

When Hope Meets Experience

“There are three kinds of lies: lies, damned lies and statistics.”

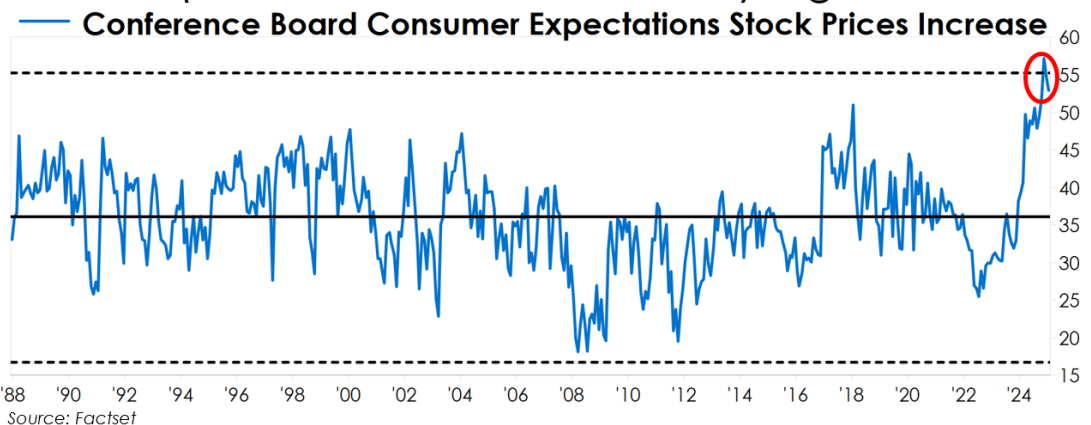
– Mark Twain (*Chapters from My Autobiography* 1907)

Hope is defined as the expectation of an outcome while Experience is a direct observation of what is. When Hope and Experience align, a high degree of satisfaction is often achieved. Conversely, misalignment leads to disappointment. Setting appropriate expectations seems to be the key.

Investors’ expectations are often referred to as bullishness (hopefulness) or bearishness (desperation). This can sometimes also be described as investor sentiment and is generally attitudinal or psychological, thus, much more fickle than the fundamentals. The direct result of investor sentiment is rendered out in valuations or what one is willing to pay for an asset. But sentiment can be measured in many ways, including surveys on how investors feel about stocks – for example. As can be seen in the chart below, the Conference Board survey measures

consumer expectations for stock prices over the next year. Quite literally, hope is at a three standard deviation high. Consumer expectations for rising stock prices has never been

HOPE Is (three standard deviations) High



higher over the course of this data series. Why might this be?

Price action often confirms sentiment through the use of positive or negative conditioning, which leads to more deeply rooted expectations that can become wildly contagious. The analogy would be Newton’s First Law of Inertia – “an object in motion stays in motion”. For the casual US stock investor, the environment has been incredibly bullish – some might say even “easy”. Since the major market low back in October 2022, the S&P 500 has garnered incredible returns that got even better with increased concentration in some of the largest and well known growth companies. Not surprisingly, such performance has come with increasingly optimistic



expectations for things to come. In short, hope is sky high and those expectations are certainly rolling with positive inertia.

What does Experience say? No one knows what the future holds, but history can often be informative as a guide in helping to anchor expectations. Right now, things look pretty out of step. That's because in the third year of a bull market, things generally get more challenging. As can be seen in the table below, since 1950 there have generally been twelve major market lows. While these lows can only be confirmed with hindsight, the subsequent performance has generally followed a consistent directional pattern. The first year of a bull market is exceptional and well above the long-term historical average (of about 12%) in every instance. Year two of a bull market is not quite as good as the first twelve months, though returns are still above average the vast majority of the time. Equity bull market returns in year three are almost always below average. The drop off is notable and consistently seen with the exception of 1990 – a circumstance where below average second year returns allowed for an unusual reset. The current episode has been distinctive in that the second year has been stronger than the first – most comparable to 1987. Still, the likelihood that the third year delivers double digit returns is low and certainly not as high as what might be implied by investor expectations.

THIRD YEAR OF A BULL MARKET
S&P 500 Index, Since 1950

Major Low - S&P 500	First 12 Months Year 1	Next 12 Months Year 2	Next 12 Months Year 3
1953	45.8%	40.9%	8.0%
1957	43.1%	12.0%	0.5%
1962	31.1%	21.5%	6.2%
1966	30.5%	9.5%	-6.4%
1970	41.7%	10.7%	0.2%
1974	38.1%	30.4%	-4.1%
1987	16.6%	31.7%	-3.1%
1990	33.6%	8.8%	17.8%
2002	36.2%	9.9%	8.5%
2009	72.3%	18.1%	6.1%
2020	77.8%	15.6%	-9.9%
2022	23.7%	35.6%	4.3%*

Average	40.9%	20.4%	2.3%
Median	37.1%	16.8%	2.4%

Source: Factset. S&P 500 data series uses quarter end pricing to determine major low periods from 1949-1987 and daily pricing to determine major low periods from 1988-current. *Year 3 from latest October 2022 low is as of 1/31/25.

Yes – as the Mark Twain quote implies – there are no such things as perfect statistics and, given high expectations, many individuals might find comfort in this old adage. Taken together with some rendition of, “this time is different” is littered throughout the current landscape. However, we think

observations are especially noteworthy when Hope and Experience are misaligned. This doesn't suggest disaster so much as it does potential disappointment if expectations aren't appropriately reset. Of course, these instances can also be seen as opportunities. Misalignment can lead to disconnects that also allow for benefits to accrue with the requisite being an open mind and a contrarian spirit. We're staying tuned in.



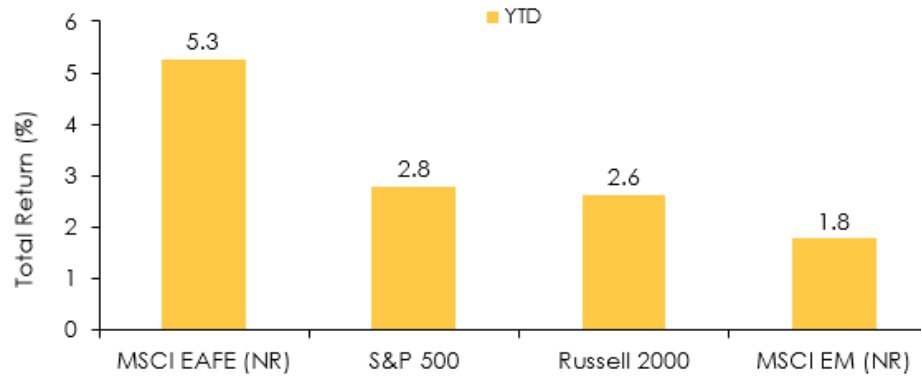
Stocks, Bonds, Commodities, and REITs all posted positive returns to start the year as interest rates stabilized (after spiking in December) and equity markets broadened out again. Returns were led by Commodities and International Developed Market Stocks which posted especially strong returns in January.

Stocks

International Developed Markets (MSCI EAFE) had a very strong month, perhaps as investors rebalanced portfolios back to desired target allocations. Domestic stocks posted positive returns for January with U.S. Large Caps (S&P 500) leading. From a

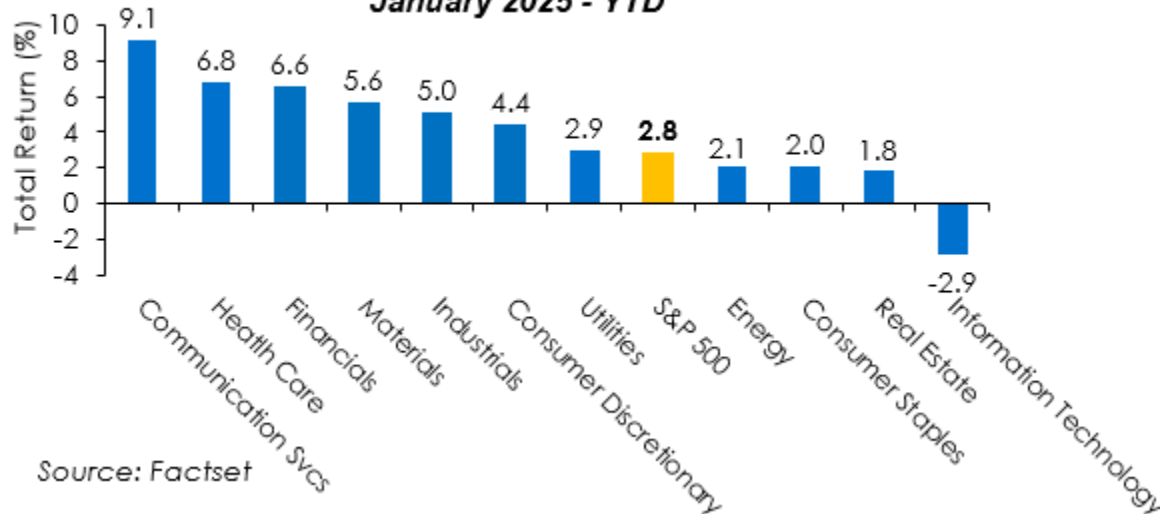
sector perspective, strength was much broader with the notable exception of Information Technology, which lagged. US Small Caps (Russell 2000) also performed well as equity markets broadened on expectations for deregulation and continued economic growth. Emerging Markets (MSCI EM) lagged amid ongoing questions regarding the effectiveness of China’s stimulus programs and the impact that US tariffs might have.

Global Equity Returns
January 2025



Source: Factset

S&P 500 Sector Returns
January 2025 - YTD



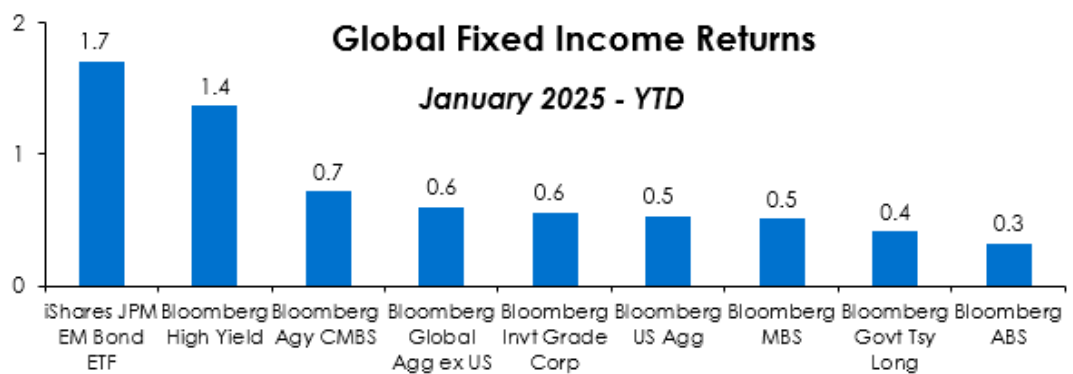
Source: Factset



Bonds

Despite ongoing balance sheet reduction – policymakers pivoted to an easing bias by reducing the Fed Funds rate by 50 basis points at their September meeting and another 25 basis points each at their November and December meetings (Fed Funds at 4.25-4.50%). While this easing bias is the first in over four years, policymakers left rates unchanged in January and recently reduced the number of expected 2025 rate cuts from four to two (25 basis points per) as inflation remains sticky and labor markets solid. Bond returns were positive in January as interest rates stabilized after rising during the final three months of last year. Emerging

Markets (JPM EM) and Credit (High Yield) were among the best performing areas in January. Conversely, Asset Backed Securities (Bloomberg ABS) and long duration Treasuries

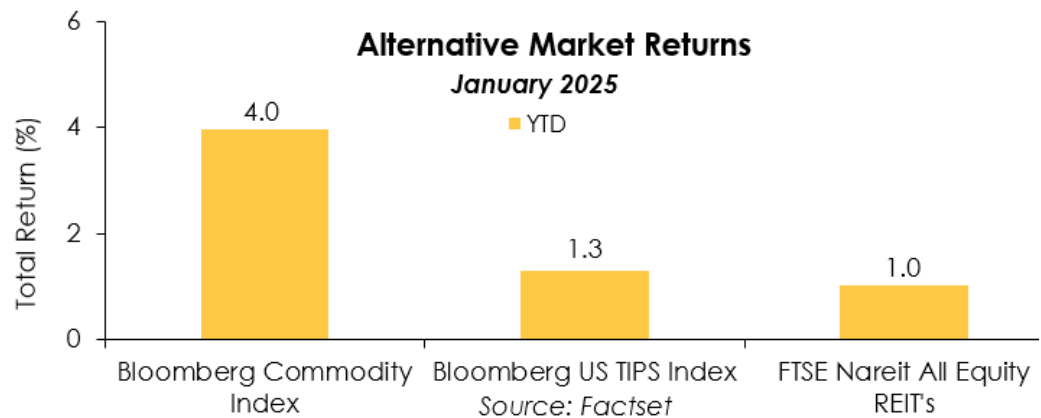


Source: Factset

(Bloomberg Govt Tsy Long) lagged somewhat.

Alternatives

Commodities started the year off with strong results led by precious metals and agriculture. Meanwhile, publicly traded Real Estate (REITs) posted solid returns as interest rates stabilized after backing



Source: Factset

up late last year. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) outperformed nominal Treasuries amid rising inflation expectations of late.



Market Outlook

“It’s Tricky to rock a rhyme, to rock a rhyme that’s right on time. It’s Tricky.”

– Run DMC, *It’s Tricky* (1986)

As the page turns to 2025, we’re focused on the incongruencies that exist within the “Tri-Cycle” – the “three cycle” framework we’re using to assess the landscape. A de-synchronous orientation – one later (Economic Cycle), one earlier (Profit Cycle) and one that runs counter to history (Fed Cycle) – makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and “Head on a Swivel”. Let’s explain.

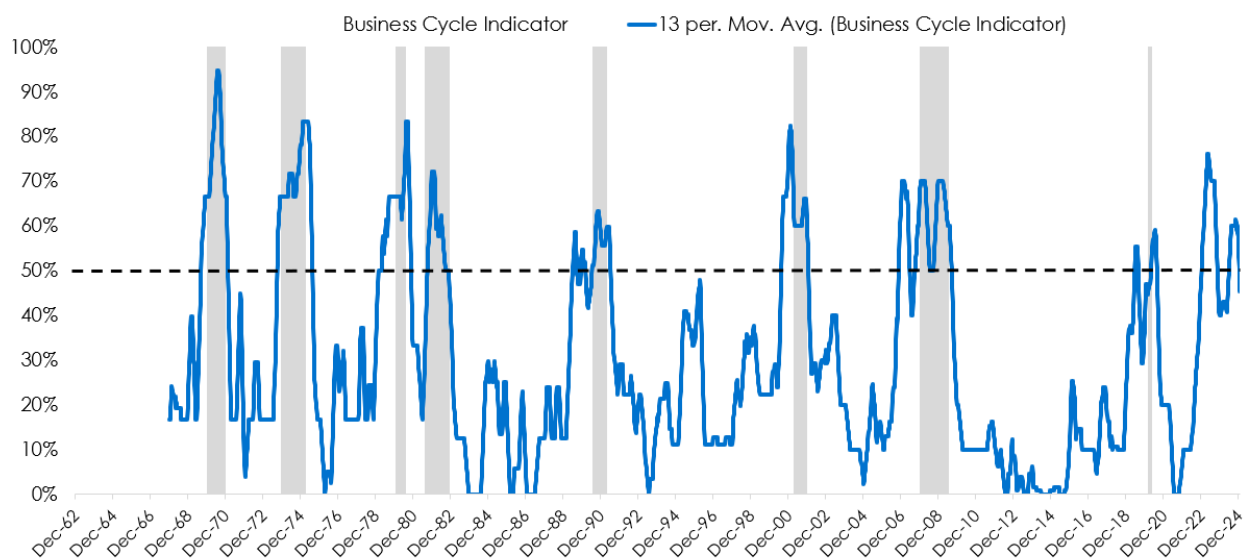
It's Tricky

Cycle	Stage
Economic Cycle	Later
Profit Cycle	Earlier
Fed Cycle	Counter

While only four years removed from the (short) COVID induced recession, we’re more than fifteen years removed from the more economically oriented one prior to that. But it’s not just the duration that suggests we’re on the later side of

the economic cycle. Several fundamental data points including the yield curve, leading economic indicator composites, certain survey relationships and especially labor market measures suggest a similar conclusion. As can be seen below in our business cycle indicator, an increased percentage of measures being triggered

Business Cycle Indicator



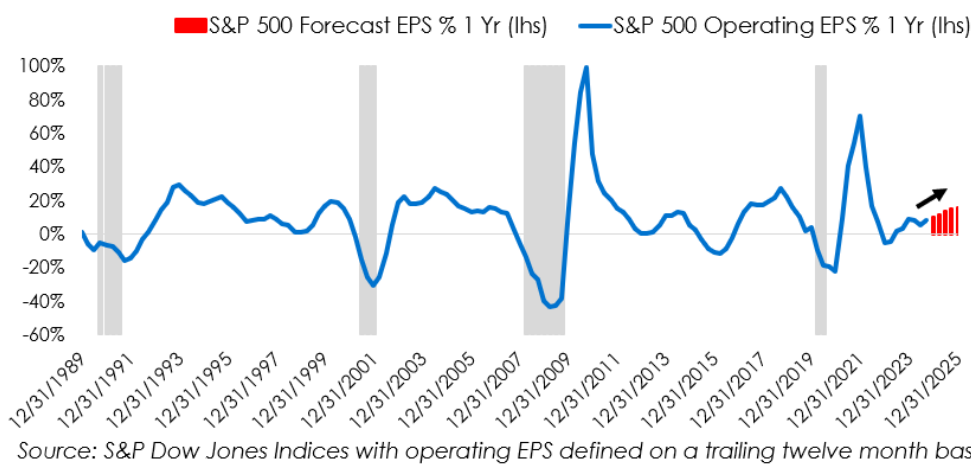
Source: Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.



is additional confirmation that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions).

And yet from a profit cycle perspective, we don't look nearly as late. In fact – as can be seen in the chart below – profit growth continues to ramp off of the earnings recession trough in 2022. As expectations point to an earnings acceleration into 2025, this would argue for being at an earlier respective stage in the profit cycle.

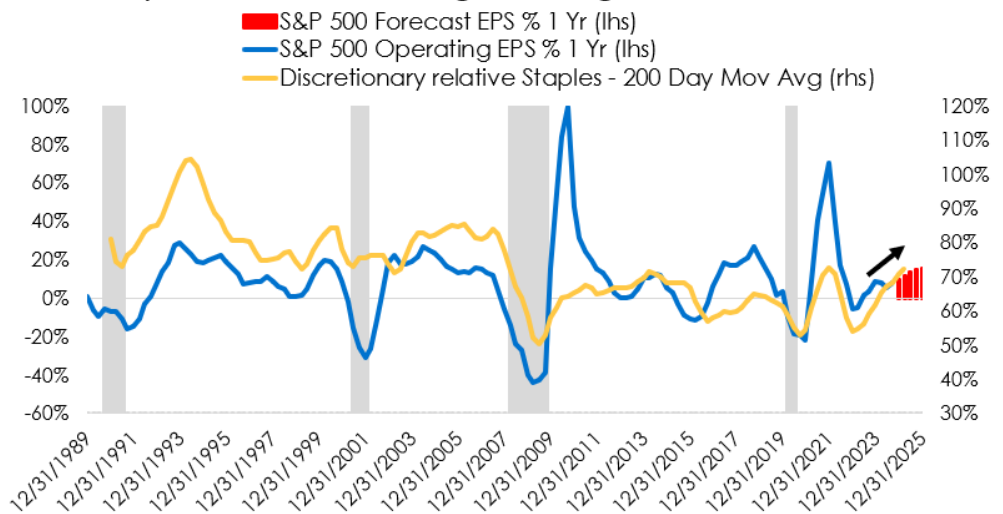
Earnings Growth Continues to Ramp



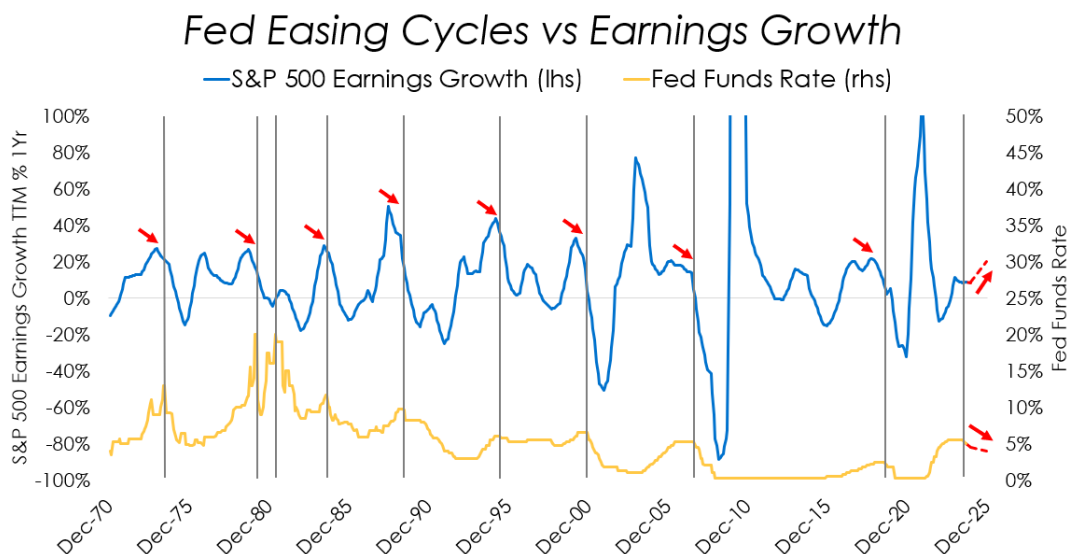
As additional evidence, the price action in the equity market seems to be confirming the cyclical improvement in corporate profits. As noted in the chart below, when comparing the Consumer Discretionary sector against the Consumer Staples sector (both on an equal weighted basis using

the relative 200 day moving average), the pro-Discretionary tilt implies a cyclical bias that tends to coincide with an acceleration in earnings growth. And the expected improvement in earnings growth looks even more pronounced as one goes down market cap. We think this suggests the anticipation of operating leverage to benefit smaller sized companies (with higher fixed cost structures) should nominal growth be stronger than expected.

Cyclicals Confirming Earnings Acceleration



Add to that the third leg of the stool – a Fed Cycle that looks counter to history. The chart below highlights the nine other Fed easing cycles (i.e. cutting rates) over the last half century. Acting as a countercyclical body, the Fed has almost always started its rate cutting cycle after earnings growth has peaked. Should earnings growth continue to ramp into 2025, such would not be the case in this current Fed cycle. We remain mindful of how such an occurrence might impact both growth and inflation.



Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; www.shillerdata.com. Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported earnings using the S&P Dow Jones Indices datasets; www.wpglobal.com. Next twelve month forecast for Fed Funds rate based on FOMC projection from the December dot plot and forecast exhibits; www.federalreserve.gov.

So what do we make of this de-synchronous setup?

To the extent that earnings growth accelerates and broadens, this could initially unlock a recalibration of valuations in companies that might be more economically sensitive and smaller in size. According to Factset data, consider that since the end of 2009, the “average” stock (as defined by the equal weighted S&P 500) is trading at an almost 25% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 6%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are still rather extreme – not far off from their disparate readings witnessed back in late 2021 and before that, the Tech Bubble peak. It remains noteworthy that the highest valuations still remain in the hands of the largest and growthier weights in the index. A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with increased concentrations – and with a disregard of building valuation (and mean reversion) risk – at a time when growth might be becoming more balanced.

At the same time, we want to remain on guard for additional scenarios that could lead to a faster peak in earnings growth translating into a change in market conditions. Such a development might occur due to the de-synchronous setup referenced earlier and could play out – for example – with labor markets weakening



quicker than anticipated and/or a stickier inflation backdrop that causes the Fed to pivot to more restrictive policy. With what seems like an increasingly large number of potential scenarios, it's no wonder that the only certainty might be a high degree of uncertainty.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance as a way to mitigate the high uncertainty as referenced above. While diversification has previously been an uncontroversial concept, the concentration present in portfolios today – by virtue of the price action over the last couple of years – suggests this notion remains a relic of the past. We respectfully disagree and remain UW the most expensive and concentrated areas where the long-term risk reward is especially skewed.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially. Acknowledging the more constructive profit cycle with prospects of a broadening, our bias has generally been to have more exposure to less expensive areas (down market cap vs top). As such, we've maintained a larger OW in Cyclical Value and a lesser OW in Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we are longer in duration and have previously repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains OW in portfolios for diversification purposes though we've also added to International Fixed Income (EW), where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where spreads remain tight. High Yield corporate bonds tend to benefit from cyclicalities though their incredibly tight credit spreads suggests this might already be fully recognized.

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities.

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