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A Complex Puzzle with Missing Pieces

As investors, we always try to make sense of the thousands of pieces of information and data that come our way each day, week, month, and year. Taken altogether, these pieces of the investment puzzle help us to build opinions, assess probabilities, think about likely outcomes, and to then move forward with our asset allocation and security selection decisions.

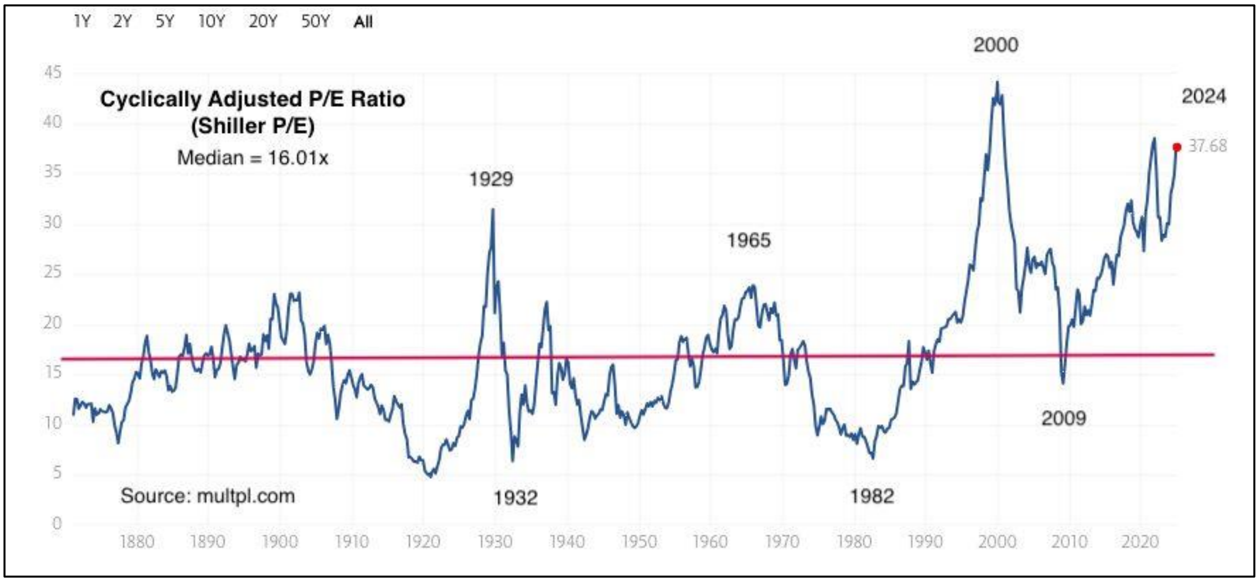
This year, however, is different.

With Donald Trump's election as 47th president of the United States, key elements of the investment puzzle are unknown to investors or are known only in sketch form. That's because Mr. Trump's agenda is vast and ambitious and will ultimately depend on his administration's more detailed initiatives and his own mastery of the legislative give and take. These initiatives will cover everything from taxation, to tariffs, to global trade, deregulation, immigration, and government downsizing.

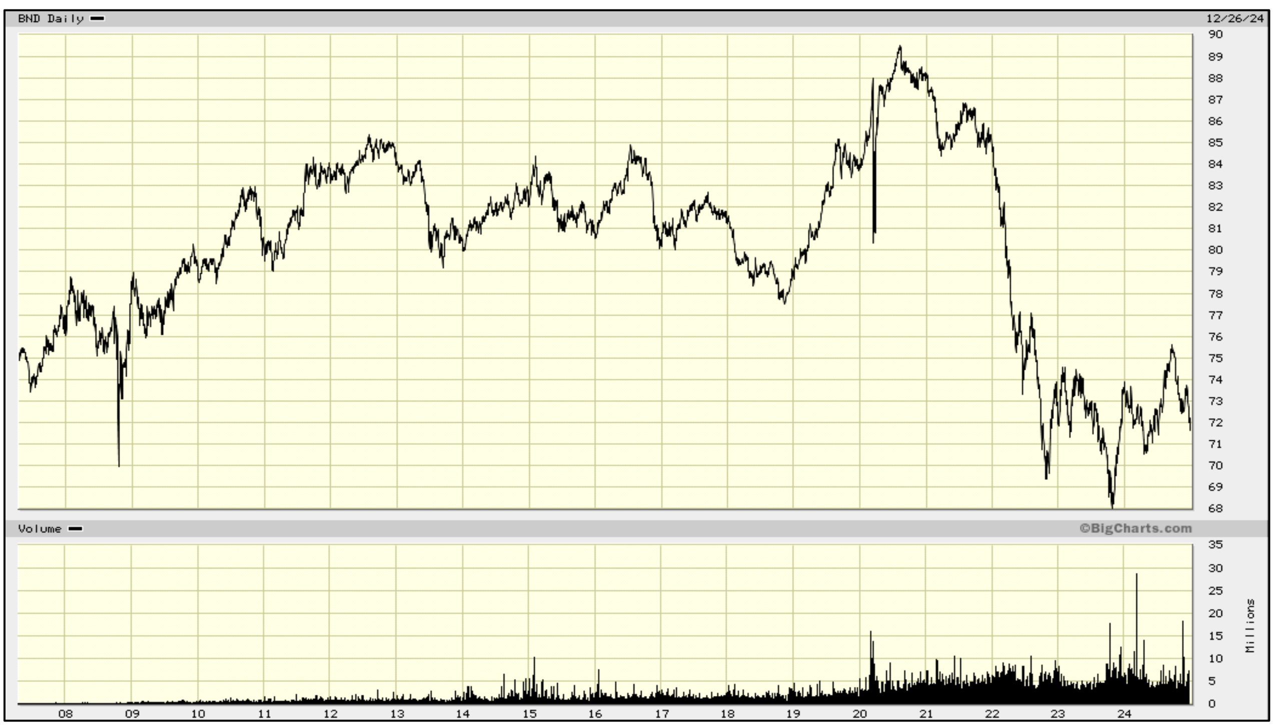
Perhaps the greatest unknown factor that will affect the investment environment in 2025, is the extent to which Mr. Trump himself will take on the quadruple roles of chief executive officer, chief financial officer, chief investment officer, and chief information officer of the massive $29 trillion enterprise that is the United States of America. He is noted for his hands-on approach to management where decisions cannot be made without his approval, so it's not farfetched to think that he will be a hands-on president. That degree of personal involvement will create an additional element of uncertainty for investors as Mr. Trump is also known to be mercurial and an "out of the box" thinker.

While there is much about the 2025 investment climate that we don't know, as things stand now in early January 2025, there are some things we *can* say with certainty about the likely investment environment over the next year, including the following:

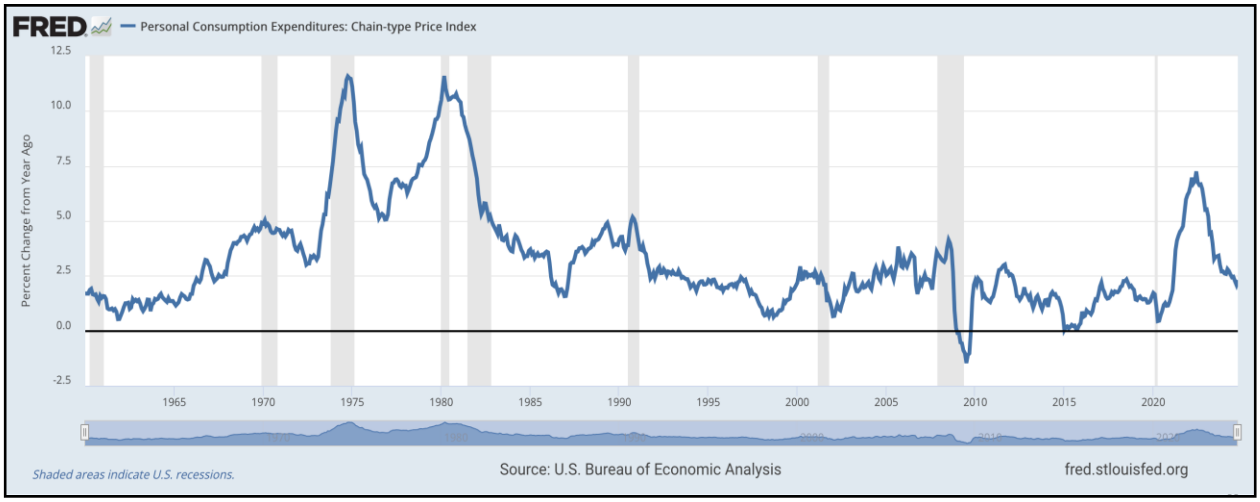
- **Stock market valuations** remain extremely high by historical standards and should continue to be taken as a cautionary signal. High valuations do not in and of themselves indicate imminent danger to stock prices. They are however an unambiguous indication that investors are too optimistic about their investments and about the market's prospects for future returns. That degree of optimism makes investor psychology susceptible to unexpected negative news. This chart of the Shiller P/E shows how expensive the market has become relative to history. The red line is the historical average P/E, which is around 16x. The market is now around 38x.



• **The bond market** has declined in value by more than 20% since its highs in 2021 on rising inflation and rising interest rates. As a result, bonds now offer good yields relative to the past 10 years, as well as the possibility of healthy capital appreciation over time as the Fed lowers interest rates or as interest rates are pushed lower by market forces; and



- **Inflation** (Personal Consumption Expenditures) stands at 2.4%, close to the Fed's 2% target - prior to the election I would have said that this was good reason for the Fed to lower interest rates, but Trump's rise to the presidency and his stated goals for the economy may alter that outlook as those goals have the potential to be inflationary.



Beyond these "knowns", here are the things Trump has said his administration may focus on, and what effect I would expect those actions to have on our investments:

- **Tax cuts** are a cornerstone of Trump's economic policies. If enacted, across the board, income tax cuts could offer a significant boost to economic growth by allowing consumers to keep more of what they earn, and therefore to spend more if they wish to do so. The risk to investors is that broad-based income tax cuts may also be inflationary and may then warrant higher interest rates by the Fed.

- **Deregulation** and **government downsizing** at their most beneficial level, could reduce the constraints under which companies operate, making them potentially more profitable. Higher profitability can benefit equity investors by boosting share prices. On the other hand, deregulation can also result in risky decisions and actions by CEOs who may find that a lack of constraints leads them to take more risk than previously allowed. Government downsizing may also mean that some of the public services that companies have come to rely on for their own benefit in areas such as foreign trade and interstate commerce (think infrastructure quality, for example), may no longer be available, leaving companies worse off.

- **Tariffs** are once again a real possibility in the new Trump Administration as they were in 2018. Trump sees them as a way to fight the rise of Chinese power globally, as a bargaining tool to get trade concessions from Canada and Mexico, and as a long-term strategy to force U.S. companies to bring manufacturing back to the U.S. Tariffs can in fact have all three of those effects over time. In the short-term, however, they would come at a potentially high cost to the U.S. itself. Across-the-board tariffs could result in supply chain disruptions, higher inflation for U.S. consumers, and can lead to retaliatory tariffs and trade restrictions by other countries against the

U.S. That could lead to a lack of foreign sourced commodities and products that American consumers and companies need. All in all, tariffs are a painful remedy to a re-shoring problem that may be better solved through a long-term plan aimed at incentivizing U.S. companies to bring manufacturing back home.

- **The deportation of illegal immigrants** is one way of enforcing immigration laws that have been lax for many decades. In large part, American companies and consumers have welcomed the benefits they have derived from having cheap foreign labor in the country. It has kept costs relatively low. In the very near-term, deportations can be inflationary as cheap undocumented workers are replaced by higher priced domestic ones, when available.

- **Influence over the Fed's interest rate policies**. Mr. Trump has said he should have a say in setting interest rates for the country. In fact, many presidents have expressed this opinion to one degree or another. Since 1913, however, when the Federal Reserve Bank was established as the central bank of the country, interest rate policy has been the purview of the Fed. Mr. Trump appears to want more direct control.

  I should note that the Fed is not a governmental agency. In fact, it is a private club of the largest banks in the nation. These banks through the Federal Reserve network have been legislatively tasked with maintaining stable prices and maximum employment across the economy.

  While the Chairman of the Fed is appointed by the President, the chairman's role is independent of the presidency for the sound reason that interest rates are so important to the economic life of the nation that they must be set rationally and for the benefit of as many people as possible, not just for the benefit of a select few.

  Taking a lesson from the actions of Turkey's President Erdogan who decided some years ago to directly control interest rates in his country, direct presidential control is a patently bad idea. For a time, Erdogan floated the unorthodox concept that high interest rates are the cause of inflation, not the cure. He deliberately kept Turkey's interest rates low even as the country's inflation rate topped the global charts at more than 100% per year!

  Most leaders in a position of that much power are likelier to favor lower interest rates over higher ones as low rates keep wealthy supporters happy and help to promote the leader's power.

Taken altogether, President Trump's planned policies and actions during his second term could produce one of two broad outcomes: either they will create inflation and recession much like the stagflation of the 1970s where unemployment soared; or they will free businesses of regulations and burdensome costs and will unleash the vital elements needed for long-term economic prosperity, as we saw in the Reagan and George H.W. Bush years of the 1980s and 1990s.

At the moment, it is almost impossible to know with any degree of certainty what will materialize from the Trump presidency over the course of 2025 and beyond. Most of what is claimed to be known publicly in the media tends to be more in the realm of speculation and hopeful thinking rather than fact.

Disruption and uncertainty are a normal part of the investment environment at all times, not just now. This time, it's more a matter of degree.

The tools and strategies of conservative investment management, which include mindful security selection and sensible asset allocation focusing on safety over nonstop risk-taking, are more valuable today as we await the missing pieces of the puzzle than during times of less disruption and greater certainty.

Wishing you a happy, healthy, and prosperous 2025!

V. Henry Astarjian