True Partner Capital

2025 Outlook

Near-term optimism on continued U.S. equity outperformance abounds – should investors stay along for the Trump ride and what does it mean for volatility markets?

December 2024

Outlook

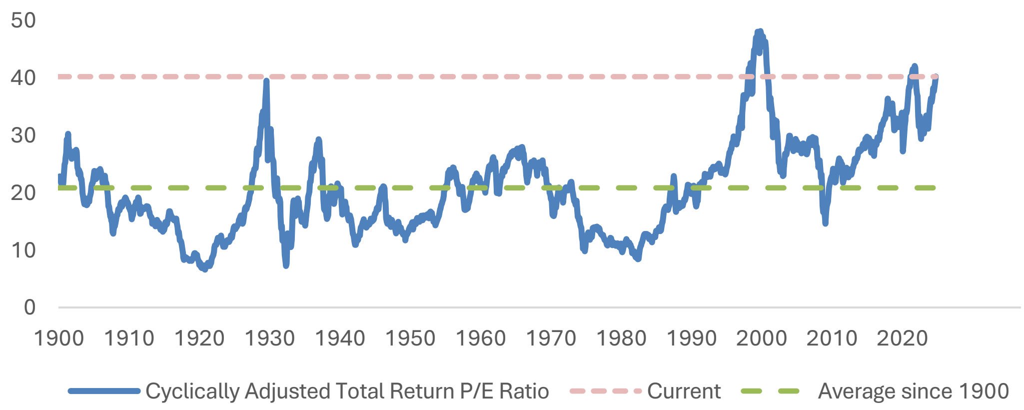
Barring a shock, 2024 will mark the second consecutive year of an over 25% return for the S&P 500. The last time we had two consecutive 25%+ years was 1997 and 1998, in the midst of the dot-com boom. Meanwhile, implied volatilities languish near historical lows in the U.S. and Europe.

Near-term optimism on continued US equity outperformance abounds – should investors stay along for the Trump ride? Is diversification dead? U.S. exceptionalism is a core question for asset allocators. While timing markets is always tough, we think investors should also step back to consider how their portfolios would fare in a correction. First, we'll look at some of the metrics around U.S. exceptionalism to quantify how optimistic investors are. Then we'll turn to potential sources of diversification.

Over the long-run, one of the best valuation indicators is the cyclically adjusted P/E ratio, developed by Robert Shiller in the late 1990s. On that metric (we show the total return version below, which also accounts for buybacks), US equities are close to peak expensiveness, with a 40x cyclically adjusted P/E ratio – the same level as just before the 1929 Wall St Crash, but still a little below the all-time high of 48x hit in 1999. That was of course just before the dot-com bubble burst – the ratio would fall by more than half in the next 3.5 years.

Valuations are unusually high

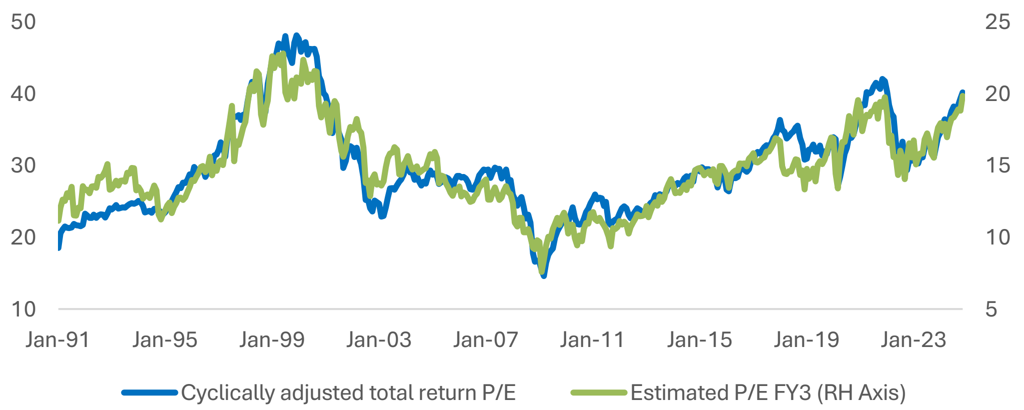
US equities: S&P Composite cyclically adjusted total-return P/E ratio (CAPE TR P/E)[1]



Bullish market participants often counter that the CAPE is a backward-looking measure. But expectations for future growth are also high, and valuations based on forward P/E ratios are also near all-time peaks. Forward looking valuation measures also tend to move in sync with the backward-looking CAPE, as shown below.

Even when factoring in high expectations for earnings growth

US equities: S&P Composite CAPE TR P/E vs S&P 500 Fiscal Year 3 forward P/E[1]



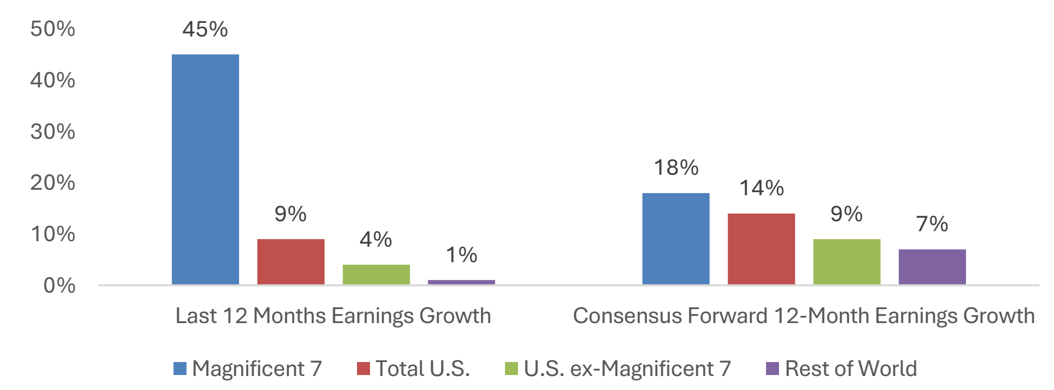
[1] Sources: Robert Shiller / Yale University, Bloomberg, True Partner. Data through November 2024

A significant part of the bullishness on future earnings growth stems from the Magnificent Seven stocks and optimism on AI. These companies are currently engaged in massive capital spending on AI projects. AI seems likely to be a driver of future profitability, but how much profitability? The top stocks are also historical outliers in their importance to index investors: the top 10 stocks in the S&P 500 account for over a third of its market capitalization, well above peak levels seen in the dot com era (just over 25% in the top 10).[2]

It is not just the Magnificent Seven where there is heady optimism. Earnings growth expectations are bullish across the board, as shown in the chart below. For context, earnings have grown at 6.6% in the U.S. and 4.2% outside the U.S. over the last 10 years. Analyst estimates are for future growth excluding the Magnificent 7 to be roughly double those levels.[3]

Even factoring in optimistic earnings growth expectations

Trailing and Expected Earnings Growth



Amidst such high expectations, it is worth recalling the fate of the huge telecom and network related investments of the late 1990s amidst the growth in the internet. While there were many dot-com companies with questionable business models (Pets.com springs to mind), there were also many fast-growing companies with substantial businesses. For years, there was a 'virtuous circle' of inter-related growth as internet demand grew rapidly and companies competed to build infrastructure. Companies such as Lucent Technologies, Qualcomm, Nortel Networks, Cisco and Sun Microsystems saw strong growth for several years. Then valuations and growth expectations got too high, growth disappointed, capex was cut dramatically (US telecoms capex doubled from 1996 to 2000, then fell to below 1996 levels), and companies became trapped in a vicious circle of cost cutting and falling share prices. AI undoubtedly has huge potential and investments could be as profitable as the market is pricing. But there is also a risk that all this capex may engender competition and oversupply that will ultimately result in disappointing profit margins.

The Trump effect

There has been a marked increase in optimism following the U.S. election. Markets appear to be pricing a 'goldilocks Trump' for Wall Street – where U.S. corporates get lower taxes and less regulation, government spending shrinks / becomes more efficient and fiscal deficits stabilize but more disruptive campaign promises on tariffs and immigration are not realized. Trump's nominations have favored loyalists and markets may need to adjust much further if he follows through on his campaign pledges in more disruptive ways. Tariffs and deportations of illegal immigrants would likely be negative for growth and inflationary – pushing up prices for imported goods and raising wages as labor supply shrinks.

With that in mind, the Fed dot plot released on 18th December (just around our cut off point for data for this outlook) and market reaction is interesting. The Fed dots projected inflation to be higher and paired back rate cut expectations, and we even saw one dissent from the decision to cut rates. As we have warned in outlook pieces for some time, inflation keeps surprising in its persistence. Powell warned in the press conference that further progress on inflation is required to make further cuts, while markets had been assuming a more dovish view. A persistence in inflation could push normalization beyond the forecast window. This could further unnerve markets, which were already jittery in the hours following the FOMC, but then started to recover overnight.

[2] Has stock market concentration reached a tipping point, Capital Group, September 2024. https://www.capitalgroup.com/individual-investors/se/en/insights/articles/has-stock-market-concentration-reached-a-tipping-point.html

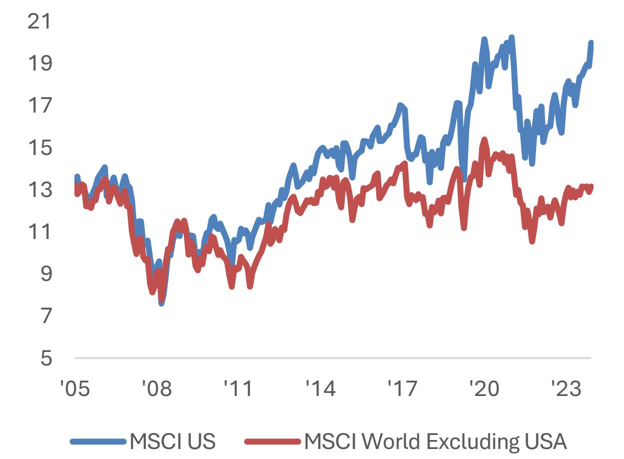
[3] Diluted EPS for MSCI U.S. and MSCI World excluding USA. Inflation doesn't account for the difference – U.S. CPI inflation has averaged 2.9% over the 10 years to November 2024, above the 2.7% breakeven inflation priced in for the next year. Sources: Bloomberg, True Partner

Is the rest of the world in better shape?

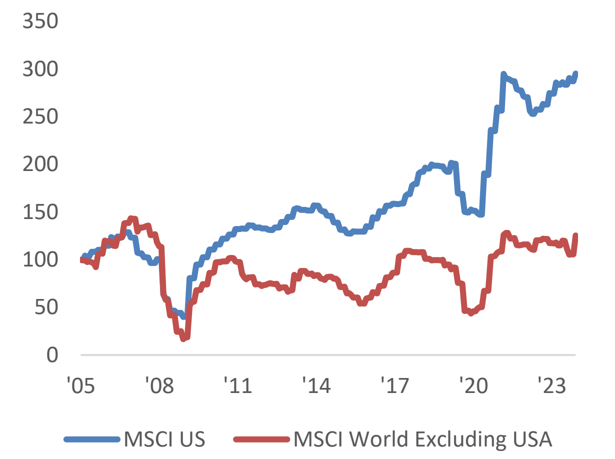
After years of U.S. outperformance, many investors have a high U.S. equity allocation already. Will investors diversify into other equity markets? Should they? It's true that valuations elsewhere are less demanding, and are at an unusually wide discount to the U.S.. However, as we show below non-U.S. earnings have also been relatively stagnant, despite strong monetary stimulus following the financial crisis. Some of the key non-U.S. markets face headwinds from low growth, the threat of tariffs, political instability and fiscal challenges.

Those looking to play a correction in relative valuation also need confidence to buck the return trend, as non-U.S. equities have notably underperformed U.S markets on a total return basis, as shown below. With the U.S. now 67% of the MSCI All-Country World Index (and 74% of the MSCI World Index) relative to 47% back in 2012 (and only 42% back in 2007), the risk of benchmark underperformance is also likely to weigh on many a portfolio manager's mind.[4] While there are commentators making the case for geographic diversification, we see few signs that investors are materially underweighting the U.S.. From a volatility perspective, this also makes the U.S. the place to watch for a correction. If we get a big downward move, history and current relationships suggest that other major markets (notably Europe and Japan, less so China) are likely to see highly correlated downward moves too.

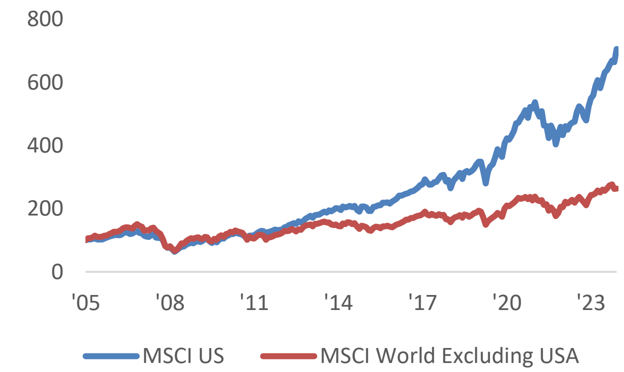
Non-U.S. equities trade at a discount, even adjusting for expected earnings growth (FY3 P/E, consensus)[5]



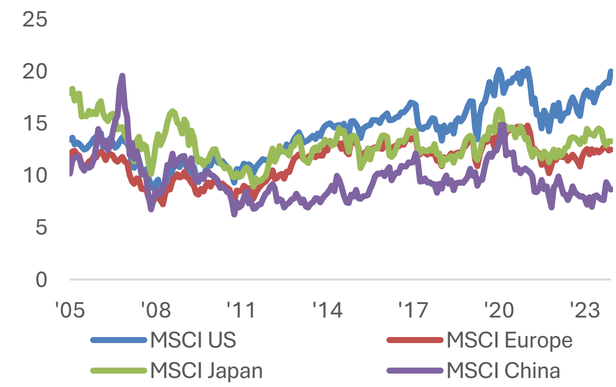
But non-U.S. earnings growth has been disappointing for many years (diluted EPS)



U.S. markets have massively outperformed (total return indices)



Of the major markets, China stands out as unusually cheap (FY3 P/E, consensus estimates)



[4] Source: MSCI

[5] Source for all charts on this page: Bloomberg, data as of end-November 2024

One area we are watching closely is China. China-related equities are the only major market that tend to trade relatively independently of Western markets, and they exert a strong influence on other Asian markets, which are core to our trading opportunity set. Having been unloved for many years, Chinese equities now trade at a substantial discount to other markets. The authorities are engaging in coordinated fiscal and monetary stimulus and earnings yields (over 10% on a forward basis for the HSCEI, just under that for the MSCI China) are *multiples* of government bond yields (less than 2% for 10-year bonds). 10 years ago, S&P 500 earnings yields were also well above 10-year Treasury bond yields – but now the S&P 500 earnings yield is below the 10-year bond yield. While China has many challenges, we think that Chinese equities are one place that could see strong upward movement. Over the last several years, we have been developing and paper trading a strategy internally that takes advantage of volatility opportunities in China-related equities while also capturing this cheapness. Please get in touch if you'd like to hear more about that.

Is valuation the only red flag?

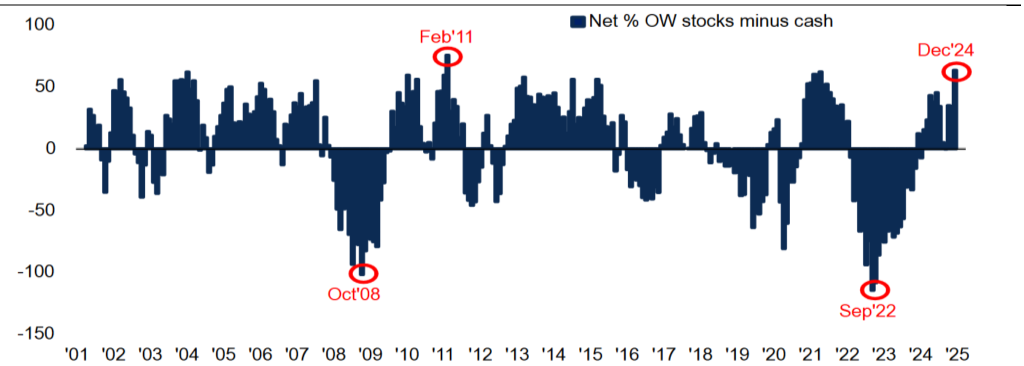
Turning back to U.S. markets, the problem with valuation as a forward indicator is timing. In the long-run, valuation is a powerful indicator; but in the short-run the distribution of returns is very wide. Stocks looked expensive in 1998 and ultimately did drop precipitously – but the S&P 500 was up another 21% in 1999 before the market then began to fall. That caught out some of the world's best investors, famously including Tiger's Julian Robertson and Soros' Stanley Druckenmiller. Druckenmiller lost on shorts and then went long at an unfortunate movement. His comment on how emotions can influence investing is worth repeating:

"I bought $6 billion worth of tech stocks, and in six weeks I had lost $3 billion in that one play. You asked me what I learned. I didn't learn anything. I already knew that I wasn't supposed to do that. I was just an emotional basket case and I couldn't help myself. So maybe I learned not to do it again, but I already knew that."[6]

Are there other warning signs? Positioning has started to flash too. Bank of America has been surveying fund managers for over 20 years. The December 2024 survey shows extreme bullishness in asset allocations, and also saw the biggest month-on-month rise in BofA's related fund manager sentiment survey since June 2020.

Fund manager positioning is unusually bullish on equities

BofA Global Fund Manager Survey – net % overweight equities – net % overweight cash[7]



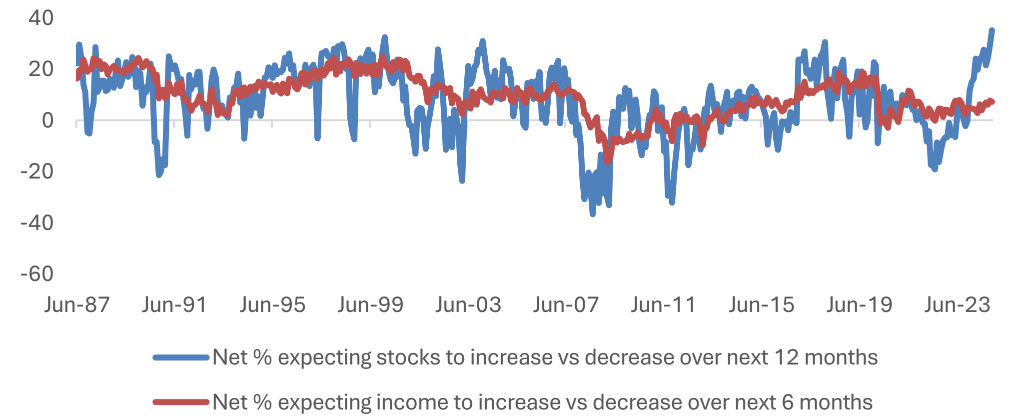
Source: BofA Global Fund Manager Survey

U.S. consumers are also the most bullish on equities they have ever been. Over the last almost 40 years, they have on average been a pessimistic bunch (despite sizable equity allocations) with on average a net balance of 8% for those who expect an increase in equities over the next 12 months vs those who expect a decrease over the next 12 months (since 1987). The net balance is now 35% positive. In an interesting disconnect, while consumers are unusually bullish on equities, they are not particularly optimistic on their own income growth prospects. Prior to 2024, the last time consumers were strongly positive on equities was in February 2020 (21% net balance). Until the new all-time high in December, the previous peak in bullishness in the net balance was in January 2000, near the top of the market.[8]

[6] Source: "Stanley Druckenmiller's big mistake", Michael Batnick, Yahoo Finance, May 2018
[7] Sources: BofA Fund Manager Survey, 17 December 2024, Datastream
[8] Sources: Conference Board surveys, Bloomberg

U.S. consumers have never been this bullish on equities before

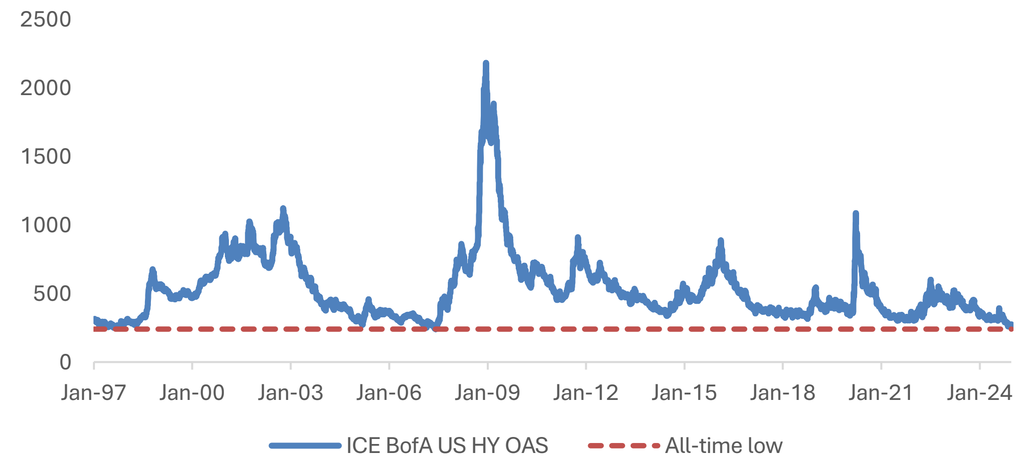
Conference Board Consumer Surveys - % expecting stocks to increase vs decrease[9]



Looking across the capital structure at credit, corporate credit spreads are also close to all-time lows, limiting diversification benefits. Private credit spreads are not so easily tracked, but evidence suggests they are also tight.[10]

Credit spreads are also near all-time lows

US high yield credit spreads to US Treasuries[11]



Outside of traditional markets, Exhibit A is the land of meme coins, where assets with no apparent utility have garnered eye-watering valuations. As an example, Pepe, which has an over $8bn market cap, *"appeals to the cryptocurrency community by instituting a no-tax policy and being up-front about its lack of utility, keeping things pure and simple as a memecoin."* Dogecoin, the best known of the meme coins (and with unlimited supply), has a market cap of around $55bn depending on the day – or roughly equivalent to Bank of New York Mellon.[12]

Broader crypto markets are spilling over into traditional markets via stocks such as MicroStrategy, which is posed to join the Nasdaq 100. Whether or not you like Bitcoin at over $100,000, MicroStrategy is trading at more than a 100% premium to the value of its Bitcoin holdings. It also has several billion dollars of 2x leveraged ETFs tracking it that have over 200% annualized volatility.[13] These ETFs could easily be wiped out in a day or two simply by MicroStrategy falling to trade at NAV, without a decline in Bitcoin. If Bitcoin falls a lot too, hedging dynamics from convertible bond holders (mostly hedge funds) could start to focus on protecting their notional, exacerbating a fall. Hedging dynamics can be complex and change

[9] Sources: Bloomberg; the latest data point is from the Conference Board survey released on 26 November 2024 (latest available)

[10] See e.g. "Private Markets: How Will Private Credit Respond To Declining Yields?", S&P Global, 4 December 2024

[11] Source: Ice Data Indices, LLC, retrieved from FRED, Federal Reserve Bank of St. Louis, as of 17 December 2024

[12] Sources: Coinmarketcap, Bloomberg. Dogecoin market cap has varied from $53bn cap to $62bn between 11-18 December 2024. Bank of New York Mellon's market cap has varied between $55bn to $58bn over the same period.

[13] Sources: Bloomberg. True Partner, as of 16 December 2024

along the way down – please get in touch if you'd like to discuss the details. However, in the absence of a correction, MicroStrategy continues to issue more stock and buy more Bitcoin, helping to drive up prices further.

Leveraged ETFs are also popular for some of the biggest stocks. Let's take NVIDIA, which is roughly 8% of the Nasdaq 100. On a look-through basis, there is over $25bn in single name or highly concentrated leveraged ETFs/ETPs tracking NVIDIA, plus another almost $40bn of exposure via leveraged Nasdaq 100 ETFs/ETPs. In March 2020, NVIDIA had an 18% down day. These ETFs did not exist at that time. An 18% drop in NVIDIA today would wipe out around $570bn of market cap – more than the GDP of Singapore, without considering the leveraged ETFs. ETFs need to trade within a relatively narrow window near the close. Imagine what kind of market day that could be? We've looked at the numbers, and it's not pretty. A repeat of that -18% drop in Nvidia would trigger sales resulting from the daily rebalancing of these ETF's of well over $4bn (over 15% of daily trade volume), all to be transacted during the very last minutes of the trading day.[14] As Nvidia does not trade in isolation from the rest of the market and given the existence of various other leveraged structures on popular names and indices, this could easily morph into an avalanche of forced selling into the close.

The combination of overpricing, leverage and extremely bullish sentiment can be a toxic one. There are also slower moving risks. As highlighted by the Bank for International Settlements and ECB earlier this year, developed market governments' fiscal positions are looking somewhat dire, [15] while the ECB also highlighted vulnerabilities in US dollar liquidity. In a crisis, both issues could quickly rise up investors' priority lists. When investors worry about the safety of safe assets, there is a risk that they panic about risky ones.

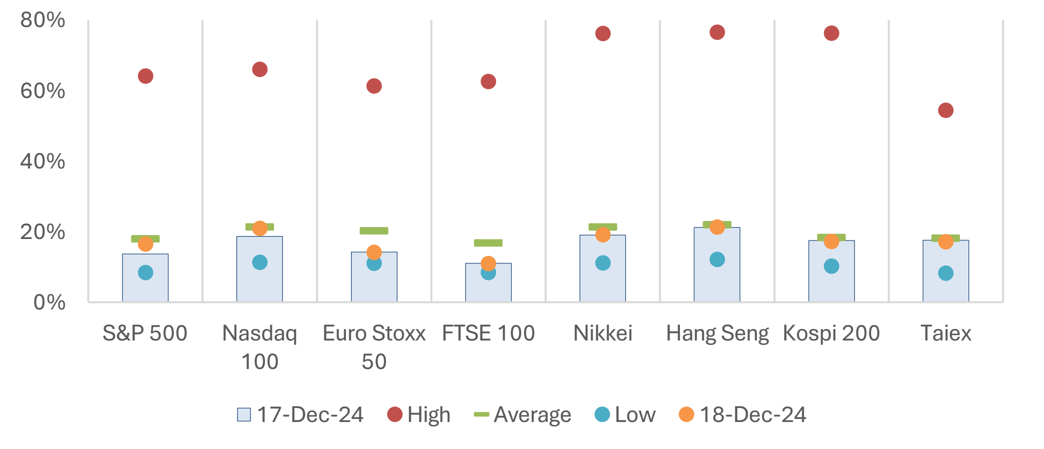
Are markets completely ignoring the risks?

Volatility markets provide a snapshot of investors' perception of risk. If we look at volatility pricing, 3-month at-the-money volatility is near all-time lows in Europe and is below average in the US, despite this period incorporating the first couple of months of announcements from the new U.S. administration (where most expect some action). We show both 17th December and 18th December as there was a brief move higher in US volatility post the FOMC surprise on 18th December – but this had little follow through elsewhere and was already retracing in Asian and European trading hours on the 19th.

Out-of-the-money downside volatility is also at low levels. That makes tail hedging relatively cheap in several markets. Implied volatilities are higher in some Asian markets, reflecting higher recent realized volatility. The premium for downside protection relative to at-the-money volatility is somewhat elevated in the S&P 500 – generally most investors' preferred focus for hedging (and hance a market that tends to have a higher volatility risk premium than some others). This reflects the market pricing in some risk of normalization of volatility higher and markets lower. While the premium for downside mostly reflects a normal premium given the low at-the-money volatility levels, changes in downside premium have also quite closely tracked the rise in P/E ratios. Of note, the premium for protection is lower elsewhere, interestingly including in the high-flying Nasdaq.

Implied volatility is relatively low, particularly in Europe

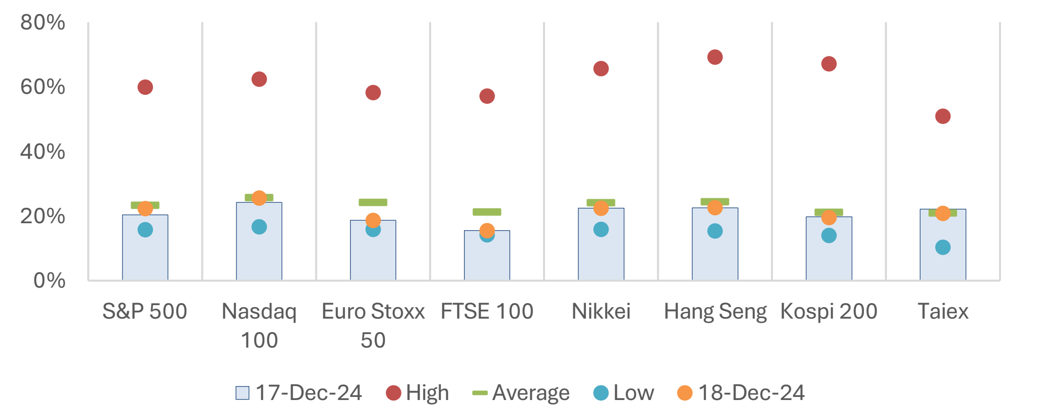
Implied volatility is low in several major markets (3-month, ATM)[16]



[14] Sources: Bloomberg, True Partner. As of 16 December 2024.
[15] Source: BIS Annual Economic Review, June 2024, ECB Financial Stability Review, November 2024
[16] Sources for implied volatility charts: Bloomberg, Goldman Sachs. Data as of 18 December 2024.

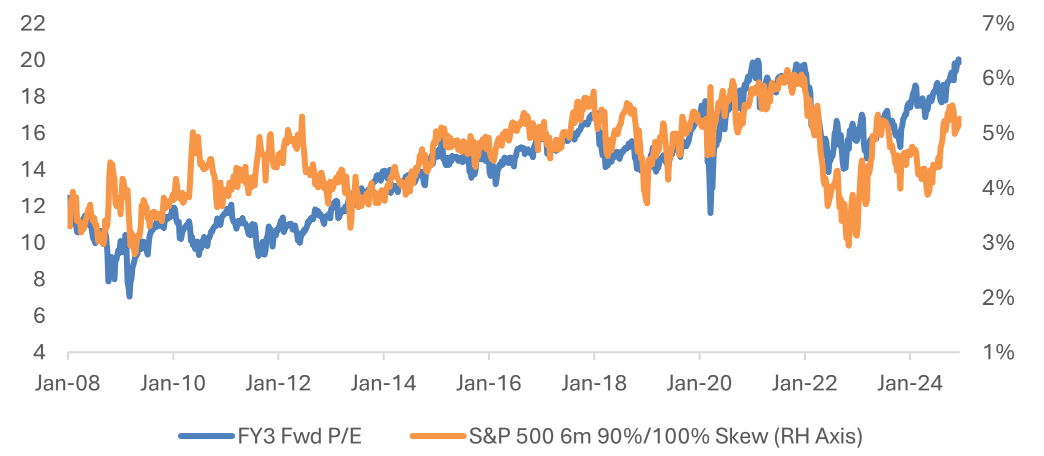
Out-of-the-money downside protection is also relatively cheap in several markets

Longer-term OTM hedging costs (10% OTM, 6-month implied vol)



The premium for downside protection suggests some worries that volatilities could jump higher

The premium for downside protection has risen alongside rising valuations[17]



What can investors do?

Very few can hunker down with no risk assets. But you can think about the rainy day, and plan. What kind of strategies are robust to a change in the proverbial market weather? This is one way we think that volatility strategies can add value. Investors need portfolios that are robust to a change in the market environment. One option is to add tail risk protection, which seeks to provide a strong return in the event of a significant drop in markets. This can offer high certainty of return, enabling investors to take more risk elsewhere in the portfolio. It also has the benefit of using limited capital, enabling investors to stay fully invested in the market. Making tail risk hedging more opportunistic in nature can significantly cheapen implementation options. We would be happy to share our ideas and a case study of a hedging strategy we designed for a U.S. pension fund.

Our relative value volatility strategy, which we have been running for over 13 years in the True Partner Fund, can be another important diversifier. The strategy has delivered attractive absolute returns over time and tends to perform best during shocks when volatility rises and dislocations occur. This has given it a negative correlation to equities over the long-run. The strategy has also often been a 'first responder' to a shock when slower moving strategies such as trend-following take time to change course. In short-lived shocks like February 2018, it has an ability to monetize that can be difficult for tail risk strategies. Of course, being non-directional means that it will tend to underperform a pure tail hedge in a March 2020 type scenario – but that characteristic has also helped the strategy be up +5.5% YTD in 2024 (through 13th December), while having been negatively correlated to equities over the year.

[17] Sources: Bloomberg, Goldman Sachs, True Partner. Weekly data through 13 December 2024.

2025 Outlook

The strategy's cash efficiency means that it can also be run as an overlay on a long-only equity portfolio, providing diversification benefits without sacrificing equity exposure. Please do reach out to us if you'd like to further discuss.

Will 2025 be the year equities retreat from their recent exuberance? In truth, we don't know and very few investors have a truly accurate crystal ball. But investors can use strategies with different characteristics to construct portfolios that are robust to changes in the market weather. We thank all our investors for their support in 2024 and would like to take the opportunity to wish all our readers happy holidays and the very best for the year ahead.

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