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TRANSCRIPT: Q4 2024 Market Update

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Hi everyone. This is Steve Elwell, chief Investment Officer of Level Financial Advisors, and this is your fourth quarter market review. US stocks had a good quarter overall, but mainly really just driven by big tech companies that did well because just about everything else did not do so well to varying degrees. Specifically, if you look at small value stocks or global real estate, emerging markets, international stocks, the bond market, all of which were essentially negative for the quarter, some by a large degree, but big US stocks being such a large part of the overall investment markets in the US stock market specifically carry such a heavy weight. I mean approximately about 39% of the s and p 500 is the total weight of the top 10. So the 10 largest companies of the 500 largest represent almost 40% of the total. So the weightings have become quite large based on how they've grown as those companies go, the s and p 500 tens to go and those companies did well for the quarter, but like I said, just about everything else was either meager returns or negative returns for the quarter.

Specifically, the US stock market was up 2.63%. International developed stocks were down 7.43%. Emerging market stocks were down 8.01% and global real estate down 9.02% for the quarter. A big reversal from how the returns played out in the third quarter partially may be a result of how the election turned out. The bond market also down 3.06% for the quarter, although global bonds were slightly up at 0.74. So what were some of the driving factors of what caused the variation in returns of different asset classes in the fourth quarter? Like I said, the results of the election I think had a major impact, at least temporarily on the returns. We'll see if those returns actually stick, but for the quarter at least, or for November and December at least, like I said, big tech stocks did very well. The US dollar rallied significantly, specifically based on the new upcoming administration's proposed tariff plan resulted in the dollar surging, which meant many other currencies like the Euro declining in terms of international stocks and emerging market stocks.

If the dollar surges and other foreign currencies decline relative to the value of the dollar and you earn profits from Europe, for instance, let's call it France, which of course uses the Euro. Let's say you have a company in France that you earn a hundred euros of profit and previously based on the exchange rate with the US dollar that might've translated to back towards its high, a dollar 30 of US profits. So a hundred dollars, a hundred euros translating to $130 as it was repatriated back to the us, to you as the end investor. If the Euro declines in value relative to the dollar, that a hundred euros of profit may now only be worth 103 US dollars when it's repatriated back to you, the end investor. So that's not the sole determin of how international stocks perform. Of course, how the actual companies themselves do and how the economies overseas perform are all important in terms of how foreign stock markets grow or decline.

But currency swings are also part of the end return that US investors get since everything really needs to be translated back to US dollars. And so this proposal of a tariff impact and what might actually happen and all the moving parts of that, initially, investors have used that. The market has used that as a reason to exit some international stocks in emerging market stocks. But to be fair, international stocks and emerging market stocks were already fairly unloved relative to the US stock market in terms of just about every metric you can look at. And so this kind of seems to be a bit of a continuation of that negative sentiment for international stocks that has taken place over quite a long period of time here, multiple year timeframe. In fact, if we pull up this chart from JP Morgan, this kind of emphasizes just how negative investors are on international stocks.

Now, just to be clear, as I point all this out, there is no guarantee, there is no predictive analysis in the short term that any of these metrics or this information tells us that either this is going to continue or this is going to turn around in the

short run. In the long run, actually, we would view some of this information as a guiding indicator, but no guarantee of when things might change. But as we look at this chart from two of these charts from JP Morgan, the one on the left, international price to earnings discount versus us, so this is taking basically all the stocks outside of the US compared to the s and p 500 and looking at the price to earnings ratio, which is one of the most common measures of a valuation of a group of stocks or an individual stock.

And essentially this is telling us that the 20 year average for the s and p 500 is about 15.9%. So 15.9 times earnings, and that's what the price on average would be for the s and p 500 over the last 20 years. Current price to earnings 21.5, so quite a bit more expensive than what the last 20 year average has been. When you look at the A CWI, so all country world index X us, so all stocks outside of the us, the 20 year average is 13.1 times, and the current PE ratio is 13.3, so right in line with long-term averages, whereas the s and p 500 is quite a bit more expensive than the last 20 year average, that discount relative to the US, the size of that discount. So what this is kind of telling us is over the last 20 years, there has always been a discount, but it hasn't been an earth shattering discount, but compared to today, there actually is a pretty large discount for international stocks relative to US. Valuations are much more attractive.

The price you're paying for a dollar of earnings outside of the US is much less expensive than the price you pay for a dollar of earnings from the s and p 500. In fact, this chart is showing as of December 31st, 2024, essentially a 38% discount, and that's quite a bit more than the average 17.8% discount. So they're kind of over the last 20 years has, like I said, always been this discount, some level of a discount, but as of recently, it's about twice as large, more than twice as large as what it normally is. That's two standard deviations beyond what is considered average. Anybody with any type of expertise in math knows that that's a pretty big move relative to what averages. So is this telling me, am I saying that international stocks are about to have a great run? Not necessarily. Sometimes trends can last longer than you think they can.

In fact, I would guess many people would say this trend has already lasted longer than most people think. I mean, if you, again, look at this chart on the left, you're looking at the last time we were at average was 2017. That's seven years ago. If you were someone who were just simply looking at this and saying, well, if international stocks valuations are below the normal discount to the US below the average discount, you would've started buying international stocks in 20 18, 20 19, 20 20. You would've backed up the truck in 2021 and said, give me every international stock that's out there. But yet the trend has moved even to a deeper discount since then, and this is the biggest discount that there's been the entire time of the last 20 years. So a lot of interesting information there. If we go to the chart on the right price to earnings discount by sector, depending on which sector you're looking at.

So this goes through all the big sectors ranging from healthcare to consumer, discretionary banks, technology, everything. It is really across the board. I mean the discount ranges, but virtually every single category here has a discount relative to what US ends up looking at, with the exception of one, which is healthcare. So healthcare and consumer staples I guess you could call is even, but just about everything else has a major discount. Financials a 40% discount relative to US financials, consumer discretionary, a 50% discount relative to US consumer discretionary. I mean the numbers are pretty large. Again, this is not me saying that international stocks are going to turn a corner tomorrow. They very well might for all I know, but in the short term, you really can't look at information like this and say, okay, well this is the moment to make a change. I think the way to use this type of information is to, number one first, understand that anyone that has a diverse portfolio certainly is going to own some international stocks and relative to US stocks they haven't done as well.

If you look at the last three, five years, and that seems fairly obvious by looking at all this information. I think the other way I would use this information is for a longer timeframe. So let's say the next five to 20 years, I would look at this information and say, I better temper my expectations for what US stocks, specifically big US stocks will earn. And that doesn't really mean that earnings will be bad. It doesn't mean that returns will be bad. It doesn't mean that there'll be

negative. It doesn't mean that there's going to be a crash. It just means that at current valuation levels, the market is expecting some pretty serious performance, some pretty serious growth in terms of earnings from the biggest companies in the us and maybe that happens and the prices are all justified and maybe it doesn't. Maybe they grow but just not as fast as expected and their stocks cool off and that, again, that doesn't even mean they go down.

It just means maybe they don't go up very much. Vanguard themselves have a 10 year forecast that they have come out with. Now, to be fair, they've had this similar forecast for the last couple of years projecting that over the next 10 years, they expect big US growth stocks to have mediocre returns and to have international stocks and value stocks lead the way and have the best returns. And that's no guarantee, but they also manage $6 trillion and have a pretty serious economic forecasting model. So it's some pretty interesting insight as to where do things currently stand and what might we want to think about for the future. So I guess in a roundabout way, I would look at this information and I would say, don't give up on your international stocks, even though it starts to seem like a whole lot of other investors are actually doing that.

And if I can go back to actually a famous saying, not that this is, I'm going to just kind of paraphrase, but a famous saying from Warren Buffet is really the time to buy something is when no one else wants it. I mean, that's when you're going to get the best deal, right? If you went to your local baker at the end of the day and they had a ton of stale bread, I bet you can get a pretty good deal because what are they going to do? They're going to get rid of it. Nobody wants it anymore. And that's a really simple, silly example. But boy, it kind of seems like international stocks are getting to that point where you just don't really hear anybody talking with any level of huge excitement about the prospects for international stocks. And there could be a lot of really good reasons for that.

But that also doesn't guarantee that things can't change in the future. There could be innovations that happen in European economies or Asian economies developed Asian economies, emerging market economies. There can be developments in the infrastructure and regulatory nature of different countries outside of the us. There can be changes in the geopolitics that we all have seen a front row seat to over the last couple of years in a positive way. I mean, obviously some have happened in a very negative way, but we could also see changes in a positive way. So there's a lot of different things that could happen and what will ultimately drive investment returns in those stocks will not be things that everybody is already aware of that's already priced in. That's what a functioning stock market does. Every second of every day that the markets are open is price in information that's already known as soon as it becomes available.

So what will result in changes in prices will be information that is new that is not currently known, whether that's a surprise or just simply even the quarterly earnings results that are released every three months, which again could result in a surprise, right? X, Y, Z company earns more than what we thought. So there could be a lot of different reasons why things change, or even just simply, like I said back in the beginning, currency changes. It doesn't mean that foreign companies have to earn a ton more money if the Euro goes through the roof or the pound goes through the roof or the yen goes through the roof for whatever geopolitical reason, all of a sudden the money that we earn from stocks in those countries when those profits are translated back to US, dollars are worth more than what they used to. That's part of the benefit of investing in international stocks is currency changes, which historically are nearly impossible to try and predict and tend to ebb and flow all the time, all the time.

So some interesting information there on international stocks and what's been happening. I mentioned a little bit before as to tariffs and that being part of the reason for the US dollar soaring since the election. In general, if you're someone who's about to take a vacation overseas, that's good news, but that can be bad news if you're someone who is making a product in the US and all of a sudden somebody who's making a product somewhere else that may become cheaper to buy for us consumers because the dollar is stronger and it's going to go a lot farther when they go to spend that money outside of the us. But if we look at this separate chart from JP Morgan, this dotted line all the way to the right is the proposed tariff rate, average tariff rate on US goods that are for consumption. And this shows us the average tariff rate

for each year going all the way back to 1930, and the tariffs that are proposed under the upcoming administration, which are not set in stone, we will see what happens on that front.

The tariffs that are proposed are obviously quite a bit larger, in fact about 10 times larger than where they currently stand. And so we're going to find out if that, number one, if that ends up getting implemented. Number two, how it gets implemented to what products, to what type of things, to which countries, at what rate, how fast, how long will it last, and are these being used as a negotiating tactic in return for something else? Are they being used to try and replace revenue that's lost when tax cuts might be extended? We don't know. That's what we're going to find out. But what will be interesting is if tariffs are imposed at this rate, what impact that ultimately has on consumer inflation in the US because there is very clear evidence that if tariffs are applied in a major way for everyday products that the US consumer buys, that the importer will pass those costs along to the consumer and we'll pay more for things that we're already buying.

So we'll see. Time will tell how they get implemented, what impact they have, what impact they have on the US dollar, the US economy, foreign economies, negotiating tactics. Certainly a lot of moving parts when it comes to how tariffs may be implemented and how they may affect everything in terms of your investments. Beyond that, I would say there are a few other things that we'll be watching closely in 2025 obviously we already mentioned, and something that everybody already knows. There's a new administration along with new Congress taking shape that will have a major impact on taxes. I don't think there's any doubt about that as an enormous talking point during the campaign season. So we're going to find out probably pretty quickly here in 2025 whether the tax cuts from 2017 will be extended or even further reduced for some people if those that have been listening to this commentary for a while.

We've touched on multiple times that the current tax cuts are scheduled to revert back to the old higher rates starting in 2026, literally January 1st, 2026, unless Congress passes a bill to extend them and the president signs them. So I would expect that the Republicans would make that pretty close to priority number one or number two, since the timeline is relatively short to make all those negotiations and determine what a plan is and then ultimately pass it. And of course the margin of error in the house is razor thin, they really cannot afford to lose very many votes to be able to get that extension passed. There was also a lot of talk about making social security tax free. Currently, up to 85% of your social security might count as taxable income depending on the amount of other income that you have. It's a very formula that cannot be done on the back of an envelope.

In fact, most people have really no idea how that calculation is even done. But ultimately you could pay zero. You could have zero. None of your social security count is taxable income if you had no other income, if you have a lot of other income, then the full 85% of it would count as taxable income. It's never a hundred percent, or at least not under current law. It's not because they have actuarily determined that 15% of the money you get from social security is a return of your own contributions. So we'll see whether they make changes on that. That would be a major change affecting tens of millions of people. It'll be a very costly change as well. So I'm not quite sure how they intend to pay for that. That's what we'll find out. There's also a high likelihood that within that same tax cut package or extension package, that they will tackle the federal estate tax exemption and extending that as well currently stands at 13.99 million per person is the amount that you can have as an estate when you pass away and not owe any federal estate tax.

If they do nothing, that will essentially be cut in half once it expires, starting in January, 2026. So I have to assume they're going to include some type of extension for that or some type of change that isn't quite as dramatic as what will happen if they do nothing. There's been a lot of talk about expanding the child tax credit. Currently $2,000 per qualifying child, as long as your income is below the limits, there's extension. Talk about making that tax credit larger. That's one that actually tends to have a pretty serious impact on the economy because anyone with young children is probably well aware that there are a lot of costs associated with having kids. And so if you give somebody with young kids a couple

thousand dollars, they're going to be able to spend that pretty quickly. Sure, they have a lot of expenses that they're going to be able to use that on.

And then actually another thing that here in New York and anyone else in California or New Jersey or Massachusetts is very interested in is several Congress members of the Republican Party from big blue states like California and New York are pushing very hard for either eliminating the state and local tax limits, which are currently stand at $10,000 to itemize $10,000 limit per person. And that's the same number per couple, which obviously seems like a bit of a marriage penalty if you have two people and they only get a $10,000 exemption, and one individual also just gets a $10,000 exemption usually within the tax code. If you're a married couple, you generally get double whatever the single number is. So we'll see, do they change that from 10,000 to 20 for married couples and that kind of equalizes it? Do they eliminate it altogether? Do they change it to some other limit?

We don't know. We don't know. But there is a lot of talk and certainly a lot of negotiations to be done in the future regarding that particular area of the tax code. And so it'll be very interesting to see how all of this plays out in 2025 and then ultimately how that ends up impacting the investment markets. Because if people have more money in their pocket, then one would assume there's a pretty good chance that in aggregate they spend more money. But we will find out what ends up happening with all of these interesting tax and financial planning related items. So with that, that's this fourth quarter market review. I'm Steve Veel, chief Investment Officer of Level Financial Advisors, and until next quarter, we'll talk to you soon.