Our 2025 Playbook — January 15, 2025

Each year, we look back at the prior year's Investment Playbook to assess what we got right, what we got wrong, and what we learned in the process. We then turn to the coming year, putting our dominant ideas in writing, with hopes of gaining greater clarity on the factors that might drive our investment returns going forward.

This piece is not meant to be detailed or comprehensive like the many forecast pieces that Wall Street publishes at the beginning of each year. We also will not promote headline-grabbing predictions just to get the attention of readers – we're far more comfortable being boring, if that's what seems right and is more helpful to our clients.

Our Playbook is as much for us as it is for you; it is meant to serve as a compass for orienting our investment decisions during the year and helping you to understand the primary influences that may affect those decisions. How we react to new information that comes along during any given year is always subject to our discretion, a distinguishing feature of active management. Regardless of the outcome, the intent is always to drive superior returns over time, learning from our inevitable mistakes along the way.

Thank you for your continued confidence in our approach and interest in our work!

Looking Back and Looking Forward

Our annual playbook has typically focused on three variables each year: the economy, the markets, and politics. This framework has served us well over the years so we will stick with it!

The Economy

With respect to the economy, we made the following prediction at the beginning of last year:

"In general, (we expect) more of the same. The economy should continue to expand, and the Fed may be able to cut rates a time or two by year end as inflation moderates towards their 2% goal. With the national debt level as large as it is, we do not think a recession will be required to get the Fed to reduce rates if for no other reason than that government shouldn't pay a higher rate of interest than they need to. Even in the face of economic weakness from China and elsewhere, our outlook for the domestic economy in 2024 remains positive given the strong employment outlook."

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This outlook proved relatively accurate, as the economy continued to expand, employment remained robust, and the Fed did indeed start to reduce rates, even in the absence of a recession.

What do we see for 2025?

Once again, we suspect much of the same. Employment should remain vibrant, and capex should continue to tick up as the country brings manufacturing back home and as artificial intelligence in the data center and eventually the enterprise takes hold. GDP growth of at least 3% feels like it is in the cards.

We believe the Fed will be on hold in 2025 after a few cuts in 2024, as inflation appears stuck at improved levels even as employment, their other mandate, continues to improve. The strength of the economy might imply a higher probability of rate hikes rather than further cuts at this point, but we aren't calling for that at this time.

Longer term interest rates – those that the Fed does not control – have risen even as the Fed cut rates in 2024. While. some see bond vigilantes trying to discipline the government against doing things that might make inflation worse, we believe a more probable cause could be an outlook for a more robust economy than we've seen in over a decade and a "normalization" process at work.

As long as employment stays strong and the demand for money to fund capex higher than normal, the yield curve should continue to normalize and become more upward sloping. Higher rates may remain a headwind for housing and auto demand, but with employment strong, we suspect folks will eventually move forward with their need-based spending plans, as we've always done at varying interest rate levels historically.

A five percent long bond may seem unusual from the perspective of the last twenty years, but over the last fifty is about average. With a retrenchment in globalism, we suspect rates to remain higher than they have been as we look to rebuild our middle class politically. We think inflation at the 2.5-3% level may be the price of a shift in these priorities but also believe that artificial intelligence can be an offset, keeping rates lower than they might have otherwise been. If rates move substantially above 5%, we may have to reassess our outlook accordingly, although it would likely affect the markets more than the economy in the short term.

<u>The Markets</u>

We have long held to a proprietary investment approach in which three cycles work together to influence value creation in the stock market. These three cycles include the *Economic Cycle, the Innovation Cycle and the Credit Cycle.*

Last year, we made the following statement about the stock market:

"As we look to 2024, we'll once again put ourselves in the more of the same camp with respect to the markets. While the gains may not be as great as they were in 2023, the Innovation Cycle will in all likelihood have a greater impact on returns than the Economic Cycle. Companies will

no longer be able to raise prices and may even be forced to reduce them, meaning growth will be scarcer and innovation more vital for market success."

This prediction was also a good one. The markets didn't quite post the same gains that they did in 2023, but they were pretty close. The S&P 500 gained double digits in 2024, up 25%, following gains of 26% in 2023. To be sure, part of the 2023 gains were a rebound from the double-digit declines experienced in 2022, but the markets went well beyond that in establishing new highs and ending just off those levels in 2024. Earnings gains were decent in 2024, but multiple expansion was a predominant factor in returns, implying that a greater responsibility might lie with earnings for gains in 2025.

For 2025, we think the market can make additional progress, but perhaps not to the same extent that we have seen in each of the last two years. With employment gains strong, and an investment theme for artificial intelligence that feels as overwhelmingly positive for the future economy as the internet and electricity have been in the past, we feel that earnings gains can do the bulk of the heavy lifting as we go forward. Drawdowns are to be expected in any given year. Readers might be interested to know they average 14% - including the positive years! The potential for greater turbulence in 2025 seems probable given the multiple expansion we saw in 2024, yet we still think 2025 can end up in the positive column.

We think the *Innovation Cycle* will be the primary driver of returns, but some of the more mature areas typically associated with the *Economic Cycle* may see an upswing to the extent they receive help from the associated spending on innovation. The *Credit Cycle* will likely be a relative headwind to what it might otherwise have been if rates were lower, but businesses and consumers should eventually accept higher rates as a necessary cost of bringing future projects to life.

The greatest risk to the market is still the unexpected – perhaps a geopolitical flare up or the popping of an asset bubble that no one saw coming. The obvious candidate for bubble formation would seem to be in the artificial intelligence space, but with companies like Microsoft and Meta still accelerating their plants and the edge opportunity for such apps largely untapped, it's hard for us to see it happening anytime soon.

Productivity gains should manifest themselves more clearly within the enterprise as AI use cases are developed to solve specific problems, and then perhaps more generally for consumers later as the technology makes its way to the iPhone and other edge devices. In ways, this may be the opposite of the rollout of productivity gains associated with the internet, which seemed to benefit consumers first with things like search, and then business model disruption later on. It is equally important to realize that the gains associated with the internet have lasted for over twenty years. Artificial intelligence gains should similarly be long lasting and enduring.

<u>Politics</u>

Last year, we made the following comments on the political scene:

"With the 2024 Presidential election looming, this year will likely be a nasty one politically. It could quite literally be dangerous to one's health if proper boundaries aren't set. For our part,

we plan to avoid cable news at all costs and will seek to understand what is true by interacting with our families, neighbors and church. While some feed on digitized discontent, we'll feast on simple joys like a good book, hikes in the outdoors with our dog Lilly, and a warm, cozy fireplace. Call us selfish, but this will be our intentional reality. "

While the political environment was volatile – with President Biden dropping out of the race and Kamala Harris rushing to fill the void – the election itself, quite thankfully, was not as close as feared. Donald Trump won the vote in a landslide and for the first time in the last few elections, there wasn't counterparty bickering about who cheated or stole the election. More importantly, we enjoyed plenty of quality time with Lilly by the fire!

Donald Trump's election to a second term has been met with a completely different response than his first election, both by the media and many from the "elite" halls of corporate America. The rest of the world even seems to be following suit, shifting rightward, and pulling back from the progressive emphasis on programs like DEI and others associated with Musk's "woke mind virus". The pace of such a shift is quite astonishing given the tone of the last eight years.

The incoming administration will likely attempt to run the country like a business rather than a non-for-profit enterprise dependent on tax contributions. On the positive side, as the head of DOGE, Elon Musk has a strong pedigree when it comes to getting a house in order while simultaneously investing in things that bring the realm of science fiction to life. At the same time, Washington DC also has a strong pedigree as a bureaucracy like no other the world has ever seen.

While Trump and Musk may not get everything they want, they will likely seed what we need. As two extreme alpha males, we shouldn't be surprised if they spar with one another on more than one occasion in the coming four years. Tough stuff often requires tough hides, and both silver backs have that in spades.

We have learned that success can often be defined differently by various individuals, shareholders, citizens and governments. Just as businesses strive for sustainable profits as a sign of exceeding the expectations of customers and shareholders, governments may be more focused on the safety, freedom, and opportunities of citizens as a mark of success.

While some efficiency gains will be made in the government sector, as Pete pointed out in our fourth quarter update, the objective of a local city in the snow belt is not to maximize its profits by underspending on snowplowing equipment, but to make sure the capacity is there to keep the roads clear even if it only dumps once a year. Gains will be made, but not without a hard fight. It will likely prove more difficult than expected.

Trump has already proposed some wild ideas like annexing or buying Greenland, Canada, and the Panama Canal. Like the talk over tariffs, it is hard to know how much is substantive versus strategy in the negotiation department, but when Trump says things like the Israeli hostages better be safe by the time he gets into office, I think our enemies are hearing a voice that they've not heard in quite some time. Changes in immigration will also be forthcoming and worth paying attention to.

"Talk loudly and carry a big stick."

Like him or not, this is Trump at his finest. If others treat the United States fairly, we suspect our allies and enemies alike will have nothing to worry about. President Trump will more clearly spell out where our boundaries as a nation lie. The times of being taken advantage of economically, militarily, and perhaps even spiritually are likely over, at least for the next few years.

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We will close our 2025 Playbook as we have always done, by reminding investors that our business is never easy, but is always an intellectual challenge we enjoy pursuing. We appreciate your faith and trust in Broadleaf!

May God bless you abundantly in the coming year, even if it comes in ways you do not expect!

Kindest Regards,

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