fourward

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The 4th quarter of 2024 generated a small loss for the quadrant portfolio. Not surprisingly, the presidential election dominated investors' attention for most of the year. In the weeks leading up to Nov. 2nd, stocks rallied higher along with the increasing odds of a Trump victory. Finally, in what seemed like a celebratory frenzy, prices leapt even higher for a few weeks before correcting into year-end. Although the stock market generated a strong performance for the year, CNBC did not get the Santa rally they hoped for.

Gold, for all its independence and historical lack of correlation to stocks ended up tracing out similar 2024 performance and October capped an 8-month rally that resulted in a subsequent 8% correction into year-end. However, as of this writing gold prices now sit, once again, at all-time highs. From a historical standpoint, it's unusual for gold and the S&P 500 to move with such high correlation. In fact, I believe that 2024 was the first year that both markets appreciated over 20% in the same year.

Portfolio Updates

The portfolio's largest performance contributors for the quarter were our energy companies (**AR, RRC, EXE**) and StoneX (**SNEX**). I've liked the energy sector for the last few years and continue to think that it'll be a worthwhile investment going forward. Separately, StoneX is a well-run commodity brokerage company that should be positioned to benefit from any upcoming commodity cycle. It's a wonderful mid-cap growth company, yet somehow can only be found in two ETFs. The largest of these holds only $188m in aum compared to the roughly $500B in the largest S&P 500 index fund. Needless to say, the broad investing public owns very few Stonex shares, therefor the company should benefit from any rotation out of index investing and back into active management.

Laggards included A-Mark Precious Metals (**AMRK**) and Exact Sciences Corp. (**EXAS**). A-Mark Precious Metals experienced a slower Q3 and investors punished it for those results. A-Mark owns several of the largest online precious metals dealers and should benefit from a continued bull market in gold. If you want to buy gold or silver bullion online (many do) then chances are you'll use an A-Mark-owned website such as: JM Bullion, Silver Gold Bull, BGASC, and others. The other negative performer was Exact Sciences Corp. which reported earnings below estimates and, consequently, faced downward price pressure on its shares. Exact has a history of consistent growth and a unique product offering of non-invasive cancer screening products. As a "growthier" company this type of volatility shouldn't be too surprising and instead should be a bump in the road on their path to higher sales and, hopefully, a higher share price.

General Thoughts

I'm fairly excited about the prospects for the precious metals sector. Various developments, data points, and trends are converging to make me think that this sector alone will be responsible for keeping gold-owning investors in decent overall financial shape over the next decade. Gold benefits from a host of potential drivers: stock market volatility (i.e. bear markets), severe inflation or deflation, negative real

interest rates, a general commodity bull market, or a shift in demand for the physical metal (e.g. central banks buying gold). One of these potential drivers that I'm monitoring for is a major stock market top.

Bull markets in gold and equities are mutually exclusive. Sure, depending on how one measures things, gold and stocks can move in the same direction in any particular year (like they did in 2024) or they may overlap for a few years at the end of a major secular move. But over the long-term, the conditions that drive a major gold bull market are nearly completely opposite that of the conditions that drive major bull markets in stocks. In other words, if gold ends up being the top performing asset over the next 10 years, chances are that stocks will be one of the worst. The last multiyear bull market in gold lasted from 2001-2011 (the dot-com bust and the Great Recession occurred during this time) and the other major bull market lasted from 1970-1980, an awful period for equities.

I do suspect the stock market is in the process of making a major top, something similar to 2000 or 1968. If I'm correct then stocks will only provide volatility and headache in the coming years, not capital gains.

Historically, major secular bull market tops tend to be a process and don't just crash on a certain day (thankfully). For example, the 2000 market top took about 18 months to churn and roll over and the 1968 top really started in 1965 and exhibited sizable volatility. Even 1929, just before the Great Depression kicked off, took about two years before the most damaging portion of the decline began.

Explaining market tops in this way makes them seem less threatening. A reader wight think "since market tops are often a prolonged process, I have time to react and protect myself." True, but I caution too much passivity since, depending how you measure things, the current topping process may have started some time ago. That said, I admit that no official (or even clear) way of determining or measuring a market top exists. Doing so falls squarely under the heading of "art" rather than "science". For that, reason investors must evaluate the stock market from multiple angles.

Dow Jones Industrial Average Adjusted for the Producer Price Index, 5 years of volatility.
Was Nvidia's addition in '24 why this recently broke out to the upside?

One such angle is to obtain an honest view of the stock market by adjusting for inflation. With this adjustment a cleaner view often unfolds. Currently, with the inflation-adjusted Dow Jones chart above we see that momentum peaked in Feb. 2018, 6 years ago and prices only recently exceeded the high of 2021. If one looks at the small- or mid-cap indexes the story looks even uglier. Using the small-cap Russell 2000 index (adjusted for the PPI), it topped out in 2021 and currently sits about 20% below that peak. Admittedly, small-caps continue to underperform and aren't the best representation of the broad market that's driven by large-cap tech names like Nvidia, Meta, and Microsoft.

Dow Jones Industrial Average divided by the CRB Commodity Index, appears even weaker.

So, why do I think we're approaching a generational market top in stocks? I have many reasons (valuations, sentiment, inflation, demographics, etc.) but to keep this commentary readable I'll just touch on valuations.

Valuations

Valuations are not a market timing tool. However, high (or extremely high) valuations can provide a view into a market's vulnerability should a bear market begin. Think of the concept of potential energy from your long-ago physics class. Furthermore, a catalyst is needed to actually start a bear market. Valuations, however, are the best guide in determining how damaging the bear market will be once it starts. Either how much it will decline or how long it will stay below it's prior peak price level.

Current valuations challenge levels seen in 1929, 1966, and 2000. The market tops of 1929 and 2000 marked the ends of two periods in financial history which exhibited more speculative tendencies from investors compared to today. There's plenty of speculation in today's stock market, but nothing like the 1990s or the years leading up to 1929. Instead, with the current inflationary pressures and more

subdued levels of speculation I'd prefer to compare today to 1966. Today's valuation level, although below the bubble-like peaks mentioned above, does stand above the level of the 1966 top.

In other words, we currently sit in the top 96th percentile of all historical observations. If you insist on staying the course with U.S. stocks then a strong stomach and a very long-term orientation will be required travelling companions. Otherwise, a counterbalancing position in gold may serve you well.

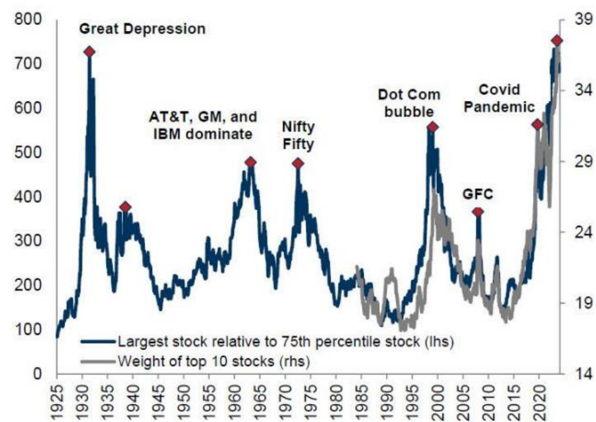
The chart below shows today's stock market valuation versus the past 100 years.

This chart shows the Dow Jones Average's 10-year PE ratio adjusted for interest rates.

Bull markets, as they mature, tend to experience increasing concentration in the top names, an increasing capital flow into a small percentage of winning stocks. At each of the major stock market peaks of the last century, concentration increased materially above the historical average as investors focused on a small number of winning companies.

This concept maintains some similarities to breadth, an investing concept that has to do with broad or narrow participation among traded stocks. In a healthy market a large number of stocks will advance, the stock markets appreciation will be the result of the shared effort of hundreds or thousands of underlying names. In a less healthy advance, or possibly the final stages of a bull market, fewer underlying stocks will be the engine carrying the broad market higher. This feat will occur while an increasing number of individual stocks begin to falter and decline.

Shared widely on social media, the below chart shows the market cap of the largest and the ten largest stocks relative to the 75th percentile stock. Clearly, with the advance of the "magnificent seven" or the FAANG stocks, the markets internals have developed a concentration profile similar to prior peaks. However, be warned, high readings can stick around for a while or rise further. The elevated readings in early 2020 illustrate this reality, they were high then and moved even higher.



*Consists of US stocks with price, shares, and revenue data listed on the NYSE, AMEX, or NASDAQ. Series prior to 1985 estimated based on data from Kenneth French data library reflecting the market cap distribution of NYSE stocks.
Source: Compustat, CRSP, Kenneth R. French, Goldman Sachs GIR.

Where does this leave us?

Once again, high valuations don't necessarily mean the stock market will drop immediately. I suspect there's enough excitement around a Trump presidency and, frankly, confusion (albeit positive) about what exactly the regulatory, tax, political, and geopolitical landscape will look like 12 months from now, that an immediate top seems unlikely. But, within the next year? Sure. Sometime within the next two years? That sounds reasonable as well.

With the timing of an ultimate top unknowable investors must either diversify out of stocks, hedge, or move into T-bills. Each of these can be done either all at once or in phases. Through Fourward Capital and the quadrant portfolio I prefer the diversification method with a heavy reliance on gold and owning companies that can benefit from an inflationary environment.

Lastly, the concentration chart above is visual evidence of an indexing bubble. Even if I'm wrong about an approaching bear market in stocks, I do think there will come a time to remove exposure to every stock in the S&P 500 and Nasdaq indices.

If any future stock market correction prompts investors to sell, they would likely sell that which had been purchased most recently (positions with the smallest unrealized gain or the largest unrealized loss). That unwind might get disorderly if it becomes self-perpetuating which seems possible due to the high concentration in a relatively few companies. I don't know how this resolves itself but it makes me nervous. For that reason, I like owning small and unique companies like StoneX and completely ignored sectors like oil/gas.

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