



January 2025

Dear Turtle Creek Client,

Global markets wobbled through year end, with both stock and bond markets shifting course considerably in response to the unforeseen sweep of both Congress and the Executive branch by the Republican Party. Major domestic stock indices posted volatile but ultimately flat results throughout the final months of the year, an outcome that masked significant changes in underlying stock market leadership. International stocks sold off across the board as traders adjusted their outlook for renewed trade hostility and potential tariffs by the incoming Trump administration. Bond markets also posted losses in the final months of the year as longer-term interest rates climbed in anticipation of increased deficit spending and a potential resurrection of inflationary trends that were largely dormant by year end.

Turtle Creek entered into 2024 with an optimistic outlook, noting durable economic growth, a bullish outlook by corporate managers, and the historically dependable stock market tailwind of declining rates due to an improving inflationary backdrop. Even with the fireworks of the fourth quarter, this view proved justified as 2024 was an excellent year for investors. U.S. stocks posted strong gains with most indexes posting mid-teens percentage gains and the growth-oriented, tech heavy S&P 500 index finishing with a 25% advance for the year. Short and intermediate-term bonds delivered stable mid-single digit gains as well, resulting in strong risk-adjusted performance for diversified portfolios.

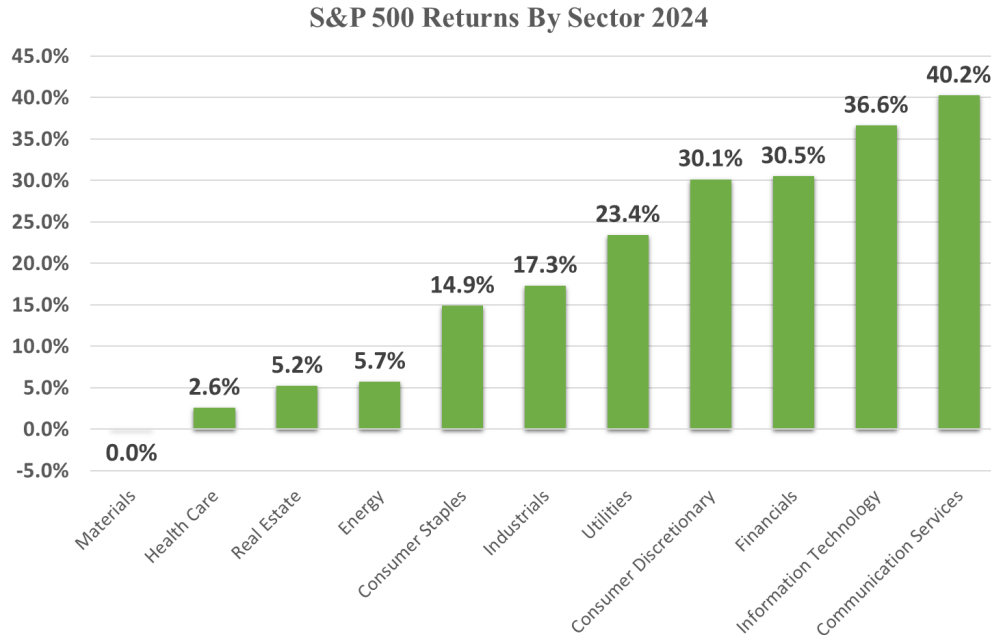
The backdrop entering into 2025 is a much more treacherous one, however, with many risk assets now trading at historically extreme valuations and the tailwind of declining rates and inflation potentially reversing. With a more uncertain path ahead over the near term, clients are best served at this moment by taking profits in winning investments and rebalancing into their longer-term strategic asset allocations. While we still maintain faith in excellent longer-term outcomes for your portfolio, the ride could be a bumpy one through 2025.



Source: Bloomberg

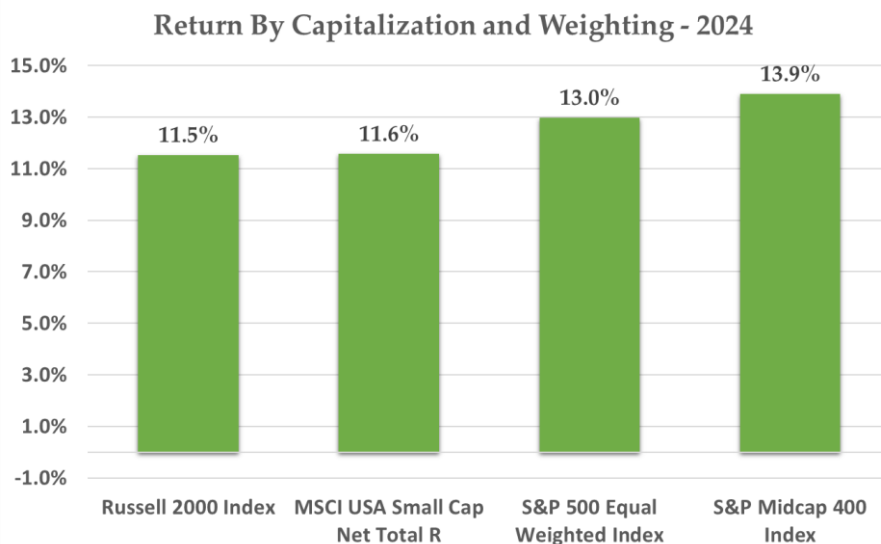
Fourth Quarter and Full Year Stock Market Performance

U.S. stocks (as measured by the S&P 500 Index) finished with a 25% gain for the year with a diverse set of economic sectors driving market performance. Ongoing speculative exuberance for AI related stocks resulted in outsized gains for Information Technology and Communications companies. Financial and Consumer Discretionary companies also notched market leading gains, as the official start of the Federal Reserve rate-cutting cycle and better than expected economic growth drove these stocks during the year.



Source: Bloomberg

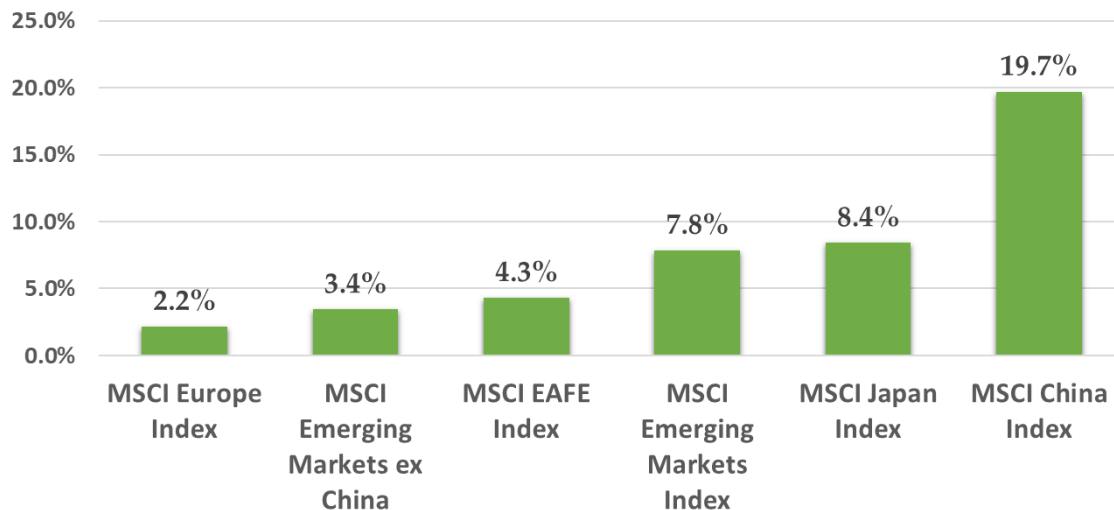
Market returns for the year were once again very narrow, with the top 10 S&P stocks accounting for nearly two-thirds of market performance and AI darling Nvidia accounting for 5.4% of the overall index return. The Equally Weighted S&P Index and Smaller Capitalization companies posted less impressive but still respectable low teens returns during the period.



Source: Bloomberg

International markets had posted strong results through the first three quarters of the year, with both developed and emerging market indexes posting mid-teens percentage gains. These trends reversed throughout the fourth quarter, however, with U.S. interest rates climbing and the dollar strengthening against most global currencies. Both developed and emerging market countries posted worse than expected economic results in the fourth quarter. These trends as well as the Trump administration's planned resumption of tariff-based trade negotiations, resulted in losses through the fourth quarter that wiped out most of the year's prior gains. China shares were the lone bright spot, posting a 20% gain during the year.

Global Stock Returns By Region 2024



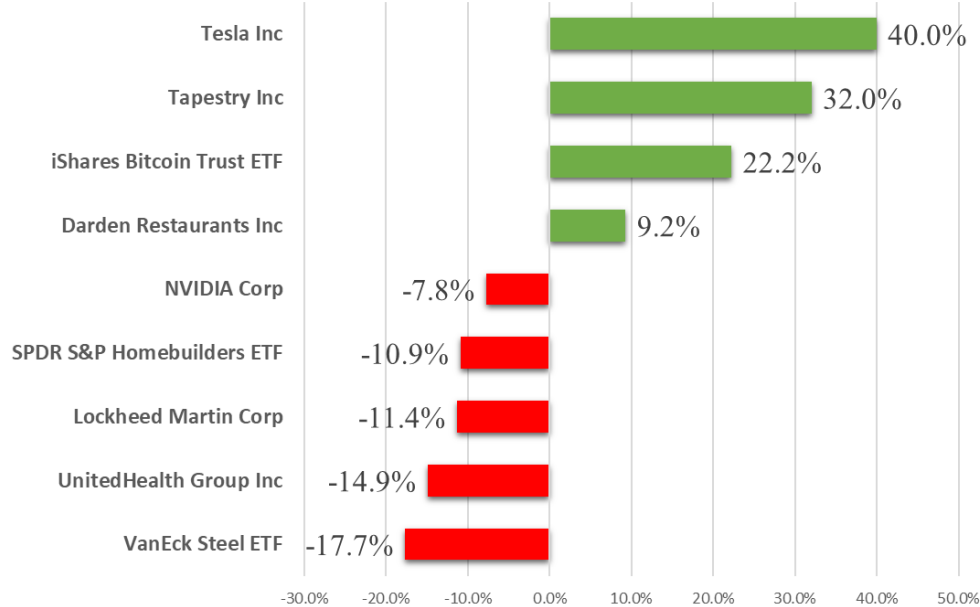
Source: Bloomberg

Analyzing the Trump Trade

The wholesale shift in federal government policy ushered in through this year's election resulted in a notable shift in market leadership. The incoming Trump administration's pro-domestic growth platform drove a surge in economically sensitive industry groups such as restaurants, retailers, and travel and leisure stocks. Companies ranging from Darden Restaurants to Tapestry (owner of luxury brands such as Coach and Kate Spade) posted double-digit gains. The Trump platform's pro-crypto currency stance also revitalized Bitcoin, Ethereum, and host of other digital currencies. Big technology companies rallied on outlook for a less aggressive regulatory stance by the Department of Justice, which had previously been exploring antitrust measures against companies including Alphabet (Google), Apple, Amazon, and Meta (Facebook). The biggest winner of all was Tesla Inc., with its CEO Elon Musk earning a prominent position in the Trump governing team. Tesla shares jumped 40% through the end of year.

There were losers in the Trump Trade, especially businesses exposed to global trade. Importers and exporters suffered from a potential renewal in tariff-based trade tensions. Homebuilders and auto manufacturers tumbled due to potentially higher input costs. Health insurers such as Humana, Cigna, and United Health all dropped due to the Trump platform to lower Medicare reimbursements. Solar companies dove due to a potential elimination of renewable resource credits and defense companies also dropped as Trump's Department of Government Efficiency announced would scrutinize the Pentagon budget. Finally, the Trump economic platform of tax cuts and robust spending once again kindled concerns over deficit spending. Longer-term interest rates increased steadily after his electoral win and rate sensitive stocks ranging from Utilities to Consumer Staples dropped as a result.

Trump Trade Stocks - 11/6 to Year End

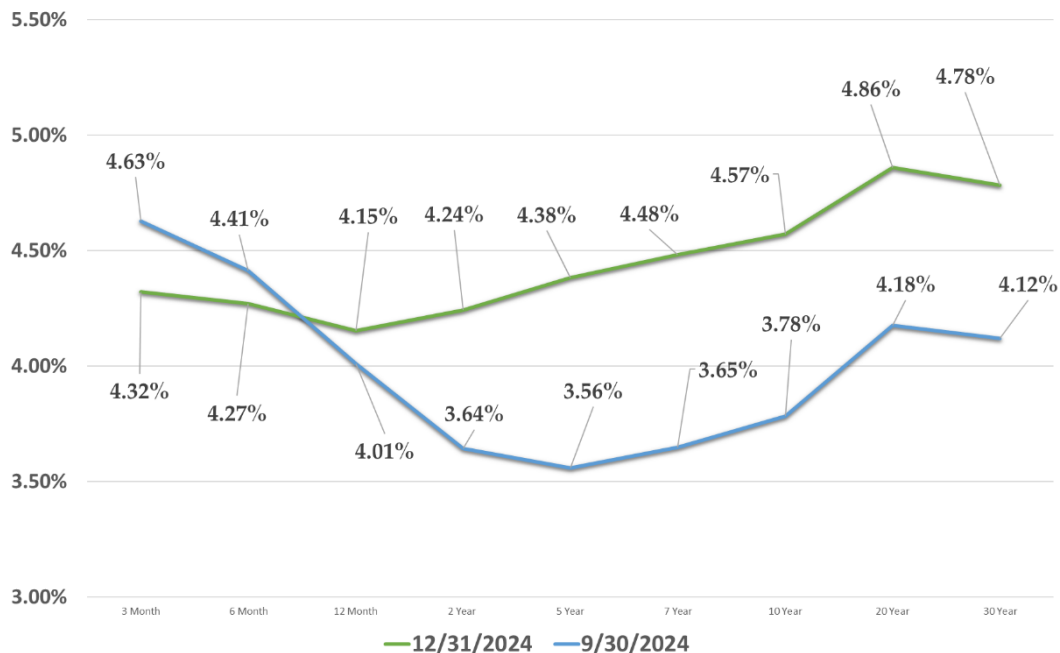


Source: Bloomberg

Fixed Income Markets

The late year surge in longer-term interest rates pushed bond markets into a “Bear Steepening”, industry jargon for the yield curve shifting with short-term rates declining and longer-term rates increasing. The Federal Reserve implemented two 25 basis point rate cuts during the fourth quarter, lowering the Fed Funds rate from 5.0% to 4.5% and pulling down shorter-term bond rates in the process. At the same time, the 10 Year Treasury yield jumped 80 basis points to 4.57%.

U.S. Treasury Curve - 09/30/2024 and 12/31/2024



Source: Bloomberg

This pattern “un-inverted” most of the yield curve for the first time since July of 2022 and sent multiple signals to investors. The first is that, despite theoretical views that new government policies could potentially rekindle inflation, the Federal Reserve still feels comfortable in relaxing its currently restrictive short-term rate policy due to favorable inflationary trends. The spike in longer rates has multiple explanations, primarily signaling increased optimism of the longer-term growth in the U.S. economy due to a less burdensome regulatory environment and pro-growth stance in Washington. Spiking rates also reflect increased nervousness over accelerating budget deficits and the longer-run potential for inflation to return in a faster growing economy.

Lessons from the 2024 Market Year

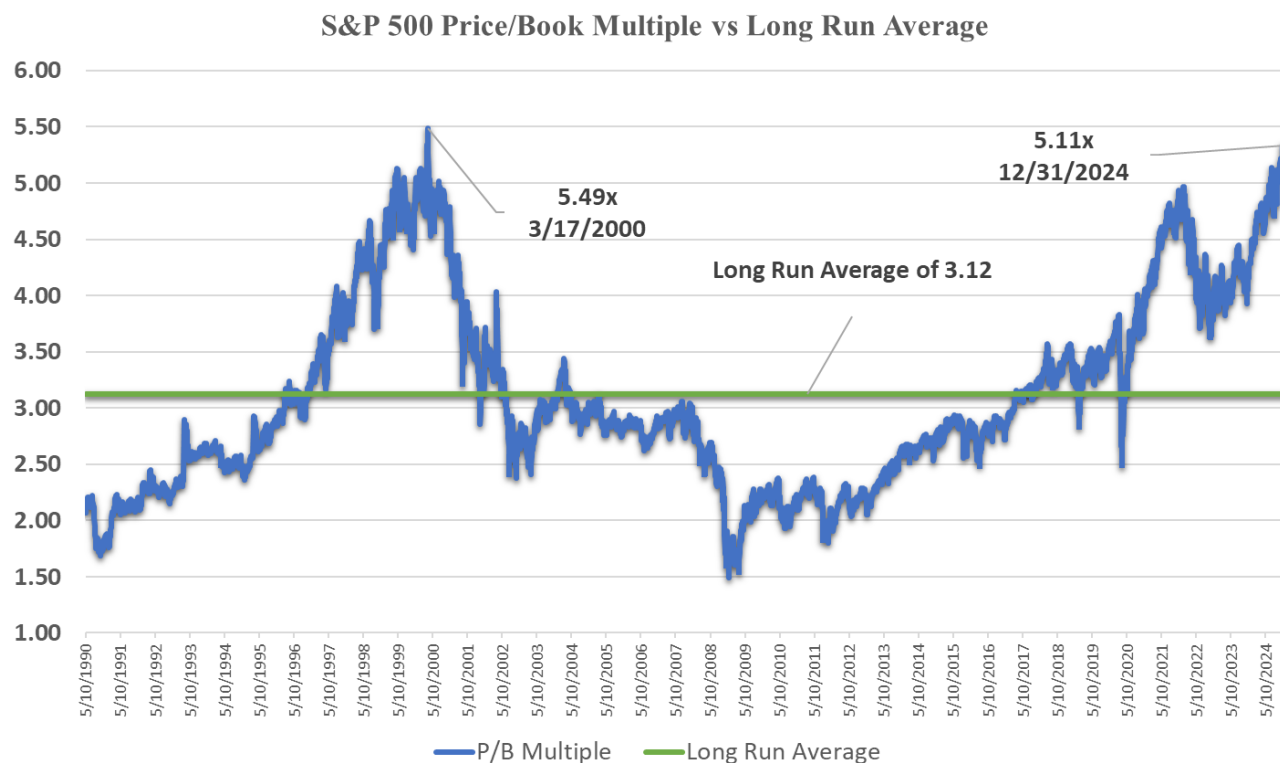
2024 provided investors with a strong reminder that, even with today’s abundant data and split-second trading, investment cycles take years to run their course, and investors navigate them most effectively with a longer-term outlook. The 2021 outbreak of global inflation in the wake of the COVID-related stimulus came to an end in the fourth quarter. It should have been easily understandable based on historical economic patterns. The resulting inflation fighting measures enacted by global Central Banks should have given investors’ confidence that price pressures would eventually fizzle back to longer term historical trends in a similar fashion to previous inflation-related Fed tightening cycles. This did not prevent a multi-year spasm of market gyrations and too many talking heads predicting permanent change.

The current optimism over Artificial Intelligence stocks should also be viewed through a historical lens. The current Artificial Intelligence trade is entering its third year with many leading AI stocks continuing to surge through year end. Historical patterns show that this is often just a mid-point for such cycles. The dot.com and telecom bubble of the 1990s lasted six years, kicking off in 1994 before collapsing and inflicting deep losses on investors in 2000. The Nifty Fifty Growth Stock market of the 1960s ran for seven years before collapsing in 1968 and the stock market taking more than a decade to recoup losses. History shows that the persistence of above average stock market performance by a group of stocks, even over a multi-year period, is not a justification for extreme valuation and nor is a predictor of successful longer-term returns for those securities.

2024 did show that some historical trading rules do have merit. Turtle Creek’s research process spends much of its time debunking conventional Wall Street wisdom, as most trading rules cannot withstand even cursory statistical analysis. The impact of Federal Reserve easing on interest rates as well as the stock market reaction to declining rates are much more reliable guideposts, however. Our strategy to extend maturities in fixed income portfolios and stay committed to risk assets into 2024 was backed by this view and it once again played out as expected.

Investment Strategy

Investors should acknowledge elevated market valuations and a more uncertain outlook and adjust portfolios accordingly. The ongoing outperformance of tech and communications stocks has pushed aggregate market valuations to extremes not seen since the tech bubble of 2000. The S&P 500 Price/Book ratio finished the year at 5.13x, nearly the highest on record since this statistic was first tracked in 1990. Similar to 2000, these valuation distortions are narrowly focused in certain sectors and mega-cap market leaders while the majority of the market continues to trade at more sensible valuations. Many outperforming stocks currently trade at valuations three to four times greater than even a few years ago and trimming back these positions and allocating to more reasonably priced quality companies is a prudent step. The year 2000 is a comforting comparison because, despite the permanent impairment of capital suffered by many market leaders, the vast majority of companies carried on with little difficulty and a properly diversified investor side-stepped much of the resulting fallout and benefited from stable portfolio returns in the aftermath.



Source: Bloomberg

Even with the revised backdrop for potentially rising rates, our current fixed income strategy remains appropriate. Fixed income investors can lock up attractive yields on investment grade bonds going out many years without introducing too much duration risk that could pressure bond prices in the event of a severe spike in borrowing costs. We continue to urge investors to take advantage of this opportunity.

And while no investor can foreshadow sudden recessions, geopolitical events, or acts of fate that trigger bear markets; we do view the current economic backdrop as a healthy one with strong employment and healthy household balance sheets. Even with heightened concern over the inflationary implications of government policy, near-term inflationary trends remain benign. Investors with a properly diversified portfolio of quality investments should sleep well at night no matter the near-term volatility brought on by factors discussed in this letter.

As always, we appreciate the trust and faith you have placed in our firm. We look forward to discussing these topics, or any questions or concerns, with you in the months ahead.

Sincerely,

TURTLE CREEK TRUST

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