

INVESTMENT UPDATE

FOURTH QUARTER 2024

The S&P 500 delivered another year of exceptional returns in 2024. It's been quite a run. Today, U.S. equity market valuations fully reflect both recent good news and expectations of more, increasing the risk of a correction if inflation picks up, the economy slows or anything else goes wrong. We see the broad markets as less attractive than 12 months ago, but we're still finding opportunities in individual companies at home and abroad that we believe will better withstand – or even benefit from – the challenges that may lie ahead.

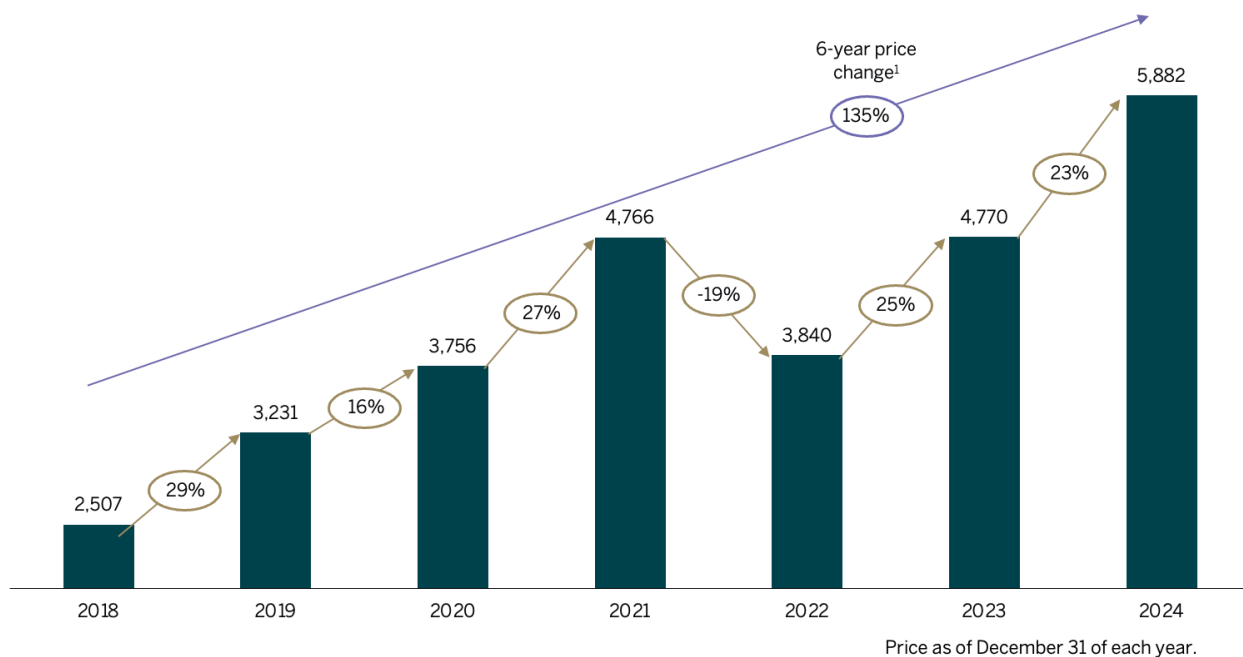
INVESTING IN FROTHY MARKETS

It was another very strong year for global equity markets, and the U.S. again performed better than most. While the MSCI All-Country World Index generated a total return of 18% in 2024, the S&P 500 Index returned 25%.

The S&P 500 delivered similarly strong returns in 2023, and double-digit returns in five of the past six years. Its price has more than doubled from 2,507 at the start of 2019 to 5,882 at 2024's close. In contrast, U.S. Treasuries have delivered four consecutive years of negative returns.

S&P 500 Has More Than Doubled Since the Start of 2019

S&P 500 Year-End Pricing and Point-to-Point Performance: 2018 - 2024



¹Price change excludes impact of dividends. Including dividends, total return for the 6-year period is 159%.
Source: Gavekal Research/Macrobond

SOLID FUNDAMENTALS AND FROTH

There were good reasons for equity market strength in recent years. U.S. economic growth has beaten low expectations, and there still isn't a recession in sight. In addition, inflation has fallen sharply from its highs of two years ago, prompting the Federal Reserve to lower its benchmark discount rate repeatedly, from 5.25%-5.50% in early September to 4.25%-4.50% at year end. Most analysts expect the Fed to continue cutting interest rates. There is also widespread optimism that the incoming Trump Administration will slash regulations and corporate tax rates, and that artificial intelligence (AI) will improve productivity.

But this “good news” is already reflected in share prices, and there are clear signs of froth. Consider:

- The sudden surge in cryptocurrency prices
- Massive retail inflows into speculative corners of the market, such as leveraged ETFs and options with zero days to expiration
- Stock valuations that imply that every company related to AI will capture a significant share of a massive and highly profitable new market

Not to mention a banana duct-taped to a wall selling for \$6.2 million at Sotheby's.

SEVEN (OF MANY) RISKS TO CONSIDER

For the reasons below, we have worked over the past year to reduce risk in clients' equity portfolios, and we think it prudent to position more defensively for 2025.

1. High Expectations: At the beginning of 2024, Wall Street economists were bearish, expecting the S&P 500 to rise by just 2% for the year, well *below* its long-term average annual gain. Instead, the Index rose far *more* than average. In contrast, the same economists now expect 2025 to be a banner year for equities, projecting *above* average returns despite slowing revenue growth and margins already near record highs.

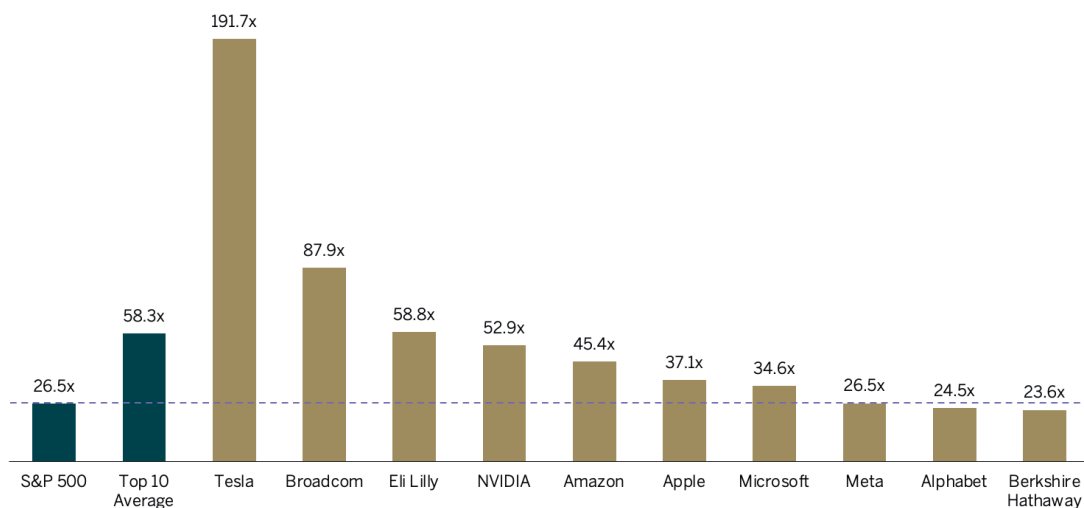
2. Very High Valuations: The S&P 500 was trading at more than 26 times earnings at year end, far above its average of 19 since 2008. P/E multiples for the index have only been higher twice: in the 1990s heading into the tech and telecom bubble and for brief periods during the pandemic.

3. U.S. Equity Dominance: U.S. stocks now make up over two-thirds of the MSCI All-Country World Index's market capitalization, an even larger share than in the Nifty-50 era of the 1970s. At \$63 trillion, the total value of U.S. stocks is now four times bigger than all of Europe's stock exchanges combined. Ten years ago, the U.S. market wasn't even twice the European markets' size. The Stoxx Europe 600 Index is trading at a record 40% discount to the S&P 500. In our opinion, U.S. outperformance has gone too far, even given the well-known structural deficiencies of other developed markets.

4. Unprecedented Market Concentration: The top ten companies by market capitalization in the S&P 500 now represent 39% of the Index's total capitalization, a record high. On average, these companies are trading at about 58 times earnings, more than double the Index P/E, and more than three times their average a decade ago.

Valuations for the Top 10 Stocks in the S&P 500 Look Quite Rich

Trailing P/E Ratio of Top 10 Companies in the S&P 500 by Market Capitalization



Source: Bloomberg

Within the top ten lies the Magnificent Seven (“Mag 7”), which drove well over half of the S&P 500’s return over the past two years. These companies may continue to do well in 2025, but we believe their best returns are behind them. Their profit-growth advantage is narrowing, and their market dominance is becoming less assured. Further, much of the excitement about the Mag 7 is tied to AI, which has thus far delivered low returns on investment.

5. High Bond Yields: Yields on 10-year Treasuries are not high relative to history, but they are well above levels typically seen since 2008. Higher bond yields theoretically raise the opportunity cost of investing in equities—particularly growth equities, whose value is expected to be generated far into the future.

6. Policy Risks: November’s U.S. election results buoyed equity markets, and small-business optimism rose markedly. While it’s true that deregulation, a cornerstone of the new administration’s platform, often leads to productivity improvements, and lower corporate taxes should boost earnings, two other pillars of its platform may be less market friendly.

First, widespread tariffs would increase the cost of goods for both consumers and businesses and may depress spending by both. More than half of global trade consists of intermediate goods that will likely be subject to higher tariffs, increasing expenses for both foreign and domestic companies. And the U.S. stock market is not an island: S&P 500 companies derive over 40% of their earnings abroad. After decades of global economic and financial market integration, the fate of many U.S. companies is intricately tied to economic prospects overseas.

Second, tight restrictions on immigration and deportation of current U.S. residents could slow the economy or increase inflation. The recent surge in immigration allowed the labor force to grow rapidly to meet demand, while wage growth normalized. As a result, U.S. policymakers, unlike most peers abroad, were able to moderate inflation without depressing economic growth. If immigration falls substantially and labor demand remains strong, the downtrend in inflation might reverse or economic growth might slow.

According to the National Foundation for American Policy, immigration has accounted for 88% of the growth in the U.S. labor force since 2019. Historically, slower labor force growth has led to slower economic growth.

7. Extremely Broad and High Levels of Equity Ownership: Strong equity market performance over the past several years has enticed U.S. investors to hold more of their wealth in equities. Today, a record-high share of U.S. families across all income levels own stocks, and equities comprise a larger share of total household financial assets than at any time since the Federal Reserve started collecting the data in 1952. That means more people would be hurt by a market drop, which could set off a broad decline in consumer spending and a negative economic feedback loop.

This list is far from all-inclusive. We could also have highlighted risks associated with record-high deficit spending and government debt, which have increased Federal interest expense from \$350 billion per year in 2020 to nearly \$1 trillion today; or structural issues in residential and commercial real estate; or the slowdown in U.S. job creation.

PORTFOLIO POSITIONING

Our responsibility as portfolio managers is to maximize returns while mitigating risk. In fast-rising equity markets, the responsibility of mitigating risk is often overlooked. It is hard to contend that the balance between risk and reward has not shifted at least a little after the dramatic rise in U.S. equities.

Over the past year, we have been thinking about an old quote from Bob Farrell, who was at the time chief economist at Merrill Lynch: “Exponentially rising or falling markets usually go further than you think, but they don’t correct by moving sideways.”

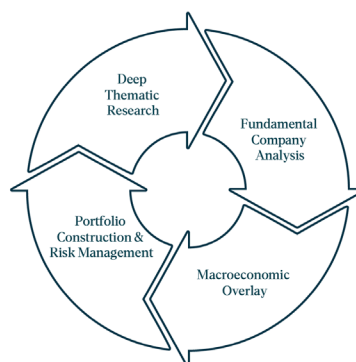
Farrell wrote this in late 1998, when the tech and telecom bubble was expanding to an unsustainable extreme. Farrell was right, but early. The bubble continued to expand for more than a year, before bursting in March 2000. Leaving the party too early can be very costly for investors, as can leaving the party too late.

We recognize that we, like Farrell, might be too early in taking a more cautious stance. Equity markets rise more frequently than they fall. That’s why we trimmed, rather than eliminated, many holdings that have experienced outsized returns in recent years. In general, we redeployed the proceeds from these sales into areas that have done less well and that, in our view, offer greater return potential.

Assessing the macroeconomic landscape is an important part of our four-step investment process. We use this judgment to weight our investment themes and the holdings within them. Over the past year, we reduced the portfolio weight of our *Dawn of Heterogeneous Computing* theme. Many of its technology stocks – including several in the Mag 7 – enjoyed outsized returns over the past two years. We believe these stocks are more vulnerable than others if the economy slows or the AI journey stumbles.

Macro Analysis and Risk Management Are Key Parts of Our Four-Step Investment Process

Thematic Equity Investment Process



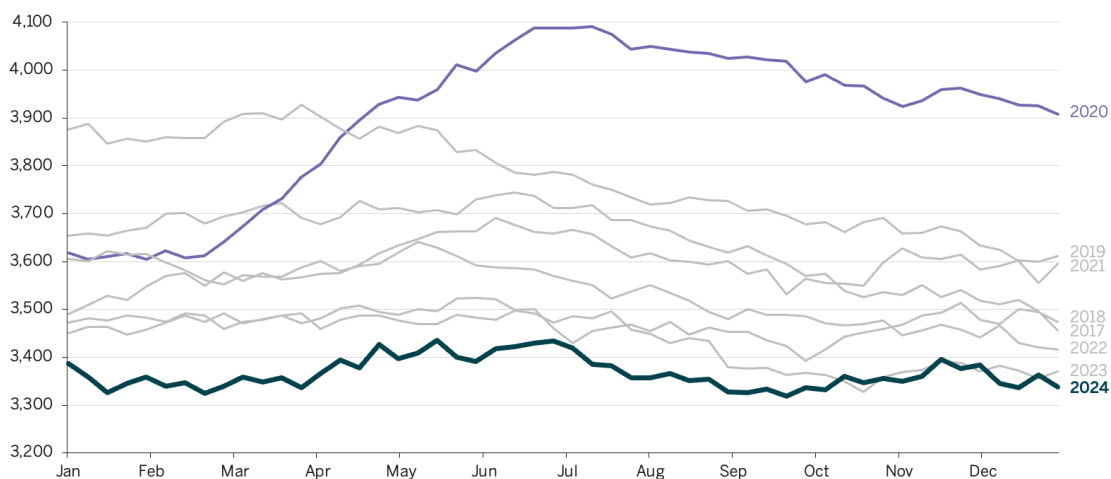
After several years of underperformance, our *Advent of Molecular Medicine* and *Next Generation Automation* themes look particularly enticing to us. Significant technological advancements in the past few quarters have boosted the prospects for both themes, but this progress is not yet reflected in share prices.

We are now evaluating additions to our *End of Disinflationary Tailwinds* and *Opportunities Abound Abroad* themes. With inflation declining globally, countries outside the U.S. will likely stimulate their economies, by increasing government spending and lowering interest rates. Both actions would be likely to boost the relative performance of these two themes.

Energy, a key component of our *End of Disinflationary Tailwinds* theme, has been the worst-performing sector over the past two years, underperforming the S&P 500 by 54 percentage points. Investors seem to be expecting sharp declines in oil prices, despite all-time highs in global oil demand and very low inventories.

2024 Crude Inventories Below Levels Seen 2017 - 2023

Global Observable Oil Inventories (onshore + oil-on-water)
Millions of barrels



Note: Global crude oil inventories (including floating storage), million barrels. This is after the global oil market absorbed ~ 206 Millions Barrels net from the U.S. Strategic Political Reserve (SPR) since January 7, 2022.

Source: Kpler, Barclays Research (inventory data only available back to 2017)

Investors may worry that the incoming President's "*Drill, Baby, Drill*" rhetoric could drive up supply, depressing prices. We do not. Large U.S. energy producers have shown incredible discipline in managing their investments, balance sheets and uses of cash. They have reduced capital spending growth in recent years, and aggregate capex remains significantly below the levels of a decade ago, even in nominal terms. Many companies have told investors that they have no plans to increase production at current oil prices. Instead, they are returning cash to shareholders at record payout ratios. We view this as an opportunity.

In general, our portfolios are trading at lower valuations than their benchmark indices, while having similar-to-faster expected earnings growth. That is a setup we like and one we believe can deliver strong relative returns over time.

CONCLUSION

After more than doubling in price since the beginning of 2019, the S&P 500 was near record highs at year end. Therein lies the challenge: Defining an alternative to passive investing in a broad market that has continued to set new all-time highs and appears increasingly driven by flows and exuberance.

As active managers, we don't invest in the market as a whole. We seek to invest in good companies with superior return potential, and avoid those with inferior potential, based on our research into broad themes that we see reshaping the economy and markets.

As 2025 begins, we are engaged in a delicate balancing act: carefully assessing risk versus reward, selling neither too early nor too late, pursuing opportunities while remaining clear eyed in the face of uncertainty. This is the mission that has energized us for decades.

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