

Deep Thoughts and DeepSeek

Multiple Expansion Drives 2024 Market Performance

In 2024, much of the 25% equity market return came from multiple expansion. Earnings for S&P 500 companies only grew about 10%, but the amount investors were willing to pay for those earnings (P/E multiple) expanded by about 16%. Thus, about two thirds of 2024 equity performance came from multiple expansion. See details on the chart below.

S&P 500: 2024 Performance Can Be Attributed To...



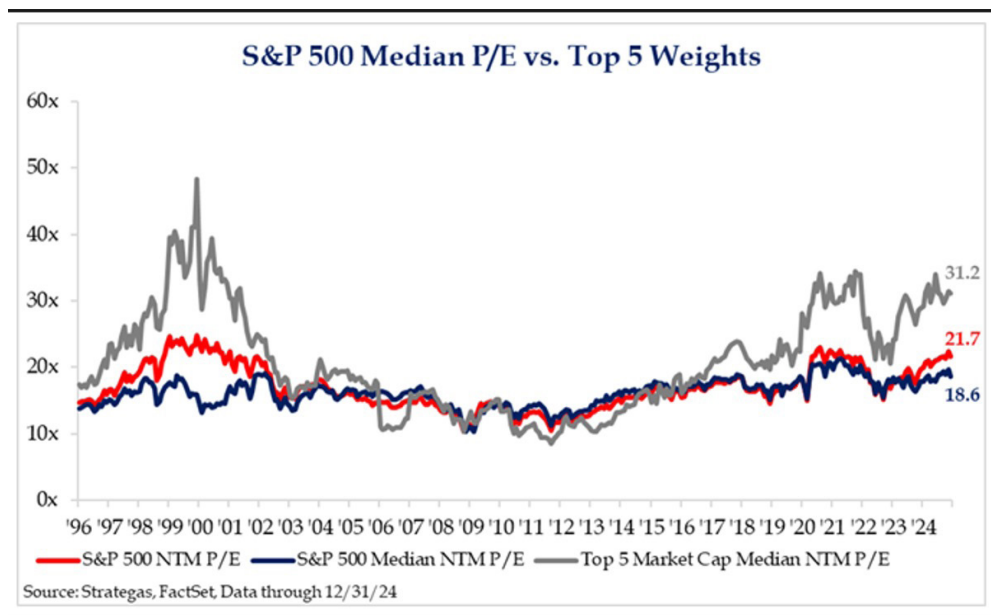
Martin Roberge, Canaccord Genuity, December 18, 2024.

Usually, investors are willing to pay more for a company's earnings when interest rates are *low or falling*. So, the rise in the P/E ratio was surprising given bond yields rose about 1/2% by the end of the year. Further, this multiple expansion brought the market to historically high P/E levels (over 22) which is cause for concern going into 2025 unless we continue to see strong earnings growth.

The Magnificent Seven¹ Strikes Again

Last year, diversified portfolios suffered versus the S&P 500 (SPY) as the market became more concentrated and the biggest stocks outperformed. In 2024, the magnificent seven stocks represented 34.6% of the S&P 500, up from 30.1% in 2023. To put this in perspective, the magnificent seven were already largely equal to the size of the Japanese, Canadian and UK stock markets at the beginning of 2024! So, trees did grow to the sky!

In the chart below, you can clearly see how the price/earnings (P/E) multiples of the top 5 companies have grown to 31.2 (gray line) while the median S&P multiple is 18.6 (blue line). While expensive, these companies have not risen to the astronomical levels prior to the dot-com bust in 2000.



While animal spirits (aka optimism) can clearly contribute to multiple expansion, there are other reasons behind the rise of the Magnificent Seven. Mihir Desai, professor at Harvard Business School, offers his explanation, "Global investors have come to see the equities of these seven companies as the premier safe assets. In a world of inflationary spikes, political instability and gridlock and fiscal uncertainty, why not invest in companies with fortress balance sheets, recurring revenue, stable cash flows, commanding market positions and esteemed management teams? It seems a new generation of investors implicitly views these companies almost like governments. Indeed, as evidenced by Tesla's extraordinary valuation, it's clear its founder Elon Musk has inspired a loyalty that is akin to a sovereign. In a world of algorithmic trading and passive investing, those beliefs take on a velocity that results in the extremely high prices for Big Tech stocks we see today." Mihir A. Desai, New York Times January 28, 2025.

Equity Outlook

Looking to 2025, we think the odds of another multiple expansion for the S&P 500 are low, and we are focused on owning companies with earnings growth. Because software stocks underperformed semis by a wide margin by mid-year 2024, we shifted our emphasis in technology from semiconductors to software companies. We remain overweight software in 2025 as these companies are still inexpensive relative to history. As the AI buildout progresses, software companies will be the bigger beneficiaries of wide-spread adoption.

Fixed Income Trends

Bonds had broad swings throughout the year in response to fears of economic slowdown, euphoria about future Federal Reserve interest rate cuts, and concerns about an indigestible supply of Treasuries to fund our debt. In the final analysis, the U.S. Aggregate Bond Index (AGG) was up slightly. However, our cash and gold positions both significantly outperformed bonds in 2024.

Looking forward in 2025, we expect inflation to remain sticky and believe (as we said in our December predictions) the Federal Reserve will be slow to cut rates. On Wednesday, January 29th, Fed Chair Powell reiterated that the Fed was in no rush. Thus, we look forward to money market fund yields around 4.25% until mid-year.

On the longer end, the 10-year Treasury note issuance will be restricted by the debt ceiling until it is lifted by Congress later this year. A slowdown in new Treasury supply should help moderate interest rates in the early part of the year.

Gold has performed well in its role as an uncorrelated asset (to stocks and bonds). It provides protection in times of geopolitical strife, can be helpful in inflationary periods, and is currently rallying as foreign central banks increase their holdings to diversify away from the U.S. dollar. We will continue to hold our gold position.

DeepSeek or Deepfake?

Recently, a Chinese-made artificial intelligence model called DeepSeek attracted attention in global AI circles. The DeepSeek-R1, released January 20th, is **20 to 50 times cheaper to use** than the U.S. developed OpenAI o1 model, depending on the task, according to a post on DeepSeek's official WeChat account. This news has raised doubts about the reasoning behind some U.S. tech companies' decision to pledge billions of dollars in AI investment. The news caused a rout in all things related to an AI datacenter buildout (utilities, semiconductors, power generation) while software companies who might benefit from cheaper AI capex rallied. P/E multiples for the AI oriented companies came a little closer to earth.

Skeptics Abound...

Some experts don't believe DeepSeek built their model as cheaply as they say or that they only used older model Nvidia chips. "Scale AI CEO, Alexandr Wang, said during an interview with CNBC on Thursday, without providing evidence, that DeepSeek has 50,000 Nvidia H100 chips, which he claimed would not be disclosed because that would violate Washington's export controls that ban such advanced AI chips from being sold to Chinese companies. DeepSeek did not immediately respond to a request for comment on the allegation.

In a research note on Monday, Bernstein analysts wrote that DeepSeek's total training costs for its V3 model were unknown but were much higher than the \$5.58 million the startup said was used for computing power. The analysts also said the training costs of the equally acclaimed R1 model were not disclosed." Edward Baptista, Reuters, January 28, 2025.

Others See Cheaper Processing as AI Nirvana...

Technology experts are highlighting a concept called 'Jevons Paradox' whereby increased efficiency can paradoxically lead to an increase in consumption of resources. This means lower costs of AI could beget higher consumption of AI, causing some to think a similar number of datacenters and amount of energy will still be needed. Ultimately, analysts believe the newer, cheaper models will speed up AI adoption rates and improve U.S. productivity rates over time – a good thing for the economy and also for keeping inflation at bay.

We expect 2025 to be an interesting and volatile year as dramatic government policy changes are both promoted and withdrawn.

Contact Us:

Lisa James

lisa@2xwealth.ingalls.net
212-269-7758

Lori Zager

lori@2xwealth.ingalls.net
212-269-7757

¹The magnificent seven are Alphabet, Amazon, Apple, Microsoft, Meta, Nvidia, and Tesla.

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