THE OPTIMIZED PORTFOLIO SYSTEM®

November 2024 Monthly Update: TOPS® Exchange-Traded Fund Portfolios & Managed Risk ETF Portfolios

TOPS® Update

Topics for this month include:

- Investors Remain Bullish on Tech Excitement
- Europe Beats Most of S&P 500 Over Bull Rally
- The Federal Reserve Expected to Decrease Rates Again in December

Investors Remain Bullish on Tech Excitement

Stocks and bonds posted strong November returns, the economy is showing decent growth, new government leadership is promising lower taxes and softer regulation, and we live with the exuberance and hope artificial intelligence will (rather soon) boost productivity and wealth. It's no surprise that short-term stock momentum is strong. We are pleased to see great results.

As portfolio managers, we are responsible for managing the hard-earned wealth of thousands of investors. We don't have the luxury of getting drunk on the bull market, instead keeping our eye on the goals while enjoying the ride. We focus on the long term, not short-term momentum. We absorb, recalibrate, and plan for the appropriate strategies as markets evolve.

The tech and communications sectors are continuing to lead the charge for stocks. They are also doing an admirable job of continually fueling the rally. Google released information on their new Willow quantum computing chip in early December. According to Fortune[1], Willow recently outperformed the world's best supercomputer on an advanced test. Fortune noted, "The new chip, which wowed even Tesla CEO Elon Musk, can complete in five minutes a complex computation that would take the most powerful supercomputer 10 septillion years—more than the estimated age of the universe, wrote Hartmut Neven, the founder and leader of Google Quantum AI, in a blog post. "

Calculation errors have historically plagued quantum computing. A key breakthrough of Willow is that it reportedly allows adding more computing "qubits" without compounding errors. We understand this technology to be years away from providing practical business uses, but it's an exciting story and raises the lid on expectations. Similarly, when Salesforce announced they beat Q3 earnings expectations on

[1] Quiroz-Gutierrez, Marco. December 11, 2024. Fortune. Google's breakthrough Willow Chip means we'll get useful quantum computers sooner than some people thought.

their quarterly earnings call in early December, shares jumped 11% higher. CEO Marc Benioff undoubtedly stoked the jump by touting the company's AI-powered chatbots on the earnings call.

The Willow story is another example of what we feel is a major driver of outperformance in technology and communications stocks. Financial modeling relies upon assigning values to variables, which are then plugged into models. If investors are modeling expected returns for 10-year bonds, they may look at a range of 4-6% returns. If investors are modeling returns for tech stocks, the best-case scenario (if relying upon rosy AI assumptions) can seem astronomical. Can Amazon warehouses be fully staffed by AI robots in 10 years while the deliveries are made by self-driving vehicles? The chance of it happening is surely greater than zero. If that is in your model, the growth assumptions could be massive.

This rally has no shortage of fans but no shortage of critics, either. Economist Dr. Ed Yardeni[2] recently noted, "*AI differs from the dotcom mania of the late 1990s. It is less hype and more the natural evolution of the Digital Revolution, which is all about processing more and more data faster and faster. This latest innovation in data processing should help to fuel a productivity boom, which is already underway, over the rest of the decade. The Nasdaq has been discounting this development and is on track to reach 20,000 by mid-2025, if not sooner. Let the good times roll!*"

On the other side, there is famed strategist Bob Doll. Bob recently stated[3], *"While market bulls focus on tax tailwinds, anticipated deregulation, heightened investing and good earnings, those less bullish worry about stretched valuations, bond yield backup, renewed inflation concerns and overly bullish sentiment……..The longer-term setup for the equity market is demanding, given the high starting point for valuations and already high earnings expectations. Moreover, sticky inflation and upward pressure on bond yields could eventually challenge the positive market sentiment……Earnings estimate upgrades would be needed to fuel further meaningful upside in stock prices*."

As we have discussed, this exuberance is reflected in large-cap U.S. stocks' valuations. We run eight valuation metrics monthly on seven key indexes using Bloomberg data. Our information on forward price/earnings (forward P/E) ratios goes back to July 2005. This data shows large-cap U.S. growth stocks are trading in the 97.4 percentile, with large-cap U.S. value stocks trading in the 99.5 percentile. In one interpretation, they are more expensive than they have been about 97-99% of the time in the last twenty years. To get to these valuations, a plethora of good news must be embedded, with sentiment levels and bull market positioning extended.

We typically liken this situation to the spreads in sports betting. If you are holding a stock at a high valuation, it is like betting on the favorite to win. For the favorite to win, they also need to beat the spread. This raises the bar of success these companies need in earnings. Betting on U.S. stocks right now is like betting the Chiefs will win by more than 21 points when their average margin of victory season-to-date is 4.3 points. It can happen but is less likely than if the spread was 5 or 6 points.

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[2] Yardeni, Edward. December 4, 2024. Yardeni Research. Let the Good Times Roll.
[3] Wisenberg Brin, Dinah. November 18, 2024. ThinkAdvisor. Noting Buffett's Cash Hoard, Bob Doll Warns of Stock Pressure.

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Valuations have been high for large-cap U.S. stocks for several years, though, and they have continued to push upward. This has created a hefty dose of fear of missing out among many participants and stretched some investor's resolve. Those who have doubted this bull market, specifically the ability for large-cap U.S. stocks to press into valuations rarely seen historically, have been struggling to reconcile their beliefs with the reality of what prices have done. David Rosenberg, the acclaimed President of Rosenberg Research, has been a skeptic for years. He released a letter in December where he was sure to note he wasn't throwing in the white towel but adjusting his story. He had the following remarks in a December letter[4] to investors:

But as we saw then and are witnessing today, a speculative asset class like equities will always price in a certain future, and when we have technological breakthroughs as we have with AI, the stock market is going to extend its time horizon, build in expectations that transcend just one year, and a bear market only ensues if and when these expectations prove to have been excessive. That day may well come, but Mr. Market has been saying for some time: "Not quite yet." – David Rosenberg.

We are excited about the opportunities in large-cap U.S. stocks, encompassing the largest AI leaders and other technologies. As such, large-cap U.S. stocks remain the highest equity allocation in every TOPS portfolio. However, we remain cautious about the scope and timing of technology's impact on earnings. We also remain measured on the risk of momentum shifting quickly in the shorter term. Even the bullish Dr. Yardeni noted on a December 11th CNBC interview that he would not be surprised to see some profit taking soon, maybe after the 1st of the year. However, we like to focus on much longer cycles.

We are happy to see our investors enjoy the rally's benefits; in the following sections, we will cover some of the other market factors we are considering. We are soberly working on balancing the risk and return opportunities markets present.

Europe Beats Most of S&P 500 Over Bull Rally

Julius Caesar reportedly said, "*Men are quick to believe that which they wish to be true.*" A key part of our jobs as portfolio managers is to cut through the emotions, politics, rhetoric, etc., to strive to provide appropriate returns over time. We don't have the luxury of simply falling in love with a story, and we must focus on our process of using a vast amount of research and experience to balance risk and return.

In line with Julius Caesar's point, in investing, we often see research supporting a conclusion already reached instead of reaching a conclusion after rigorous independent research. We have managed money for decades over all types of cycles. International stocks outperformed U.S. stocks for much of the first decade of our TOPS portfolios. For the last decade, the opposite has been true.

After a long period of international outperformance, we had pressure from investors to move our allocation to 50% U.S. and 50% international. We rejected that idea and have allocated about 2/3rds of

[4] Fox, Matthew. December 7, 2024. Business Insider. A longtime stock market bear is rethinking his view after this year's dizzying rally.

our equities to the U.S. over the last decade. If we had followed the story and moved to 50/50, our investors would have missed participating in one of the best periods of U.S. outperformance on record. Portfolio management involves a record of what you decide to do and what you decide not to do. Furthermore, hindsight provides 20/20 but does not provide a clear picture of how close markets were to other potential scenarios playing out instead.

We believe that the U.S. stock market has a lot of positive momentum, as supported above. Likewise, we believe the European economy has numerous challenges and that there are significant social and regulatory hurdles to producing the next Nvidia. We can point to strong research to support our heaviest allocation to large-cap US stocks, which have outperformed.

According to commentator Thomas Hornall, in an early December posting to X, *“All six of the most valuable companies in the U.S. -all of which are worth more than $1 Trillion -have been created in the last 50 years. By contrast, no European company valued at more than $100 billion has been started in that period.”* With this information, it may seem like 100% should be allocated to U.S. stocks.

Let’s reconcile that information with this important fact, however. According to Jeffrey Kleintop, Chief Global Strategist for Charles Schwab, the MSCI EMU Index (representing Europe) outperformed the S&P 500 Index (minus NVIDIA) from the start of the bull market rally on 10/13/2022 through 12/10/2024. For many people, it seems obvious that the U.S. is simply destroying Europe economically and in the markets. However, if you take one company out, the U.S. loses to Europe in return. As mentioned earlier, this is an example of how close markets came to another scenario. One corporate scandal at Nvidia would have likely shifted the tide enough to allow European markets to outperform the overall S&P 500 index.

This made us think of the Cleveland Cavaliers' confidence after winning the 2016 NBA Championship and following up with two straight Eastern Conference Championships. It would seem the Cavaliers were firing on all cylinders. Surely, the front office, coaches, managers, and food vendors all felt they were better than the average NBA team. They were champions and had figured it out. Jump forward to the 2018-2019 season, after Lebron James left, the Cavs fell to 19 wins. What happened? Surely, it's a fluke. Well, they added another 19-win season the year after. What would have happened if someone had bet on the Cavs to win the title in 2016 and Lebron James had gotten hurt? One twist of a knee would have changed the reality.

A key part of our investment process is attribution; the Cavs story is a picture of what attribution analysis can reveal. Likewise, we are focused on providing the best risk-adjusted returns we can over a wide range of potential scenarios, not putting all the investor’s chips on a Cavs championship (which was heavily reliant on a healthy and successful Lebron James).

For those who have been there, Europe has some beautiful sites, including some of the richest history on earth. The food, the museums, and the culture are many features of Europe that are hard to beat. Unlike the United States, the European Union is a collection of independent countries. Like the United States, however, Cheyenne, Wyoming, and San Francisco, CA, are as different as Paris, France, and

Tallinn, Estonia. We have overweighted the U.S. over Europe in our portfolios, a winning trade. However, we are also sober to the attribution that led to that win. As we look at future allocations, we approach decisions with this sober viewpoint. It's not always the best story that wins, and there are many factors to each investment.

In Morningstar's 2025 Outlook Report: Empowering Investor Success report, they outlined an expected return of 3.3% annualized for U.S. stocks over the next 10 years. They expect 6.7% annualized for European stocks over the same period. We believe there is an opportunity for U.S. stocks to beat that number, with help from small and mid-cap stocks and some luck regarding the positive factors discussed above, but this research is a consideration as we balance our allocations. It is important to note bond yields over 4% highlight the slim equity risk premium, given at least Morningstar's expected returns.

Another key consideration in looking at U.S. versus international exposure is currency movements. The U.S. Dollar Index (DXY) is up 2.9% from the November 5 election through December 10 (Yardeni Research). This is further strengthening on top of a strong decade for the Dollar. The DXY now sits right below 110, while the index was at about 90 ten years ago. Currencies typically cycle over 7-10 years; they don't typically appreciate over time in a ratchet format like the Dollar has recently. If the Dollar were to simply cycle back to its 2014 level, international stocks would presumably outperform the U.S. market by over 18% from currency movements alone.

Currently, we are keeping our overweight of U.S. stocks compared to international stocks. Hopefully, the above discussion is a reminder of why it would not have been prudent to double down on U.S. stocks in 2024 and why that is a highly uncertain bet going forward. As an aside, the story behind indexing versus active management is just as strong in Europe as it is in the U.S. According to the SPIVA Global Scorecard Mid-Year 2024, 82.27% of active managers underperformed the S&P Europe 350 Index for the first half of 2024 and 92.07% have underperformed over the past 10 years. Lastly, it is important to note that Europe represents less than 50% of our overall international allocation.

The Federal Reserve Expected to Decrease Rates Again in December

Markets are now predicting about a 98% chance the Federal Reserve will reduce the Federal Funds Rate by another 0.25% at their December meeting. In line with our ongoing commentary on this topic, the Federal Reserve continues to balance the risks of stifling or overstimulating the economy, with inflation and employment being key byproducts. There are strong arguments on both sides of this debate as well. With the strong economy, some argue there is no reason to drop rates. Others argue the Fed is playing a dangerous game and that high rates are already creating some cracks.

We will continue to monitor this closely, specifically with an eye on the several billion dollars we manage in bond investments. While the Fed Funds Rate directly impacts short-term rates, markets drive longer-term rates. The yield curve has been changing over the last few months, with longer-term rates hovering near 15-year highs.

Closing Thoughts

With the election results in the books and investors now looking towards a Trump Presidency, we have been getting some questions about tariffs. Some love them; some hate them. We see them simply as tools. Tools can be used in different ways, and even the threat of using a tool can have an effect. It is not the tool itself that is evil.

Some tariff fears have already diminished, as the earliest examples show they are being used primarily as a threat. As a reminder, Donald Trump wrote a popular book called *The Art of the Deal*. So far, it looks like the threats are working, at least in the cases of Mexico and Canada. Markets seem to have applauded Trump's choices for his economic team as well.

Tariffs are lobbied at the port as a fee on imports. They are not the same as a sales tax, as many may believe. Also, in line with our currency conversation above, a stronger U.S. Dollar can offset some of the impact of tariffs for U.S. investors. It shouldn't take much time to see this play out with tariffs, as it seems the administration is much more prepared to launch its agenda immediately after inauguration than the last time.

Domestic Summary

In November, we saw broadly positive returns for domestic equities. Small cap (S&P Small Cap 600 Total Return Index) returned +10.9%, leading all other domestic equity asset classes. Mid cap (S&P Midcap 400 Total Return Index), with a return of +8.8%, lead both large cap styles. Large cap growth (S&P 500 Growth Total Return Index) returned 5.9%, slightly surpassing large cap value (S&P 500 Value Total Return Index) at +5.8%.

Domestic equities are well into positive territory for the year. Large cap growth (S&P 500 Growth Total Return Index) and large cap value (S&P 500 Value Total Return Index) are up +34.9% and +20.5%, respectively. Mid cap (S&P Midcap 400 Total Return Index) returned +22.7%, while small cap (S&P Small Cap 600 Total Return Index) is the laggard this year, but still up +18.1%.

International Summary

Unlike domestic equities, October saw negative returns for most international equities. Developed international (FTSE Developed ex US All Cap Net Tax [US RIC] Index) was flat at +0.0% while broad-based emerging markets (FTSE Emerging Markets All Cap China A Inclusion Net Tax [US RIC] Index declined the least at -2.9%. Emerging markets ex-state-owned enterprises (WisdomTree Emerging Markets ex-State Owned Enterprises Total Return Index) and emerging markets ex-China (MSCI Emerging Markets ex China Net Return USD Index) followed with returns of -3.1% and -3.3%, respectively.

Year-to-date, broad-based emerging markets (FTSE Emerging Markets All Cap China A Inclusion Net Tax [US RIC] Index) is the leader of the group, +11.3%. Emerging markets ex-state-owned enterprises (WisdomTree Emerging Markets ex-State Owned Enterprises Total Return Index) followed, up +7.3%.

Emerging markets ex-China (MSCI Emerging Markets ex China Net Return USD Index) and developed international (FTSE Developed ex US All Cap Net Tax [US RIC] Index) have returned +4.8% and +6.3%, respectively.

Fixed Income Summary

Global ex-US Aggregate bonds (Bloomberg GLA xUSD Float Adj RIC Capped Index TR Index Value Hedged USD) were the leader in November, returning +1.6%, while emerging market local currency (J.P. Morgan Government Bond Index Emerging Markets Global Core) was the laggard, down -0.5%.

For the year, high yield bonds (Solactive USD High Yield Corporates Total Market Index) leads fixed income returns, up +8.3%.

Other Asset Classes Summary

November was a mixed bag for November with global REITs (FTSE EPRA Nareit Global REITs Net Tax Index) returning +2.8% while global natural resources (Morningstar Global Upstream Natural Resources Total Return Index) fell -0.7%.

Year-to-date, global REITs (FTSE EPRA Nareit Global REITs Net Tax Index) are up +9.7%, while global natural resources (Morningstar Global Upstream Natural Resources Total Return Index) are down slightly at -1.5%.

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