APPLETON PARTNERS, INC.

Portfolio Construction and Stock Selection:

A Few Thoughts and Observations

Economic developments rarely have isolated impact as one factor affects another. A pandemic-influenced spike in inflation was followed in 2022 by rapid Fed Funds rate increases and an inversion of the US Treasury and AAA Municipal yield curves. Alluring short-term yields subsequently fueled a surge in money market fund assets, which totaled $6.85 trillion as of 12/31/24.[1]

While cash and equivalent holdings can be valuable sources of portfolio liquidity and risk mitigation, too much of a seemingly good thing may ultimately be detrimental to long-term financial health. Fed Funds rate cuts in November and December have already prompted a decline in short-term yields, and for some time we've recommended considering extending fixed income duration. For those without a risk or liquidity-based need for a sizeable allocation to money market investments, there may be considerable opportunity cost to holding excess cash.

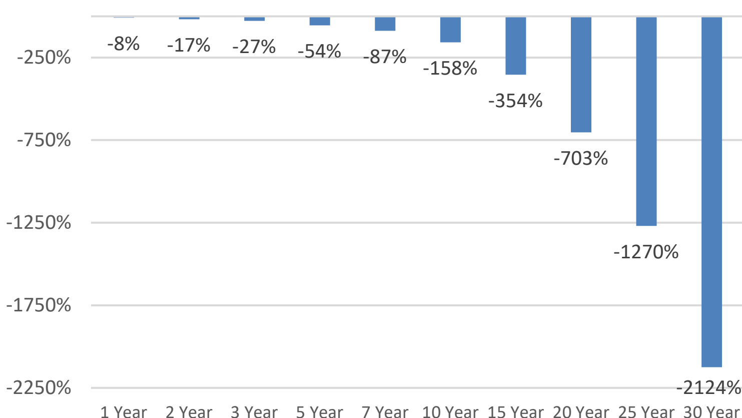
Nonetheless, asset allocation is only part of the risk equation and moving cash into stocks begs the question of, into what? At Appleton Wealth Management, we emphasize personalization, as what's right for one family may not be what's right for another. Today's markets offer a vivid example of why we feel this way.

The S&P 500 is often seen as "the stock market," yet the exposures and risk factors within an S&P 500 Index Fund or ETF may not be well understood. As the accompanying chart reveals, the cap-weighted S&P 500 is currently extremely top-heavy, as the ten largest holdings (primarily large, technology names) account for 38.7% of the entire index's market capitalization. Asset concentration in a narrow sector or risk factor is just that – a risk - particularly if an investor also has similar exposure through individual stocks or other mutual funds. Nonetheless, the largest S&P 500 companies are enormously successful, high growth businesses, and prudent risk-taking is essential to the pursuit of compelling long-term returns. In fact, as of 12/31/24, Appleton's Large Cap Growth composite had a 28.3% weight in the 10 largest S&P 500 names (significant but well below the index concentration).

Our Research team and Wealth Managers are responsible for investing your money in stocks that we feel offer attractive risk-reward profiles, and seek to avoid more speculative, higher risk names. Doing so requires making security specific relative value decisions. When building portfolios, we start by considering your personal goals and risk tolerance, and then draw upon fundamental research rather than simply following market momentum that may be reflected in the largest index holdings.

All stocks are not created equal, and widely cited market valuation metrics demand context. For example, the S&P 500's forward Price/Earnings Ratio of 21.5x sits well above long-term averages, a reality that has raised analyst concerns. Yet upon removing the Top 10 capitalization names, that ratio drops to a more typical 18.2x.[2] Said differently, the "average stock" is trading at valuations well below the largest capitalization names, although arguably for good reason.

There is no simple answer as to when we see value in high flying names and when we don't, but there are certain characteristics we look for. They include sustainable growth rates, enduring competitive advantages, and seasoned, shareholder friendly management, among others. Our goal is to build high quality portfolios aligned with client objectives while retaining the flexibility to adjust when personal circumstances or market conditions change. The performance and valuation of popular stock indices are useful indicators, but it's your portfolio that ultimately matters.



Source: Charlie Biello

Source: JP Morgan Asset Management

1. Investment Company Institute, 1/7/25
2. JP Morgan Asset Management, "Guide to the Markets," 12/31/24.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Market expectations for 6-7 cuts as 2024 began moved over the course of the year towards our 2-3 cut view. A 50bps September cut was followed by two more 25bps cuts in Q4 that left Fed Funds at 4.25-4.50% by year-end.
- The AAA curve normalized in a bear steepener during Q4 with 1-year yields rising by 31bps, while the bulk of the 2 to 10-year curve was higher by close to 50 bps. This asymmetric move caused 1 to 3-year spreads to tighten from 27bps (9/30) to 5bps (12/31).

	9/30/24	12/31/24	QTD Change
2-yr AAA Muni	2.30%	2.82%	+52bps
10-yr AAA Muni	2.60%	3.06%	+46bps
30-yr AAA Muni	3.52%	3.90%	+38 bps

Source: MMD

- Expectations for 2025 Fed Funds cuts have diminished with only 25bps now anticipated in July (CME FedWatch).
- Q4 issuance of $122.3B rose 18% over Q4 ’23, while the full-year figure of $507.6B was up 31.8% over 2023 (Bond Buyer).
- We do not expect much near-term pressure on lower-than-average AAA Muni/UST ratios and feel that 1 to 10-year ratios are likely to remain in the mid-60s throughout 2025.
- A 23-week run of positive municipal fund flows ended in December as yields rose. Nonetheless, full-year net flows of +$42.1B (+$26.3B mutual funds and +$15.8B ETFs) evidenced strong demand (Lipper).
- Credit conditions remained favorable in Q4. AAA-AA spreads rose only 1bp to 11 bps, while AAA-A spreads increased slightly to 35bps. We are maintaining high credit quality as spreads remain at or through long-term averages.
- Given upward yield pressure in Q4, duration drove performance. The Long Bond (22+ years) was the worst performing index component of the index (-1.57%), while the 1-year index was +0.12%.
- With the Fed likely in a holding pattern, and given considerable economic policy uncertainty, we anticipate rate volatility in 2025. Rates sit at the upper end of our 10-year UST range of 4.10%-4.85%, and we see near-term risk of 5.00% or slightly higher. We are finding renewed value in rolling down the yield curve and are maintaining an Intermediate duration target of 4.65 years. Given changes in curve structure, we are now reemphasizing more traditional bell-shaped 2 to 12-year curve exposure.

Investment Grade Corporates & Treasuries

- As the Fed cut the Fed Funds rate and longer rates sold off, the New Year began with the spread between 2 and 10Yr USTs at 32bps, the highest since 2022. That spread widened further to 42bps over the first week of January. We anticipate further near-term steepening in the UST curve as it continues to normalize.
- Q4 brought a sharp drop in yields inside 1-year as the Fed made four 25bps cuts in 2024, while longer rates rose steadily (10Yr +79bps to 4.57%). Only the 1Yr UST bond remains slightly inverted.
- We only expect one rate cut in 2025, most likely later in the year, given lingering inflationary pressures and a bear steepening yield curve, coupled with considerable policy uncertainty.
- IG Corporate spreads remain tight at 80bps, up only modestly from recent lows of 75bps. Credit appetite is intact as evidenced by consistent market demand in the face of the 2nd largest issuance year on record ($1.496 trillion).
- Investor sentiment and more relaxed regulation are expected to also support 2025 issuance. With new issuance often “market-testing” fair value, a strong net new supply may help constrain credit spreads.

Equities

- Despite some uncharacteristic late weakness, stocks were higher in Q4 and finished 2024 with strong returns. The S&P 500 posted a +25% total return in 2024 and achieved back-to-back >20% years for the first time since 1998.
- Consensus 2025 S&P 500 earnings growth expectations are +14.8%. The net profit margin expansion of 2024 will be difficult to repeat, and we are looking for revenue gains to fuel profit growth.
- Breadth is a key indicator of bull market health, and 55% of the S&P 500’s 2024 performance came from the “Mag 7.” While heading in the right direction, broader participation is needed going forward.
- The bull narrative remains largely intact with a resilient consumer, +2-3% GDP growth, an easing Fed and lower inflation, favorable credit conditions, and a positive outlook for corporate profits.
- Investors are also contending with several risks and uncertainties. They include the incoming administration’s stance on tariffs, immigration, and deregulation; Fed policy and absolute long-term yield levels; and lofty stock valuations.
- Although valuations have little predictive power on near-term returns, they do lower the stock market’s margin for error - hence the importance of sustained earnings growth.

ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

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