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Quarterly Perspective

Using History as Our Guide

by Will Williams
Chairman, President & CEO

So much of what we do here at DVI is our consistent and deliberate focus on increasing the probability of financial success for our valued clients. A cornerstone of our value proposition is a historical perspective gained through decades of experience managing investment portfolios through a wide range of economic climates and investment backdrops. As market historians, we draw on the lessons of the past to guide our understanding of the future.

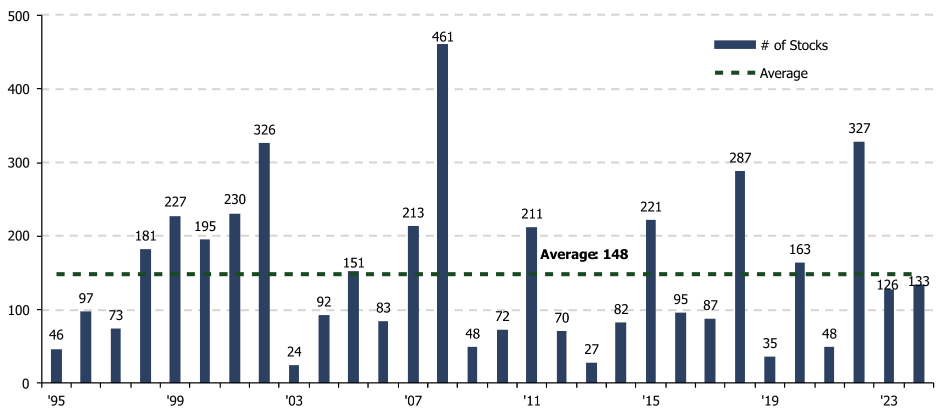
Our number one focus is understanding risk and effectively managing and mitigating portfolio losses during periods of market turmoil. Through the years of embracing investment discipline and an adherence to a historical market perspective, we've learned to avoid the traps and pitfalls that Wall Street often seems so eager to embrace. I have heard more than a few times as financial analysts attempt to explain unusual market behavior that "this time is different." DVI tends to view the world through the lens that unusual or out-of-the-ordinary market behavior tends to be a precursor for higher risk levels. And if there is one thing we want to avoid at all costs, it is higher investment risk.

As such, we are always on the lookout to steer clear of investment themes or capital market developments that are hard to explain or sound too good to be true. At the very least, it motivates us to roll up our sleeves, dig deeper, and gain a better understanding as to what is really going on. It is never an exact science, but leveraging relevant historical data provides our investment committee both the context and the unemotional discipline to make prudent, risk-adjusted investment decisions.

Equity Markets

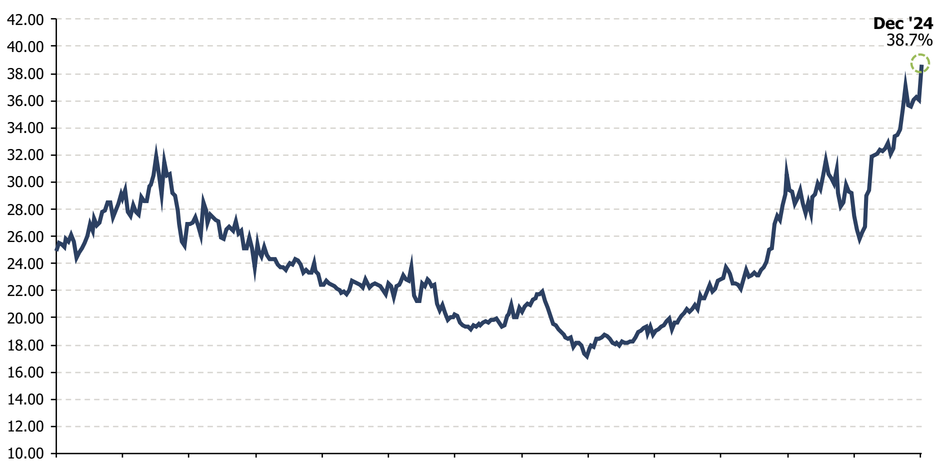
The financial press does a wonderful job providing sensational headlines—*an inch deep and a mile wide*—but fails to spend any time peering underneath the hood to understand the real data. The headlines for U.S. equities in 2024 read: "Two back-to-back 20%+ returns—Best performance since the late 1990s!" However, when you examine the return attribution, nearly 60% of the price returns over the past two years came from just seven stocks, the so called "Magnificent Seven."[1] The other 493 stocks in the index have registered far more modest price returns: 8% in 2023 and 10% in 2024, respectively. It may come as a surprise that nearly a third of the constituents comprising the S&P 500 ended down 5% or more in 2024 (see Chart 1), yet this negative price action had very little impact on the overall performance of the index. As of year end, just ten stocks represented nearly 40% of the index's market capitalization (see Chart 2). At current levels, this percentage weighting is now nearly 1.5 times the previous record set during the dot-com bubble. And, by no means, do most of these stocks come at bargain basement prices. As a group, they currently trade at nearly 30 times forward earnings.

Chart 1: Number of S&P 500 stocks that ended the year down 5% or more
(1995-2024)



Source: FactSet and JP Morgan Asset Management

Chart 2: Weight of the top 10 stocks in the S&P 500
(% of market capitalization of the S&P 500)



Source: FactSet and JP Morgan Asset Management

[1] The "Magnificent 7" is comprised of Alphabet (GOOG), Amazon (AMZN), Apple (AAPL), Meta Platforms (META), Microsoft (MSFT), Nvidia (NVDA), and Tesla (TSLA).

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Tariffs and 2025

by Brian Christensen, CFA
Senior Vice President & CIO

The centerpiece of President Trump's fiscal and foreign policy agenda has been his vow to impose tariffs on China, Mexico, and Canada immediately upon his inauguration. Table 1 provides proposed details on the key U.S. imports from our three largest trading partners.

Trump's tariff initiatives target both economic and geopolitical goals, and he has a full menu of authorities at his disposal, including the option of imposing a 10-20% global tariff. The economic impact from increasing tariffs has largely been painted as negative in the press. However, a myriad of factors will drive the ultimate impact, including the behavior of consumers, businesses, and governments.

The risk of rising consumer prices threatening higher inflation is often cited as the main objection to tariffs. The Budget Lab at Yale University, a non-partisan policy research center, estimates consumer prices could rise by 1.4% to 5.1% before consumers begin to adjust their purchasing behavior. The cost equivalent would range from $1,900 to $7,600 per household in 2023 dollars. Lower- and middle-income households would certainly be impacted if those estimates prove accurate.

Concerns around rising manufacturing input costs are warranted. Raw materials like steel, iron ore, aluminum, and a long list of critical minerals produced in other countries could be subject to retaliatory tariffs. However, during Trump's first term, deregulation, corporate tax cuts, and favorable trade deals with allies helped offset higher input costs, pushing corporate profit margins to record levels. It seems plausible that ongoing productivity gains in manufacturing, combined with favorable tax rates and deregulation, could mitigate the projected consumer price increases.

The direction of the U.S. Dollar in currency markets also has implications for the economic impact of tariffs. In an April 2024 article in the *Journal of International Money and Finance*, Olivier Jeanne and Jeongwon Son John found that tariff news accounted for up to 20% of the U.S. Dollar's appreciation during the 2018-19 tariff war between the U.S. and China.[1] During this period, the Trump administration increased tariffs on approximately $370 billion in Chinese goods from an average of 3% to 19%, prompting Chinese retaliation that raised tariffs on U.S. exports from 7% to 21%. While many factors influence currency movements, trade policy uncertainty tended to bolster the dollar, with the U.S. Dollar Index rising by as much as 10% during tariff announcement windows in 2018 and 4% in 2019. Meanwhile, the Chinese renminbi depreciated by up to 10% in 2018 and 5% in 2019, as the People's Bank of China allowed the currency to devalue through controlled foreign exchange mechanisms. A stronger U.S. Dollar effectively offsets the price impact of a tariff as foreign countries receive fewer dollars for their imports to the U.S.

Table 1: Top US Imports

Trade Partner Country	Proposed Tariff	Percent of Imports*	Top Imports
China	60%	13.5%	Phones, computers, batteries, toys, video game consoles
Mexico	25%	15.6%	Passenger cars/trucks, vehicle parts, freight trucks, computers, crude oil
Canada	25%	12.9%	Crude oil, passenger cars/trucks, refined petroleum products, vehicle parts

Source: The U.S. Census Bureau, Barron's

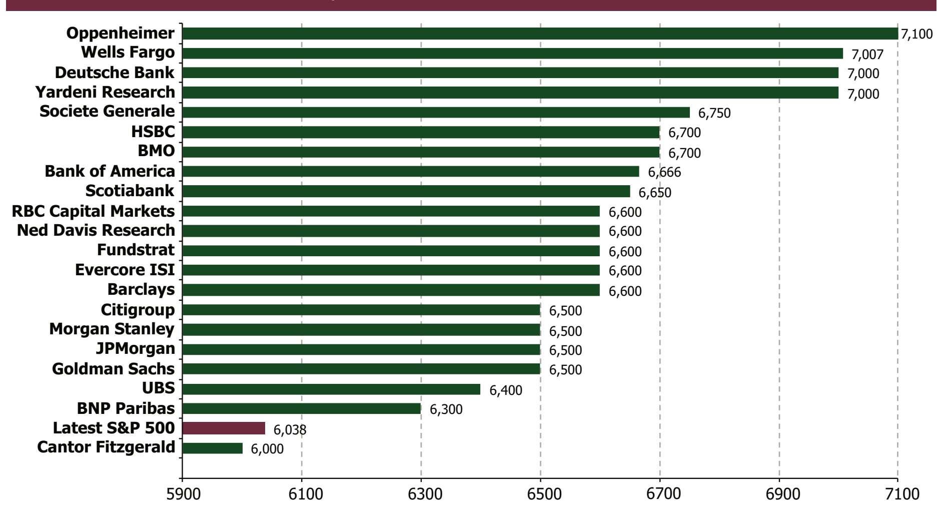
*Percent of import values is based on the past 12 months as of 10/2024

The variables potentially affecting the economic and market impact of President Trump's tariff policies are extensive. To date, the Trump Administration has specific objectives—immigration, drug trafficking, and trade barriers—with individual countries that it is willing to negotiate toward. New trade deals are likely to gain support in Congress. Ultimately, the timing and scope of these negotiations will drive markets in the near-term and could impact the geopolitical landscape in the long-term.

2025 Wall Street Year-End Price Targets

Table 2, provided by Yardeni Research, lists the 2025 year-end price target for the S&P 500 Index from twenty-one Wall Street firms. In 2024, the average target of these firms was 4,864 with a high of 5,400 (Yardeni) and a low of 4,200 (JP Morgan). The S&P 500 closed 2024 at 5,8881.63, or 21% higher than the analyst average forecast. At least they had the direction correct. Best wishes for a prosperous and healthy 2025.

Table 2: S&P 500: Wall Street's 2025 Year-End Price Targets
(as forecasted in December 2024)



Source: LSEG Datastream and Yardeni Research; Bloomberg

[1] "To what extent are tariffs offset by exchange rates?," by Olivier Jeanne, Jeongwon Son John, 2024, *Journal of International Money and Finance,* Volume 142, https://doi.org/10.1016/j.jimonfin.2024.103015.

Trump 2.0: Market Implications of the Incoming Republican Administration

by Christopher Kent, CFA
Associate Portfolio Manager

As his administration takes office on January 20, President-elect Donald J. Trump and his team are expected to implement policies that could impact financial markets and the broader economy. Three key areas to watch include taxes and tariffs, government spending and deregulation, and immigration and energy policy.

Taxes & Tariffs

Tax reforms were a cornerstone of President Trump's economic agenda during his first term. The 2017 Tax Cuts and Jobs Act (TCJA) lowered the corporate tax rate from 35% to 21% and reduced personal income tax rates, boosting corporate profits and household disposable income. Trump has indicated his desire to extend TCJA and further reduce the corporate tax rate to 15%, a move that could bolster businesses but potentially increase the federal deficit.

Trump's proposed tariff policies introduced complexity and uncertainty to global markets. While primarily targeting Chinese imports with tariffs of up to 60%, the proposals also include potential 25% tariffs on goods from Canada and Mexico, despite their free trade status under the United States-Mexico-Canada Agreement (USMCA). The proposed tariffs on Canadian and Mexican imports are aimed at curbing immigration rather than boosting government revenue. If implemented without triggering trade wars, these tariffs could generate an estimated $323 billion annually, equivalent to 6.6% of total federal receipts (Yardeni Research, 11/14/2024). However, tariffs are more likely to serve as leverage in trade negotiations than as sustainable revenue sources since they are unlikely to offset the increases in deficit spending.

Deregulation & Government Spending

Deregulation remains a core component of Trump's agenda, with significant benefits for the financial services, energy, and industrial sectors. Easing regulations, such as rolling back provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010—which created the Consumer Financial Protection Bureau (CFPB) and introduced measures to reduce risks, improve accountability, and protect consumers—would give businesses greater flexibility. Additionally, reducing environmental restrictions could stimulate domestic energy production and promote infrastructure investment.

These policies come with fiscal challenges, as the Committee for a Responsible Federal Budget estimates Trump's proposals could increase the federal deficit by $7.75 trillion over the next decade. With nondiscretionary spending (Social Security, Medicare & Medicaid, defense, and net interest payments; depicted in Chart 1) accounting for roughly 78% of outlays, significant spending cuts remain difficult. Trump's establishment of the Department of Government Efficiency (DOGE) aims to identify and eliminate waste, fraud, and excessive spending across all categories of government expenditures, with the potential to reduce overall expenditure.

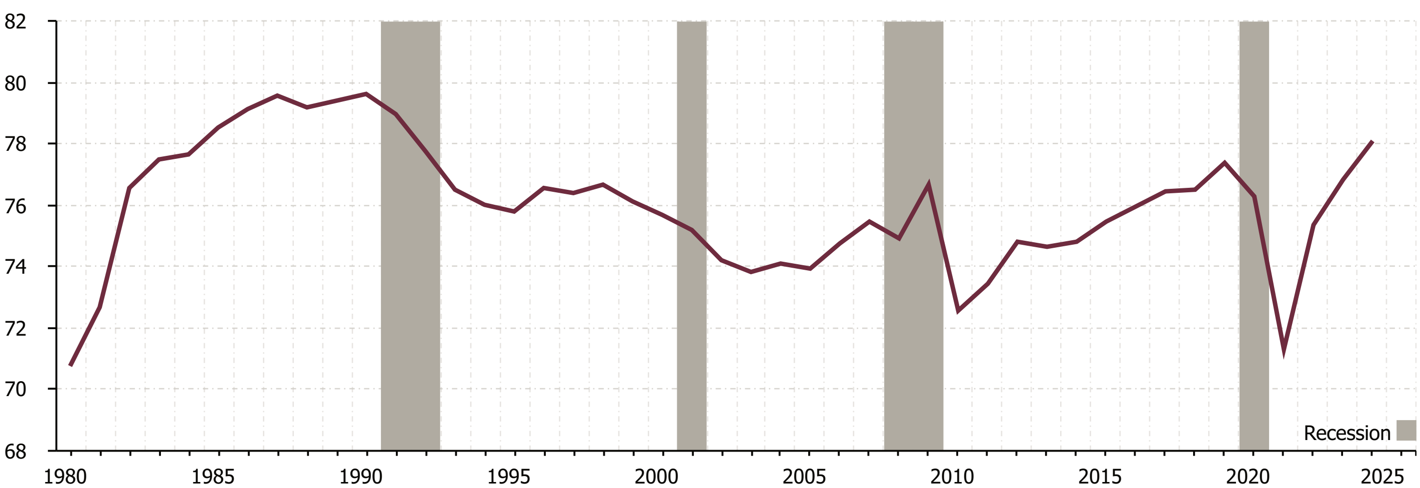
Immigration & Energy Policy

Trump's immigration reform plans include stricter enforcement, mass deportations, and reinstating policies like "Remain in Mexico" for asylum seekers. Industries such as agriculture, construction, and hospitality, which rely heavily on immigrant workers, could face labor shortages and increased wage pressures.

On energy, Trump aims to expand U.S. oil and gas production to reduce energy prices and offset inflation. His administration is expected to lift restrictions on liquefied natural gas (LNG) exports to non-free-trade countries. Chris Wright, the new Secretary of Energy, is seen as supportive of expanding fossil fuel production and infrastructure investment.

The many variables of Trump 2.0 will continue to unfold in the coming weeks; until the new administration settles in, the implementation and net impact of these policies remain unclear. For investors, these moving parts emphasize the importance of staying diversified as the political and economic landscapes evolve.

Chart 1: US Federal Government Outlays: Nondiscretionary Divided By Total (Percent, Annual)



Source: LSEG Datastream and Yardeni Research; Bloomberg

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One plausible scenario is a cooling of this current bout of market exuberance, with these companies gradually growing into their optimistic earnings forecasts over the next several years. However, looking to history as a guide, a slow and methodical unwinding of speculative excess is seldom how these situations resolve themselves.

Interest Rates

When the Federal Reserve Open Market Committee (FOMC) met in mid-September and agreed to their first reduction in the Fed funds target rate by 0.50 of 1%, they were likely confident that their actions would lead to lower short-term interest rates.

At subsequent meetings in both November and December, the FOMC elected to further decrease short-term rates by .50 of 1% (25 basis points at each meeting). After a cumulative rate reduction of a full 1% in less than 90 days, the FOMC has to be shaking their heads. Instead of rates moving dramatically lower, tracking the actions taken by the Fed, most interest rate maturities were actually trading at higher yields (Chart 3).

Chart 3: US Treasury Interest Rates

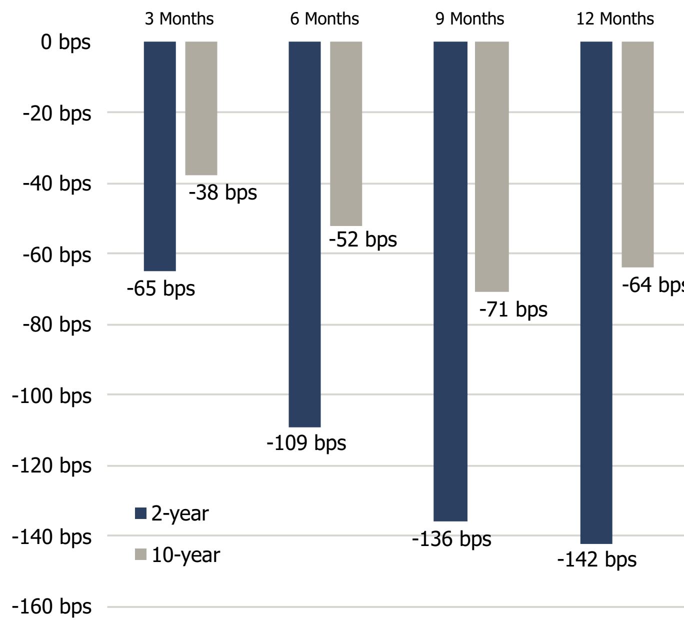
		First Rate Cut		+/(-) Since
	12.31.2023	09.18.2024	12.31.2024	9.18.2024
UST 6M T-Bill	5.26%	4.51%	4.27%	- 0.24%
UST 2Yr Note	4.25%	3.63%	4.24%	0.61%
UST 5Yr Note	3.85%	3.49%	4.38%	0.89%
UST 10Yr Note	3.88%	3.71%	4.57%	0.86%

Source: FactSet

Once again, using history as our guide, Chart 4 tracks the change in both short-term and long-term interest rates following the first FOMC rate cut over the past 40 years (inclusive of six FOMC rate cutting cycles). As you can see, interest rates consistently trended lower in every time period.

So how should we interpret this unusual recent market behavior? Economists have several theories: (1) It was widely anticipated that the Fed would lower rates in 2024, so market forces drove rates dramatically lower even before the first rate cut. (2) The new trade and immigration policies proposed by the Trump administration are believed to be inflationary. (3) The new tax policies proposed by the Trump administration will likely stimulate economic growth in the short-term while contributing to higher U.S. budget deficits over the long-term. (4) The growing national debt, which reached nearly $36 trillion as of September, is driving rates higher as investors demand higher yields to compensate for the perceived increase in credit risk.

Chart 4: Months after the first rate cut



Source: Federal Reserve and JP Morgan Asset Management

All of these theories represent plausible explanations as to why rates have climbed over the past three months, but we all recognize we can ill afford a sustained period of higher interest rates without addressing the size and growth rate of our annual budget deficit.

The Role of a Fiduciary

David Vaughan frequently reminded us to "Do no harm." Our charge is to act as fiduciaries, with an unwavering commitment to serve the needs of our valued clients above all else. Applying a historical perspective to this responsibility is a must.

DVI continues to build our team, and we are always on the lookout for talented investment professionals. To view our open positions or learn more about careers at DVI, we invite you to scan the QR code or visit **www.dviinc.com/join-team.**

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