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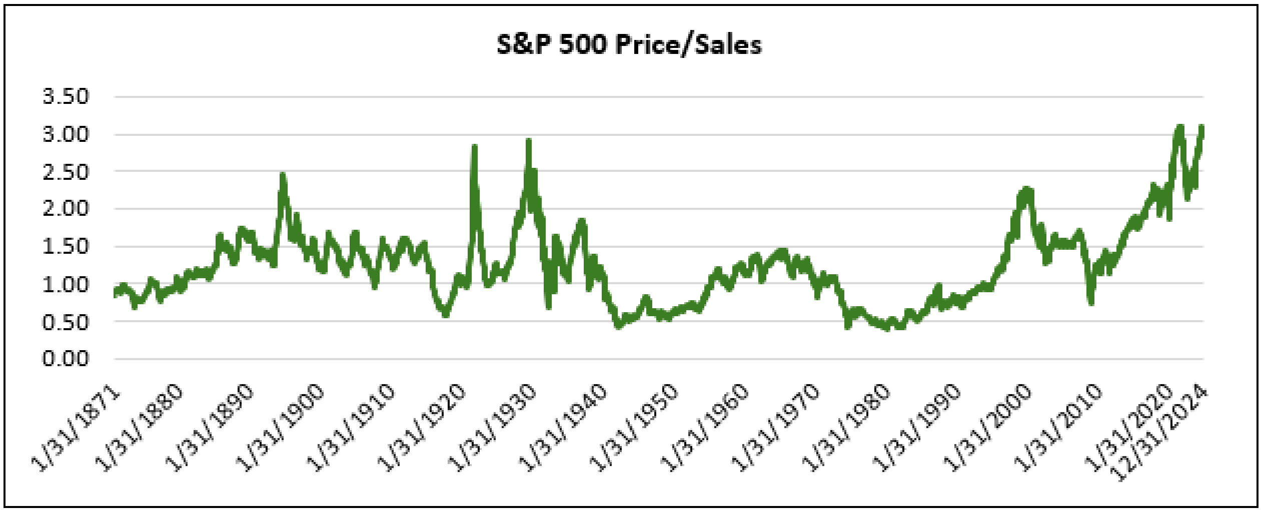
INVESTOR INSIGHTS – FOURTH QUARTER 2024

A New President with a New Approach and an Overvalued Stock Market

This is where we are today. On January 20, 2025, President-Elect Trump will be inaugurated, and we all wonder what that will bring. Those who voted for him are excited, and those who voted for Vice President Harris are worried. What, then, will President Trump's second term mean for us–as investors–given the high valuation of domestic large-cap stocks?

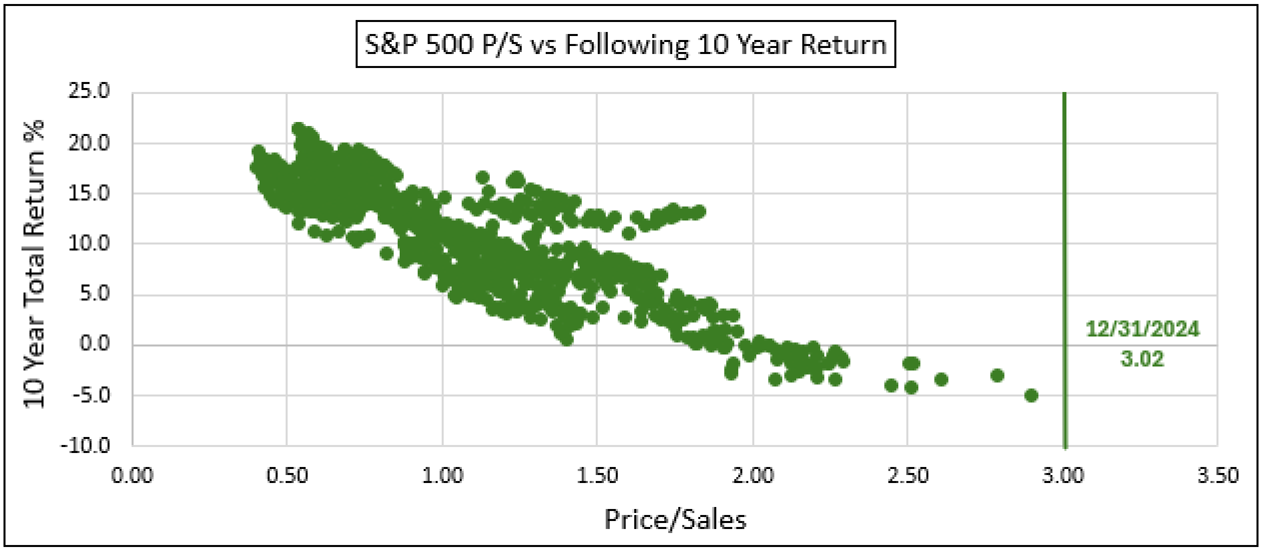
Let's start with what we know. The domestic stock market is priced for perfection. In fact, using price-to-sales ratio as a metric, the domestic stock market has never been priced as high as it is today.

CHART 1



Source: 3EDGE Asset Management

CHART 2



Source: 3EDGE Asset Management, Morningstar Direct

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The first chart goes back to 1871, and as you can see, the price to sales ratio of the domestic stock market has never been higher. Chart 2 is another way to view the same data. This chart goes back to 1926 and uses a slightly different method of configuring the data, but the conclusion is the same. Stock prices are as high as they have ever been.

What happens when you start with stocks trading at extremely high valuations? Well, the obvious answer is one of two things happen: either the market falls on the weight of the valuation, or the economic news that got us to overvaluation pushes the market even higher. History suggests either scenario is plausible, but at these stratospheric levels history also tells us caution is warranted.

For instance, investors were worried about high valuations of the domestic stock market at the start of 1998, but the rise persisted. The S&P 500 was up 28.57% in 1998 and 21.03% in 1999. The total return over the two-year period was 55.61%. Those who were concerned about high stock prices at the start of 1998, as it turned out, had nothing to worry about!

However, the period from 2000 to 2002 told a different story. The stock market fell for three consecutive years: down 9.10% in 2000, down 11.88% in 2001 and down 22.10% in 2002. By the end of 2002, $100 invested in the S&P 500 at the beginning of 2000 would have been worth just $62.39.

While we did not manage dividend portfolios during the 1998-1999 period, we did manage them during the 2000-2002 period, achieving a positive return of 15.74%. During the same period, the index fell by 37.61%.

So, while index investors felt great at the start of 2000, they were not thrilled by the end of 2002. Over the five years ending in 2002, the index was down 3%, while our dividend strategies would have been up, likely over 35%. While a 35% return over five years may not seem exceptional, it was certainly preferable to being in the red.

What Do We Expect This Time?

The obvious question is: what do we expect this time? That's anyone's guess, and we want to emphasize the guess part. At the end of 2025, you will find articles highlighting analysts who "predicted exactly what happened during the year." This happens every year, but luck plays a significant role in such successes. It is very difficult to predict what will happen to investments in a short period of time.

Predicting outcomes over longer periods, however, tends to yield more reliable results, and for good reason. Valuations play a large part in long-term returns but play almost no role in short-term returns. The history of the stock market is that when stocks are expensive, as they are today, they can often get even more expensive. The same is true when stocks are undervalued; they often get even more undervalued before they move to the upside.

We have two sources of projected future returns. The first is a projection made in chart 2. You will see that the projected 10-year return from the S&P 500 is -5% annualized. What this means is that $100 invested at the beginning of a 10 year period where the return is -5% would be worth $61. Another source we have for data on longer-term returns comes to us from Research Affiliates, a California-based research and investment management firm. They provide 10- year forecasts for 25 global asset classes.

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Today, they predict the expected return from domestic large cap stocks will be 3% per year over the next 10 years. While that would produce more than twice the ending value of -5%, neither projection would solve the investment return needs of any of your clients.

Now it is worth pointing out that both firms that make these predictions are expecting a margin of error, they do not expect returns to be precisely 3% or -5%. What they do expect is the relationship between and among related asset classes will be close to their predictions. Today they predict international equities will achieve an annualized return over the next 10 years of 9.3% while domestic small cap will achieve an annualized return of 6.8%. So, while there is a margin of error for both, these firms do expect international will outperform both domestic asset classes and they also believe domestic small cap will perform better than domestic large. Based on the current valuations of these three asset classes, we agree with their predictions.

We use this data to understand the likely relationships between and among asset classes. We think this part of their analysis will likely be right. We also think we have the best domestic strategy for weathering the next three, five and ten years when we expect the large cap domestic indices will not solve the investment return needs of almost all clients will be a growing dividend strategy. We lived through a period like the one we expect, it was the decade of the 2000s. The S&P 500 Index compounded at -0.95% per year over this decade. $100 invested in the S&P 500 Index on January 1, 2000 was worth $90 on December 31, 2009. Actually, the investor experience was far worse than turning $100 into $90 over a decade. As we mentioned earlier, $100 invested in the S&P 500 Index at the beginning of 2000 was worth $62 at the end of 2002. The market went back up for several years, but the S&P 500 fell 37% in 2008. $100 invested in the S&P 500 at the beginning of 2000 was worth $72 at the end of 2008. So, in nine years your portfolio declined 29%. 2009 saved the decade by being up 26.4%.

In contrast, our dividend portfolio compounded at 7.74% during the 2000s, and while that sounds like spectacular performance, cash flow contributed significantly to the total return. The dividend yield of our domestic large cap portfolio at the start of 2000 was 4.4%. If you grew the dividends during the decade at 8%, your cash flow return would be 6.87%. Our total return during the decade was 7.74%. Cash flow is a great thing!

Will this decade mirror the 2000s? Obviously, no one can say for sure. However, we can analyze expected cash flow over the next ten years to make informed decisions.

Will other large-cap strategies perform well? Another unanswerable question, but in reviewing the 2000s, there were no high-volatility strategies that performed well. We think it is highly unlikely there will be any great strategies during this next decade other than our growing dividends strategy.

Can We Add Bonds to Portfolios?

As you know, we have not recommended bonds be part of client portfolios for six years. While this has served us well, we would love to be able to use bonds again. Recently rates have risen and appear more attractive. The difficulty we see today can be viewed best by looking at the yield on the 10 Year US Treasury which today yields 4.58%. If bond rates rise, investors will see their assets decline in value. Now it is also true that if rates decline from here, bond investors will see appreciation in their portfolios. We

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believe the trade simply does not provide enough margin of error. Holding a 10-Year US Treasury to maturity today will provide an annualized total return to investors over the next decade of 4.58% before fees. We hold ourselves responsible for helping investors achieve returns significantly higher than 4.58%.

In addition, many analysts would say that they can get better returns than the 10-Year U.S. Treasury will provide. History is not kind to this projection. While it is true that in every 10-year period there are fixed income strategies that outperform the 10 Year, there is no predictability as to which ones. In fact, we have interviewed literally hundreds of fixed income managers over the years, and we constantly hear that they believe the 10-Year is a very difficult index to beat.

What about 3EDGE?

Our 3EDGE portfolios have weathered the storms of the last five years very well. Currently, they are as conservatively and defensively positioned as ever. Now it is worth saying that 3EDGE can change their allocation to increase risk, as they did a few months ago, and we would be supportive of that change if and when they do so. But with domestic stocks as highly priced as they are, we believe we are likely to see more conservative allocations in the near future. Volatility, both positive and negative, will be the story of the next decade. 3EDGE has historically and will continue to maneuver these types of markets successfully, and we think they will shine in the next decade as well.

What About Bitcoin?

We first recommended Bitcoin when the price was around $10,000 about 5 years ago. It went to $70,000, then to $20,000 and it has been over $100,000 recently. By anyone’s standard that is the definition of a Highly Volatile Asset. So, the first thing we would say is that Bitcoin is not for the faint of heart. We have never suggested anyone sell their position, and we would not recommend that now. Adding to those positions or establishing new positions looks potentially problematic. While we are the cycle year when Bitcoin typically rises, there is no guarantee that it will happen this year. For those who want to add a small position of Bitcoin, what happens this year should not be a consideration. The minimum period anyone buying Bitcoin should expect to hold is 5 years, and there should be no expectation that a 5-year hold will guarantee a profitable position. With that as background, we do think long-term Bitcoin will be remarkably profitable.

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