

Volatile and Concentrated

Market Update From Advanced Asset Management Advisors

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If one were to check the markets once per year, 2025 appears to have been a reasonably average one. The average S&P 500 stock returned 11.4% for the year. The Aggregate Bond Index returned 7.3%. And 30-day Treasury Bills returned 4.3%¹. However, a look behind these results shows a market of elevated volatility. The largest companies influenced major market indices most (which propelled the cap-weighted version of the S&P 500 to a 17.9% gain). The concentration of this cohort remains historically high. At the same time, the aggregate valuation of stocks against any traditional measuring stick remains high.

Volatility

The typically volatile NASDAQ 100 index fell by 22% from February to the April low¹. The index fully recovered by late summer and continued to its high for the year in late October. The tech-heavy index then marked time through year-end as investors considered the potential long-term value of investments in artificial intelligence.

We discussed the potential bubble in AI related companies in the fall. The risk remains. The question is whether the bubble will burst or earnings will eventually justify valuations with sustained growth.

Bubble predictions abound in any similar price acceleration. However, they are never confirmed until after the fact. In a “bubble”, prices usually decline before investors realize that potential future returns are not as rosy as expected. Selling begets more selling and eventually values are decimated, ultimately confirming the bubble.

Topics

Market volatility and continued concentration within the S&P 500.

Economic strength, and the impact of substantial capital expenditures related to AI infrastructure development.

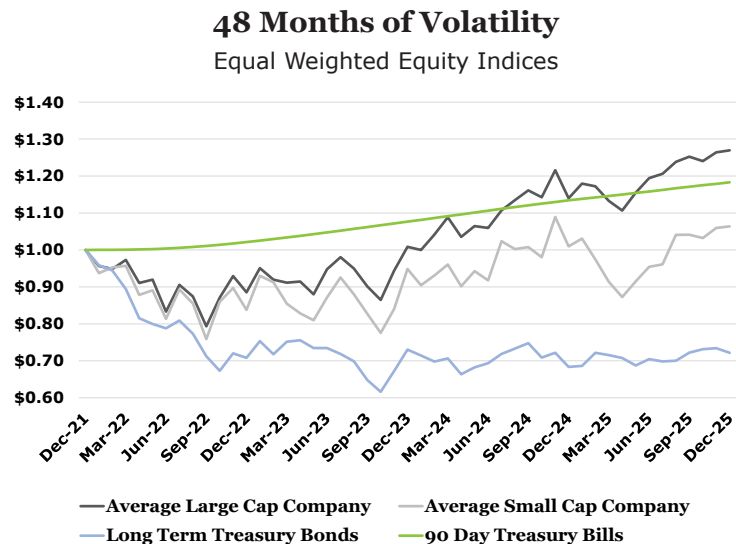
Earnings trends & expectations, and the effects on historically high market valuations.

Interest rate trends and what the ten-year Treasury bond yield tells us about bond investor expectations for inflation.

Historically high **stock valuations**, and the what that means for markets.

Arguing against the bubble theory is the fact that much of the investment in AI has been made by profitable and financially strong companies. Failure of AI expectations would mean lower earnings for these companies but not bankruptcy. On the other side of the ledger, AI has yet to prove itself as a profitable business model. While AI systems are certainly becoming more robust and revolutionizing segments of business (coding and graphic design as examples), systems still tend to hallucinate when they don't know an answer and if you have interacted with the "Susie chatbot in customer service", you understand its shortcomings and the waste of time incurred getting to a live person who can deliver what you need. It will take several years for this to sort out.

A discussion of volatility would not be complete without revisiting the market returns from early 2022 when interest rates started their ascent. Note the spread in cumulative results between the average large company stock (ahead by 27%) and long-term Treasury Bonds (still a 28% loss). The smooth Treasury Bill return has been 18%¹.



The Economy

The U.S. GDP grew on average by 2.5% over the first three quarters of the year with similar growth expected for the 4th quarter. Quarterly reports varied widely, from negative 0.65% in the first quarter to positive 4.34% in the third. Net exports contributed to the wild swings as imports surged in the first quarter to front-run expected tariffs. Net exports in the 2nd and 3rd quarters largely corrected the surge and, boosted GDP. Full year expected GDP growth is a respectable 2.5%. Spending for data center and related investments (to support AI plans) has been a significant contributor to growth with some estimating a full 1% contribution to GDP². Economic growth helps fuel corporate earnings.

Corporate Earnings

Earnings have been particularly resilient this year. Normally, expectations decline throughout the year and 2025 is not an exception. However, earnings growth expected for 2025 stands out, having declined by only 4 percentage points from its early-year high. Expectations typically decline by 12 percentage points, although this average belies a broad range of 1% decline to a 58% decline. Still, 2025 is shaping up to a solid year for earnings growth of nearly 13% when compared to 2024³.

Looking forward, projections indicate earnings growth of 17% for next year³. This is a lofty expectation and will undoubtedly be revised lower as the year progresses. Even so, earnings growth of 13% in 2025 and 17% projected in 2026 help explain why stock prices continue to trade at extreme valuation levels.

Interest Rates and the Federal Reserve

The Fed has cut short-term interest rates by 1.75% over the last 15 months to the current target of 3.63%. Analysis and projection of Fed policy consume a significant portion of the financial news flow. However, the interest rate impacting the real economy most is the ten-year Treasury. At 4.16% it remains 0.53% higher than 15 months ago², at the peak of short-term policy rates. The 30-year mortgage rate of 6.15% is slightly higher as well².



Source: Federal Reserve Bank of St. Louis

Further Fed rate cuts seem unwise given the generally strong economy, low unemployment, and favorable financial condition indices. Bond investors are clearly not convinced the Fed will be successful meeting its projections for when and how far inflation will decline. We are of that opinion as well. Over the last 70 years the yield on the ten-year Treasury bond has averaged 2.15 higher than inflation¹. If inflation settles stubbornly at 2.5%, historical averages imply a 4.65% bond yield and further losses to long term bond prices. Bond portfolios should continue with a defensive (short-term) maturity structure.

The Federal Reserve will have a new Chairperson in May and speculation abounds as to how receptive the new chair will be to heeding calls for lower interest rates. Recent Fed minutes suggest notable hesitation for the last rate cut due to stubborn inflation and strength in the economy. Chair Powell did note in his press conference that he wanted his legacy to be that he left the economy in a good place. Cutting rates does not guarantee there will be no calamity before May, but it would likely not damage his legacy objective.

Stock Market Valuation

We could copy this section from some of our comments over the last several years. The S&P 500 closed the year at 22.4 times expected earnings for 2026³, representing a level seen in only 10% of observations over the last 25 years. Warren Buffett's favorite indicator that compares total stock market value to the size of the economy has never been higher, including stock market peak in 1929. High valuations do not indicate a market crash is imminent. It does, however, mean that stock market declines (in reaction to bad or disappointing news) would likely be larger than those experienced during periods of more reasonable valuations. This is a period when portfolios should favor quality companies with a focus in less volatile segments of the market (i.e. Healthcare, Consumer Staples, Utilities).

¹Morningstar

²Federal Reserve Bank of St. Louis

³Standard & Poor's

Disclosures

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