FORTIS FINANCIAL GROUP

January 23, 2025

Dear Clients and Partners:

The markets closed out another strong year. Below is the equity performance by type (Value, Blend and Growth) and size (Large, Mid and Small):

	Value	Blend	Growth
Large	14.4%	25.0%	33.4%
Mid	13.1%	15.3%	22.1%
Small	8.1%	11.5%	15.2%

Source: JP Morgan

A few notes:

- Once again Growth won. Even Small Cap Growth outperformed Large Cap Value

- Large Caps continued to dominate. This is very much not in-line with historical risk/return frameworks. We've discussed this repeatedly for years so please refer to those letters for additional discussion. We do not see this changing

- Large Cap Growth was the clear winner. It would be very odd, given that AI is very real, if this was not the case. We are out of consensus in that we believe this will continue. We continue to believe that Large Caps in general, and Large Cap Tech in particular, will continue to win

- We believe that non-Large and non-Mid cap investments moving forward (Small, International and Emerging Markets) will likely require a non-indexed approach to maximize the odds of a favorable outcome. This means we will be supplementing the portfolios with a few ETFs that have some additional quantitative overlays and oversight by a manager vs. straight index

While equities did quite well, bonds had another challenging year, as outlined by the table to the right from JP Morgan.

	Yield		Return
U.S. Treasuries	12/31/2024	12/31/2023	2024
2-Year	4.25%	4.23%	3.79%
5-Year	4.38%	3.84%	1.19%
TIPS	2.13%	1.72%	1.84%
10-Year	4.58%	3.88%	-1.73%
30-Year	4.78%	4.03%	-8.09%
Sector			
U.S. Aggregate	4.91%	4.53%	1.25%
IG Corps	5.33%	5.06%	2.13%
Convertibles	6.22%	7.26%	10.95%
U.S. HY	7.49%	7.59%	8.19%
Municipals	3.74%	3.22%	1.05%
MBS	5.27%	4.68%	1.20%
ABS	5.38%	5.65%	6.81%
Leveraged Loans	8.68%	10.59%	9.33%

On the US government side, the 10YR and the 30YR once again had negative returns. Only the 2YR had an overall return above three percent. The US aggregate bond index (government and corporate bonds) returned just over one percent.

Only HY (High Yield), Leverage Loans (private equity backed loans, generally floating rate) and Convertibles (bonds convertible to equity) returned over 7% despite high starting yields. This was a result of yields rising once again for most bonds by year end.

Rates came down during Q3 alongside some softer economic data; however, the economy picked right back up after the August scare and then the Trump election further increased rates. We get a lot of questions about why rates would rise under Trump so it is worth addressing.

Bond Yields

There are a few reasons rates rose post Trump's victory (and leading up to it) and it really comes down to two things: (i) more debt and (ii) potentially more inflation. While historically the Republicans had more of a conservative (lower deficit) outlook around debts, that has changed, especially under Trump. Trump is not afraid of debt and both parties have effectively punted on any sort of fiscal responsibility.

The Department of Government Efficiency (DOGE) that Trump has instituted will do its best to cut some obvious wasteful spending but we are not very hopeful about massive cuts. They will not be addressing entitlements (Social Security, Medicare and Medicaid) and we are likely to spend more on defense so that removes the majority of government spending from the DOGE target list.

Getting back to interest rates, Trump's plans actually add more to the deficit due to tax cuts than the Democrat's plans did. The truth of the matter though is that unless we get real fiscal responsibility and the likely downside that would come from cutting billions or trillions of spending out of the economy, neither parties' plans do anything to make a real dent.

This means we are going to have to grow ourselves out of this debt problem. And the only way to really grow is to ignite the "animal spirits" once again. Animal spirits is another way of saying we need to run the economy hot. We need businesses to be excited and to spend aggressively on hiring, capital expenditures, etc.

The problem with this, however, is it has the potential to create inflation. This is why bonds, particularly long-term bonds, have been acting so poor. Bond principal repayments don't change in nominal dollars, so if you own a $100,000 thirty-year bond, inflation can really eat into your purchasing power when that bond comes due.

How to Invest Through This Period

There is no doubt that the next four years are going to be intense. President Trump believes he has a mandate for change, and he is not going to be shy in that implementation. As we saw during the first four years there will be a lot of strong statements. We will watch the actual actions taken.

Our job is to manage throughout this period of volatility. We plan to do so as follows:

- **Maintain a long-term outlook**: There will be a lot of noise and potentially more market volatility depending on the specific actions taken. Many of them may be positive for financial markets and others less so. We will continue to view everything through a long-term outlook. If we believe that has changed we will make specific recommendations but longer-term maintaining a disciplined approach wins

- **Continuing to invest alongside the best**: We want small businesses to be given a fair shake economically and we hope they will but the large businesses, especially the Mega Caps, will become more important not less important. To use parlance of the younger generation hope is a "vibe" but economic realities will still prevail and the Mega Caps are still the best businesses ever created

- **Invest in companies and commodities that will do well if the Trump administration chooses to "run it hot"**: As discussed above, a hot economy makes higher inflation more likely. A few specific items of note:

    - **Commodities likely do well**: Our Q2 letter will address this in detail but a broad-based basket of commodities likely does well during a period of running it hot. We want to own not only the traditional inflation commodities like gold but real world commodities that benefit (copper, steel, etc.)

    - **Long-Term fixed debt may struggle**: Fixed longer-term bonds are likely to struggle if inflation picks up again. There will be a time to own these bonds and we will keep an eye on them, but for now, we will continue to avoid

- **Implement hedging where appropriate**: Given our background, we do know how to hedge in a responsible manner. This includes but is not limited to:

    - **Buffered ETFs**: Generally index ETFs with floors to limit downside

    - **Structured Products**: There are products that allow us to take positions with limited downside while still capturing upside of specific indexes or stocks

    - **Individual Security Hedging for Concentrated Positions**: Where concentration is significant, we can hedge out future downside; however, this comes at a cost (usually in the form of capping upside)

The above may indicate that we are bearish on financial markets. To be clear, we are not. However, we do think volatility increases. The main reason for remaining positive on markets is AI.

AI

Our feelings around AI have only become stronger. The new models are becoming shockingly smarter. The newest models are clocking in around PhD level intelligence. Taking a step back this is truly mind-blowing and yes, terrifying. Scientists are now starting to estimate their IQ. They estimate these around 130 or so. That is in the top 2%. The newest models are estimated to be in the 160 range which is smarter than almost any human being.

In order to monetize these models they need to (i) make them affordable (the smartest models are very expensive as they have to "reason") and (ii) make them smart enough to be able to complete tasks with nuance. There is a lot of value in preset type instructions but true super-intelligence will be the "agents" who can complete tasks with very little direction. Replace the word agent with employee and it makes a lot more sense.

The most likely scenario is that the models get smarter and smarter but that it takes awhile to create the true agents that are easy to work with. And then they have to figure out pricing models, etc. However, this is coming, and it is coming faster than most people realize.

There is an old saying that the cynic sounds smarter than the optimist because they have specific reasons why things won't work whereas vs. the optimist's broader outlook is that "it's going to work out". With AI, we are on the optimist's side…we don't know exactly how it will work out but it is coming and it is pretty obvious (to us) that it will transform the world.

Conclusion

We are ready for what should be a very interesting four years, if not more. We will make adjustments where necessary and position your portfolios to ride out any storm over the coming period.

As always we are available at your convenience.

Regards,
Your Fortis Team

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