

# FORTITUDE CAPITAL MANAGEMENT

## Independence · Integrity · Insight

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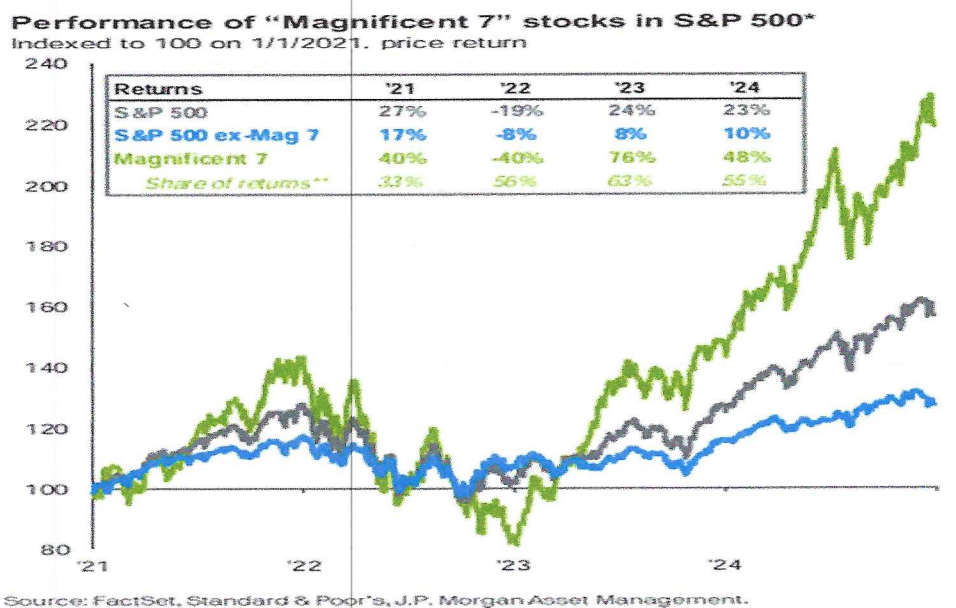
*“Models with simulations, projections and predictions prove nothing. All a model shows is something about the model itself, normally its limitations.” – Ian Plimer from his book Heaven and Earth*

*“Tradition is not the worship of ashes, but the preservation of fire.” – Gustav Mahler*

Fellow Investors:

Another year is behind us and a new one is before us. The last one was certainly one for the books and 2025 looks to be as eventful. Of course we have the new administration taking over later this month, and regardless of one’s view, it looks to be ready to hit the ground running. The new administration will have its hands full and the ultimate effect this has on the economy and markets will have to be seen. One thing that seems certain is that it will not be boring.

For 2024, the S&P 500 realized a total return of 25%, following a 26.3% total return in the previous year. Of course, as was the case in 2023, the bulk of the index return came from the top seven stocks, now commonly referred to as the Magnificent Seven. These seven companies returned 48% in 2024 and 76% in 2023, accounting for 55% and 63% of S&P returns in 2024 and 2023 respectively. Excluding these seven names, the remaining stocks in the S&P 500 returned 10% in 2024 and 8% in 2023, similar to the long-term return of the index over the last 100 years. It should also be noted that of the 19% decline in the index in 2022, 56% of that was accounted for by the 40% decline in the Magnificent Seven. Again, without the Magnificent Seven, the loss in the S&P in 2022 was a much more palatable 8% (see chart). The point of dredging up this history is to remind us that the risk of being concentrated in the current “hot” names can cut both ways. Managing risk should always be a top consideration.



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As for other asset classes, small caps, as measured by the Russell 2000, returned 11.5% in 2024. As small caps are particularly sensitive to interest rates, the uptick in the 10-year treasury in the fourth quarter took a bit off full year gains for small caps. Other equity and fixed income classes provided single digit returns. Growth equities continue to lead the charge with price/earnings ratios<sup>1</sup> well above longer term averages across capitalization levels. The large-cap growth sector sports a P/E ratio that is 129% of its 30-year average. Much like total returns, this measure is heavily influenced by the top names which have very high P/E ratios and weightings in the calculation. Excluding the top ten stocks in the S&P, the P/E ratio of the remaining stocks is only 10% above the 30-year average and within one standard deviation of the average. Everyone is watching those top names and whether they can live up to their elevated valuations.

Interest rates tell a confusing story. After sharply boosting rates in 2022 to belatedly address raging inflation, the Federal Reserve made three rate cuts to the Federal Funds rate in the last few months of 2024 totaling 1.0%. Coincidentally with the beginning of the Fed cutting in September, the ten-year treasury began a march up by 1.0% in the opposite direction. Almost to the day of the first Fed rate cut, the 10-year treasury began its climb from its low for the year of 3.63% to end the year at 4.60%. As far as affecting the economy and consumers, the 10-year treasury rate is much more important than the Fed Funds rate. For example, it is more relevant for mortgages, which remain above 7.0%. The treasury rate is set by the market and communicates what the market believes. In the current environment of excess bank reserves, the Fed Funds rate is nothing more than a signal at this point, and the Fed's slow reaction to the onset of inflation has diminished the value of its signals. Whether it reflects a doubt about further progress on inflation or the flood of treasuries due to exploding budget deficits, the bottom line is rates are heading higher. It is interesting to note that the average of the ten-year treasury over the last 66 years is 5.73%, well above the current rate. Also, while inflation still exceeds the Fed's 2.0% target, it is below the average since 1958 of 3.81%. Historically, we are levels we have lived and grown with. A lot will depend on what the economy does going forward under the policies of the new administration with its stated focus on cutting regulations and spending. The spending part is always tricky as we have all seen much talk over our lives with very little progress.

The overriding excitement in the markets is of course artificial intelligence. It is a big part of the gains of the top names, but over time the promise has the potential to affect the economy in a much broader way. Beyond the potential benefits of AI, there will be the requirements. It is anticipated to require massive increases in data centers and the energy to run them. Demand for raw materials is also predicted to increase sharply. Productivity is a key component of economic growth and AI is seen as a productivity booster. The question is whether this is already priced into the markets or will lead to further gains as its promise becomes reality. The broader market beyond the big names may be waiting for the promise as they do not reflect the excessive valuations of the top stocks. All the more reason to be conscious of portfolio diversification.

There is valid concern about the market hype of AI when reflecting on the experience of the previous tech bubble a quarter-century ago. We do have a more positive view of what may come. During the tech bubble, it seemed that any college dropout with a website was having capital thrown at them. The price/earnings ratios were irrelevant because there were no earnings in the denominator. Today's leaders have elevated P/E ratios, but they do have earnings, a big

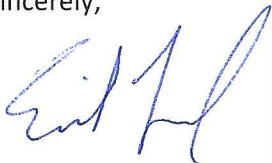
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difference. AI has yet to flow out into the economy broadly. Right now, the market beneficiaries are the AI suppliers. With time we expect to see those benefits broaden out, and hopefully with that will come broader market participation in returns.

Living in interesting times seems to be a way of life that we will have to learn to live with. This year should not disappoint.

Sincerely,



Erik Ford



Jason Marrs

<sup>1</sup>The price-to-earnings (P/E) ratio measures a company's share price relative to its earnings per share (EPS). Often called the price or earnings multiple, the P/E ratio helps assess the relative value of a company's stock. It's handy for comparing a company's valuation against its historical performance, against other firms within its industry, or the overall market. P/E can be estimated on a trailing (backward-looking) or forward (projected) basis. The figures cited above are forward-looking.

The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The term Russell 2000 Index refers to a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index. The Russell 3000 is a capitalization weighted index representing approximately 96% of the investable U.S. equity market.

The "Magnificent Seven" include AAPL, AMZN, GOOG and GOOGL, META, MSFT, NVDA and TSLA.