SUMMIT
ASSET MANAGEMENT

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"Medius tutissimus ibis - You will go safest in the middle course" --Ovid

Dear Clients and Friends: January 15, 2025

From an economic standpoint, 2024 looked a lot like 2023. The U.S. economy remained resilient, growing faster than other major developed countries, while the Fed and their interest rate policy remained front and center. And yet again, our own, homegrown, mega-cap tech stocks led the S&P 500 to dominate global markets.

Back in 2023, the rally in stocks was mostly driven by the hope of market friendly events. Inflation was expected to come down, leading to an end of rate hikes and the beginning of rate cuts. The economy would enter a soft, not hard, landing. Conflicts in Ukraine and the Middle East would be settled. We might even get through the hype and figure out how AI would change our lives.

2024's rally was driven by these hopes coming to partial fruition. Inflation did recede, but then became sticky. Growth slowed, but we avoided recession. Fed rate cuts have happened but not to the extent many expected. The geopolitical crisis didn't get solved but didn't get worse. We're not sure if we learned how AI was going to change the world, but a ton of money was spent trying to figure it out.

This progress led to positive returns across the board for stocks and bonds. However, like in 2023, the stellar results from the S&P 500, increasingly powered by the "Magnificent 7," continue to mask the much lower returns in almost every other part of the market. Outside of the brief value rotation that occurred in the third quarter, 2024's returns told the cohesive story of mega-cap U.S. growth producing strong earnings in an environment where most other investments were unable to do so.

For the quarter, the S&P 500 added another 2.5%, finishing the year with a total return approaching 25%. Small cap stocks, represented by the S&P 600, were down -0.6% for the quarter, but up 8.5% on the year. International stocks struggled as well. Hampered by slower growth and a strengthening dollar, they were down -8.5% in the quarter and only up 3.4% for the year. It was much more difficult to make money if your name wasn't Nvidia, Microsoft, Tesla, Amazon, Meta, Alphabet, or Apple.

As for the bond market, this has been a very unusual rate-cutting cycle. Bucking history, longer-term interest rates have actually risen since the Fed began easing policy rates in September. As the Fed has cut rates by 1.0%, the benchmark 10-year Treasury bond yield has risen by almost 1.0%. 1981 is the only other time rates have diverged. Then, Fed Chairman Paul Volker was taking unprecedented action to stem unanchored inflation. While concerning, today's inflation appears much different than that of the 1970s. However, the increase in rates produced a -3.1% quarterly return to the Bloomberg Aggregate Bond Index, leaving it up only 1.3% for the year.

Why don't we just own the S&P 500?

As advisors, it seems like we ask ourselves that question every day. The fact is that we do own the index or other investments that look substantially like it. But we also own other things too. History has shown that diversification and asset allocation are prudent. We also remind ourselves this particular S&P 500 doesn't look like any other S&P 500 in history.

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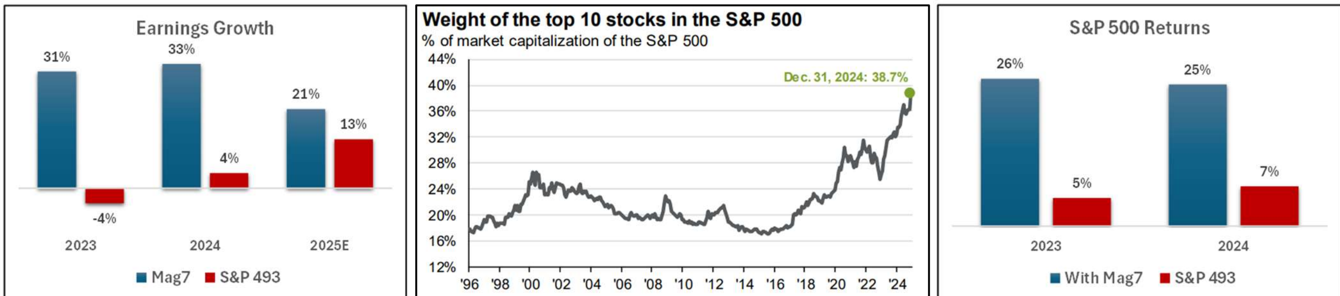
In both business and investing, value is created by spending capital in the present to generate returns in the future. Doing so in a manner that generates high sustained returns at scale is incredibly difficult. Over time, unusually high levels of profitability invite competition, and that competition eats away at the excess profits. While the world has seen very large companies before, the competitive nature of business has historically limited just how big they can get economically.

The rise of the Magnificent 7 has been uncommon in how they have continually invested extremely large amounts of capital at very high incremental returns. As "platform companies," much of their success can be attributed to winner-take-all business models that have achieved incredibly significant economies of scale and integration of their products into customers' lives. These mega-cap technology companies' businesses also exist in mostly non-overlapping end markets (search, social media, retail, cloud computing, phones), where they haven't had to compete too aggressively with one another.

The last several years have seen these highly scaled, incredibly profitable, dare we say monopolies, generate earnings growth never before seen by such large corporations. That growth has been handsomely rewarded by investors, sending their stock prices soaring and their market capitalizations passing one, two, and even three trillion dollars. Since the S&P 500 weights its constituents based on their stock market value, these seven companies' impressive appreciation has led to alarming over-weights in the index, making their performance contribution to the index impossible to overstate.

The charts below show how dominant that growth has been, the resulting index concentration and how the S&P 500 performed both with and without these companies' inclusion. The S&P 500 of the past has been a much more diversified representation of the U.S. stock market than today's unbalanced basket of stocks whose aggregate performance is dictated by a handful of companies.



Lastly, a word on the "other things" we own in client portfolios. Though performance of some of these investments has been underwhelming compared to the S&P 500, most are portfolios of businesses collectively in which we have the utmost confidence. While we own our share of the Magnificent 7, as they have grown increasingly more expensive, we tilted portfolios toward what we believe are high-quality companies with lower valuations.

We own investments that focus on dividend paying stocks. Companies included must have paid a dividend and increased it every year for the last 10 years. They must also demonstrate the ability to continue to pay and increase that dividend into the foreseeable future. We own other investments that focus on what Warren Buffet calls "wide moat companies." These are businesses with significant and durable competitive advantages, allowing them to protect their market share and profitability from competitors for long

periods of time; similar to how a castle's moat protects it from invaders. Other investments in portfolios represent similar themes. Although they may be currently looked upon with less favor, historically they have generated consistent returns and helped protect capital in more challenging times. More challenging times could be ahead.

Outlook

With the re-election of Donald Trump to a second term as President, markets originally celebrated wildly. Stocks rallied almost 7% in the weeks following the November 5th decision. Trump, having campaigned heavily on tax cuts and less regulation, is expected to make Washington much more business friendly. Music to the market's ears.

While we appear to be in a very benign environment, risks are starting to emerge. Last year, as Treasury yields climbed, stocks mostly shrugged off the move. Yields were seen as rising because of continued good times ahead. With more rate cuts anticipated by the Fed, everyone was remaining calm.

Although inflation has been running slightly above the Fed's target of 2%, investors had come to believe that the Fed would remain in easing mode. Then, December brought new information showing maybe the inflation genie was never quite put back in the bottle. This was followed by a jobs report indicating a still hot labor market with the unemployment rate ticking back down.

Now, investors have started focusing on Trump's other campaign promises, hiking tariffs and deporting unauthorized immigrants. Coupled with predicted continued deficit spending, inflation expectations are rising. So are bond yields. Stock-market investors are demonstrably worried about those rising yields with the 10-year rate seen on its way toward 5% and possibly beyond. Expectations for further rate cuts have been sharply curtailed with some economists expecting the next move could be a hike. Stocks have reacted with new volatility and by giving back most of the postelection "Trump Bump."

We anticipate policy changes to be less dramatic than those promised on the campaign trail. The scale of tariffs proposed would add to consumer inflation, snarl supply chains and invite sharp retaliation. Similarly, massive deportations could be very disruptive to business. All of this would hurt Republicans seeking their own re-election in 2026. So, smaller tariffs, with the threat of more to come, is a more likely short-term outcome.

After two years of solid gains, especially from the Magnificent 7, markets have become expensive and what appeared to be certain is becoming more and more uncertain. The AI spending splurge has also set up intense head-to-head competition for the first time amongst these tech giants. A more uncertain environment usually brings volatility which we are starting to see now. We believe a diversified approach and sticking to your plans remains the best course of action.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

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