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4th Quarter Market and Economic Update

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"If Santa Claus should fail to call, then bears may come to Broad and Wall." -Yale Hirsch

"Those who have knowledge don't predict. Those who predict don't have knowledge." -Lao Tzu (Chinese Philosopher)

Happy New Year! I hope the holiday season has been good to everyone. Unfortunately, we awakened on New Year's Day to the news of a terror attack in New Orleans. While it does not appear that this attack will have any economic or market consequences at this time, I did want to acknowledge the souls lost and wish a speedy recovery to those who were wounded. With that said, please forgive this segue to financial markets.

Despite a rough ending, 2024 was another profitable year. Coming on the heels of 2023, that is two straight good years for equity markets. In fact, it is the best two-year move for equities since 1997/1998. While there are often divergences among the equity winners, they were more pronounced in 2024 than in 2023. To illustrate these divergences, we turn to some statistics courtesy of Ned Davis Research (NDR): only 28.2% of stocks outperformed the S&P 500, which is among the lowest of all-time. Further, only about half of the stocks in the Russell 2000 index were higher in 2024. The dominance of the mega-cap stocks (the largest 10 in the S&P 500) is not a problem by itself if most stocks are participating. While the majority have been participating since this cyclical bull market started in October 2022, the recent breadth readings indicate that the majority may not be along for the ride much longer. Also, the All-Cap World Index (ACWI), which includes foreign stocks, had a very nice year, but underperformed the S&P 500. These divergences are something that we will be watching closely as we move into 2025.

In the fixed income world, a similar story of divergences emerged. For the second time in as many years, it was loans and private credit that were the big winners, while for the third time in four years, long-term U.S. Treasury bonds posted negative returns. In fact, long-term U.S. Treasury bonds were the only sector of the fixed income market to post negative returns in 2024.

Finally, commodities were a mixed bag, as they always seem to be. Gold, silver, and natural gas were higher, while oil prices and many agricultural commodities were lower in 2024. Some exceptions to the agricultural commodities were cocoa, coffee, and orange juice, all of which were sharply higher. So, if you notice the price of chocolate, coffee and OJ higher at the grocery store, then you'll know why.

As all of you know by now, I don't rely on predictions to allocate capital in your investment portfolio; that would be foolish. While making predictions can be a fun game, we will always look to our objective models and indicators to make any asset allocation decisions for your portfolio. History is also a useful guide, for as Mark Twain

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was reported to have said, "*History doesn't repeat itself, but it does often rhyme*." Finally, discipline also plays a part in managing portfolios, as we must have the discipline to adhere to the messages of the indicators and models. When many "experts" were suggesting that 2023 and 2024 could be bad after the cyclical bear of 2022, I relied on those objective indicators and our discipline to be much more sanguine.

I started this letter with a quote from Yale Hirsch, who popularized the theory of the "Santa Claus rally" on Wall Street. Typically considered to be the last five trading days of December and the first two trading days of January, the theory suggests that if the stock market doesn't rally during that 7-day trading period, then a bear market may be near. As I type this, Santa did not call this season, as the equity market finished slightly lower during the Santa Claus period. Should we be worried? This is a good time to point out that Santa didn't call last year either, but as noted on page 1, 2024 was a good year for stocks. However, the weakness in December did buck the normal bullish tendencies for a secular bull market, and that has me raising an eyebrow. We are now over two years into the current cyclical bull market, which exceeds the median length of all cyclical bull markets, including those that have taken place within secular bull markets. The current secular bull market is now almost 16 years of age. As a reminder, a cyclical trend is one that can last from a few months to a few years, while a secular trend typically lasts a decade or longer. According to data from NDR going back to 1900, we are currently in the fifth secular bull market; there have been four secular bear markets.

Why does identifying the secular trend matter? In secular bull markets, the average gain in equity market indices has been greater than 10% per year. Allocating more towards equities and trading infrequently have traditionally been the right approach in that period. Within secular bulls, the cyclical bulls last longer, while the cyclical bears are shorter in duration. However, in secular bear markets, the major stock averages have experienced annual average losses. Under that scenario, allocating capital towards other asset classes and trading more frequently (though not excessively) have traditionally been the right approach. The cyclical bears last longer within a secular bear, and the cyclical bulls are shorter. Both fixed income and commodities have their own secular histories and tendencies as well.

While the weight of the evidence continues to side with the secular bull, I should point out that we are starting to see some levels of extreme optimism, which may be a harbinger of a cyclical top, a secular top, or both. Almost everyone I see on TV is extremely bullish for 2025. On page 1, I referred to the fact that the last two years have been the strongest two-year period since 1997/1998. I recall most "experts" on TV back then being bullish about the next several years. The previous secular bull peak then came in early 2000.

To be clear, I am not saying a cyclical or secular top is in place currently. Rather, it is something I am keeping an eye on. As I suggested above, the bulls deserve the benefit of the doubt as the weight of the evidence continues to lean their way. Artificial Intelligence (AI) is real and a potential game changer for the global economy, but so was the internet in the mid-to-late 90's. At a certain point, the good news will be priced into stocks, much as it was in the late 90's. Thus, after two straight years of double-digit gains for U.S. equity indices, I wouldn't be surprised if we see more modest gains in 2025. I think the simplest way for me to put it is the following: after being confident going into 2023 and 2024, I am less so heading into 2025. One reason is what I mentioned above: extreme optimism on the part of many, as indicated by any number of surveys. Another reason for my less sanguine outlook is due to inflation remaining above the Fed's 2% target. This appears to be leading the Fed to reduce their anticipated number of rate cuts in 2025, and part of the reason for the stock market rally in 2024 was due to the idea that the Fed would cut

interest rates substantially in 2025. Finally, trees don't grow to the sky and markets don't always go up double digits. Sometimes stock markets fall and sometimes they only go up slightly. At a minimum, I would expect more volatility and a couple more corrections in 2025.

To be certain, there are always risks, and I worry about everything. The mechanics of the market have changed greatly over the past two decades as more money is traded by computer algorithms than ever before, which leads to periods of unprecedented volatility. It's one reason we see such wild swings intraday. Regulatory changes enacted after the 2007-2009 Great Financial Crisis have led to less liquidity in some markets, and that just adds to volatility. In the end though, investing is about buying assets for the long-term. That's how you grow your wealth over time: buying great assets at good to great prices and holding them until they become overvalued, or something changes with the investment. The key is to remain flexible and to avoid having a myopic view of the macro environment and of the assets into which we've invested.

As most of you know, we have three investment programs here at HFA. Simply put, the three are growth, balanced, and conservative income. When we trade, the idea is to meet at least one of the following objectives: 1) Increase the portfolio's quality; 2) Increase the portfolio's potential resiliency; 3) Increase the portfolio's expected potential returns; and 4) To provide a durable and growing stream of income for those who need it. We are always looking for a "margin of safety" when we purchase any asset for your portfolio, which essentially means that we are trying to buy something for less than we think it's worth in the future. That's the foundation on which Warren Buffett and Charlie Munger built Berkshire Hathaway. In equities, we are looking for long-term compounders and/or special situations during a certain part of the business cycle. For our balanced and conservative programs, we look for dividend paying stocks that can provide a growing stream of dividends into a portfolio. Within fixed income, we want to make certain that our more conservative clients are being appropriately compensated for the risk being taken, while hopefully providing a steady and growing stream of income, as mentioned above.

Housekeeping notes: 1) Please let us know if you need help managing your employer retirement plan. 2) We are in the process of adding additional services through strategic partnerships. More on that in future updates. 3) The pictures from our client party will be up on the HFA website soon. The website can be found here: https://www.hutchinsonadvisors.com/.

I hope you and yours are healthy and enjoying a wonderful start to the new year. Please let us know if there is anything we can do for you. We're always here to help. From all of us at HFA, thank you for your trust, confidence, and loyalty. It is a joy and a privilege to work with you and your family.

Best wishes,

Harvey E. Hutchinson IV

President

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