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Fourth Quarter 2024 Commentary

Dear Clients,

Please find enclosed your Fourth Quarter 2024 Investment Reports.

U.S. Large Cap Stocks led the way for the quarter, up +3.2%. U.S. Mid Cap Stocks (+0.5%) and U.S. Small Cap Stocks (+1.7%) also produced positive results. The U.S. dollar surged in the quarter, up 7.7% against a trade-weighted major global currencies index. For U.S. dollar-based investors, an increase in the value of the dollar subtracts from baseline international stock performance. Developed International Stocks (-8.1%) and Emerging Market Stocks (-8.0%) suffered accordingly. Long term interest rates also rose in the quarter, pushing U.S. Bonds down -3.1% and Global Bonds down -5.1%.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years (annualized)
U.S. Large Cap Stocks	3.2%	27.2%	15.5%
U.S. Mid Cap Stocks	0.5%	15.2%	9.9%
U.S. Small Cap Stocks	1.7%	14.2%	9.3%
Developed International Stocks	-8.1%	3.8%	4.7%
Emerging Market Stocks	-8.0%	7.5%	1.7%
U.S. Bonds	-3.1%	1.3%	-0.3%
Global Bonds	-5.1%	-1.7%	-2.0%

Data source: YCharts (get.ycharts.com/disclosure/). Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

The most significant geopolitical event in the quarter was the Election of Donald J. Trump as the 47th President of the United States. As noted, the dollar strengthened significantly as it became apparent that a tariff focused trade policy would prevail in the elections. For the same reason, the currencies of large exporters to the U.S., such as Canada and Mexico, declined. Tariffs will almost certainly cause Americans to import less and thus send fewer dollars overseas in the coming years. This rising dollar could also be a headwind in the fight against inflation, particularly if goods and raw material imports cost more. This updated inflation outlook, along with a U.S. economy that has proven far more resilient than many expected, likely influenced the U.S. Federal Reserve in softening its projections of future interest rate cuts.

Rising long term interest costs may prove to be a roadblock of sorts on any fiscal expansion the Trump administration might hope to create. Note that the first time President Trump took office in 2016, the U.S. federal deficit (i.e. government spending more than government income) was on a declining trajectory with President Trump inheriting a 2015 deficit figure of 2.5% of U.S. Gross Domestic Product (i.e. the federal deficit as a percentage of the national output of the entire U.S. economy). The smaller deficit likely provided more room for the bond and stock market to accept stimulative tax cuts. This time however, President Trump takes office with a rising trajectory of deficits and will inherit a 2024 deficit figure of 6.4%. To put this change in inherited deficit in dollar terms, President Trump has about $1 Trillion dollars less stimulative budget flexibility than his first start in office.

The bond market is signaling such limitations with regards to deficit spending, with (for example) the 30-year mortgage rate having increased more than 10% from 6.1% to 6.9% since the end of September (when election betting markets started to shift in President Trump's favor). Equity markets are also sending mixed signals. Sectors such as energy, materials, health care, and real estate have all sold off since the election, whereas technology and consumer cyclicals have outperformed. Some of this divergence is firm specific (e.g. Tesla), but much of the sector performance differential is likely policy related (i.e. consumers will spend more if President Trump's tax cuts are extended, technology firms are likely to face less regulatory scrutiny under a Trump administration, materials firms will likely face higher import prices on raw materials, etc.).

Taking a longer-term view, one of the tailwinds that President Trump is inheriting is what appears to be improving labor productivity in the United States. Economic output is a function of the number of people working and how efficiently they work. The number of people working is directly tied to the number of people alive and is thus reasonably predictable over longer time scales (i.e. absent a dramatic change in young people's health, we know now how many 18-year-olds will be available to enter the work force 18 years from now). Immigration, how long people work before they retire, how many hours people work per week, and what percentage of people enter the work force change over time, but usually not dramatically from year to year. Consequently, how efficient these workers are is the variable that most frequently surprises markets' growth expectations. Workforce efficiency is also a key determinant of our overall standard of living (one basic way of measuring the standard of living across time or societies is to compare a society's labor productivity).

Measuring the pace of country-wide labor productivity growth is unfortunately difficult in practice for economists, especially in the short run. Over the longer run, a clearer picture emerges, and that picture in the last twenty years has been one of slower improvements relative to the past. In the U.S., economists suggest this trend in annual labor productivity growth has been on average roughly 1.5% per year, compared to a U.S. average closer to double that rate from 1946 to 1970. This year, the 2024 improvement numbers have come in higher than the recent trend (1st quarter = 2.8%, 2nd quarter = 2.4%, 3rd quarter = 2.0%). Meaningful unanswered questions include: how quickly is technology (especially artificial intelligence) impacting these numbers? Is this current uptick sustainable over the longer term? And will we see these productivity improvements spread internationally?

Our recently retired CFO, Mike Hofto (congratulations Mike!), was fond of saying that "higher revenue can solve many of a company's problems." By similar logic, we would say that higher productivity can solve many of a country's problems.

This is why, at the level of the federal government, the American electorate intuitively likes President Trump's promise to improve government productivity by eliminating "wasteful" government spending. Improved productivity (same output, less effort) is a "painless" way to deal with the federal deficit challenge (see: "D.O.G.E.", the Department of Government Efficiency). However, the American electorate, and certainly seasoned investors, also intuitively know that keeping grand New Year's resolutions is daunting. Conquering our challenges usually proves to be something more of a longer-term process that involves developing small healthy habits whose benefits only surface incrementally with time.

Does the future hold a permanent shift higher in U.S. private and / or government labor productivity? We shall see. Such an outcome would certainly be a positive for future standards of living, for deficit reduction, and for those invested in the U.S. stock market. This year, three quarters in a row of above average labor productivity growth helped support a robust 27.2% return in U.S. Large Cap Stocks. And what if that higher level of labor productivity improvement does not prove durable next year? That is one of the reasons why we hold stocks for the long run yet complement them with bonds to hedge against the volatility that can occur in the short run. Appropriate diversification provides a buffer for when grand New Year's resolutions take longer to achieve than we had initially hoped.

As always, we remain grateful for your trust.

Leavell Investment Management, Inc.