Today's Valuations: Reasonable or Excessive?

Q4 2024 Client Letter

As we look ahead to 2025, the market narrative appears sharply divided between two prevailing philosophies: one bullish on technological advancements and the resilience of corporate earnings, and the other warning of a cycle that would end the current bull market. Both are compelling, and understanding their implications is critical to portfolio strategy. The road ahead will be defined by the interplay of technological breakthroughs and economic realities. We thought it would be wise to take a moment to lay out both the bull and bear cases for the market and try to make sense of them. The bull case, or optimistic case, argues that the S&P 500's extraordinary performance, driven by technology and artificial intelligence (AI), is not only sustainable but still in its early innings. Productivity enhancements, major breakthroughs in innovation, and deflationary forces are on the horizon that will propel society forward and have profound impacts on the workforce and humanity at large. So far, the proponents of the S&P 500 bull thesis have been proven right on the general trajectory of earnings, as strong earnings and global tailwinds have continued to favor the tech heavy and growth company trade. Although there have been sizable drawdowns along the way (think 2022), technology and innovation continue to lead the way. In 2024, the AI revolution contributed disproportionately to corporate earnings. For Q3 2024, the Magnificent Seven stocks—Amazon, Alphabet, Apple, Microsoft, Meta, Nvidia, and Tesla—accounted for nearly all of the S&P 500's earnings growth, delivering 21% year-over-year growth, surpassing the 19% consensus expectations. Stripping out these Mag7 names, the rest of the index had a really low bar with an expected earnings decline of 1%, which that segment managed to beat by a positive 1% number. As one would expect, the overall index would not even be close to its year-to-date performance without those massive stocks. The proponents of the bull case will argue this trend is far from over and we may be in for a "higher for longer" valuation environment because of it. This view will reason that the companies delivering the highest earnings growth warrant the highest premiums because of their stable cash flows and ability to leverage their massive network effects to upsell existing customers.

On the other hand, skeptics argue that markets are overdue for a correction that will bring down valuations across the board to something more in line with history. They fight the narrative that "this time is different" with respect to valuations and remind of the fact that market cycles are inevitable. Nothing is new under the sun from a human behavior point of view and the speculative excesses get wrung out time and time again. The bear case for the S&P 500 has long been highlighting concerns about rising inflation and the growing debt burden in both the public and private sectors. Continuing tensions in Eastern Europe, deflation crushing China, and the Middle East conflict that is building up are all wildcards that could disrupt energy markets and global supply chains. The pessimistic case will also give concerns that AI won't live up to the hype that is priced into the current market. Although artificial intelligence may have real transformative effects down the road, not every company can monetize it effectively. Instead of paying about 26x earnings for today's S&P 500, they will argue the historical average (20-year) is around 16x, so things are completely out of the realm of reality at current pricing. Reversion to the mean is a concept that has long been expected by bears on the stock market.

At CenterPoint Strategies we are independent advisors. It is our duty to assess the full investing universe, considering multiple asset classes (public and private, debt and equity) to make sound investment decisions for our clients. Considering both views previously discussed, how are we thinking about allocating capital in the days, months, years ahead? We recognize that the truth often lies between the

extremes, and it would be unwise to bet solely on unbounded optimism or impending doom. It's valuable to take a step back and examine the range of assets available to global investors for wealth storage. Residential real estate still seems to be the preferred place to "store" capital globally, although mortgage rates have risen considerably from a very low base over the last 3 years. Housing activity has largely been at a standstill because of this shock, prices have stayed relatively firm depending on the location, resulting in an affordability issue that has never been worse in history. The US stock market continues to enjoy passive flows from indexing, retirement plans, and offshore investors seeking growth in dollar terms and a way to hedge their local currency as well. Traditional fixed income has seen continued inflows in 2024, as flows have topped $600 billion year to date. This is in the face of lack-luster returns overall in the bond market even in nominal figures, a large part having to do with better-than-expected GDP growth and higher interest rate expectations as investors now expect less cuts in 2025. Where is all this capital coming from and how can it continue to pour into all these assets at record paces? After 2020, a widely discussed point was that 40% of all existing U.S. dollars were created solely during the COVID government stimulus period from 2020 to 2021. While those dollars weren't physically printed, the phrase holds some truth due to the extraordinary 40% increase in the broad money supply (M2) in a short period of time, which gradually finds its way into assets. This is partly why we have sided more towards the "this time is different" camp with respect to valuations in many asset classes such as equities that appear quite overextended on the surface from a historical lens. It is our view that equities can continue to stay overextended for much longer than many think, barring a negative catalyst that resets overall expectations. Overvaluation can even intensify if inflation becomes a more persistent, entrenched issue, to the point where money begins flowing out of fixed income—a $300 trillion global asset class.

Markets often move quickly—rationally or irrationally—to price in expectations for future earnings growth, inflation, and the liquidity outlook. It is important to note that 30-40 years ago, company-related news or information could take days or sometimes weeks to reach the general investing public. Today, information is almost instantly and readily accessible to nearly everyone with a smart phone or social media, so it's safe to say the investing landscape has changed quite a bit. With this in mind, how does one possibly prepare for a market that is jumping from one extreme to the next? Is it good advice to keep buying every two weeks in a 401(k) or other passive vehicle? While these questions ultimately need to be worked through and addressed on a client-by client basis, we continue to stress that it is incredibly important to set realistic expectations for the markets that align with life goals, especially after two great years of growth in the stock market. No, this does not mean you should—or realistically could—sell at a peak, take a break for six months or one year in cash, and perfectly time your purchase at the bottom. Not even the most experienced traders or in-tune fund managers can do that. It is simply impossible. Jack Bogle (founder of Vanguard) famously said, "If you invest regularly over time, you'll both buy some shares at low prices and some at higher prices. In the end, it evens out, and you'll avoid the temptation to try to time the market." As we navigate this complex and ever-changing market environment with clients, it's critical to remain disciplined, patient, and focused on the fundamentals. By sticking to a thoughtful, long-term strategy and avoiding the temptation to chase extremes, we can weather the unpredictability of today's markets and position ourselves for sustainable growth in the years ahead. We are truly grateful for the relationships we share with you and your families. We wish you a wonderful start to 2025 and look forward to continuing our journey together toward your goals and financial success.

Sincerely,

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