Fourth Quarter 2024 Key Takeaways:

In 2024, the U.S. economy and the stock market proved much stronger than many had anticipated.

Concerns remain around geopolitical tensions, elevated stock valuations, inflation, interest rates, political leadership change, and slowing global growth.

Domestic stocks delivered strong relative returns but there was disparity within US stocks as large growth stocks continued to outperform small and slower growth stocks.

International stock results for the quarter were great in local currency but only OK in dollar terms as a 7% rally in the dollar during the quarter weighed on U.S. investor returns.

Chinese government stimulus efforts led to a jump in Chinese stocks by sparking investor enthusiasm that the slumping real estate market may have a lifeline, which also led to an improvement in consumer confidence.

Bond market returns were mixed as inflation fears have led to an unanticipated rise in interest rates.

Inflation is once again on the minds on the Federal Reserve committee as the U.S. labor market job's report renewed concerns that an overheating economy could resuscitate inflation.

Broadwing's portfolio remain fully invested but with a defensive bias toward slower growth stocks as growth stock valuations for large technology companies have gotten extended well beyond historic norms.

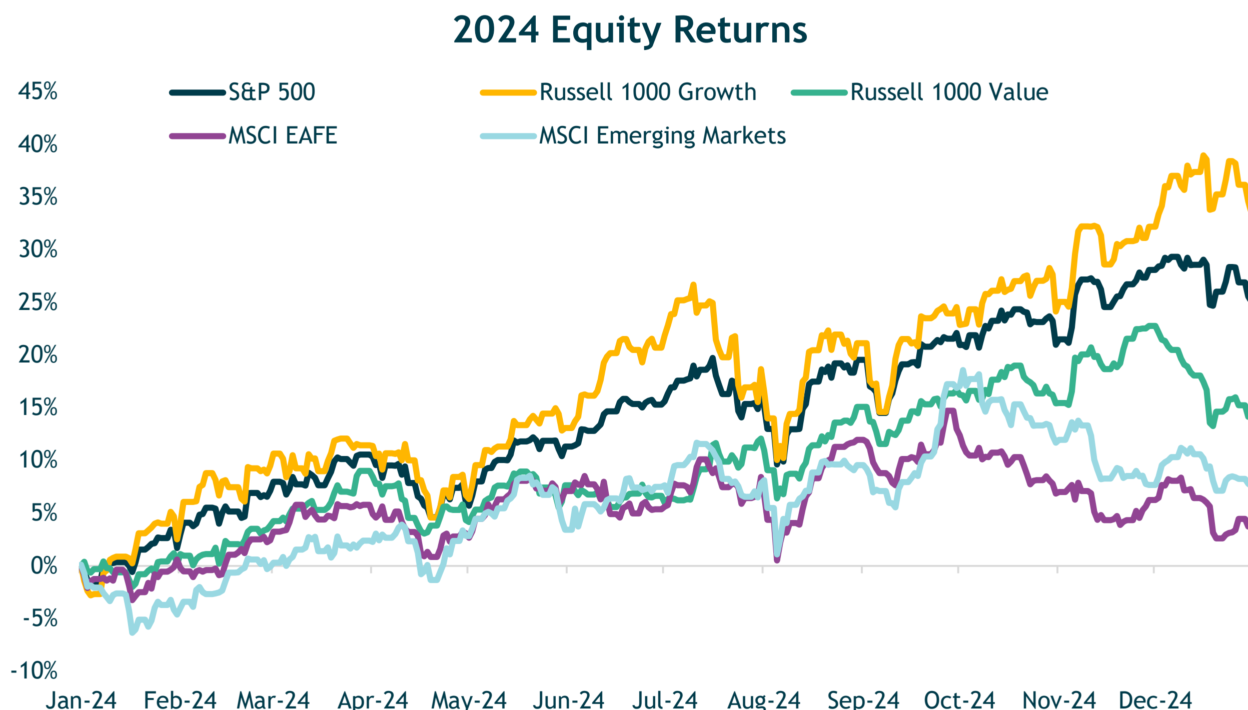
Broadwing's portfolios retain their defensive bias toward international stocks, which are attractively valued relative to the U.S. market.

Broadwing portfolios retain a bias toward shorter-term bond maturities and higher credit-quality issuers to protect against the risk that rising interest rates poses to long maturities bonds.

Market Recap

The U.S. economy and the stock market proved much stronger than many had anticipated in 2024. But there are always reasons to worry. In 2024, some of the largest concerns included geopolitical tensions, elevated valuations, stubborn inflation, interest-rate uncertainty, slowing growth in major foreign economies, and of course, the U.S. presidential election. Undoubtedly, investors will have plenty to watch for in 2025. Front and center will be the Trump administration's policies, which will likely have ripple effects both here in the U.S. and abroad.

For the year, domestic stocks delivered strong returns with meaningful disparity across the market. Large-cap stocks (S&P 500 Index) posted a gain of 25%, widely outperforming small-cap stocks (Russell 2000 Index), which rose 11.5%. Growth-oriented stocks (Russell 1000 Growth Index) led by technology names, particularly NVIDIA, were the biggest winners, posting a 33.4% gain. Value-oriented stocks (Russell 1000 Value Index and the sort of company we own in the Dividend Payers portfolios) were up 14.4% in comparison. The equal-weighted S&P 500 Index, where each of the 500 component companies in the index account for the same percentage of the index, returned 13%, owing to a failure to capture the outsized gains made by the largest and fastest-growing firms in the market cap-weighted version of the index.



Source: Morningstar Direct. Data as of 12/31/2024.

Overseas, 2024 returns were not nearly as strong. Developed international stocks (MSCI EAFE) posted a modest 3.8% gain in dollar terms - 11.3% if you ignore the impact of currency changes. Calendar-year returns for most foreign markets were dragged down by fourth-quarter losses following the Trump presidential victory, which sparked a 7% rally in dollar due to fears that tariffs will cause a widespread economic slowdown. Emerging markets stocks (MSCI EM Index) had a

volatile year, finishing the year up 7.5% -- 13% if you ignore the impact of currency changes. Much of that volatility can be attributed to China. The Chinese stock market (MSCI China Index) had a strong year (up 19.4%) but it was tumultuous, marked by significant swings in investor sentiment. Early-year optimism over government stimulus efforts and reopening momentum faded as economic growth fell short of expectations. Then later in the year, the Chinese government jolted the stock market sharply higher with a stimulus package aimed at supporting real estate prices and weakening consumer confidence. Early in the fourth quarter, Chinese stocks were up over 60% off their January lows but ultimately, high debt levels, underwhelming fiscal support, ongoing property market troubles, weak consumption, and international trade pressures weighed on the market.

Within the bond markets, calendar-year returns were mixed across fixed-income segments. The benchmark 10-year Treasury yield experienced significant volatility throughout the year amid concerns around inflation, interest rates, the budget deficit, and the impact of potential tariffs under Trump. After starting the year with a yield of 3.88%, the 10-year Treasury finished the year higher at 4.58%. Against this backdrop, the interest-rate sensitive Bloomberg U.S. Aggregate Bond Index was slightly positive at 1.3%. Conversely, short-term and high-quality intermediate credit sectors of the bond market -- both areas we emphasized in portfolios -- performed well during the year, particularly our allocation to floating rate bonds.

Investment Outlook and Portfolio Positioning

Looking ahead to 2025, my base-case is that the U.S economy will continue to grow, albeit slower, with a low probability of recession. This should be a supportive backdrop for both bonds and stocks, although I expect the pace of growth to slow. I continue to think it's likely that the market will broaden out beyond large-cap growth stocks to include small and mid-caps and non-tech sectors of the market. At the same time, I anticipate bouts of volatility caused by central bank policies, slowing global growth, geopolitical tensions, and elevated stock market valuations.

As of year-end, Broadwing's portfolios have a full strategic weighting to stocks, and remain diversified across geographies, including the U.S., developed international, and emerging markets. Within global equity allocations, the ratio of U.S. stock to international stock exposure ranges from 80%/20% in conservative portfolios to 67%/33% in moderate and growth-oriented portfolios.

Drilling down, within our U.S. stock allocation, the ratios of slower-growth to faster-growth stocks range from 50%/50% for conservative portfolios, to 40%/60% for moderate portfolios, to 33%/67% for aggressive growth portfolios.

Our allocation's overall relative bias toward slower-growth and international stocks has restrained returns, as U.S. faster-growth stocks have outperformed U.S. slower-growth stocks, and U.S. stocks have outperformed international stocks (which here includes emerging markets stocks), and by a not-small margin. But history tells us that hot trends eventually come to an end, and I want our portfolios positioned to cushion against the impact of this eventuality.

Within fixed-income, our portfolios continue to be significantly overweight short and intermediate high-quality bonds relative to a traditional bond benchmark. The PIMCO Income fund (PIMIX, PIPNX), our central vehicle for bond exposure, currently invests largely in government bonds (both U.S. and foreign) and mortgage-backed bonds with high credit ratings, bond sectors not typically offering high returns. Where PIMCO augments portfolio returns is on the periphery. For example, the fund current holds nearly 30% of its portfolio in AA-rated and AAA-rated non-agency residential mortgage-backed bonds (a mouthful, I know). While these mortgages are not guaranteed by any government or non-government agency, and thereby carry more risk than guaranteed mortgages, the underlying borrowers have good credit and are statistically less likely to default on their loans, thus the AA and AAA credit ratings. PIMCO is rewarded for this additional risk by a higher yield than the yields available on agency-guaranteed mortgages.

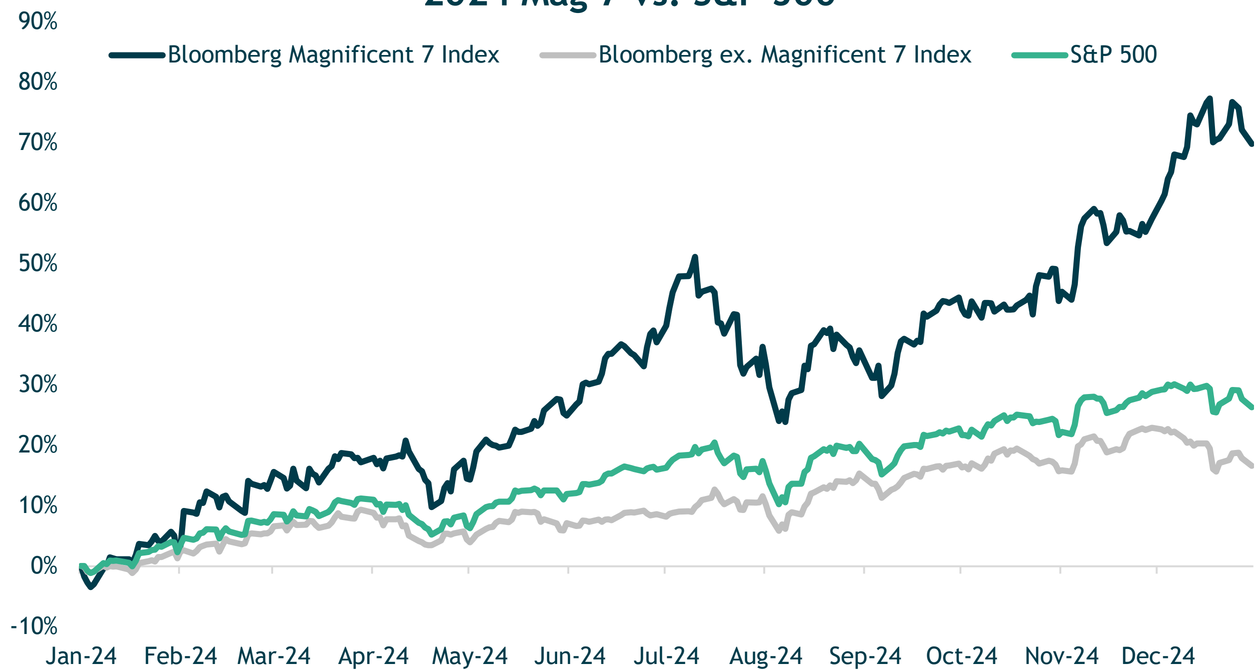
Broadwing's portfolios supplement the broad government and mortgage-backed bond exposure provided by the PIMCO Income fund with exposure to high-quality intermediate corporate bonds through the iShares 2029 term Corporate ETF (IBDU) and ultra-short term floating rate AAA collateralized loan obligations ("CLO") through the Janus Henderson AAA CLO ETF (JAAA).

Importantly, our portfolios' fixed income exposure is not "stretching" for yield, i.e., taking on excess risk (in the forms of long maturities or poor credit) to achieve attractive income payouts. While this approach may limit upside returns, it also limits downside returns.

U.S. Stocks

The S&P 500 marched higher throughout 2024 ending the year up 25%. The index notched 57 all-time highs in 2024, the sixth most since 1928. The S&P 500 also recorded consecutive annual gains of over 20% for the first time since the late 1990's, and for only the fifth time on record.

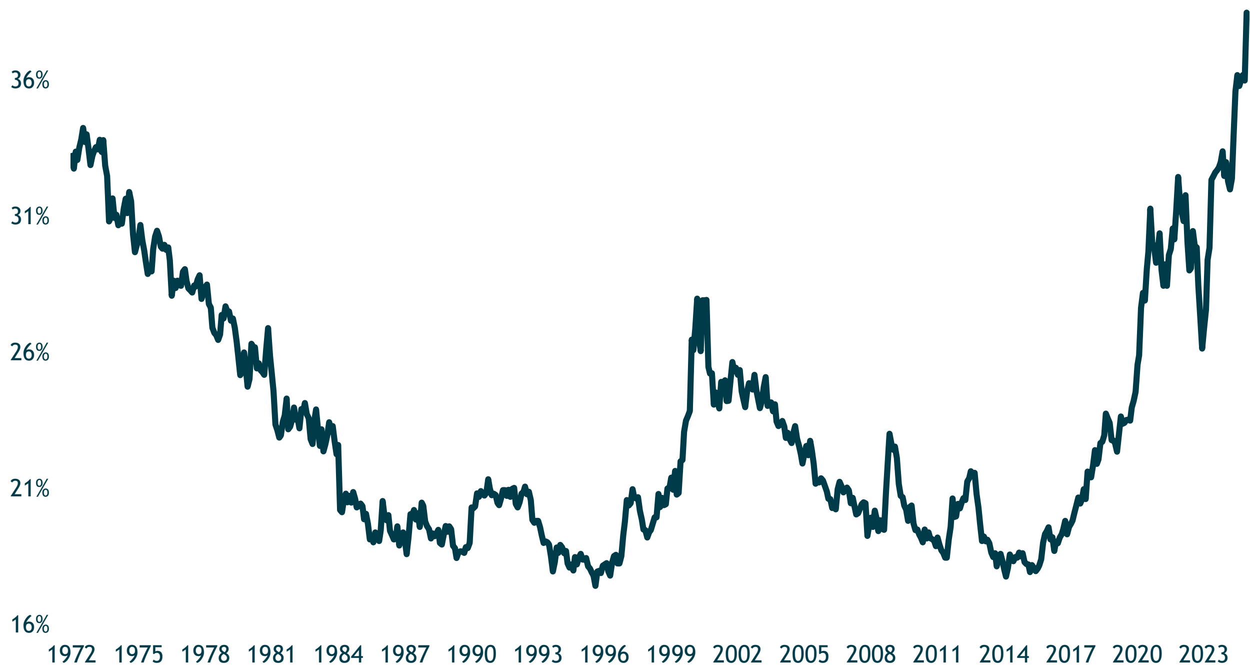
Once again, the performance of large-cap growth/technology stocks led the way. The often-quoted Magnificent 7 stocks, generated returns of nearly 70%, while the remaining 493 stocks clocked in with a 16% return (a respectable figure to be sure, but well behind the Mag-7). Standout performers included semiconductor companies such as NVIDIA (+170%) and Broadcom (+113%).



Source: Bloomberg LP. Data as of 12/31/2024.

The strong performance of large-cap growth stocks in recent years has resulted in one of the most concentrated stock markets on record. There are now eight companies in the S&P 500 valued at greater than a trillion dollars, and the weight of the top 10 stocks in the S&P 500 index has reached an all-time high of 39% (see chart below). Pardon the military metaphor, but while this narrow market leadership could persist for some time, the generals cannot lead the market higher into perpetuity. The infantry must join the battle for a healthy bull market to continue. Otherwise, the failure of a few companies to meet extremely optimistic expectations will drag down market cap-weighted indexes (like the S&P 500).

S&P 500: Top 10 Stocks as a % of Market Cap

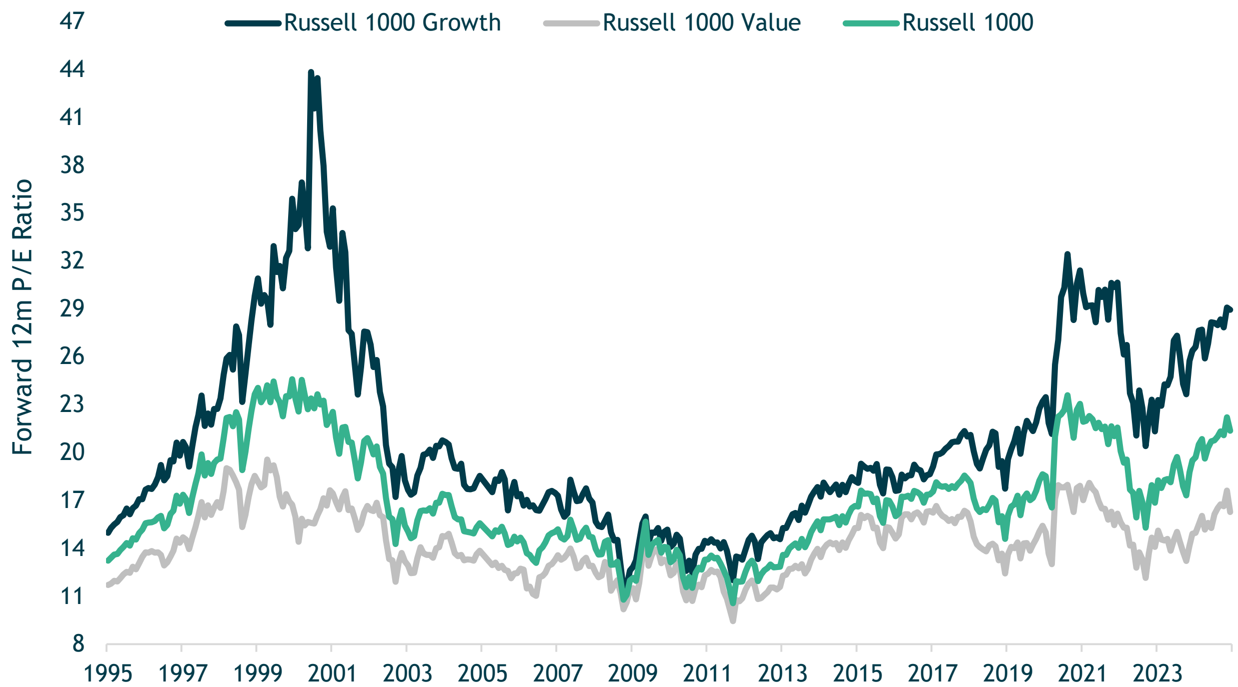


Source: Ned Davis Research. Data as of 12/31/2024.

Looking ahead to 2025, I think the economic backdrop is still favorable for stocks and I believe the market rally can broaden outside of large-cap tech. The U.S. economy continues to grow (albeit more slowly), inflation is back to normal-ish levels, profit growth is expected to broaden, there are growth-oriented themes (AI) that could continue to drive investment and productivity, while Trump's business-friendly policies could further support growth.

While my economic outlook is generally positive, there are plenty of risks. For starters, equity valuations are historically expensive and reflect a significant amount of investor optimism. Current valuation levels — particularly for larger-cap growth stocks — suggest that there is less room for upside, and there is more downside risk if expectations are not met. As mentioned previously, the high level of concentration in the S&P 500's top-weighted stocks could magnify volatility if any of these companies disappoint. In addition, there is the list of usual risks to the equity market including macroeconomic developments, inflation, central bank policies, and the risk that some of the anticipated Trump policy tailwinds don't pan out and turn to headwinds.

Elevated Valuations



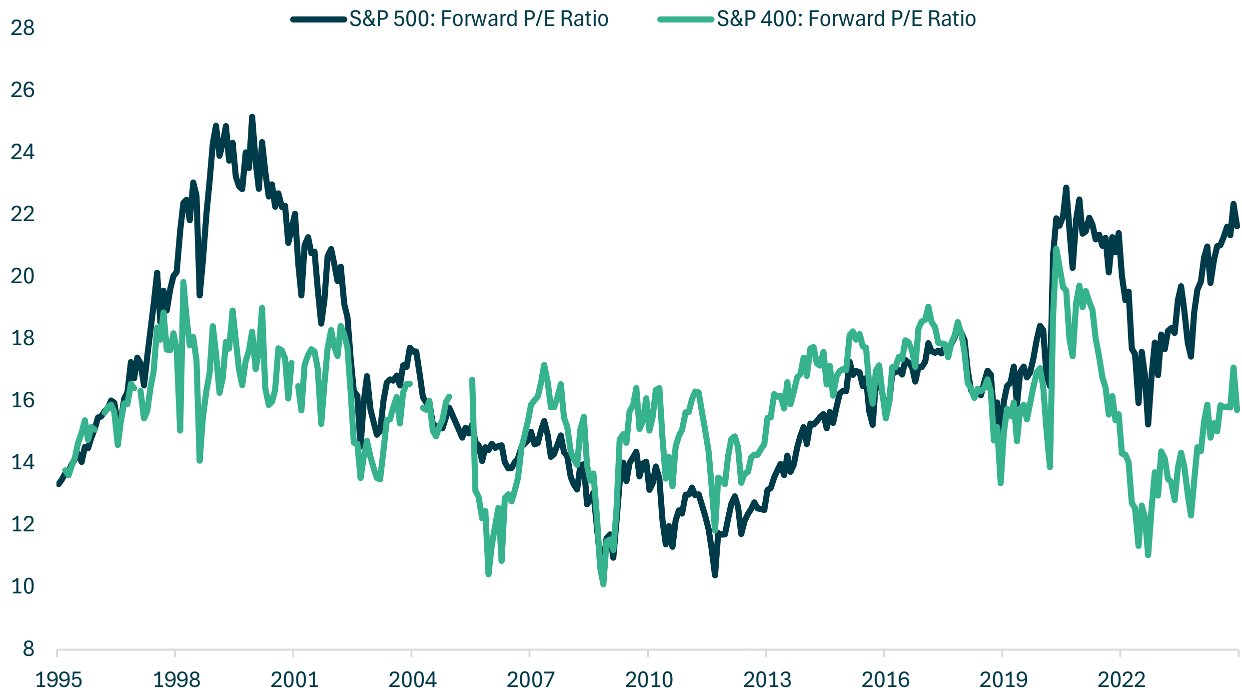
Source: Bloomberg LP. Data as of 12/31/2024.

Given these risks and opportunities, I am actively considering potential changes to our U.S. equity exposure.

One consideration is to underweight larger-cap stocks in favor of mid-cap stocks. Historically, I've divided equities into two buckets: larger-cap and smaller-cap stocks. But today I think mid-caps could offer a compelling investment case. Mid-cap stocks are currently trading at fair value relative to their historical valuations, and are also trading at a steep discount relative to elevated valuations for larger-cap stocks. In theory, mid-caps' relatively attractive valuation could lead to less downside risk in a market decline. Relative to smaller-caps, mid-caps have less exposure to floating-rate financing. If interest rates and therefore borrowing costs remain elevated, a prosect looking more likely now than just a few months ago, small-cap stocks will come under more pressure. This is especially true when you consider that 42% of companies in the Russell 2000 Index, a popular small-cap index, are currently unprofitable.

If the economy continues to grow, I think a broadening out of the market beyond the largest-cap stocks could benefit mid-caps. The composition of the mid-cap index has higher exposure to domestically focused sectors than the S&P 500, such as industrials, financials, and consumer discretionary. By comparison, information technology stocks, which derive a larger percentage of their revenues globally, make up nearly 30% of the S&P 500. Being more domestically oriented, mid-caps are less exposed to geopolitical risks and currency fluctuations that can affect large multinational corporations. This could make mid-caps relatively attractive in periods of heightened global uncertainty.

Mid-Cap Stocks Trade at a Steep Discount to Large-Caps



Source: Bloomberg LP. Data as of 12/31/2024.

Mid-caps strike a balance between growth potential and stability, offering the potential for fast growth while also having the operational flexibility that can come with a mature business in the event of an economic slowdown. For now, our portfolios have an overweight to large-cap growth and underweight to smaller businesses. For now, I am comfortable with exposures in models, but I will continue to evaluate mid-cap stocks as an alternative to large-growth stocks.

Another option I have been exploring is equity buffer ETFs. Equity buffer ETFs are exchange-traded funds designed to limit the downside and cap upside returns over a specific period, typically one year. They use options strategies to "buffer" against a predetermined percentage of losses (e.g., the first 10%) while limiting gains beyond a set cap. These ETFs appeal to investors seeking reduced risk while maintaining some equity market exposure. I should add that some of our portfolios already have exposure to hedged equity, through the J.P. Morgan Hedged Laddered Overlay fund (HELO), but this fund provides a hedge against the broader stock market, not large growth stocks specifically.

I will continue my evaluation and explore opportunities for our portfolios. Looking ahead, I think investors should be prepared to weather occasional storms in 2025.

Foreign Stocks

While the U.S. economy has remained strong, economic growth elsewhere in the world has been relatively weak. The European economy, for example, was much more impacted by the recent rate hikes than in the U.S.—likely due to massive U.S. fiscal programs and the boom in domestic AI-related

investments. A stronger U.S. dollar was another headwind for foreign equity returns, which moved even higher after the U.S. election. Better prospects in the U.S. resulted in another year of significant outperformance. Developed international stocks (MSCI EAFE) returned 3.8% in dollar terms, and 11.3% in local currency terms. U.S. outperformance continued last year in large part to higher earnings growth relative to European companies. This has been the case for the past 15 years—the U.S. has enjoyed structurally higher economic and earnings growth. This has not gone unnoticed by investors as the market is now paying upwards of 22x for U.S. earnings compared just over 13x for European earnings. This P/E multiple discount is at a historically wide differential.

In fairness, European equities have performed decently since the bull market that started in October 2022. The main reason for the underperformance relative to U.S. stocks is the lack of mega-cap technology companies. Analysis from Ned Davis Research shows that since mid-October 2022, the S&P 500 is up 22.6% annualized, easily outpacing MSCI Europe's return of 16.1%. However, when removing the large eight tech leaders from the S&P 500 (Alphabet, Amazon, Apple, Broadcom, Meta, Microsoft, NVIDIA, and Tesla), the S&P has returned 13.8% annualized. While one cannot simply remove the best performers from an index, it does highlight the significant impact these technology giants have had in recent years.

Throughout 2024, emerging market economies faced uncertainties around the weakness in China and potential tariffs from a second Trump administration. Both factors helped push the dollar higher and weighed on emerging-markets equities. My growing concern in late-2023 and into early 2024 led me to reduce our tactical overweight to emerging-market stocks and fall back to a neutral positioning.

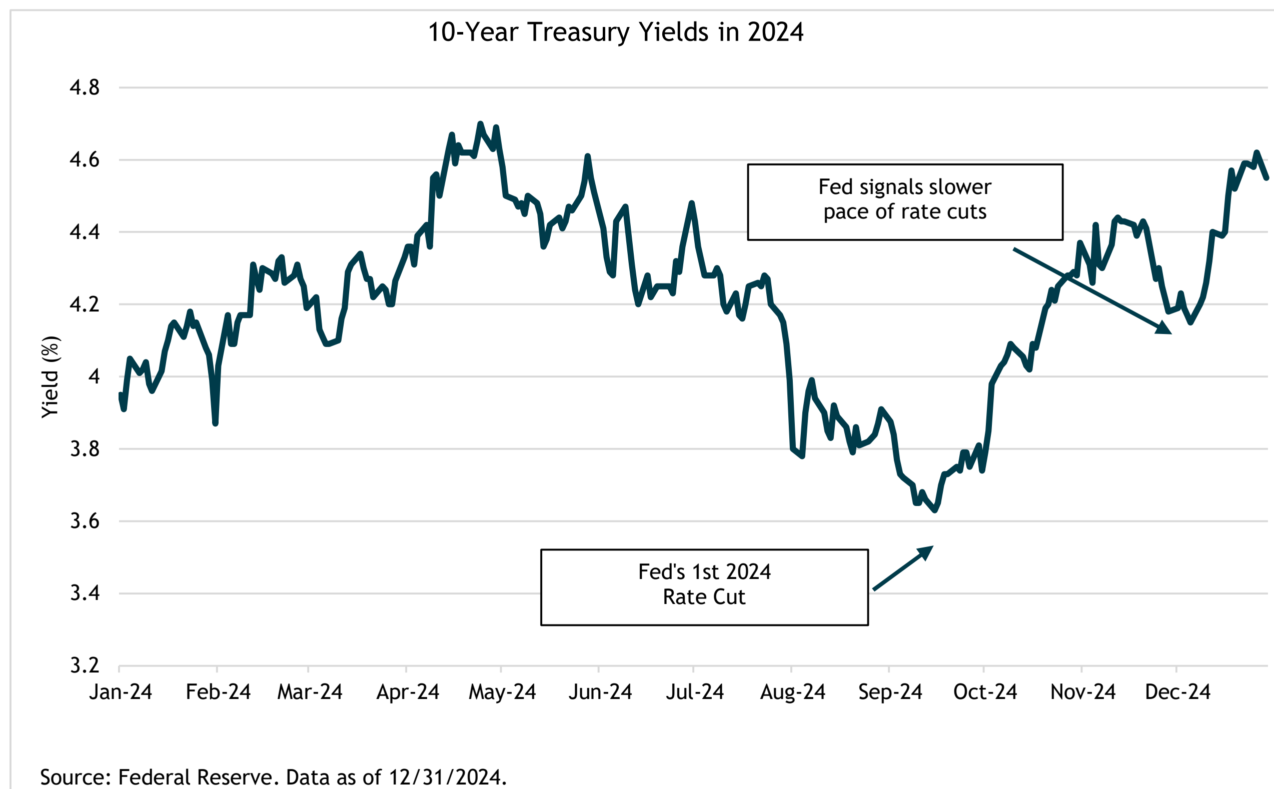
Much like developed international stocks, emerging markets trade at a historically wide discount to their U.S. counterparts. However, on a stand-alone basis, they trade at a slight premium to their own historical average. Given elevated geopolitical uncertainties, I won't consider an overweight in emerging markets until valuations are discounted in absolute terms, and the global financial environment is less favorable to the U.S. dollar.

Federal Reserve and the Fixed Income Market

Within the bond markets, investors remain hyper-focused on every economic data release, ranging from inflation and employment reports to GDP growth and consumer strength. Each data point has been heavily scrutinized for its potential impact on central bank policy, driving heightened volatility as investors attempt to project the likelihood of interest-rate changes and the implications on returns. Investor guesswork has led to a very volatile year for the 10-year U.S. Treasury bond, reflecting the market's sensitivity to economic conditions in an uncertain environment.

In the first three months of the year, inflation pressures proved persistent, prompting the Fed to keep interest rates elevated. But as the year progressed, inflation began to trend lower, and the Fed delivered its first rate cut in September 2024. The September cut was significant for two reasons. It was the first cut in over four years, and it was a more aggressive 50 basis point reduction, compared to the typical 25 bps cut. This was followed by a 25 basis-point reduction in November, and another widely expected 25 bps cut in mid-December, the final Fed meeting of the year.

Although the December cut was expected, the Fed added a bit of a twist, and the market did not like the news. Specifically, the Fed shared a concern over the slowing pace of year-over-year inflation rate declines. The Fed's median inflation estimates, as measured by core Personal Consumption Expenditures (PCE), for 2025 and 2026 increased from 2.2% to 2.5% and 2.0% to 2.2%, respectively. The following day, stocks fell sharply, and long-term bond yields increased. In fact, since the Fed started cutting rates in mid-September, interest rates have increased by roughly 100 basis points (see below).



Looking ahead to 2025, the U.S. bond market is stuck between the Fed's plans to cut interest rates (to some degree) and the risk of higher inflation and increasing federal deficits. As was the case in 2024, I think 2025 will be another bumpy ride for fixed-income. My approach has been and continues to be focused on shorter-term, high-quality bonds over those with higher yields and more interest-rate risk. That could change if interest-rate volatility creates opportunities, but whatever the case, today's starting higher yields will result in better bond returns over the long run.

As mentioned above, there can be a wide range of economic forecasts even within the Fed, despite its extensive resources, highly skilled staff, and a wealth of theoretical and empirical models at its disposal. Therefore, it should come as no surprise that I don't hang my hat on the Fed, and I view them as any other forecaster, which is to say, imperfect.

My investment approach attempts to navigate uncertainty rather than trying to predict precise outcomes. Instead of relying on pinpoint forecasts, I focus on understanding a range of possible

scenarios and analyzing their potential implications for portfolios. By evaluating risks and opportunities across different economic and market conditions, my goal is to stack the odds in our favor, even in complex and volatile environments.

Closing Thoughts

I remain cautiously optimistic as we enter 2025. While there are promising signs of growth and resilience in the economy, I am also acutely aware of the potential risks that could negatively impact market stability. For example, the U.S. economy will likely downshift into a slower gear. I do not believe this slower growth, in and of itself, will cause a recession, but it does leave the economy more vulnerable to shocks, including significant policy changes from the new administration. Furthermore, the past two years of strong returns leaves valuations elevated. My focus will continue to be on identifying opportunities to improve long-term returns while being vigilant of the risks I am taking. By staying disciplined and opportunistic, I aim to navigate the complexities of the market and position your portfolios for long-term success.

As always, I appreciate your trust and wish you and yours a wonderful new year.

Best,

Kelly D. Kane, ChFC, CFP©

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