CARDEROCK
CAPITAL® MANAGEMENT, INC.

January 9, 2025

It was another strong year for the stock market, with notable performance across major indices:

- **S&P 500 Index (Market Weight)** – 25.02%
- **S&P 500 Index (Equal Weight)** – 13.01%
- **Dow Industrial Average (Price Weight)** – 14.99%

This marks two consecutive years of double-digit returns, largely driven by the Artificial Intelligence ("AI") theme and the anticipation of lower interest rates. While these returns are robust and well above our Investment Plan expectations, it's important to note that not all stocks have kept pace. In fact, only 28% of stocks outperformed the S&P 500 Market Weighted Index, a significant departure from the typical 45% to 50% range. This divergence was last observed during the Technology bubble of the late 1990s.

Upon further analysis, we found that Lower Quality stocks—those with limited profits but high expectations based on AI technologies—were among the leaders, along with sectors that were hardest hit by the pandemic (e.g., banks, airlines, cruise operators). As you know, these are areas we generally prefer to avoid.

Carderock's strategy of maintaining a broadly diversified set of high-quality growth stocks has led to performance that, on average, falls between the Market Weighted and Equal Weighted S&P Indices. Our 39 years of experience have allowed us to stay the course during various market cycles and avoid the risks of chasing thematic trends. We have successfully navigated euphoric periods driven by Real Estate (1980s), Technology (1990s), and Financials (2000s) without overextending our portfolios, while observing the eventual market corrections that followed.

To us, the current environment appears no different. AI investments, although promising, are heavily capital-intensive and largely speculative at this stage. The large-scale investments by Big Tech in AI remind us of the Red Queen's advice to Alice in *Alice in Wonderland*— "You have to run as fast as you can just to stay in the same place." While we are confident that remarkable technological advancements will unfold, it remains unclear who will emerge as the long-term beneficiaries. We expect the market to continue pricing in the transition to an AI-oriented economy, but it will likely take years before these technologies fully impact our daily lives. In the meantime, we will resist the temptation to excessively concentrate our investments in this area until there is a clear path to sustained profitability.

Our View for 2025

- **Economic Growth** – We anticipate growth in the 2% to 3% range, supported by a strong labor market, rising wages, and ongoing demand.
- **Interest Rates** – We foresee modest reductions in rates as the Federal Reserve manages the balancing act between a slowing real estate market, modestly rising unemployment, and a resilient economy.
- **Investment Outlook** – While AI continues to attract substantial investment, higher interest rates are likely to restrict capital flows into other capital-intensive sectors.

Stocks

- **Earnings Growth** – Remains strong, though largely confined to sectors less sensitive to interest rates.
- **M&A Activity** – Expect an uptick as the regulatory environment softens.
- **Profit Margins** – Should continue to improve, barring any major input inflation caused by tariffs.

Fixed Income

- **The Yield Curve** – We anticipate normalization as short-term rates decrease, making laddered portfolios more attractive than in recent years.
- **The Federal Reserve** - Faces a challenging position between growth and rising unemployment, limiting its ability to make substantial rate cuts in the near term.

Final Thoughts

Although valuations are stretched at the start of the year, we remain optimistic about the outlook for stocks, especially as emerging industries continue to recover from the post-COVID period. We do expect increased volatility as investors process the impact of new government policies and international conflicts, which could result in realized capital gains exceeding 2024 levels.

However, our approach remains unchanged: we are committed to managing your portfolio with a focus on quality growth stocks, bonds, and cash reserves, providing the balance and consistency of returns necessary to meet your long-term objectives.

As always, we are available to discuss your investment progress or answer any questions you may have. Please don't hesitate to reach out.

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

"Stock and bitcoin prices are at record highs, the growing tower of federal debt, ditto. The S&P 500 is valued at 38 times its cyclically adjusted price-to-earnings ratio, a level surpassed only in two months of 2021 and during the peak of the dot-com bubble. Everyone is all-in. According to polling by the Conference Board, 56.4% of households are bullish on the stock market, a record high since the survey started in 1987. There is one big problem: the good ship SS Market capsizes when everyone is leaning on the same side. Since 2011, every time that investment fund cash holdings have dropped this low, the MSCI All-country World Index has delivered losses averaging 2.4% in the following month. The one-sided positioning could be especially painful if economic activity unexpectedly lurches lower." Evan Lorenz, "*Beware the un-inversion",* **Grant's Interest Rate Observer**, December 20th, 2024.

"When Trump escalated a trade war the first time he was president, the Fed ended up lowering rates. Officials feared the hit to business sentiment and investment from a trade war might swamp potential effects of higher prices from tariffs. But it isn't clear the Fed would react the same way this time around because the underlying conditions are different. During Trump's first term, inflation was low, and consumers and businesses didn't have any recent memory of being asked to accept notable price hikes. In 2018, Fed staff modeled the impact of a tariff increase and concluded the central bank could 'look through' or hold rates steady while prices rose so long as two conditions held: households and businesses expected inflation to stay low and the price increases flowed through the economy quickly." Nick Timiraos, "*The Fed is Trying-Again-to Size Up Trump",* **Wall Street Journal**, December 27th, 2024.

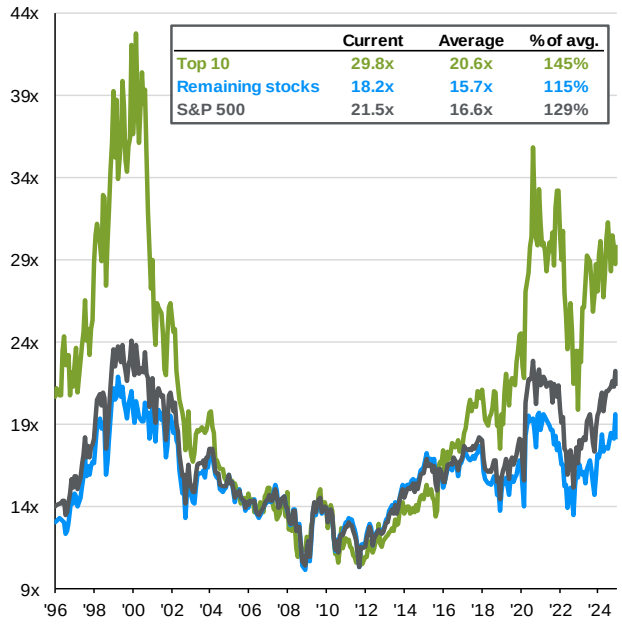
"The sustained prosperity of the US is astounding. The relative outperformance against European economies is remarkable if one considers America's size and diversity. Not surprisingly, the US economy also remains far more innovative than other large high-income economies. So, how can such an economic marvel also be 'the worst of countries'? The most telling indicator of a people's welfare is life expectancy. US life expectancy is forecast at 79.5 years for both sexes this year. This makes it 48th in the world. Yet the US spends far more on health than any other country. A big question for non-Americans is whether these pathologies are the necessary price of economic dynamism? There is this lingering fear that the technologically dynamic society Europeans seek might require the rugged individualism of the US. What has ultimately underpinned the US rise to prosperity and power, however, were the rule of law and political stability. Is it possible that its strengths are now combining with its weaknesses to overthrow that legacy?" Martin Wolf, "*What Makes the US Truly Exceptional",* **Financial Times**, December 3rd, 2024.

"In countries like the US, political polarization is intensifying. The underlying problem seems clear- it is hard to keep voters in a democracy happy when their standard of living is not improving. During all this popular discontent, the equity markets couldn't be happier. US equity indices are regularly hitting all-time highs and the S&P 500 index is up nearly a quarter this year. A key reason is that the experience of the ordinary voters and the experience of the corporate sector are quite different. The profit margins of large US companies are close to an all-time high, however profit margins cannot go up forever and eventually populist parties may turn on the corporate sector. It may turn out that stock markets are like the first-class passengers on the Titanic; toasting each other with champagne as the boat bears down on the iceberg." Philip Coggan, "*The zero-sum game investors are betting on",* **Financial Times**, December 28th, 2024.

"The market feels toppy. Sentiment is euphoric, according to Citigroup's Levkovich indicator, which has only been more positive twice in its history. Investment newsletter writers also have rarely been more bullish, according to the weekly survey by Investors Intelligence. Households have never been so confident that stocks will rise over the next year, according to the Conference Board's monthly survey. And fund managers shifted after the election to be more overweight U.S. stocks than any time since 2013. None of these points are proof that the market must fall, let alone that it will happen soon. But I don't want to be part of a crowd buying into a narrow story when prices, valuations and hope are already extremely high, and insiders aren't willing to back it with their money." James Mackintosh, "*Why This Frothy Market Has Me Scared",* **Wall Street Journal**, December 17th, 2024.

S&P 500: Index concentration and valuations

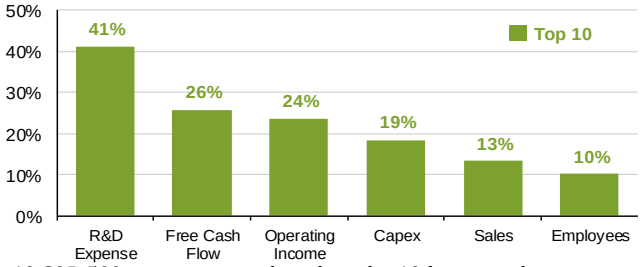
P/E ratio of the top 10 and remaining stocks in the S&P 500
Next 12 months, 1996 - present



Weight of the top 10 stocks in the S&P 500
% of market capitalization of the S&P 500



Economic concentration in the S&P 500
% of S&P 500 metric, 3Q24

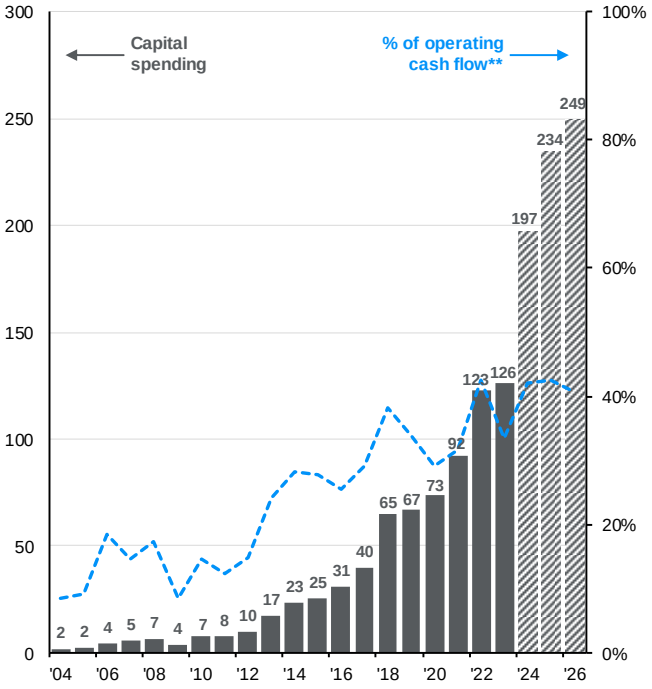


Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each quarter. As of 12/31/2024, the top 10 companies in the index were AAPL (7.6%), NVDA (6.6%), MSFT (6.3%), AMZN (4.1%), GOOGL/GOOG (4.0%), META (2.6%), TSLA (2.3%), AVGO (2.2%), BRK.B (1.7%) and JPM (1.4%). The remaining stocks represent the rest of the 492 companies in the S&P 500.

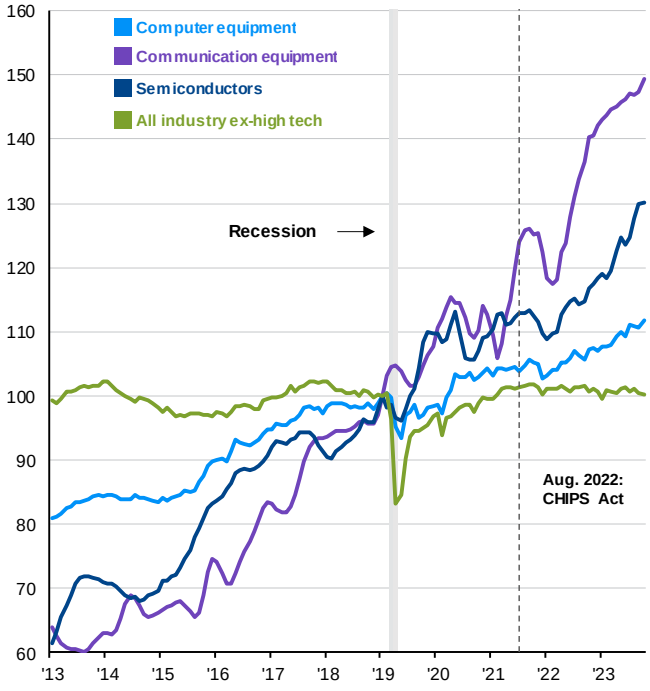
Guide to the Markets – U.S. Data are as of *December 31, 2024*.

Tech-driven capital spending

Capex from the major AI hyperscalers*
USD billions; Alphabet, Amazon (AWS), Meta, Microsoft, Oracle



U.S. industrial production of high tech industries
Indexed to 100 in Jan. 2020



Source: J.P. Morgan Asset Management; (Left) Bloomberg; (Right) Federal Reserve Board. Data for 2024, 2025 and 2026 reflects consensus estimates. Capex shown is company total, except for Amazon, which reflects an estimate for AWS spend (2004 to 2012 are J.P. Morgan Asset Management estimates and 2012 to current are Bloomberg consensus estimates). *Hyperscalers are the large cloud computing companies that own and operate data centers with horizontally linked servers that, along with cooling and data storage capabilities, enable them to house and operate AI workloads. **Reflects cash flow before capital expenditures in contrast to free cash flow, which subtracts out capital expenditures.

Guide to the Markets – U.S. Data are as of December 31, 2024.