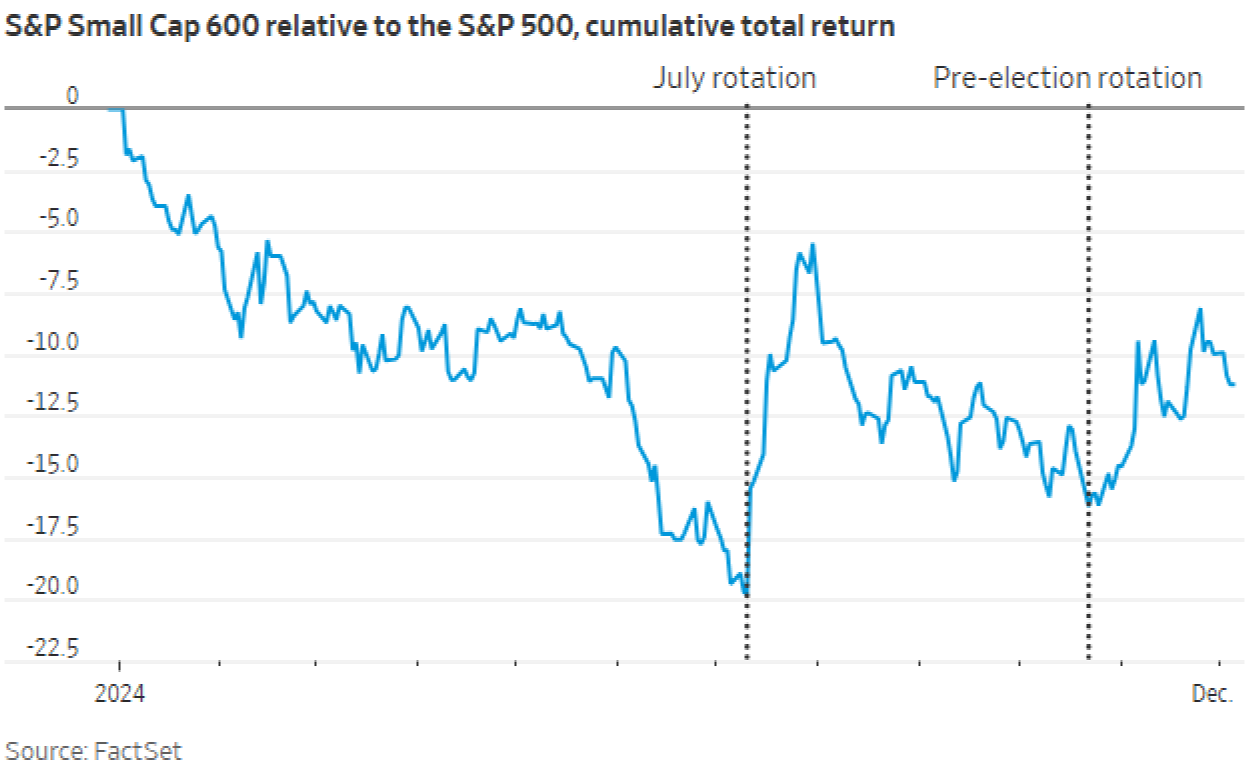
By *Jon Sindreu*
Dec. 5, 2024

Small-capitalization stocks are having their moment in the sun as part of the "Trump trade." Whether they end up having staying power might have little to do with tariffs.

Since the Nov. 5 election, the S&P SmallCap 600 Index is up nearly 8%, compared with a roughly 5% gain for the S&P 500. ...

Back in July, Trump's improving chances for victory, as well as disappointing earnings by some technology companies, had already pushed money into small-cap funds. Yet for 2024 as a whole, the S&P 600 still lags behind its blue-chip counterpart by more than 10 percentage points. Since the end of 2019, the shortfall is almost 40 percentage points.

Catalysts for a more lasting shift are accumulating. The Republican Party's sweep appears to herald lower taxes, lighter financial regulations and higher tariffs, which Wall Street believes will benefit domestically oriented businesses more than multinationals.



The S&P 500's gains also have been so top-heavy that its largest 10 companies now make up the biggest part of the index ever.

"When you get this extreme level of concentration, eventually there's a buyer's exhaustion," said Jonathan Coleman, who manages small-cap funds at Janus Henderson.

Finally, the Federal Reserve has started cutting interest rates. Many analysts argue that small-caps are the ideal investment during monetary-easing cycles, as is the case after recessions.

Small-caps should be more than a short-term trade, though.

Looking at a data set by economist Kenneth French that starts in 1926, average five-year small-cap returns aren't hugely different whether they start inside or outside of these specific periods, especially relative to large-cap performance.

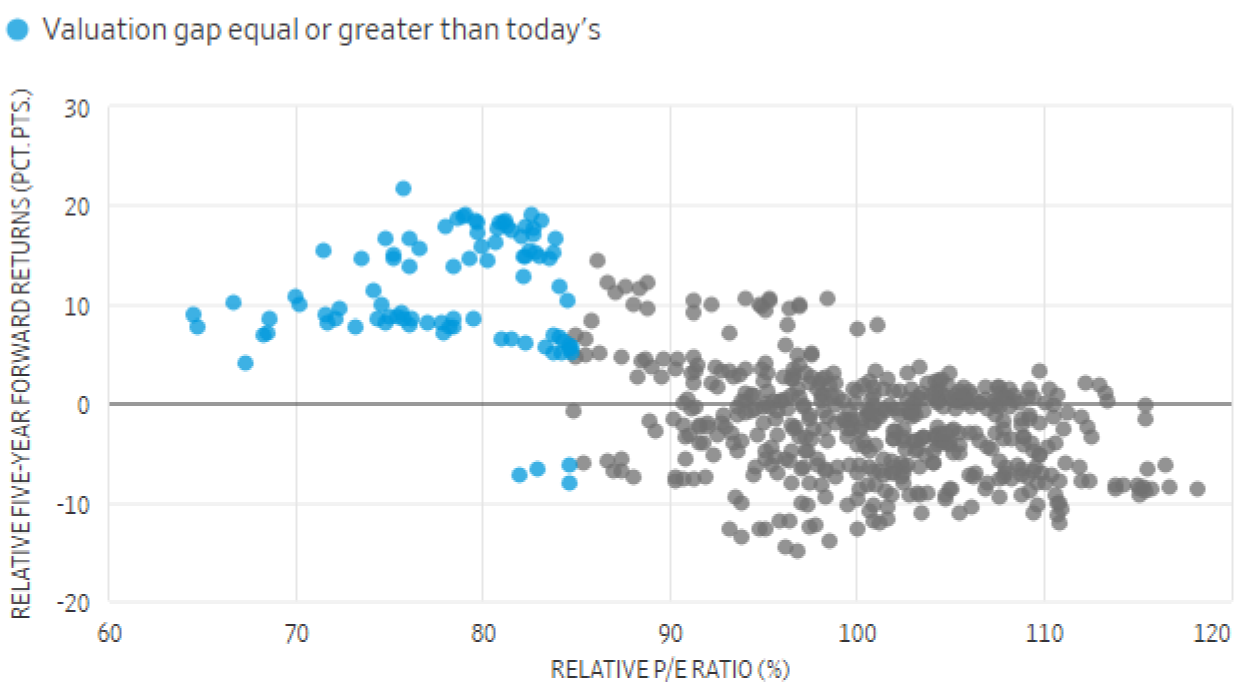
As for politics, their impact is notoriously hard to predict. Tariffs are a particular headache for import-dependent small businesses. Case in point: Small-caps did very well during the turbo-globalization of the early 2000s, yet lagged behind in 2019 as Trump's first round of protectionist measures actually came into effect.

Instead, the compelling reason to buy these stocks is that, since 2015, small-caps have been cheaper than blue-chips. The S&P 600 now trades at 18 times the earnings generated over the past 12 months, compared with 28 times for the S&P 500, according to FactSet.

According to monthly data by Furey Research Partners going back to 1968, which includes only profitable companies, a valuation gap as large as the one at the end of November has historically led small-caps to outperform over the following five years 96% of the time, and 51% of the time by more than 10 percentage points. This is what happened after the Nifty Fifty era of the 1970s, when blue-chips were massively overvalued, and the dot-com bubble of the late 1990s and early 2000s.

Historically, a small-cap discount as large as today's has nearly always led small-caps to outperform

U.S. small caps versus large caps



Notes: Monthly data starting in 1968. Profitable stocks only.
Source: Furey Research Partners

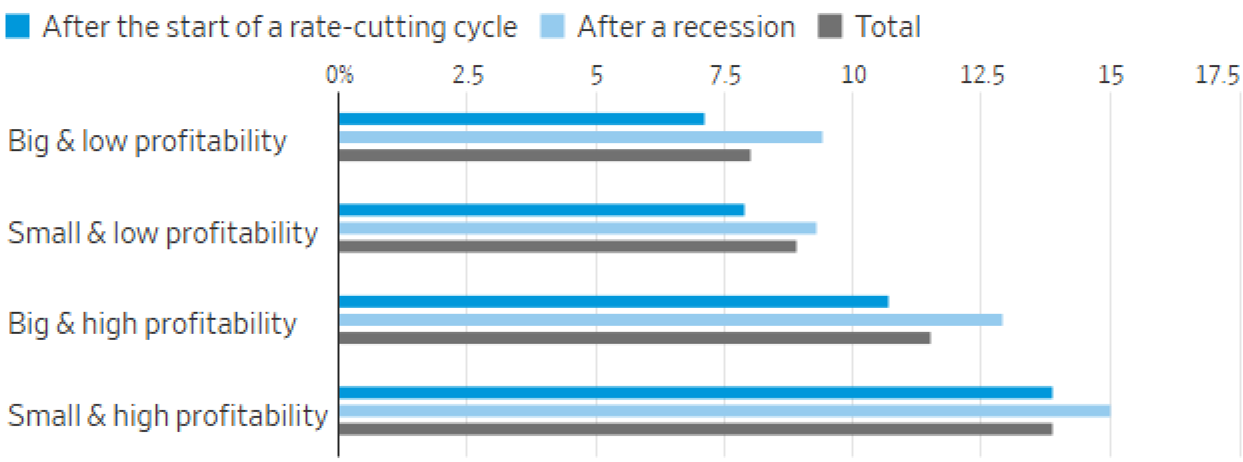
When it comes to longer, 10-year stretches, smaller companies have been the place to be almost without regard to when investors bought them, French's figures show. They have beaten out large-caps three-quarters of the time, even after stripping out the bottom 25% of largely uninvestable microcaps. It isn't because they are riskier: Adjusted for volatility, the result is the same.

This “size effect,” first identified by Rolf Banz in 1981, explains why smaller companies have historically traded at higher valuations than larger ones.

It is also a boon for the fund-management industry, because this is one of the few corners of the market in which actively managed funds can still claim to do better than index trackers and charge fatter fees. Between 25% and 40% of small-cap indexes are made up of unprofitable companies, and it has usually been a good strategy to avoid them. Indeed, stock pickers have been able to generate excess returns simply by being benchmarked to the popular Russell 2000 index while aping the S&P 600, which screens stocks for profitability, liquidity and investability.

Over long stretches, investing in small-caps has been about picking profitable companies and not about market timing

U.S stock market, average annualized total return



Note: Value-weighted returns for each category. Small/big definition based on the median capitalization of the New York Stock Exchange. Small caps include microcaps. Profitability defined by revenues minus cost of goods sold, interest expense, and selling, general, and administrative expenses divided by book equity. High/low definition refers to top and bottom 30%, respectively.

Sources: Kenneth French, Federal Reserve (interest rates & GDP), Robert Shiller (valuations), WSJ calculations

On a rolling 10-year basis, the average annualized return for U.S. small-caps in the top 30% in terms of operating profitability has been 14% since 1963, compared with 12% for large-caps of similar profitability and 9% for small-caps ranking in the bottom 30% of profitability.

To be sure, investors can ask reasonable questions about the declining number of high-quality companies found in small-cap indexes, especially at the same time megacaps keep improving their return on assets.

Nevertheless, the case for going smaller is one of long-term commitment, not opportunism.

Market Timing Has Picked Up Since Covid. It Has Cost Investors Dearly.

Research finds investors in all categories of active funds have been trying to buy low and sell high—and they aren’t very good at it

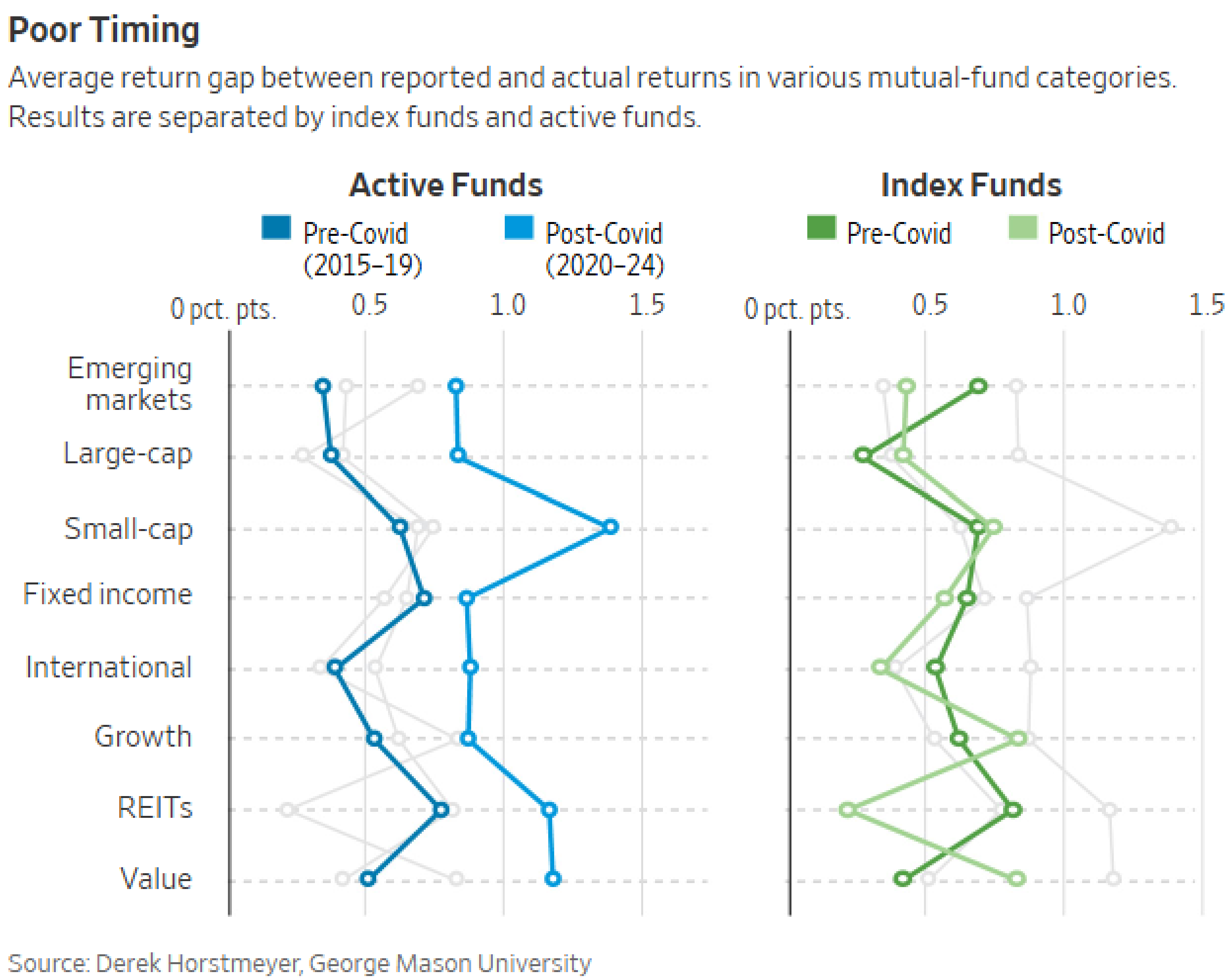
By Derek Horstmeyer
Dec. 5, 2024

The Covid-19 pandemic wreaked havoc on more than just public health—it also disrupted the trading behavior of individual investors.

Between 2020 and 2024, such investors have exhibited more detrimental trading behavior than before Covid, taking riskier bets and trading more inefficiently by trying to time market tops and bottoms. The upshot: Billions of dollars in lost portfolio value annually.

Over a variety of actively traded mutual-fund styles from 2015 to 2019, my research assistants (Ali Alhassan and Brian Gaydos) and I estimate poor market timing cost investors 0.53 percentage point a year in value to their portfolios.

By comparison, from 2020 through Oct. 31, 2024, the average value destruction to one's portfolio from poor market timing nearly doubled, to just over 1.01 percentage points a year in actively managed holdings.



Our research methods

To study this phenomenon, we pulled all return data for U.S. dollar-denominated mutual funds over the past 10 years. We then separated them by actively managed and index-tracking passive funds.

Next, we took the average return gap of each fund category for the five years before Covid and the five years since. The return gap of a fund is the difference between the stated annual return and the actual dollar-weighted return in the fund (an internal rate of return that factors in fund inflows and outflows—that is, net buying or selling). This gap captures the difference between the average return for a fund and what the average investor *actually experiences* in returns within that fund.

Why might these two numbers not match up exactly? A mutual fund's stated return will reflect the average return of its holdings over a period. But because investors on average pull their money at the wrong time (panic-selling when the market has already hit a bottom and investing more when at the top), they often don't experience this stated return in full. In other words, this return gap captures how inefficiently investors are trading in their mutual-fund holdings.

Our findings

Across the board for active mutual funds, the return gap increased over the 2020-24 period. For instance, from 2015 to 2019, the average return gap for investors in active U.S. large-cap stock funds was 0.37 percentage point a year. From 2020 to 2024, this return gap jumped to 0.83 percentage point a year. This means that since Covid struck, investors in U.S. large-cap funds have been leaving an extra 0.46 percentage point of return on the table thanks to poorly timed trading. That return gap might seem small, but it is enough to negate some or all of a fund's fees.

The area where investors are doing the most damage to their portfolios is in actively traded U.S. small-cap funds. Before Covid, the average return gap in this segment was 0.62 percentage point a year. Since Covid, this return gap jumped to 1.38 percentage points a year. This means that investors in small-cap funds have missed out on an additional 0.76 percentage point of return in their portfolio.

These results persist throughout the active mutual-fund arena, but become a little less pronounced when we look at index-fund holdings. For investors trading index funds, we see the return gap gets worse during the Covid period in only 4 out of the 8 fund classes we studied—large-cap, small-cap, value and growth. And the increased return gap for these fund groupings was only marginally higher on average and nowhere near as significant as the results documented for active funds.

Covid's role in the increased market timing isn't entirely clear, but it seems that homebound do-it-yourself investors got a little trigger-happy during some of the market's wilder moments. And such suboptimal trading has persisted as the public health threat has faded thanks in part to resources that encourage active trading and internet forums that hype stocks like Reddit's WallStreetBets forum.

Ultimately, the lost returns since Covid speak to something that has long been known: Most investors are better off not trying to time the market.

Derek Horstmeyer is a professor of finance at Costello College of Business, George Mason University, in Fairfax, Va.

SEC, States Investigate Firm Holding Couple's $763,094 Retirement Fund

The probes focus on Next Level Holdings and Yield Wealth, which offered investors the promise of double-digit returns

By Jason Zweig
Dec. 4, 2024

Federal and state authorities are investigating Next Level Holdings and Yield Wealth, firms that offered investors financial products touting outsize yields that are now in limbo.

The firms, along with investors who are no longer sure they can access their funds, were the subjects of three recent articles in The Wall Street Journal.

In late November, the Securities and Exchange Commission's enforcement division sent subpoenas to several people involved with Next Level and Yield Wealth, according to people familiar with the matter. Securities regulators from several states are also looking into the investment products, people familiar with those inquiries said.

The two affiliated investment operations raised tens of millions of dollars in 2023 and 2024 by promising investors annual rates of return of 10.5%, 15% and up.

In November, after the second of the Journal's articles, Next Level ceased paying interest and announced it was winding down its operations. Yield Wealth shut down in early September.

Next Level's chief executive, Paul Regan, didn't respond to requests for comment. Regan, the Journal has previously reported, was barred for life from the securities industry in 2004. Next Level is based in Miami and Medellín, Colombia.

Kimberly and Richard Whitacre, who were profiled in a Nov. 22 Journal article, are among investors who say their money is frozen. The Whitacres had invested $763,094 in retirement money into a Next Level account.

Kimberly Whitacre says that after the Journal's article appeared, Regan told the insurance agent who sold the couple the product that Next Level would pay the back interest that was due. On Nov. 25, the Whitacres received a wire payment of $30,000 from Yield Receivables, a Florida company run by Regan associate Christian Fernandez.

Fernandez didn't respond to requests for comment.

However, the Whitacres had invested in Next Level Holdings, not Yield Receivables. Two days later they received an email from Next Level in which Regan asked them to sign a waiver stating that the $30,000 payment reduced their remaining account balance to $733,000—even though the $30,000 was purportedly for back interest. They refused to sign.

The bank that handled the wire transfer was JPMorgan Chase, where Yield Receivables has an account. A spokesman for the bank declined to comment.

While the Whitacres have received an interest payment, they don't know how much of their roughly $763,000 they will get back, or when, because Next Level has given no indication of how much asset value remains. They also may face a tax hit on those funds.

The custodian for Next Level ended its relationship with the firm in November, automatically triggering a retirement-account distribution. A rollover of that money to a new custodian must be completed within 60 days to avoid an onerous tax bill.

Positions

As a general rule we sell any individual stock with a 20% or greater loss that we no longer consider a buy at the end of the year in all accounts, and may do so in taxable accounts even if we still consider the stock a buy and there is an equally attractive opportunity, or we believe it is likely that we will be able to profitably reenter the position after the 30 day wash-sale rule has expired. We have sold all positions in the following stocks: AFCG, BRSP, COMM, GPMT, MODG, PDM, and UNIT. We sold NLY in taxable accounts, and closed all positions in GPIIX, which, as shown below, has fallen to a Morningstar past performance rating of 2 out of a possible 5, and is no longer outperforming ISCF, our core holding for foreign stocks:

Grandeur Peak International Opps Instl GPIIX ★★

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Distribution Fee Level	Share Class Type
3.07 / −0.32%	378.4 Mil	1.360%	1.360%	High	Institutional
Category	**Investment Style**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Turnover**
Foreign Small/Mid Growth	Mid Growth	1,000	Limited	0.55%	30%