Sabrient Systems

Sector Detector

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Investors enter a transitional year with a mix of hope, angst, and optimism

by **Scott Martindale**
President & CEO, Sabrient Systems LLC

Overview

Strong US stock market performance has been driven, in my view, by the combination of: 1) a dovish Fed, money supply growth and global capital flight to the US ("shadow liquidity"), 2) expectations of lower energy costs and falling inflation, 3) AI exuberance and capex and the promise of massive productivity gains, and 4) growing optimism about technologies like nuclear energy, blockchain, quantum computing, robotics, autonomous vehicles, and genomics. But after two consecutive years of 20%+ gains in the S&P 500 for the first time since 1998 (and even greater gains for the Tech-dominated Nasdaq 100)—greatly outperforming all prominent forecasts—investors are looking ahead to a year that arguably brings even greater uncertainty and a wider range of expected outcomes, ranging from a recession and bear market to a continued bull run within a *Roaring '20s*-redux decade.

Will Trump 2.0 business-friendly fiscal policies (e.g., tax cuts, deregulation) and DOGE cost-cutting impact the economy, inflation, federal budget deficit, and corporate profits negatively for a period of time before kicking in later? What about sluggish economic growth abroad and the disastrous impacts of the ultra-strong dollar, particularly among key trading partners like Canada, Mexico, Europe, China, and Japan? And will the massive corporate capex (which is expected to accelerate under the new administration's policies) start to show commensurate returns in the form of rising productivity and profitability, leading to rising GDP growth (in true supply-side style) without the crutch of government deficit spending (which accounted for about 30% of growth over the last 4 quarters)…and ultimately to rising tax receipts to quickly offset any initial rise in the deficit?

The bull case sees an economy and stock market driven by business-friendly fiscal policies under Trump 2.0 including deregulation, lower corporate tax rate, and restoration of civil liberties and constitutional freedoms should also be stimulative and might fuel *disinflation* (as opposed to the inflation that many critics expect). Trump's energy policies are also likely to be disinflationary. Capital flight into the US (most of which stays outside our banking system and therefore is not captured by M2), huge corporate capex, less deficit spending (and politburo-style "malinvestment" and mandates), and strong productivity growth, and rising velocity of money that offsets any tightening in money supply growth.

According to Capital Group, a mid-cycle economy typically displays rising corporate profits, accelerating credit demand, modest inflationary pressures, and a move toward neutral monetary policy—all of which occurred during 2024. And besides expectations of a highly aggressive 15% earnings growth in the S&P 500 over the next couple of years, Silicon Valley VC Shervin Pishevar recently opined, *"I think there's going to be a renaissance of innovation in America…It's going to be exciting to see… AI is going to accelerate so fast we're going to reach AGI [Artificial General Intelligence, or human-like thinking] within the next 2-3 years. I think there will be 'Manhattan Projects' for AI, quantum computing, biotech."* So, it all sounds quite good.

However, my observation is that GDP and jobs growth have been highly reliant on huge government deficit spending bills, which is not so good. The Atlanta Fed's GDPNow model forecasts Q4 GDP to come in at just 2.7%, which is sluggish growth considering the huge amount of government money and corporate capex being spent. Rising bond yields and strengthening US dollar means less liquidity and tighter financial conditions, which are negatives for risk assets. The incoming administration—free this time of the unknowing appointment of deep-state obstructionists like in his first term—is suggesting a new tack characterized by smaller government and the unleashing of animal spirits in the private sector, with the goal of achieving GDP growth north of 4%.

So, for 2025, I expect strong fiscal and monetary policy support for economic growth (albeit with some pains and stumbles along the way as government spending is reined in) as well as moderating inflation as shelter costs recede, military conflicts are resolved (war is inflationary), and deflationary impulses arrive from struggling economies in China and Europe. I also expect stocks and bonds will both attain modest gains by year end (albeit with elevated volatility along the way). In this transitional year in which a more politically seasoned Donald Trump's policies and leadership have gained broader support domestically across demographics (and indeed across the world), how it all gets off the ground and how quickly it generates traction this year will have profound implications for the rest of his term and beyond. Heck, even a growing contingent in ultra-blue California have become willing to give his approach a chance—further red-pilled by the disastrous LA wildfires (more on this below).

To me, the biggest question marks for our economy and stocks in 2025 (other than a Black Swan event) are: 1) the net impacts of Trump's cost cutting efforts (on federal deficit spending and boondoggles) balanced with his pro-business policies and a supportive Fed, and 2) the impacts of economic growth struggles abroad. China is dealing with deflation (PPI has declined for 26 months in a row), a real estate crisis, weak retail sales, and surging excess savings among a shrinking population. Since the Global Financial Crisis, China's marginal returns on capital have plunged from around 14% to barely 5% (on par with the US). As for the Eurozone, its share of world GDP has fallen from a high of 26.4% in 1992 to just 14.8% in 202, as its obsession with renewable electricity (rather than fossil fuels and nuclear) costing 5x the price of conventionally produced electricity—and driving low returns on capital and thus capital flight. As MacroStrategy Partners UK has opined, *"With all of GDP [essentially] an energy conversion, our future depends on either extending fossil fuel production further or developing nuclear."*

Indeed, the US remains the beacon of hope for global investors. However, at the moment, surging bond yields, weak market internals, and a strengthening dollar suggest investors have grown cautious. All the major stock and bond indexes fell below their 50-day simple moving averages (although they are trying to regain them today, 1/15). Inflation hedges gold and bitcoin have risen back above theirs, but all these asset classes have lost both their momentum in concert with sluggish global liquidity growth since October (as pointed out by economist and liquidity guru Michael Howell of CrossBorder Capital). Of course, rising *real* yields tend to reduce the appeal of gold, and nominal yields have been rising much faster than the modest (and likely temporary) uptick in inflation.

Indeed, the latest PPI and CPI readings this week show stabilization, which the markets cheered (across all asset classes). As I write, the 10-year Treasury yield has fallen below 4.70% and the 20-year dropped below the important 5% handle. Hopefully, this will stem the rise in 30-year mortgage rates, which are above 7.0%, creating a big impediment to the critical housing market. The delinquency rate on commercial office MBS jumped to a record 11% in December, which is the highest since the Global Financial Crisis. Consumer credit card defaults jumped to a 14-year high as average cc interest rates hit a record high, now in excess of 23%. And then we have our federal government needing to roll over at least $16 trillion (of our $36.2 trillion debt) during the next four years.

Although Michael Howell thinks the 10-year Treasury yield could continue to rise to perhaps 5.5%, which would be a huge definite negative for risk assets, my view is that bond prices will soon find support (and stabilize yields), which would help stocks stabilize as well. After all, US Treasury yields are attractive in that they are among the highest among developed markets, and the two largest economies are diverging, with China's yields collapsing (10-year below 1.7%) as US yields surged. Indeed, debt deflation and sluggish economic conditions in China are at risk of creating a deflationary spiral. Also, the traditional 60/40 stock/bond portfolio rebalancing is taking place, which shifts capital from equities to bonds.

If I am right and the bottom in 20-year Treasury price (i.e., peak yield) is nigh, we likely would see the dollar decline, gold rally, and bond yields fall, which would be a tailwind for growth stocks. Ultimately, I expect the terminal fed funds rate will be around 3.50% (from today's 4.25-4.50%), although it might not get there until 2026, and I think the 10-year will gradually settle back to around 4.25%.

Assuming AI and blockchain capital spending and productivity gains are already largely priced into the lofty Big Tech valuations, perhaps this is the year that the market finally broadens in earnest such that opportunities can be found among small caps, bonds and dividend paying stocks, value, and cyclical sectors like Financials, Industrials, and Transports (and perhaps segments of Energy, like natural gas production, liquefication, and transport), However, the Basic Materials sector, particularly industrial commodities (like copper), may struggle with weak Chinese demand, and because many commodities are priced in dollars, a strong dollar reduces purchasing power among all our trading partners, which further hinders demand. As such, Materials continues to rank at the bottom of Sabrient's SectorCast rankings.

I go into all of this (including my outlook for 2025) in my full post below. Overall, my suggestion to investors remains this. Don't chase the highflyers and instead focus on high-quality businesses at reasonable prices, hold inflation and dollar hedges like gold and bitcoin, expect elevated volatility given the uncertainty of the new administration's policies and impact, and be prepared to exploit any market pullbacks by accumulating those high-quality stocks in anticipation of gains by year end and beyond, fueled by massive capex in blockchain and AI applications, infrastructure, and energy, leading to rising productivity, increased productive capacity ("duplicative excess capacity," in the words of Treasury Secretary nominee Scott Bessent, would be disinflationary), and economic expansion.

When I say, "high-quality company," I mean one that is fundamentally strong by displaying a history of consistent, reliable, and accelerating sales and earnings growth, positive revisions to Wall Street analysts' consensus forward estimates, rising profit margins and free cash flow, solid earnings quality, and low debt burden. These are the factors Sabrient employs in selecting our portfolios. We also use many of those factors in our SectorCast ETF ranking model. And notably, our Earnings Quality Rank (EQR) is a key factor in each of these models, and it is also licensed to the actively managed, absolute-return-oriented *First Trust Long-Short ETF (FTLS).*

Sabrient founder David Brown describes these (and other) factors and his portfolio construction process in his new book, [*How to Build High Performance Stock Portfolios*](), which is available on Amazon for investors of all experience levels. David describes his path from NASA engineer on the Apollo 11 moon landing project to creating quant models for ranking stocks and building stock portfolios in 4 distinct investing styles—growth, value, dividend, or small cap growth. To learn more about **David's book and the companion subscription product** we offer that does most of the stock evaluation work for you, visit: https://DavidBrownInvestingBook.com

As a reminder, our research team at Sabrient leverages a process-driven, quantitative methodology to build predictive multifactor models, data sets, stock and ETF rankings, rules-based equity indexes, and thematic stock portfolios. As you might expect from former engineers, we use the scientific method and hypothesis-testing to build models that make sense—and we do that for growth, value, dividend, and small cap strategies. We have become best known for our "Baker's Dozen" growth portfolio of 13 diverse picks, which is packaged and distributed quarterly to the financial advisor community as a unit investment trust, along with 3 other offshoot strategies for value, dividend, and small cap investing.

In fact, the Q1 2025 Baker's Dozen will launch on Friday 1/17, followed by Small Cap Growth on 1/22 and then Dividend on 2/11.

Lastly, let me make a brief comment on the LA wildfires. It seems every wildfire in SoCal has always ended when "we got lucky," as the fire chiefs and local meteorologists would say, due to the winds tapering off and/or rains arriving just in time. I certainly saw this firsthand a few times during my 20 years raising a family in Santa Barbara. And I always wondered, what will happen when this "luck" doesn't materialize the next time? Of course, even if one believes that reversing climate change is humanly possible, the lengthy timetable to decarbonization (while countries like China and India continue to increase carbon emissions by burning coal at record amounts to generate 60% and 70% of their electricity, respectively) means that proper preparation today for disasters is essential. And yet California's leadership was doing the opposite, prioritizing specious social justice agendas while degrading readiness for the "perfect storm" of wildfire conditions…when luck fails to arrive. My deepest sympathies, thoughts, and prayers go out to all those impacted by this preventable tragedy.

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Market Commentary

Soaring electricity demand for power-hungry AI applications has shed a spotlight on nuclear and natural gas as providing the optimal mix of clean, abundant, and reliable, which means energy, utilities and infrastructure companies involved in expanding the electrical grid are now AI plays. The "hyperscalers" (including MAG-7 members Amazon, Microsoft, Alphabet, Meta, and Apple) now ran about 2,700 massive data centers last year, which is forecasted to consume nearly 10% of total electricity demand in the US by 2030. And the Energy Information Agency (EIA) predicts that global electricity use could rise 75% by 2050.This is why Microsoft made a long-term power supply deal with Constellation Energy to reopen the Three Mile Island nuclear plant, Amazon made a deal with Talen Energy for a nuclear-powered data center, and both are studying small modular reactors (SMRs) as future options.

Microsoft Vice Chair and President Brad Smith recently published a blog post on the company's website indicating that the company plans to spend around $80 billion on AI infrastructure this year, following capex of $53 billion in 2024 (28% of revenue), with the majority going toward data-center infrastructure plus AI and cloud-based applications. So, when you consider capex from the other Tech titans, we likely will see hundreds of billions of dollars invested during 2025. In the view of AlpineMacro, we are on the cusp of another AI-driven technological wave with accelerating AI adoption, enhanced by expected deregulation, lower taxes, and lower energy costs. The firm sees the US as the only major economy that is truly embracing supply-side economics.

Of course, we are all familiar with the big performers in 2024 among AI-oriented Tech names like AppLovin (APP), Palantir (PLTR), NVIDIA (NVDA), and Broadcom (AVGO). But in addition, under-the-radar names from other industries that have become involved in the AI build-out were also among the top performers. Vistra (VST), which operates natural gas and nuclear power plants, surged due to its ability to power energy-hungry AI datacenters, and Texas Pacific Land (TPL), which has expansive land holdings and abundant oil & gas royalty acreage around the Permian Basin of West Texas that are expected to host AI datacenters. Indeed, natural gas is expected to serve as the go-to (and relatively low-emission) energy source until nuclear is up and running to share the load.

So, the future is now for AI, and as such, it will continue to dominate the spotlight and attract investment capital. In fact, some are predicting we will soon see an AI-generated CEO and management team running a real company—perhaps as soon as this year!

Valuations:

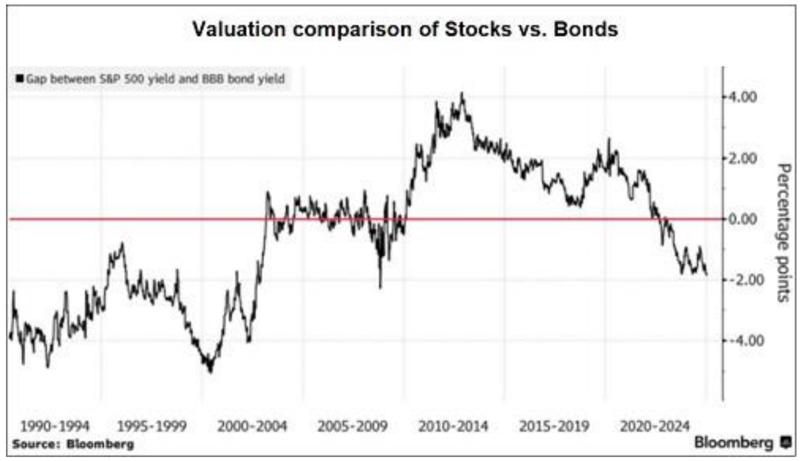
Even though the massive capex reduces profit margins, Big Tech still shows exceptional momentum in earnings estimates heading into Q4 2024 earnings season and 2025, particularly when compared to the S&P 500's non-Tech constituents. According to FactSet, the bottom-up EPS estimate for the S&P 500 in calendar year 2025 is $275. This represents the aggregation of median EPS estimates for all companies in the index and suggests a YoY earnings growth rate of 14.8% for the S&P 500, which far surpasses the trailing 10-year average of 8.0%. The leading sector of course is Technology at roughly 20% expected EPS growth. Although all eleven sectors should display earnings growth, Technology, Healthcare, Industrials, Materials, Communication Services, and Consumer Discretionary are expected to achieve double-digit growth.

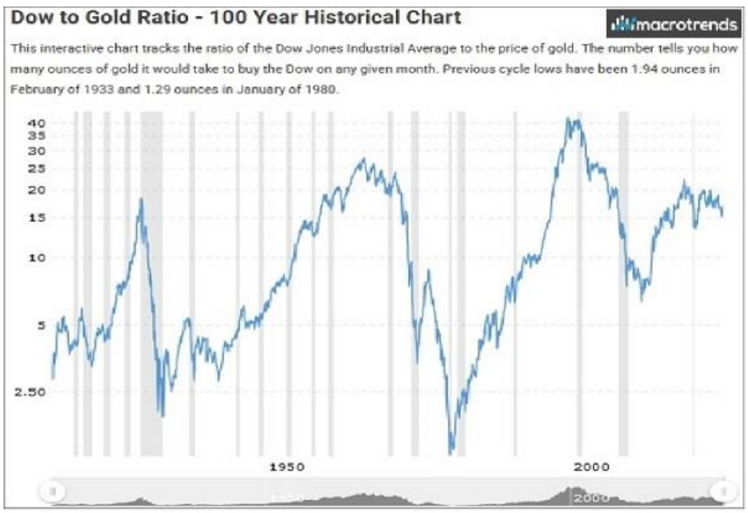
However, some commentators think these expectations are wildly optimistic, particularly as government spending is cut while the full benefits of fiscal stimulus lag, and thus stocks are overvalued and due for a fall. For example, Crossmark Global Investments' CEO/CIO Bob Doll foresees a 10% market correction as earnings underperform and unemployment and inflation both rise. He opined, *"A mix of pro-growth and disruptive policies could heighten uncertainty and market volatility. Trade and immigration risks may hurt growth, raise inflation, and compel the Fed to halt rate cuts—or even consider hikes—pushing bond yields higher and weighing on equity valuations."*

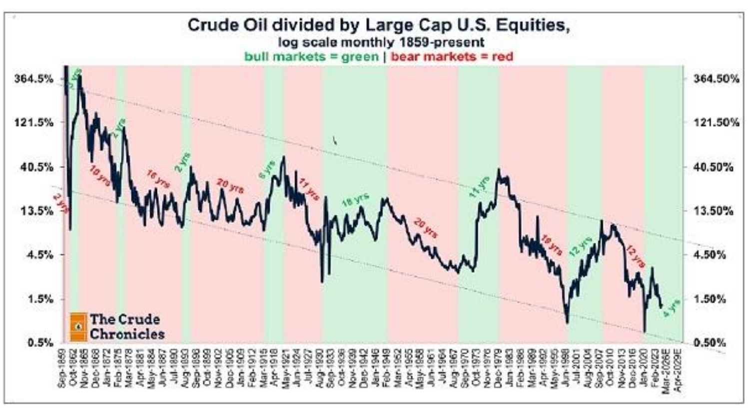
Tight corporate spreads provide the smallest premium over Treasuries in over 25 years, reflecting bullishness and investor confidence in the aggressive earnings forecasts. Also, the difference between the S&P 500 *trailing* 12-months earnings yield of 3.70% (current trailing P/E of 27x) and BBB corporate bond yield of 5.75% is negative 2.05%, which is the lowest since 2008 as shown in the chart below. Of course, stocks are inherently riskier, so this further illustrates investor confidence in earnings expectations. Moreover, if we assume a *forward* P/E (next 12 months) of 22x for the S&P 500, the traditional "Fed Model" tells us that the forward earnings yield (E/P) has fallen to about 4.6%, which roughly matches the risk-free 5-year Treasury note and is below the 10-year note, i.e., it offers no equity risk premium.

Also, the Buffett Indicator (Warren Buffett's preferred market valuation metric, the ratio of the total stock market capitalization to GDP) now stands around 200%, which is considered "significantly overvalued." It is slightly below the level pandemic recovery peak in 2021 but well above 175% of 1999.

As shown in the two charts below, large-cap stocks appear to be near extremes relative to key commodities like gold and oil. Both show logarithmic scales. The top chart from MacroTrends showing Dow divided by gold prices shows the Dow Jones Industrials Index rolling over relative to gold prices, which suggests stocks might soon fall *relative* to gold. The bottom chart from The Crude Chronicles has the commodity in the numerator (so it displays the trend inversely to the upper chart) with oil divided by large-cap equities (most recently the S&P 500). It shows the ratio has aain fallen toward the lower end of the historical downtrend channel and near 1998 (Internet Bubble) and 2020 (pandemic) levels, which suggests stocks might soon fall *relative* to crude oil.







Notably, according to SentimenTrader, although share buybacks may have set a record last year, corporate insiders made the fewest open market buys of their company's stocks over the last 6 months of the year since the GFC. Moreover, a recent article by Financial Times (based on VerityData), *"Record numbers of US executives are selling shares in their companies [Wilshire 5000 Index]. The ratio of insider sales-to-insider buys has hit a record high for any quarter in two decades."*

The US stock market now makes up 70% of the world index, the 50 largest companies in the US account for over half total US market cap, and the MAG-7 stocks represent about 30% of total US market cap. However, because these titans tend to have high earnings growth, free cash flow growth, profit margins, and productivity, "asset-light" business models (focused on intangible assets like IP, software, data), outsized cash balances, low debt, global market penetration, persistent secular growth (rather than cyclicality), and wide economic moats (pricing power, brand loyalty, recurring revenue streams, and competitive advantage), they are generally looked upon as defensive "safe haven" stocks rather than risky plays, even at what traditionally would be considered elevated P/E multiples. And according to DataTrek Research, incredibly strong profit margins and ROE among the mega-cap Tech leaders has pushed the S&P 500 to a structural net margin (income after tax divided by revenue) increase from 10% to 12% over the last 10 years, which serves to support the rise in the index's forward P/E over that timeframe from roughly 16x to 22x today.

This is why I don't put much validity in comparing index P/Es through history, or using the Shiller Cyclically Adjust P/E (CAPE), because the makeup of the index has evolved so greatly. Today, the indexes are dominated by companies with the qualities listed above, as opposed to the industrial conglomerates and oil companies in days of yore, which were asset-heavy, capital intensive, cyclical, slower growth, and value-oriented, paying solid dividends. In 1980, the five largest companies were IBM, AT&T, Exxon, Standard Oil of Indiana, and Schlumberger, and 7 of the top 10 were oil companies. By 2000, at the height of the dot-com bubble, the five largest were Microsoft, GE, Cisco Systems, ExxonMobil, and Intel, but by 2002, the five largest were GE, ExxonMobil, Microsoft, Walmart, and Pfizer.

You get my drift. But even if the mega-caps are poised to maintain their valuations during market uncertainty (or turmoil), that doesn't necessarily mean they will provide the best upside in a rising market going forward. Where to look instead? Well, if you compare the equal-weight versions of the major indexes to take away that dominance of the MAG7 mega-caps, the valuations appear to be much more attractive.

Let's examine this more closely. The mega-cap cohort now boasts eight members of the $1 trillion market-cap club, encompassing the MAG-7 plus newcomer Broadcom (AVGO)…and with Berkshire Hathaway (BRK-B) knocking on the door. The chart below compares performance over the past year among the cap-weighted S&P 500 (SPY) and Nasdaq 100 (QQQ) versus the equal-weight S&P 500 (RSP) and Nasdaq 100 (QQQE) as well as the small-cap Russell 2000 (IWM). As shown, the performance differential between SPY and RSP is stark, and the outperformance of QQQ over QQQE is even greater, which illustrates how critical the mega caps have been to the amazing 2-year headline performance of the cap-weighted indexes.

Notably, small caps were also doing quite well until December (including a big post-election spike) but have shown the worst performance since then—such that small caps valuations relative to large caps are now at an extreme. In fact, the Russell 2000 actually touched—and bounced from—its 200-day moving average last week. Looking ahead, the case for small caps includes mean reversion, reasonable valuations, tight credit spreads that suggest the bond market sees no default risk, and a move toward greater portfolio duration (which would also benefit Treasuries and growth stocks beyond the low-debt, "safe haven," Tech titans). However, you can't just throw a dart to choose small caps since many are debt-ridden and unprofitable (40% of the Russell 2000). Quality really matters in this cohort.

<u>Economy, liquidity, yields, interest rates</u>:

The final BEA estimate for real GDP in Q3 was revised higher to 3.1%; however, it remains overly reliant on government deficit spending, earmarks, and boondoggles rather than organic growth from a vibrant private sector, which has been contributing only around 2% to GDP growth—and which the new administration's policies aim to reinvigorate. Also, real GDI was revised slightly lower to a 2.1% annualized growth rate. Theoretically, GDP and GDI should be equal, as the first measures spending and the second measures income, which should balance each other, and indeed they historically show 97% correlation. But GDI has been significantly lagging GDP lately, and when they diverge like this, many economists believe GDI is the more accurate gauge. Looking ahead, over the past few weeks the Atlanta Fed's GDPNow model cut its Q4 estimate from a high of 3.4% to as low as 2.4% on weaker construction and manufacturing reports, but the latest report (as of 1/9) has it at 2.7%.

I continue to be dubious about the often-rosy GDP and jobs reports, with heavy reliance on government spending and direct hiring and private sector jobs paid for by spending bills (rather than organic private sector growth), as well as wild fluctuations each month in the official reports, disconnects between various reporting entities, and large revisions on prior reports (mostly downward). According to KPMG, *"We generated 2.2 million jobs in 2024, the slowest pace since 2020... Brace yourself for significant downward revisions to payrolls in 2023 and early 2024 when benchmark revisions are released with the January employment report in early February."*

Stagnant or falling global money supply has been an impediment to global growth, but it has been partially offset by rising *velocity* of money (transactions per dollar in circulation). Still, despite the Fed's rate cuts, monetary policy today is actually more restrictive than when they made the first 50-bp cut in September, as rising bond yields and a strong dollar mean less liquidity and tighter financial conditions (which are negative for risk assets like stocks and crypto). Starting with the September rate cut, the dollar began to surge along with longer-dated Treasury yields.

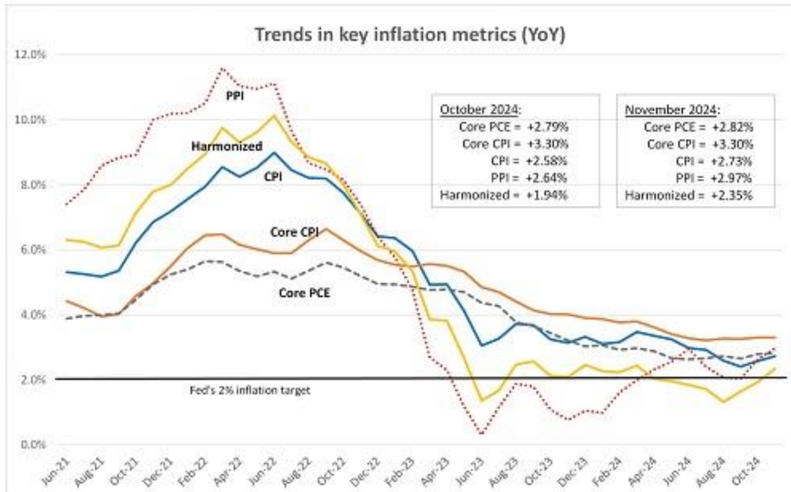
Beginning with the Fed's first 50-bps rate cut in mid-September, the dollar began its latest surge along with longer-dated Treasury yields. I have spoken in the past about how the yield curve was being manipulated by the Treasury by having virtually all new issuances in short-dated T-bills, which kept supply low on the long end, thus driving down bond yields and creating a maturity mismatch. Going forward, though, short-term supply will need to be more limited to drive down rates (through open market operations), and the yield curve should steepen further—although I expect it will be driven by lower short-term rates and a slight rise in term premium (reflective of investor concerns about high debt and deficits and perhaps some "bond vigilantes," i.e., investors who don't think the Fed should be cutting).

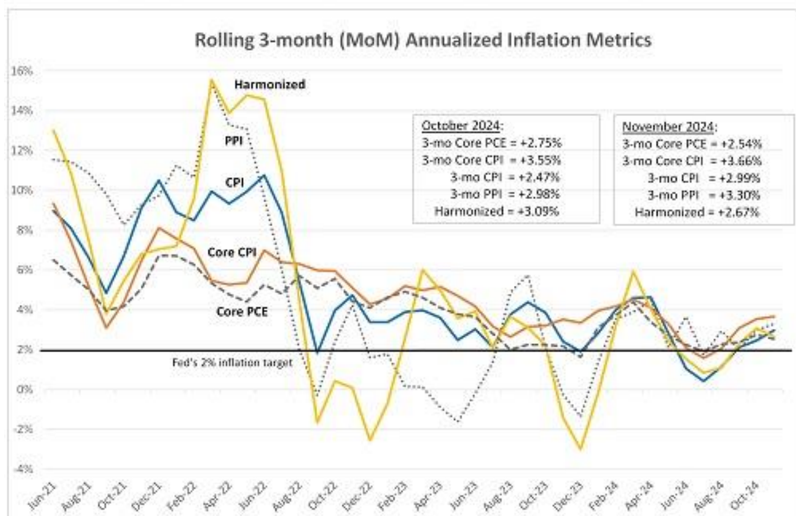
Although lower rates may be "reflationary," I believe it will be largely offset by deflationary impulses from China (which is desperate to maintain some semblance of growth) as well as blockchain and AI-driven productivity growth. As economist Ed Yardeni likes to say, *"Productivity is like fairy dust. It makes everything better. When its growth increases, that boosts real GDP's growth rate, moderates inflation, allows real hourly compensation to rise faster, and lifts profit margins. That's what the Roaring 2020s is all about."* And I do not believe Trump's threatened tariffs will be inflationary, to the extent they are implemented at all.

The surge in longer-term yields and mortgage rates is indeed unnerving, but rather than an impending "Liz Truss moment" in which investors dump stocks and bonds in protest of a proposed federal budget that cuts taxes and increases spending, I believe the yield curve is simply *normalizing* after a long period of manipulation by the US Treasury, with issuance (i.e., supply) entirely on the short end in expectation of lower short-term rates in the future when the debt must be rolled over. My view remains that the Fed should target a terminal fed funds rate of around 3.5% (versus today's 4.25-4.50%), and it should get us there soon because, as Jerome Powell admits, current monetary policy remains restrictive.

As for inflation, I like to look at alternative metrics to get a better sense of the current trend rather than where the given price index was 12 months ago, and I talk about this regularly in my blog posts. They include annualized 3-month rolling averages of PPI, CPI, CPI, PCE, and the Harmonized Index of Consumer Prices (HICP), which is a European methodology. The general trends in these metrics were looking quite promising during the summer, with many of the alternative metrics I watch falling below the Fed's 2% target. But the numbers have ticked up over the past few months, with some metrics over 3% in November, with this week kicking off the December readings.

As shown in the upper chart below, the BLS's 12-month PPI, CPI, Core CPI, Core PCE, and the Harmonized Index of Consumer Prices (HICP, a European methodology) for November all posted roughly around 3%, with HICP the lowest at +2.35% and Core CPI the highest at +3.30%. Other inflation indicators are the BEA's quarterly GDP Price Index and Price Deflator, which both came in at just +1.9% YoY for Q3.





Also shown in the lower chart below are other metrics I follow that give a better sense of the *current* trend rather than comparing today's price index with where it was 12 months ago. They include the annualized 3-month rolling averages of PPI, CPI, Core CPI, Core PCE, and HICP. Earlier this year, the annualized 3-month metrics were suggesting much more subdued inflation than the headline numbers, but lately it has reversed, with the short-term inflation trend rising similar to the YoY readings, with HICP the lowest at an annualized 3-month level of +2.67% and Core CPI the highest at +3.66%.

This week, December PPI and CPI were both released showing slowing and/or stabilization, with those high readings for YoY Core CPI and annualized 3-month Core CPI dropping to +3.25% and +3.30%, respectively. I expect this will soon lead to a resumption in the downtrend (aka deceleration). Wage growth and the quit rate have both been falling, which is disinflationary. Also, although shelter cost is still elevated and a key driver of sticky inflation, it is decelerating. Shelter accounts for nearly 20% of the core PCE index and more than 40% of core CPI. One reason that inflation metrics are running lower in Europe than in the US is that the Eurozone does not have the shelter cost component that has kept the Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) index elevated here. Owners' Equivalent Rent (OER) must fall further to allow CPI and PCE to go lower. But if we exclude shelter costs, CPI less shelter is running below the Fed's 2% target rate.

Also, the final Q3 estimate of the GDP Price Deflator was unrevised at 1.9% annualized—which is much less than the official YoY and annualized monthly inflation metrics described above.

Dollar strength and weak global liquidity growth have slowed global economic growth. But the US has benefited from foreign capital flight, the majority of which does not show up in our M2 money supply thus creating "shadow liquidity" that has helped inflate our capital markets—albeit at the expense of the rest of world (ROW). As inflation eases and central banks cut interest rates, the United States and India continue to drive global economic activity while Europe and China (among others) struggle to reinvigorate growth.

Because other countries are struggling and cutting rates, and because the US economy doesn't function in a vacuum, the Fed must cut as well to keep the dollar from continuing to strengthen. We can't have a strong economy if the rest of world falls into recession or worse (e.g., currency crisis, war, or political chaos).

Final comments:

Economic revitalization—through much lower dependency on government spending, supportive fiscal policy, and a normalization in interest rates—would reduce the hyper-financialization of our economy and lead to a renaissance among small businesses and our vast middle class. Already, the NFIB's Small Business Optimism Index for December has surged following the election to 105.1, which is the highest reading since October 2018 and up dramatically from a pessimistic reading of 93.7 right before the election.

The problems with Trump 1.0 included: 1) a lot of the freed-up cash from tax cuts went to stock buybacks rather than new capital investments and hiring, and 2) there was insufficient rollback of government overreach to stimulate productive investment. Government (especially a Dem-controlled Congress and sprawling Administrative State) is an Angry Beast that seeks more size, power, and control.

So, I believe the path to sustainability under Trump 2.0 will require an earnest 3-pronged attack: 1) "inflate away" the debt with somewhat elevated inflation (perhaps in the 2.5 to 3% range), 2) "cut away" government waste and spending with the DOGE initiative, and 3) "grow away" the debt by truly stimulating real organic, private-sector-led, productivity and economic growth with lower tax rates and deregulation. Capital tends to flow to where it is most welcome and earns its highest returns.

1. Inflate it away by tolerating somewhat elevated inflation in the 2.5-3.0% range to erode the value of the dollars owed and increase nominal GDP (which reduces the debt-to-GDP ratio).
2. Cut government waste and deficit spending (at the federal, state, and municipal levels), including what I call "smart austerity," such as stopping the funding of foreign wars and malinvestment in boondoggles and lobbyist directives.
3. Grow our way out of debt by stimulating organic private-sector-led productivity and economic growth with business-friendly fiscal policy and deregulation.

Tolerating somewhat elevated inflation can be acceptable if we are simultaneously incentivizing and nurturing strong growth through supportive monetary policy (modest interest rates and gradual money supply growth in line with GDP growth) and fiscal policy (lower tax rates and less red tape) while slashing our bloated federal (and state) government would return precious capital to consumers and the private sector for wise, high-return investments in projects that create robust organic growth in GDP, jobs, wages, free cash flow, and earnings…and, by extension, tax receipts—because as DataTrek Research has observed, *"Regardless of individual and corporate tax rates, Federal receipts have averaged 17% of GDP since 1960. Economic growth is the only reliable way to increase government revenues."*

So, tax cuts can pay for themselves if they can help supercharge real economic growth—and by extension, productivity, margins, corporate earnings, wages, and tax receipts. A productivity growth boom boosts real GDP growth, keeps a lid on inflation, drives up real labor compensation, and widens profit margins. So, the problem is not the tax cuts per se, but the lack of sufficient complementary support for economic growth.

Cato Institute study, which supports Trump's proposed 15% corporate tax rate, concluded: *"Because corporate taxes are so economically destructive, lowering or eliminating the tax altogether may not have the fiscal consequences some fear. Trump and Congress should build on the success of the TCJA by repealing targeted subsidies, like those in the Democrat's Inflation Reduction Act, and replace them with broad-based business tax cuts that will make America the most attractive place in the world to do business."*

Furthermore, data from the OECD "suggest that cutting corporate taxes in 2025 will likely not result in steep revenue losses. Additionally, more competitive business taxes will make America an even more attractive destination for global investment…"

Indeed, if we get out of own way, as they say, and stop the malinvestment of wars, boondoggles, and unwinnable battles against a changing climate, we can allow the magic of an unleashed private sector to do its thing in creating disruptive innovation and productivity gains from so many amazing and once-unthinkable but now rapidly advancing technologies, including generative AI, artificial general intelligence (AGI), quantum computing, blockchain and cryptocurrency, 5G, IoT, Big Data, Web 3.0, cloud computing, digitization, ecommerce, video conferencing, augmented/virtual reality (AR/VR), computer vision (CV), gaming, networks, sensors, 3-D printing, robotics, automated manufacturing, autonomous vehicles, horizontal drilling & fracking, clean fuels, green/renewable energy, nuclear fusion, electric/hydrogen transportation, space exploration, cybersecurity, decentralized finance (DeFi), fintech, nanotech, biotech, telehealth, precision medicine, computational biology, genomics, genetic sequencing, biologics, and the rapid development of diagnostics, therapeutics, and vaccines that may render future pandemics obsolete.

Latest Sector Rankings

Relative sector rankings are based on Sabrient's proprietary SectorCast model, which builds a composite profile of each of over 1,400 equity ETFs based on bottom-up aggregate scoring of the constituent stocks. The *Outlook Score* is a Growth at a Reasonable Price (GARP) model that employs a forward-looking, fundamentals-based multifactor algorithm considering forward valuation, historical and projected earnings growth, the dynamics of Wall Street analysts' consensus earnings estimates and recent revisions (up or down), quality and sustainability of reported earnings, and various return ratios. It helps us predict relative performance over the next 3-6 months.

In addition, SectorCast computes a *Bull Score* and *Bear Score* for each ETF based on recent price behavior of the constituent stocks on particularly strong and weak market days. A high Bull score indicates that stocks within the ETF recently have tended toward relative outperformance when the market is strong, while a high Bear score indicates that stocks within the ETF have tended to hold up relatively well (i.e., safe havens) when the market is weak. Outlook score is forward-looking while Bull and Bear are backward-looking.

As a group, these three scores can be helpful for positioning a portfolio for a given set of anticipated market conditions. Of course, each ETF holds a unique portfolio of stocks and position weights, so the sectors represented will score differently depending upon which set of ETFs is used. We use the iShares that represent the ten major U.S. business sectors: Financials (IYF), Technology (IYW), Industrials (IYJ), Healthcare (IYH), Consumer Staples (IYK), Consumer Discretionary (IYC), Energy (IYE), Basic Materials (IYM), Telecommunications (IYZ), and Utilities (IDU). Whereas the Select Sector SPDRs only contain stocks from the S&P 500 large cap index, I prefer the iShares for their larger universe and broader diversity.

The table below shows the latest fundamentals-based Outlook rankings and my full sector rotation model. I would call the rankings neutral given that secular growth, cyclicals, and defensives are mixed throughout. Bullish rankings would entail cyclical and economically sensitive sectors dominating the top half of the rankings with scores well above 50 and defensive sectors in the lower half. In the immediate wake of the Fed rate cut and dovish pivot, the rankings were more bullish, but with the market's renewed strength and broad reductions to earnings estimates, valuation multiples are back to extremes once again as prices have gotten ahead of earnings growth forecasts but boosted by lower interest rates.

Sabrient SectorCast Sector Rotation Strategy - As of 1/15/2025
Suggested Top 3 Sector ETFs for Bullish, Neutral, or Defensive Outlooks
Bullish/Neutral/Defensive bias based on SPY vs. 50/200 day moving averages; 30-90-day forward look

Sector	ETF	Outlook Score	Bull Score	Bear Score	Net Score: Neutral Bias	Net Score: Bullish Bias	Net Score: Defensive Bias
TECHNOLOGY	IYW	97	61	44	97	90.0	63.2
HEALTHCARE	IYH	56	50	57	56	52.9	76.6
FINANCIALS	IYF	55	53	55	55	59.0	71.2
CONSUMER DISCRETIONARY	IYC	53	56	52	53	64.9	62.8
TELECOMMUNICATIONS	IYZ	49	51	55	49	52.7	68.4
UTILITIES	IDU	45	46	64	45	40.6	88.9
INDUSTRIALS	IYJ	30	52	53	30	48.7	54.7
ENERGY	IYE	15	52	70	15	43.9	90.0
CONSUMER STAPLES	IYK	12	40	63	12	16.9	71.2
BASIC MATERIALS	IYM	2	47	56	2	28.8	49.2

Sabrient's ***Outlook Score*** employs a forward-looking fundamentals-based scoring algorithm to create a composite profile of the constituent stocks. ***Bull Score*** and ***Bear Score*** are based on price behavior of the underlying stocks on particularly strong and weak days over the prior 40 market days. High Bull indicates a tendency for relative strength in a strong market, and high Bear indicates a tendency for relative strength in a weak market (i.e., safe havens). High for all scores is 100, and higher is better.

Technology (dominated by the mega-cap MAG-7) remains at the top with a near-perfect Outlook score of 97, despite having by far the highest forward P/E (29.2x). However, because of its EPS growth estimates (19.4%), its forward PEG (ratio of P/E to EPS growth) is a relatively modest 1.50, so investors are happy to "pay up" for strong growth. Tech also displays stable Wall Street analyst earnings revisions, by far the highest return ratios, and continued insider buying.

Why? Because it's a secular grower (i.e., little cyclicality) no matter the economic conditions, and no other sector comes close to its consistently strong growth, margins, operating leverage, and return on capital. For example, the three largest US Tech companies—Apple, Nvidia, and Microsoft—average net profit margins of over 40% and ROE of around 90%. How do you compete with that? And Tech not only benefits from its own product development and productivity gains, but those products help other companies with their product development, product delivery, and productivity—so Tech benefits by helping all sectors grow and prosper.

Rounding out the top 5 are Healthcare, Financials, Consumer Discretionary, and Telecom, followed by Utilities (buoyed by AI involvement) and Industrials. Notably, 7 of the 10 sectors have seen net negative revisions to EPS estimates from the analyst community, with only Consumer Discretionary, Financials, and Utilities positive.

At the bottom of the rankings are Materials and Consumer Staples, mainly due to the largest negative revisions to earnings estimates, low projected EPS growth rates, and mediocre return ratios. Notably, Telecom, Financials, and Energy display the lowest (most attractive) forward P/Es at 13.9x, 14.7x, and 15.4x, respectively.

Energy has shown attempts at times to rise in our SectorCast rankings. After a prolonged period of underinvestment, oil & gas companies increased capex by 53% over the past 4 years, according to Deloite's 2025 industry outlook, with forward focus on capital discipline and efficiency, shareholder payouts (dividends and buybacks), as well as ongoing digital transformation, M&A and integration, strategic partnerships, innovation, enhanced productivity, and cost reduction. Additionally, some companies are engaging in increased investments in low-carbon technology projects to help balance the risks associated with the traditional oil and gas market. So, perhaps we will start to see increased sales and earnings projections for the Energy sector as the year progresses.

Keep in mind, the Outlook Rank does not include timing, momentum, or relative strength factors, but rather reflects the consensus fundamental expectations at a given point in time for individual stocks, aggregated by sector.

Sector Rotation Model and ETF Trading Ideas

Our rules-based Sector Rotation model, which appropriately weights Outlook, Bull, and Bear scores in accordance with the overall market's prevailing trend (bullish, neutral, or defensive), dropped from a lengthy bullish bias (since 9/12) to a neutral bias, based on the SPY falling below its 50-day moving average, but staying above its 200-day. *(Note: In this model, we consider the bias to be bullish from a rules-based trend-following standpoint when SPY is above both its 50-day and 200-day simple moving averages, but neutral if it is between those SMAs while searching for direction, and defensive if below both SMAs.)*

Thus, it suggests holding **Technology (IYW), Healthcare (IYH), and Financials (IYF)**, in that order. However, if you prefer a <u>bullish</u> stance, the Sector Rotation model still suggests holding the same sectors Technology, Consumer Discretionary (IYC), and Financials, in that order. Or, if you prefer to take a <u>defensive</u> stance, it suggests holding Energy (IYE), Utilities (IDU), and Healthcare, in that order.

An assortment of other interesting ETFs that are scoring well in our latest rankings include: Invesco Biotech & Genome (PBE), Goldman Sachs Future Consumer Equity (GBUY), BNY Mellon Innovators (BKIV), Invesco Dorsey Wright Healthcare Momentum (PTH), iShares Global Tech (IXN), Hartford Large Cap Growth (HFGO), Burney US Factor Rotation (BRNY), Cambria Cannabis (TOKE), Fidelity Blue Chip Growth (FBCG), Alger 35 (ATFV), First Trust Innovation Leaders (ILDR), Invesco S&P SmallCap 600 Pure Growth (RZG), WealthTrust DBS Long Term Growth (WLTG), Invesco Leisure & Entertainment (PEJ), Roundhill Generative AI & Technology (CHAT), Alger Concentrated Equity (CNEQ), iShares Technology Opportunities Active (TEK), iShares US Pharmaceuticals (IHE), AXS Esoterica NextG Economy (WUGI), US Global Technology and Aerospace & Defense (WAR), AdvisorShares Hotel (BEDZ), First Trust Multi-Manager Large Growth (MMLG), and First Trust Active Factor Small Cap (AFSM). All score in the top decile (90-100) of Outlook scores.

As always, I welcome your thoughts on this article (whether supportive or critical)! Please email me anytime. Any and all feedback is appreciated. Also, please let me know of your interest in any of Sabrient's new **indexes** for ETF investing, such as *High-Quality Growth* (similar to our Baker's Dozen model), *Quality Growth & Income*, *SMID-Cap Quality Plus Momentum*, *High-Quality Technology*, *High-Quality Energy*, *Quality Legacy & Green Energy*, or *Defensive Equity.*

IMPORTANT NOTE: I post this information periodically as a free look inside some of our institutional research and as a source of some trading ideas for your own further investigation. It is not intended to be traded directly as a rules-based strategy in a real money portfolio. I am simply showing what a sector rotation model might suggest if a given portfolio was due for a rebalance, and I do not update the information on a regular schedule or on technical triggers. There are many ways for a client to trade such a strategy, including monthly or quarterly rebalancing, perhaps with interim adjustments to the bullish/neutral/defensive bias when warranted, but not necessarily on the days that I happen to post this article. The enhanced strategy seeks higher returns by employing individual stocks (or stock options) that are also highly ranked, but this introduces greater risks and volatility. I do not track performance of the ideas mentioned here as a managed portfolio.

Disclosure: *At the time of this writing, of the securities mentioned, the author held positions in SPY, QQQ, FTLS, gold, and bitcoin.*

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