



Financial Outlook

First Quarter 2025

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At a Glance

- The US Equity market (S&P 500) was up +25% in 2024, boosted by optimism about growth and anticipation of Trump's policies
- The yield on 10-year Treasury Notes is up almost 1% (from 3.60% to 4.57%) since the FED first cut rates in September
- The US economy still looks strong but clouds are gathering
- The Equity risk premium in the US is now the lowest in 23 years

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Point of View

Jan Erik Warneryd, Chief Investment Officer



In the fourth quarter of 2024, investors continued to display more of the same optimism about the US economy and US Equities that had marked most of the year. Remarkably, the S&P 500 ended 2024 with a total return of +25.02% even while the yield on 10-year Treasury Notes rose from 3.88% at the end of 2023 to 4.57% at the end of 2024. For the Equity market to perform that well with long yields rising would normally be associated either with the economy coming out of a recession or with the beginning of a bubble where fundamentals such as interest rates no longer matter.

If the market's optimism earlier in the year 2024 was inspired by the anticipated Federal Reserve (FED) pivot towards cutting rates, the rise in Bond yields in the fourth quarter should have dampened enthusiasm. The sell-off in the Bond market could be attributed to the US economy performing stronger than expected in the second half of 2024 while inflation proved stickier than predicted, resulting in a less dovish FED outlook.

According to the FED's "Survey of Economic Projections" (SEP, also known as the Dot Plot), the median forecast by members of the FED's Open Market Committee (FOMC) for where FED Funds will be at the end of 2025, went from 3.375% at the September FED meeting to 3.875% at the December meeting. So, while the FED did cut rates in December, and although they indicated that they are likely to cut a further 50 basis points in 2025, the market has perceived the recent change as the FED being effectively on hold for the time being. No rate cut is expected until at the earliest in July 2025, which represents a significant change in the outlook for FED policy. It was only a few months ago that FED Chairman Powell indicated that the increase in unemployment, from a low of 3.4% in 2023 to 4.2% at the end of 2024, had caused him and the FOMC to shift their focus away from fighting inflation to concerns about a weakening labor market.

However, the election of Donald Trump as the next US President has ushered in a new wave of optimism among investors. Expectations are now that a pro-business political climate in Washington will result in stronger economic growth, lower taxes, less regulation and a more efficient government. While this may all happen eventually, the road there is full of obstacles and a stock market that already trades at a very lofty valuation level after a total return of +69% for the S&P 500 since Q3 2022 may now be vulnerable to disappointment.

As mentioned above, the trend towards higher long rates relative to shorter maturities continued in Q4 2024. The following chart shows the spread between the 2-year and the 30-year Treasuries since the beginning of 2023. The continued steepening of the yield curve is a function of both the market's expectations that monetary easing is close to being completed and an increase in the "term premium" – the risk premium that investors require in order to take long duration risk. For most of the last 2 decades, the term premium was unusually low, even negative at times. Explanations for this unusual phenomenon included investor fears of deflation, an aging population wanting safe assets and quantitative easing, the FED actively buying Bonds in the market to keep rates (artificially) low.

2yr/30yr Treasury Yield Curve

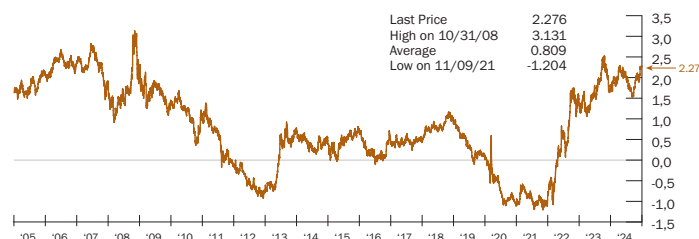


Source: Bloomberg

Now that the term premium is in the process of normalizing, and real rates have increased, the US Treasury Bond market is looking more attractive to institutional investors such as pension funds and insurance companies. The term premium represents a pure risk premium separate from expectations of future FED interest rate policy and is therefore quite desirable for long-term investors.

The market's expectations for long-term inflation have, perhaps surprisingly, not gone up very much in recent years. The main component of the rise in yields from 2021 until now has been real rates going higher. The chart below shows how the real yield on 10-year TIPS (Treasury Inflation Protected Securities) has increased from as low as -1.2% in 2021 to about +2.27% now.

10-year TIPS Real Yield



Source: Bloomberg

This move in real rates means that forward-looking returns have improved by over 3% per annum for fixed income investors in the US market. Coupled with the relentless rise in the S&P 500, as the Equities portion of this quarter's Financial Outlook shows, the forward-looking risk premium in the US Equities market is now very low compared to Treasury Bonds.

The rise in real interest rates back to levels last seen before the Global Financial Crisis (GFC) could have a significant impact on the real economy as many business models relying on the cheap funding and high leverage available during the 2009-2021 period will have trouble rolling over expiring debt in the next few years.

Point of View (cont'd)

Jan Erik Warneryd, Chief Investment Officer



We have already seen this play out in commercial real estate, but other sectors are likely to follow unless interest rates start to come down. Likewise in the residential real estate market, while a majority of borrowers locked in low rates (more than 50% of mortgage borrowers pay 4% or less), over time more homeowners will face the current, higher, rates when buying a new home.

The fixed income market has been focused on worries about higher inflation and large budget deficits keeping the FED on hold, but an argument can be made that any slowdown in the economy could alter the FED's policy stand quickly, ushering in another round of rate cuts.

Bond Markets

Mark McDonnell, Senior Portfolio Manager



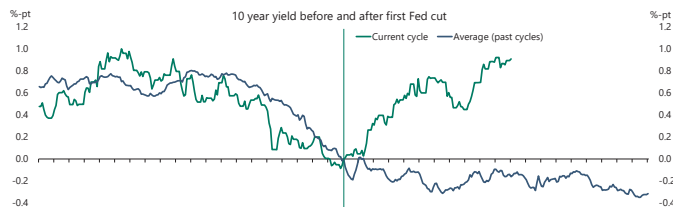
The Bloomberg Aggregate Index ended the year in positive territory after a very turbulent fourth quarter for the Treasury Market. Shorter Treasury maturities fared better into year end. Corporate Bonds performed moderately better than Treasuries in the last quarter and Mortgage Bonds performed marginally worse. We will explore the reasons for all this as well as the opportunities over the next year. We will look at the changes in the underlying Treasury Curve and then build on that to understand what drove Corporate Bonds to outperform comparable Treasuries.

Barclays Aggregate Index Returns

	Long Index Name	3 Month Tot Ret	12 Month Tot Ret	3 Month Excess Return	12 Month Excess Return	Yield to Worst
U.S. Aggregate	U.S. Aggregate	-3.06	1.25	0.18	0.78	4.91
Intermediate	Intermediate U.S. Aggregate	-2.07	2.47	0.09	0.61	4.81
Quality						
Aaa	U.S. Aggregate: Aaa	-1.80	3.07	0.26	1.13	4.72
Aa	U.S. Aggregate: Aa	-3.13	0.84	-0.03	0.19	4.76
A	U.S. Aggregate: A	-3.28	1.68	0.55	1.99	5.22
Baa	U.S. Aggregate: Baa	-2.79	2.70	1.04	2.99	5.54
Maturity						
1-3 Yr	U.S. Aggregate 1-3 Years	-0.02	4.39	0.02	0.26	4.42
3-5 Yr	U.S. Aggregate 3-5 Years	-1.53	3.11	0.12	0.58	4.66
5-7 Yr	U.S. Aggregate 5-7 Years	-2.85	1.84	0.13	0.71	4.96

Source: Courtesy of Bloomberg

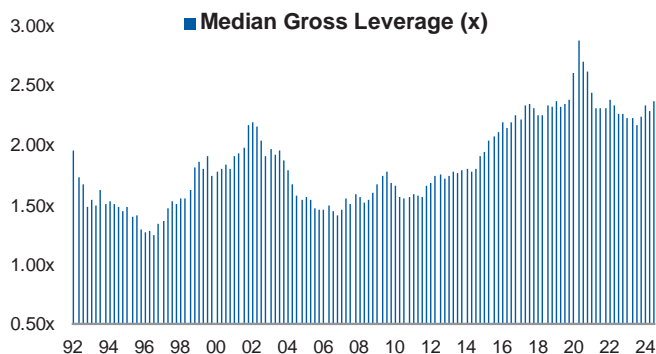
As one can see from the chart, shorter maturities fared materially better, especially in the fourth quarter. This was primarily driven by the Federal Reserve. As we entered the fourth quarter, the FED had already started an aggressive easing campaign, kicking it off with a half a percent cut in the Federal Funds rate on September 18th. The market had priced in another full percentage point of cuts by January of this year and an aggressive series of cuts through the remainder of 2025. Stronger data derailed that and the FED turned considerably more hawkish. While we did receive a further half percent in cuts by year end, the markets went from pricing a Federal Funds rate below 3% by October to pricing in a very modest one to two cuts, and settling down closer to 4% rather than 3%. This repricing of shorter term rates had an unusual effect on the Treasury market. Longer Treasuries sold off aggressively in what is called a bear steepener. Bear because it was bearish for prices, and steepener because the yields on longer Treasuries rose faster than shorter Treasuries. The Treasury Curve in some sense normalized. One should typically get rewarded with higher yields for lending longer since that is riskier. The following chart puts into perspective the unexpected nature of a bear steepener. The 10-year Treasuries tend to fall in yield and rise in price as the FED initiates a series of rate cuts. As you can see, the longer end of the Treasury market rose over one percent even as the Federal Reserve followed through with two more smaller rate cuts. There are a number of factors that went into the aggressive rise in longer rates, fears of deficits as far as the eye can see and the hints of a return to higher inflation being a few.



Source: Bloomberg, Apollo Chief Economist

This rise in longer term interest rates, what we call the term premium, came amid stronger economic data but the data wasn't appreciably stronger. Key metrics Bond investors typically look at like gross leverage actually saw a modest deterioration. Yet we saw a large increase in what is called the "excess return" in credit. Simplifying it down, the excess return is that additional return over a similar Treasury obtained during a holding period. It is composed of the additional interest one is paid for owning a Corporate Bond plus or minus the change in the price of credit risk. We calculate the price of credit risk in a straightforward manner; most of the additional yield one gets paid to own a Corporate Bond is an expression of the credit risk.

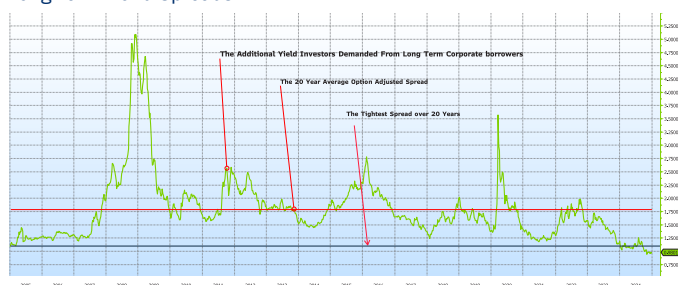
Gross Leverage Increased to 2.37X in 3Q2024



Source: Bloomberg, S&P Capital IQ, Morgan Stanley Research. Data through 3Q24

For example; if a 30-year Treasury yields 5% and a similar maturity Corporate Bond yields 6%, that 1% difference is mostly the additional yield investors demand for taking credit risk. The following is a chart of the Option Adjusted Spread (OAS) or additional yield Bond investors demanded in order to lend to Corporate America for all Bonds maturing in more than 10 years. The green line traces that OAS back 20 years and it is evident that at 0.98% or 98 basis points, we are at the richest level through the previous tight spread in early 2005 and well below the 20-year average of 1.79%.

Long Term Bond Spreads



Source: Courtesy of Bloomberg LP

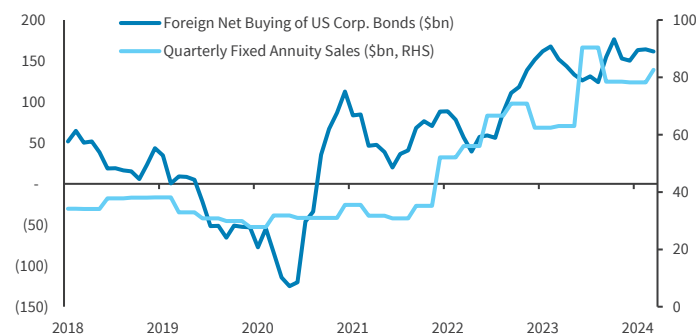
Bond Markets (cont'd)

Mark McDonnell, Senior Portfolio Manager



How do we explain this? The investors buying Corporate Bonds these last months are yield buyers and less focused on credit risk. If the buyer is an insurance company looking to issue a fixed annuity, then that buyer is focused on the yield more than the credit risk. The flows from both offshore yield buyers and insurance companies issuing fixed annuities was sizable. Foreign demand for US dollar credit was strong and may continue to be strong. Buying came from both Europe and Asia. Flows into Fixed Annuities were also quite strong.

Strong Demand from Annuity Sales and Foreign Buyers



Source: Bloomberg, Lipper, Barclays Research.

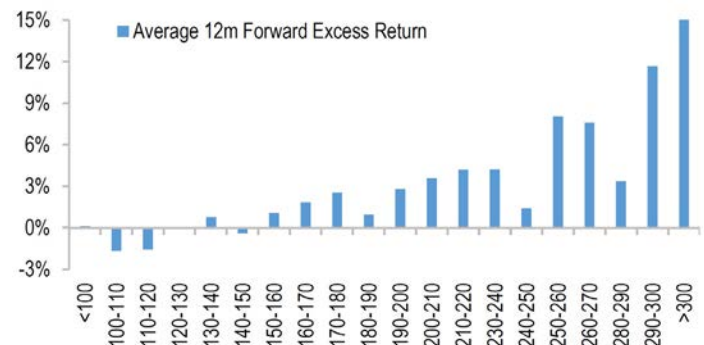
There are reasons to expect these trends to continue. However, and this is where we look to provide added value, the markets are priced to perfection. With the S&P 500 price to earnings ratio at levels we haven't seen since the DotCom boom and credit spreads near all-time tights, the economy and markets have to perform in a near flawless way. The new administration has a number of goals to include a significant reduction in deficit spending. One can agree or disagree with any number of the policies. We can all agree that uncertainty will pick up both in the economy and the markets. With that uncertainty will come volatility and with volatility comes changes in risk appetite. We believe the next year will provide a number of opportunities to add value by taking advantage of the volatility as we have done in the past. One opportunity that might open up is to increase exposure to Corporate Credit. We are positioned with a modest underweight in credit for our clients on the belief as value-driven investors that one isn't adequately compensated. The following chart on the right shows that historically excess return from Corporate Bonds from these levels is usually negligible and can be negative. Implicit in those numbers is the answer why.

12 Month Excess Return Breakeven



Source: J.P. Morgan

Historical Excess Return over the Subsequent 12 Months



Source: J.P. Morgan

As we discussed, excess return can be broken into the additional yield or carry as it's called and the change in spreads. If you hold the Bond for the full year, you receive the additional yield. How can one have a negative excess return? If spreads increase or widen from these levels. The chart above does the math. The breakeven spread is that spread widening that will so negatively impact the price of the Bond that the total return of that Bond is the same as holding a similar Treasury. In this case, were you to buy a Corporate Bond maturing in 30 years and spreads widen 8 basis points or .08%, you would have made the same return as holding a 30-year Treasury. The current option adjusted spread is 98 basis points. That is 12 basis points richer or more expensive than the previous tightest level seen over the last 20 years. It strikes us that a market priced to perfection coupled with a change in administrations to one with a markedly different approach to fiscal policy are the ideal conditions to see changes in risk appetite. We hope to take advantage of the volatility.

STRATEGY

We maintain a modest overweight in duration as the markets have significantly increased the term premium. We maintain a modest underweight in credit as spreads seem inadequate relative to risk. We maintain a modest overweight in Mortgage Backed Securities

which we see as fairly valued. Since they are fairly valued, they serve to compensate our investors for yields they forgo in the underweight in credit.

U.S. Equities

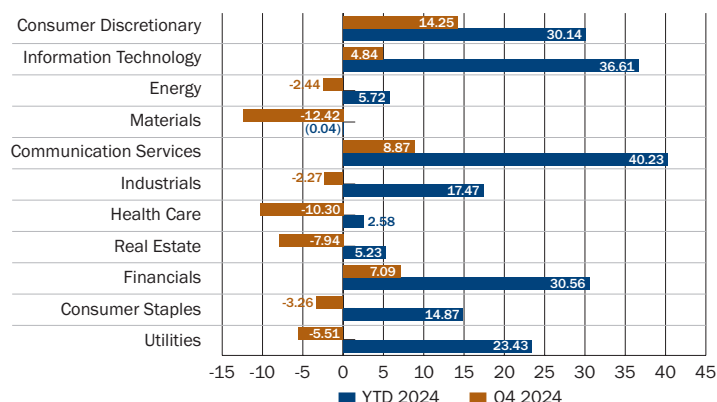
Jan Erik Warneryd, Chief Investment Officer



The fourth quarter of 2024 saw a continuation of the Equity bull market that started in the fall of 2022. After adding +2.41% in Q4, the S&P 500 had a total return of +25.02 for all of 2024. The best performing sectors for the quarter as well as all of 2024 were Communication Services, Information Technology, Financials and Consumer Discretionary (see Chart below for details). For the year, only Materials had a (small) negative return.

S&P 500 Index

Total Return (%) by Sector - Quarter End December 2024



Source: Optimum Quantvest and S&P Global

Earlier in 2024, the Equity rally appeared to be broadening, with some sectors, such as Utilities and Materials, starting to catch up to the leading sectors. However, in the fourth quarter, the Magnificent 7 group of large-cap tech stocks (Nvidia, Microsoft, Alphabet, Meta, Apple, Amazon and Tesla) were back in the lead and the Equal Weighted S&P 500 index finished the year up +13.01%, a full 12 percentage points behind the (Capitalisation Weighted) S&P 500. The Magnificent 7, as a group, returned +68% in 2024.

The market rallied even in the face of a change in the FED's outlook for rate cuts. In response to inflation staying higher for longer than expected, the FED have revised their forecast (median of FOMC members' estimates) for rates from expecting 100 basis points by year end 2025 in September 2024 to just 50 basis points of cuts in 2025 by their December meeting. In fact, compared to expectations at the beginning of 2024, the FED has disappointed the market by "only" cutting the FED Funds rate by 100 basis points. Recently, however, the market appears to have become much less focused on the FED rate path, especially after Donald Trump's election win in November.

Market sentiment is now optimistic because of Trump's expected policies: bullish on Equities (tax cuts and deregulation), bullish on the US dollar (rates staying higher due to economic growth and inflation) and bearish on Treasury Bonds (higher deficits and high inflation). Earnings growth for the S&P 500 is expected to accelerate to 13.6% in 2025 after growth of about 8% in 2024, according to Thomson Financial's consensus estimates. The new uncertainty regarding tariffs and immigration does not appear to worry financial markets focused on deregulation and tax cuts. Somewhat surprisingly, the optimism from earlier in 2024 has carried over even though President Trump will have a very different policy agenda than President Biden did. In addition to policy uncertainty, corporate earnings may face headwinds from an ultra-strong US dollar, higher interest costs as maturing debt get re-financed as well as higher labor costs.

As far as the overall market valuation is concerned, recent all-time-highs in the S&P 500 and rising Bond yields have conspired to push the Equity risk premium* (see chart below) down further, from 125 basis points at the end of Q3 to just below 60 basis points now.

Real Equity Risk Premium



Source: Bloomberg

As can be seen above, the Equity risk premium is now back to levels last seen in early 2002. With the risk premium having fallen significantly since it peaked during the 2008-9 Global Financial Crisis (GFC), Equities are now valued at levels where they may underperform if the market's required risk premium increases in the future, as happened in the 2002-2008 period. If history is any guide, returns to the S&P 500 could be lower than normal for the foreseeable future. For an asset allocator, choosing between, say, Equities and Fixed Income, this may be a time to consider scaling back the Equity allocation in favor of Fixed Income. This is especially true if recent relative performance has resulted in Equities being overweight relative to the long-term policy portfolio.

*The Equity risk premium used here is defined as the spread in percentage points between the inverted CAPE (Cyclically Adjusted Price/Earnings, also known as the Shiller P/E) ratio and the real yield on 10-year TIPS (Treasury Inflation Protected Securities).

U.S. Equities (cont'd)

Jan Erik Warneryd, Chief Investment Officer



STRATEGY

The US economy, while still fairly strong, is starting to show signs of weakening centered on the labor market and consumer confidence. The labor market appears to be cooling after the post-pandemic surge in hiring and consumers are increasingly expecting high inflation to be a long-term problem. Lower-income consumers who haven't benefited from the wealth effect created by a rising stock market and high home prices, are facing higher delinquency rates on credit card and auto debt. Coupled with the FEDs reluctance to declare a win over inflation, which has resulted in rising Bond yields, headwinds are gathering for the US economy even before taking policy uncertainty under President Trump into account.

We believe a change in market leadership will eventually result in better relative performance for sectors that have lagged the multi-year Equity rally. Cyclical and Value sectors such as Financials, Health Care, Utilities and the Telecom sub-sector are likely to outperform the overall market if, and when, the Magnificent 7 stocks give up their leadership. The timing of when that may happen is difficult to predict but the catalyst could be an economic slow-down coupled with uncertainty about future Washington policy. This scenario would also likely bring Bond yields lower which could further support Cyclical sectors and Financials, for example.

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