QUARTERLY
INVESTMENT REPORT

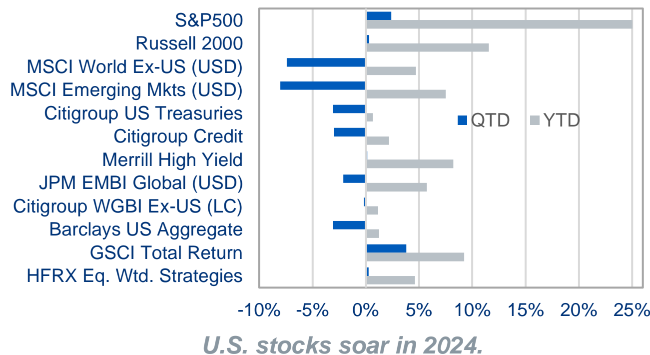
Q4 2024

Strategic Investment Group®

Global Market Review

Propelled by a continued surge in AI-related stocks, the U.S. equity market gained 25% in 2024, further stretching valuations. Advanced and emerging equity markets rose moderately, extending a long period of underperforming the U.S. market. The Fed's decision to cut its policy rate by 25 basis points in December was widely anticipated, but the hawkish tone of its forward guidance was not, contributing to a steepening U.S. Treasury yield curve and increased policy uncertainty. The prospect that expansionary fiscal policies under the new administration might be met by tighter Fed policy fueled an increase in longer-term yields. This constellation of policies, combined with expectations for an increase in tariffs, also contributed to an appreciation of the U.S. dollar against most major currencies. Gold and Bitcoin prices were up sharply in 2024 and closed the year near record highs. Oil prices were little changed.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Quarter ending December 31, 2024.



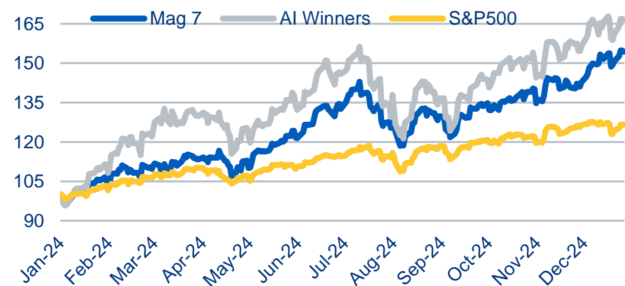
U.S. stocks soar in 2024.

Strong U.S. Equity Gains Stretch Valuations

Although the most spectacular advances were reserved for AI-related stocks, all market segments and sectors generated strong gains last year, albeit with significant dispersion. Growth stocks (+32.5%) outpaced value (+14.0%) by a wide margin, and large cap stocks (+24.5%) handily beat small (+11.5%). Across sectors, tech and telecom stocks led the pack by a mile, rising 35.7% and 37.7%, respectively.

This pattern of performance reflects hopes that AI will become a transformative general-purpose technology whose widespread adoption yields a productivity renaissance boosting output and living standards. An index of 45 stocks judged likely to prosper in an AI revolution rose by 66% in 2024, while the gains of the Magnificent 7 index were more than double that of the S&P 500 (Exhibit 2). NVIDIA rose by 171%.

Exhibit 2
Broad Advances Across Equity Market Sectors
Source: Bloomberg. Index January 1, 2024 = 100.



By any measure, the valuation of the U.S. equity market is near record highs. Its forward P/E ratio is in the first decile of historical valuations. Lofty valuations are not limited to a few outliers. The valuation of the S&P 500 excluding the high-flying Mag 7 is in the top decile of valuation peaks. The valuation spread of the U.S. market over non-U.S. exchanges is at a record high. The U.S. equity risk premium relative to real U.S. Treasury yields is low. Given these valuation metrics, the forward return potential of U.S. equities appears limited. High levels of market concentration, policy uncertainty, and geopolitical risk further cloud the outlook. Nevertheless, surveys of investor attitudes as well as portfolio flows point to widespread bullish sentiment. The momentum behind the market rally appears strong, at least for the moment.

1001 Nineteenth Street North
17th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com

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Non-U.S. Equities Continue to Lag U.S.

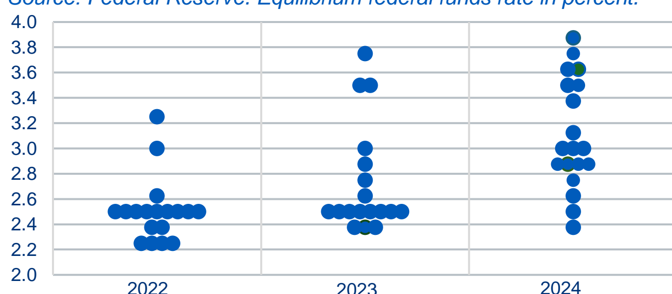
The MSCI World ex-U.S. index of advanced economy stocks rose 4.7% in U.S. dollar terms last year, well shy of the U.S. market's 25% return (Exhibit 3). Emerging equity markets gained 7.5%. Chinese equities, which had been languishing in the face of persistent debt deflation, rebounded following the announcement of far-reaching stimulus measures in September. They gained nearly 20% in 2024, with most of those gains generated immediately following the announced stimulus. Despite last year's strong performance, Chinese economic growth remains weighed down by excess capacity, high debt levels, deflationary pressures, a declining workforce, and slowing productivity gains. Its excessive reliance on exports as an engine of growth appears increasingly at risk in an era of growing protectionism.

Over the past 10 years, the U.S. equity market has outpaced other advanced economy bourses by a wide margin, generating annual gains of 13% versus 5.2% for non-U.S. advanced markets. Over this period, emerging markets lagged even further behind the U.S., returning 3.7%. Given these trends, U.S. equities represent nearly three-quarters of the MSCI World index and two-thirds of the broader MSCI ACWI Index comprising both advanced and emerging markets.

Fed's Hawkish Guidance Sows Uncertainty

The Fed's decision to cut rates by a further 25 basis points in December was widely anticipated. However, the hawkish tone of its forward guidance was not. The dot plot of each FOMC member's forecast for the long-run equilibrium federal funds rate now points to a much higher rate than previous forecasts and increased dispersion in expectations (Exhibit 3).

Exhibit 3
Dot Plot Points to Higher Rates and Uncertainty
Source: Federal Reserve. Equilibrium federal funds rate in percent.

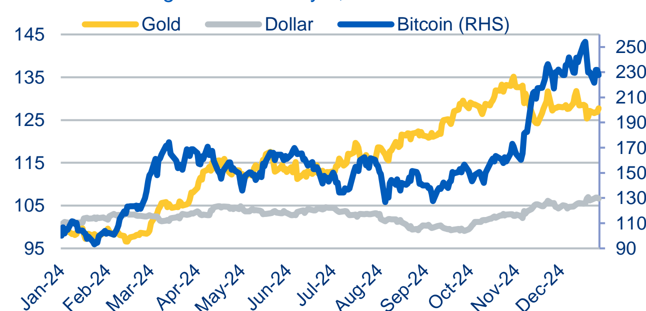


Longer term U.S. Treasury yields rose in the course of 2024, as short-term yields followed the fed funds rate lower, resulting in a steepening of the yield curve. The rise in longer term yields was mainly driven by an increase in real yields and a rising term premium reflecting, respectively, the prospects for continued strong growth and increased policy uncertainty.

Bitcoin Fever Grips Market

Bitcoin surged 38% higher following the November election. It rose 125% for the year (Exhibit 4). Speculation that the new administration will actively promote cryptocurrency use was the main catalyst for the latest Bitcoin frenzy. Gold also had a good run in 2024, gaining 27.7% to close the year near a record high. Sovereign purchases to diversify central bank reserves, especially by China and Russia, as well as geopolitical concerns were the main drivers of gold's 2024 surge. The gains to Bitcoin and gold came even as the U.S. dollar appreciated against most major currencies.

Exhibit 4
Bitcoin and Gold Surge Despite Strong Dollar
Source: Bloomberg. Index January 1, 2024 = 100.



Although Bitcoin and gold grabbed the headlines, the increase in the real effective exchange rate of the dollar (an index of the U.S. dollar versus major trading partners adjusted for inflation differentials) to 30-year highs is the more fundamentally important development. Over the past 10 years, the dollar has had a real appreciation of 24%, while the real value of the Chinese RMB declined 12%. A U.S. policy combination of expansionary fiscal policy, tight monetary policy, and tariff increases, if it ultimately materializes, is likely to lead to a further appreciation of the dollar, eroding the competitiveness of U.S. exports and contributing to a widening current account deficit. China's export-led growth strategy and depreciating currency will only exacerbate these trends.

Abundant Alpha Potential in Hedge Funds

The HFRX equal-weighted hedge fund index rose 4.6% last year with equity strategies leading all other reflecting the strong performance of the U.S. equity market. There were abundant alpha opportunities for skilled managers to exploit last year. Strategic's low-beta hedge fund portfolio was well positioned to exploit these opportunities.

Real Estate Remains in Doldrums

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), lost 8.1% in the 12 months through September 2024. The office and apartment sectors posed the largest drags on performance.

Venture Headwinds Ease

The buyout and growth equity components of the Thomson Reuters/Cambridge Index of U.S. private equity (reported with a delay) rose 9.1% and 9.4%, respectively, in the 12 months through September 2024. The headwinds facing venture strategies eased somewhat, resulting in a gain of 3.2% in the 12 months through September.

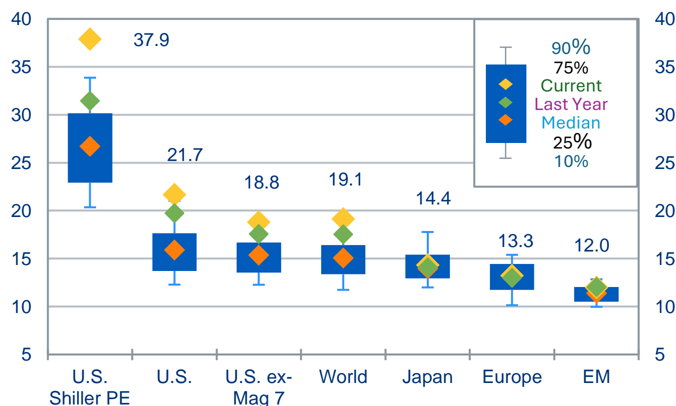
Outlook & Strategy

Momentum, Valuations, and Uncertainty

After two successive years of U.S. equity returns in excess of 20%, investor sentiment is bullish, and their portfolios are positioned accordingly. Part of the market's momentum reflects the ephemera and exuberance typical of booms. This time the dominant narrative buoying sentiment and justifying lofty valuations is the transformative potential of AI coupled with the animal spirits expected to be unleashed by a new era of deregulation.

Part is more solidly grounded. U.S. economic performance has been exceptional, well above estimates of potential output and the growth rates of other advanced economies. Unemployment is low and prices have been moderating, albeit still remaining stubbornly above the Fed's target. Corporate earnings growth has also been strong, and if analysts' forecasts are to be credited, their growth is poised to accelerate. Earnings in 2025 are forecast to increase by 15%, nearly double the 10-year trailing average growth rate of 8%. Next year's outlook is predicated on a jump in earnings of 21% for the Mag 7 and 13% for the other 493 firms in the S&P 500 index.

Exhibit 1
Top Decile U.S. Equity Valuations
Sources: Shiller Data, FactSet, and Strategic calculations. Shiller Cyclically Adjusted Price Earnings Ratio (CAPE) calculated using 10-year smoothed real earnings per share.



There are two potential flies in this heady ointment. First, U.S. equity valuations are quite high relative to U.S. history and to other major equity markets (Exhibit 1). The cyclically adjusted price earnings (CAPE) ratio developed by Robert Shiller is above 1929 levels and has only been exceeded twice before in its long history – the tech bubble of 2000, and post-COVID 2021. Lofty valuations limit the potential for future price gains and are potentially vulnerable to changes in the dominant narrative.

Second, policy uncertainty is also high. Sentiment last year swung widely with changes in the outlook for economic growth, inflation, and monetary policy. Policy uncertainty is now compounded by the potential for profound changes in trade policy, the labor market, energy policy, and fiscal policy (see this quarter's Special Topic on tariffs). There is likely to be a wide gulf between political posturing and policy adoption and an even greater chasm between policy implementation and market impact. The magnitude and timing of the impact of these policy shifts on output, prices, and employment is thus unknowable, as is how the Fed and ultimately the market will react to changing circumstances.

Neutral Top-Down Portfolio Positioning

With the noise-to-signal ratio likely to be exceptionally high, we judge it best to avoid the whiplash from the wide swings in markets that are bound to result. Accordingly, we are maintaining our neutral allocation to public equities and credit and are focusing our risk budget instead on exploiting valuation anomalies across securities. This positioning reduces the level of top-down directional risk in client portfolios and increases the scope for adding value through bottom-up security selection by skilled managers.

We believe that anomalies in the pricing of individual securities are typically the most rewarding, most persistent, and most reliable source of alpha. The environment for active security selection is especially favorable and will likely remain so as the wide dispersion across security valuations continues to normalize.

Reflecting this environment, our top-down positioning across asset classes also includes an overweight to niche opportunistic strategies focused mainly on the credit markets. This overweight to opportunistic strategies is part of our increasingly granular approach to driving portfolio alpha. We are actively considering opportunistic strategies that offer equity-like returns in the areas of levered credit, specialized direct lending, reinsurance, catastrophe risk, and CLO equity tranches.

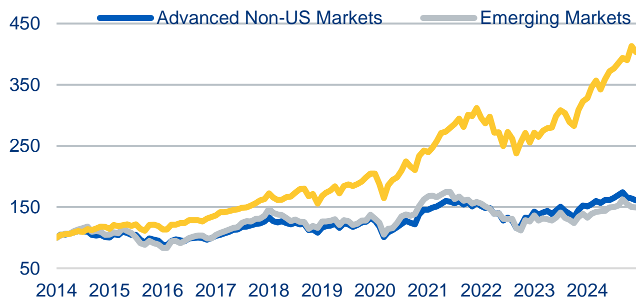
U.S. Equity Exceptionalism

While maintaining a neutral allocation to public equity overall, we are retaining our relative underweight to the U.S. market as well as our overweight to value stocks. We continue to favor managers whose strategies gravitate toward the shares of firms with solid balance sheets and strong earnings. The U.S. equity market has outperformed most other major equity markets by a wide margin over the past decade (Exhibit 2). This period of outperformance has contributed to the exceptional valuations highlighted in Exhibit 1 and justifies a cautious approach to U.S. equities despite the strong momentum behind the market.

We continue to diversify the U.S. equity portfolio structure across investment strategies and market segments as a means of increasing the scope for value added through security selection, diversifying the sources of portfolio return,

and enhancing the robustness of the portfolio. To these ends, the U.S. equity portfolio includes active long-only managers using a combination of quantitative and fundamental techniques as well as extension and portable alpha strategies, and industry-focused specialty managers in the biotech sector.

Exhibit 2
Decade-Long Outperformance of the U.S. Equity Market
Source: Bloomberg. Index January 1, 2000 = 100.

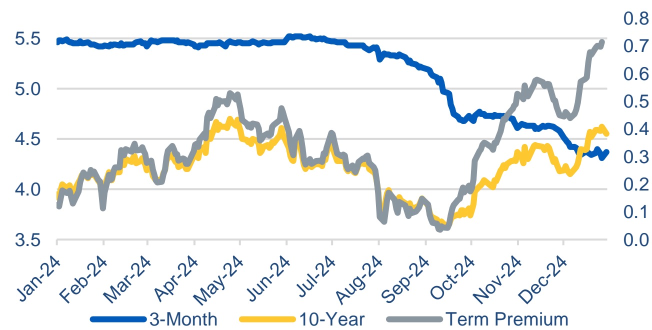


We remain modestly overweight advanced and emerging non-U.S. equity markets which are more favorably valued than the U.S. We are also pursuing a number of initiatives to boost the value-added potential of the non-U.S. equity portfolio. Having introduced a Japanese specialist manager to the non-U.S. equity roster, we are investigating the potential for adding another country specialist manager focusing on India. Moreover, we are planning to increase the exposure to Asia across our emerging managers and are reevaluating the non-core manager lineup. In addition, we are underwriting our current lineup of global equity managers and anticipate manager changes later this year.

Neutral to Duration and Credit

U.S. Treasury yield curve steepened last year as three-month yields followed the fed funds rate lower and 10-year yields rose. Reflecting these movements, the slope of the yield curve normalized in December, following a long period of inversion. As the curve steepened, the 10-year term premium rose reflecting in part increased uncertainty over policies and their ultimate impact on output and prices (Exhibit 3).

Exhibit 3
Treasury Yield Curve Steepens as Term Premium Rises
Source: Bloomberg. U.S. Treasury yields and 10-year term premium in percent.



With U.S. Treasury securities fairly valued and the distribution of prospective U.S. Treasury returns broadly symmetrical, we are maintaining our neutral allocation to portfolio duration. Although credit spreads remain tight, we are also maintaining our neutral allocation to credit. The same, at times conflicting, forces driving equity prices higher are also supporting the compression of credit spreads, militating for a neutral allocation. Moreover, the credit markets are heterogenous and segmented. This market structure offers attractive opportunities to specialist managers with the requisite experience to discriminate across issuers in niche segments of the market. We see continued opportunities to add value through security selection in the credit markets, including in the areas of mortgage-backed securities and direct lending as well as the opportunistic credit strategies noted earlier.

High Alpha, Low Beta the Hedge Fund Ideal

A well-designed portfolio of hedge funds approaches an optimal tradeoff between risk and return, making hedge funds the ideal portfolio diversifier and source of value added. Our focus, as always, is on creating hedge fund portfolios with highly diversified streams of value added from security selection that minimize market beta. We believe that this structure is likely to continue to perform exceptionally well in the current environment of wide valuation dispersion across securities. We are maintaining a neutral allocation to hedge funds. This positioning balances hedge fund benefit against the desirability of maintaining sufficient liquidity to rebalance client portfolios in the event of asset market swings.

Selective Opportunities in Real Estate

Real estate prices remain under pressure, although valuations are improving. We continue to delay new commitments to open-end funds and are avoiding new investments in the office sector. However, we see opportunities in sectors benefiting from high demand and rental income growth. These include industrial, retail, residential, and alternative property segments such as storage and data centers. With real yields on TIPS at more normal levels, we are retaining a neutral allocation to TIPS as a source of real yield and a further inflation hedge.

Private Equity Market Opportunities

Private equity performance remains heterogenous. Buyout and growth equity returns have proven resilient, while the valuations and exit opportunities for venture funds remain challenged. Despite the recent turmoil in private equity markets created by an undisciplined influx of capital, private firms represent a large, growing, and dynamic segment of the U.S. economy that offers attractive opportunities for strong returns and added value. During the boom-induced period of reduced investor discrimination, we remained focused on investments in the industrial, technology and consumer sectors with solid earnings growth. We believe that such prudent investments will continue to prosper as investor discrimination is restored. We also continue to explore opportunities in the growing secondary market for venture investments.

Special Topic

Tariff Q&A

Tariffs are usually intended to protect domestic producers by placing a tax on imports, thus raising their price and reducing import demand. In effect, tariffs impose a higher cost basis on the domestic economy relative to the rest of the world. In addition to an immediate impact on prices, longer-term harms include economic distortions and slower growth. The following Q&A addresses selected issues raised by tariffs.

Who bears the costs of tariffs?
It depends. There are three main factors to consider. First, to the extent that tariffs are passed on to the ultimate consumer rather than being absorbed by the producer, purchasers of imports will face higher costs. (Empirical studies of the impact of the 2017-19 tariffs find that all of the direct costs of the tariffs were passed through to consumers.) In addition to these direct costs to buyers of imports, society as a whole faces the cost of reduced efficiency. These costs are offset by the fiscal revenue generated by the tariff and the higher prices domestic producers can charge for their products now that they now face reduced competition from imports. Moreover, increased tariffs are often met with retaliatory tariffs by trading partners, as they were in 2017-19, to the detriment of domestic exporters and the global trading system.

Are tariffs inflationary?
Yes. The immediate impact of a tariff is to increase the price level. Estimates of the 2017-19 tariffs suggest that the average household faced increased annual costs of $625. In addition to increasing the costs of imported goods and thus the domestic price level, tariffs also shift consumption to more costly or lower quality domestic producers, in effect subsidizing less efficient producers at the expense of consumers. In this way, tariffs limit the variety of goods available to consumers, imposing intangible costs and reducing welfare.

Would tariffs make the U.S. economy more competitive?
No. On the contrary, to the extent that the goods subject to tariffs are inputs in production, a tariff on imports would raise the cost of producing goods in the U.S. Foreign firms, in contrast, would not be faced with these higher input prices and would thus compete more effectively against U.S. firms in international markets. In the case of countries with highly integrated supply chains – like Canada, Mexico, and the U.S. – where intermediate inputs cross borders multiple times in the production process, the disruption created by tariffs would be far greater. The appreciation of the exchange rate that typically accompanies a tariff increase would further erode export competitiveness. Empirical studies of the 2017-19 tariffs found that export competitiveness and volumes declined.

Why do tariffs result in exchange rate appreciation?
By reducing imports, tariffs reduce the supply of U.S. dollars available in the foreign exchange market while also reducing U.S. demand for foreign currencies. To the extent that tariffs are inflationary, the prospect of higher interest rates may also attract capital flows in anticipation of higher yields, further increasing dollar demand.

Could tariffs close the current account deficit?
Not on their own and not without a painful adjustment. It is beguiling to suppose that tariffs could close the chronic U.S. external current account deficit by compelling consumers to replace imported goods with those produced domestically. While this is, at a stretch, conceivable for an individual, it is not feasible in aggregate. To close its current account deficit, the U.S. would have to limit aggregate demand to domestically produced goods. Doing so would require a significant contraction of aggregate demand – a process that would likely entail a painful recession. So long as the U.S. consumes more than it produces, the shortfall will be made up with imports.

Could the External Revenue Service replace the IRS?
No. The tax base of tariffs is too narrow. Goods imported into the U.S. in 2023 amounted to 11% of GDP relative to total tax revenue of 16.5% of GDP. Fiscal revenue in 2023 included customs duties amounting to 0.3% of GDP, or 2% of total receipts. Given these orders of magnitude, no level of tariffs could realistically be expected to replace all fiscal receipts. Moreover, replacing progressive income taxes (49% of total revenue) with regressive and distortionary tariffs would raise broader social and economic considerations.

How big were the 2017-19 tariffs?
In 2018-19, the U.S. imposed tariffs on 17.6% of 2017 imports, representing about 2.6% of GDP. The average tariff rate increase was 22.1%. These tariffs cost buyers of imports the equivalent of about 0.6% of GDP in 2018. Retaliatory tariffs were imposed on U.S. exports amounting to 1% of GDP, bringing the total amount of U.S. trade subject to new tariffs to 3.6% of GDP. Taken together, these measures increased the price of U.S. manufactures by about 1 percentage point. The long run drag of these measures are estimated to shave 0.2 percent off GDP growth.

Are tariffs good for anything?
Yes. Threats of tariffs made to extract concessions from trading partners who directly or indirectly subsidize exports can be a valuable negotiating ploy. If and when tariffs are actually imposed, their main objective is typically to protect domestic producers from the low prices of imported goods. There may be sound reasons for doing so. The protected industry may be deemed essential for national security (steel, shipbuilding), central to maintaining a way of life (agricultural products), or the economy of important regions of the country (manufacturing). In these instances, a case can be made that the costs and distortions of tariffs are a price worth paying to achieve a social objective. However, as with all economic policies, tariffs entail tradeoffs and unintended consequences.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.