Alley Company Quarterly Letter
Frequently Asked Questions

January 14, 2025

The year 2025 is set up to be an interesting one for the economy and financial markets. The pressing issues at hand include the economy's resiliency, the impact of the election, the Federal Reserve's path forward on interest rates, and the valuation of the stock market, to name a few. While questions and concerns *always* abound, assessing their potential impact on the big two asset classes (stocks and bonds) can be a worthwhile exercise. So, what follows is a hypothetical Q & A exchange between today's investor and the Alley Company investment team.

Investor: How would you describe the economic environment as we start the new year?

Alley Team: The U.S. is currently experiencing strong and potentially sustainable economic growth, once again arguably the envy of the world. Think about it, the economy has sailed right through one of the most aggressive Federal Reserve interest rate hiking cycles on record with hardly a hiccup, inflation has come down significantly to near the target rate of 2%, unemployment is near record lows, while corporate earnings have been making record highs since the second half of 2023. So, on the economic front, the picture looks good in the United States. The stock market has indicated the same, making 57 new highs in 2024, following a strong run in 2023.

Investor: How do you think about the election outcome and its impact on the economy?

Alley Team: First, we don't ascribe a lot to politics in our investment decision making process. We are bottom-up investors, meaning we analyze the fundamentals of our companies and strive to invest in stocks that have consistent revenue, earnings and cash flow growth that tend not to be tied too much to the whims of the economy or political outcomes. Also, as depicted in the graph below, history suggests that the stock market tends to do about the same whether we have Republicans in power or Democrats.

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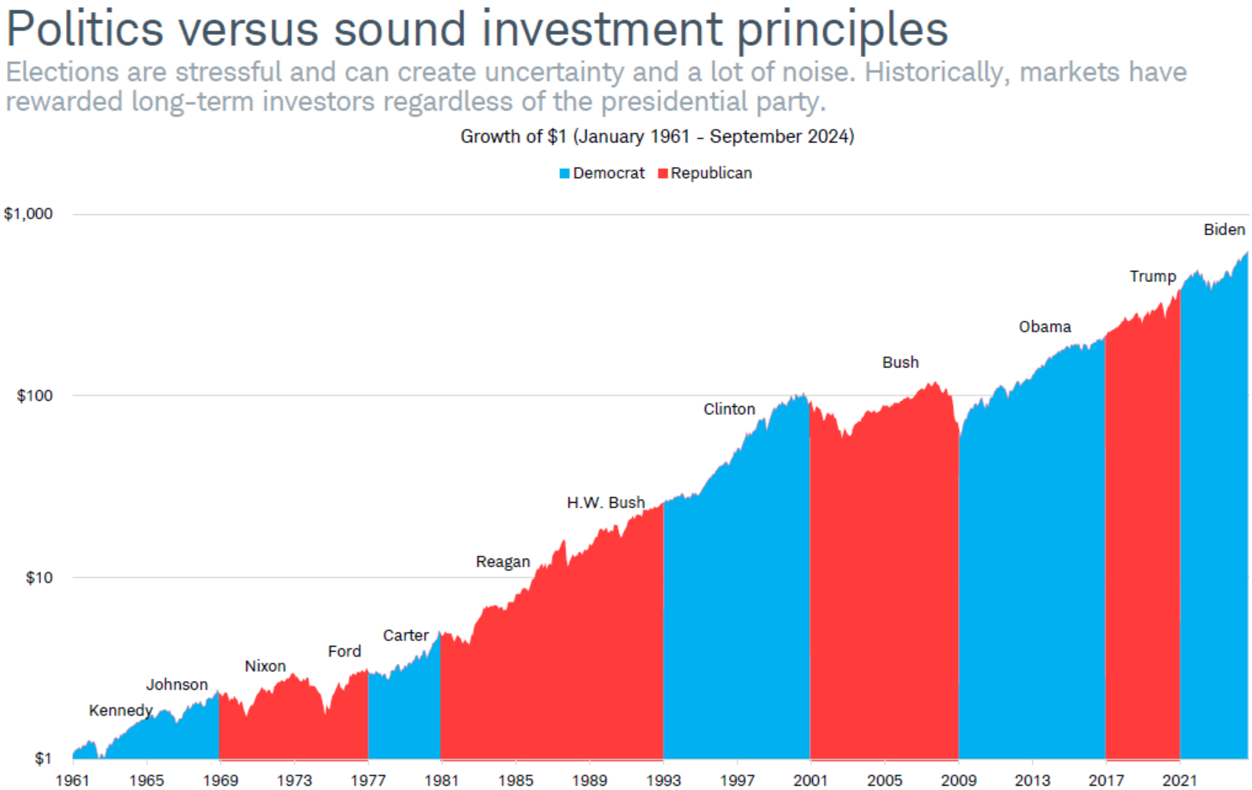


Source: Schwab Center for Financial Research, with data provided by Morningstar, Inc. The chart above shows the growth of $1 invested in a hypothetical portfolio that tracks the Ibbotson U.S. Large Stock Index starting on January 1, 1961.

That said, we know that in the short-term, political decisions can impact markets. There are definitely pluses and minuses with the new administration's policy agenda. On the plus side, lower taxes and less regulation can foster animal spirits which would be good for the economy and corporate earnings, and on the minus side, overreach on tariffs and deportation could reignite inflation. We'll watch these issues closely, but mostly take our cue from company-specific fundamentals.

Investor: Why has the economy been so resilient, despite interest rates rising dramatically?

Alley Team: In our mind, there are two underlying forces that support the unparalleled entrepreneurial spirit of the U.S. economy: innovation and productivity growth. When we think of ground-breaking innovation, we think of the U.S. having played a leadership role in the development of the internet, cloud computing, and now artificial intelligence. Innovation, no doubt, is a global phenomenon, but the U.S. in particular benefits from a proven market-based system that rewards thoughtful risk taking and entrepreneurialism within a regulated environment. The combination of these elements is the "secret sauce" behind America's productivity and its economic dominance* over the past century. Today, a large and diverse number of companies in our economy drive renewed productivity growth. Their pace of technological adoption and advancement obscures the classic definition of a technology company. Artificial intelligence, while in its early stages, is only going to accentuate this trend. This phenomenon likely played a role in the resilience of the economy during the aggressive Fed tightening cycle.

Investor: What about the valuation of the stock market? Doesn't it seem a bit high?

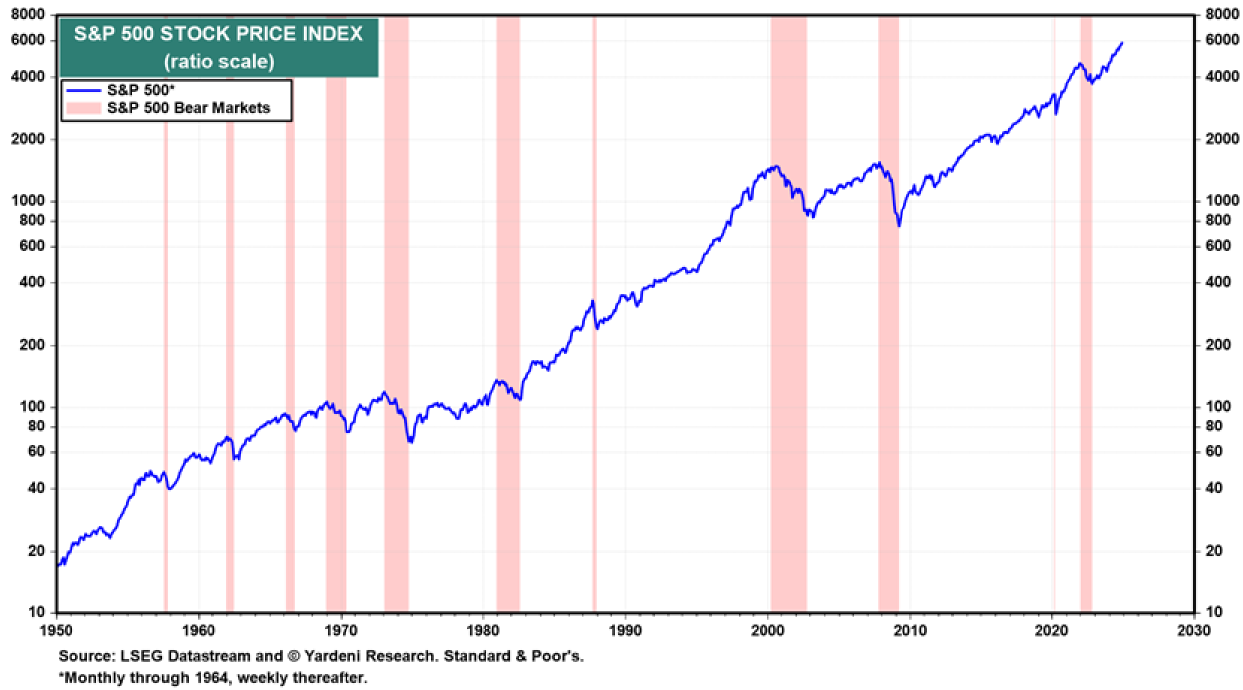
Alley Team: Yes, the valuation of the S&P 500 is on the high side, historically speaking, at about 22 times forward earnings, but there are important factors to consider. First, when you strip out the top ten stocks, which comprise approximately 39% of the index's market capitalization, the remaining 490 stocks are trading at only 18 times forward earnings. Second, many highly productive companies in today's market are deserving of premium valuations as free cash flow margins are sustaining at higher levels than companies in past decades. Additionally, now that the Fed's most recent tightening cycle is seemingly over as inflation nears its target, an extended period of economic growth could cause investors to discount the future with higher current P/E ratios. In any case, the "price of admission" in the stock market is that there can always be a *ten to fifteen percent correction* around any corner, and that certainly remains the case today.

Investor: It seems as though there is more to worry about today than other points in history, so should I reallocate some money to bonds or cash?

Alley Team: First, there really isn't more to worry about today, as there has never been a period where worry didn't exist and trying to rank the importance of worry versus any other period is impossible. What matters most is how we deal with the issues at hand, and as Warren Buffet has stated over-and-over-again, "it's always been a terrible mistake to bet against America." Concerning bonds, with the ten-year Treasury trading at a yield of 4.6%, up 100 basis points since the Fed's easing cycle began in September, yields have improved from a few years ago and represent an average yield level relative to history. Depending on one's overall asset level, risk tolerance, liquidity needs, etc., asset allocation between stocks and bonds (the big two asset classes) is always an important decision.

Currently, the "bond vigilantes" (bond investors who aim to influence economic policy through the bond market), are concerned about the national debt and deficit and may drive yields somewhat higher in the near term. This warrants investor attention. Money market yields have come down with the beginning of the Fed's easing cycle, and will continue to come down if the Fed continues on this path.

As for stocks, to quote a highly respected economist/strategist, Ed Yardeni, "*When I started my first job on Wall Street at EF Hutton in January 1978, the S&P 500 price index was at 90 (chart). Today, it is at 6000. That's a 66.6-fold increase in 47 years. I wish I had been bullish over this entire period and had the funds to invest when I started my career. Over this entire period, there were just six bear markets, and they lasted on average only a bit more than one year."* The short answer is, avoid market timing and stay the course with your asset allocation structure.



Investor: So, what is your bottom-line message as we begin 2025?

Alley Team: Our message continues to be consistent, which is to invest within your asset allocation structure. And don't try to time the stock market, as it's a fool's game that can be avoided if one adopts an investment philosophy of buying high quality blue chip American companies that can produce consistent revenue, earnings, and cash flow growth and pay attractive and growing dividends.

* The U.S. accounted for 26% of global GDP in 2023, according to data from World Bank Group, while its population represented roughly 4.2% of the world's.