KENSINGTON
Asset Management

Monthly Commentary
January 2025

About Kensington

Kensington Asset Management specializes in data-driven, quantitative investment solutions spanning across the global investment landscape. Our focus is to help provide investors with confidence through quantitative analytics, by attempting to participate in rising markets, while taking steps to help avoid exposure during times of market decline or volatility. Kensington Asset Management was founded by Bruce P. DeLaurentis, a quantitative pioneer with over 40 years of trading experience through numerous market cycles.

Investment Philosophy

Kensington believes that the best way to generate steady, above average positive returns is to employ an investment methodology that has the potential to recognize and measure consistent and repeating behavioral patterns in the financial markets. With that goal in mind, Kensington has developed clearly defined quantitative decision models that strive to minimize subjectivity in this decision-making process. The overarching goal is to capture sufficient returns in positive market conditions, while protecting capital, with rigorous mitigation during down markets.

Authors

Kensington Asset Management Team

Geopolitics: Uncertainty and Market Implications

The world remains in flux as investors assess the geopolitical and economic policies of the new administration. Trump's "America First" approach continues to drive policy, causing disruption abroad but reinforcing US leverage in global negotiations. While some alliances may be restructured, the economic impact of tariffs and other trade measures is likely already reflected in market pricing. However, with retail investors heavily engaged at this stage of the market cycle, their reaction to unfolding events remains uncertain.

This realignment of global relationships could create both risks and opportunities. While some allies may push back against US demands, trade renegotiations may also lead to improved terms for American businesses. Investors should remain watchful of policy developments and their potential ripple effects on corporate earnings, supply chains, and currency markets.

Stock Market: Changing Leadership and Concentration Risks

Equities started the year strong but with notable leadership shifts. For the first time in months, international markets outperformed the US, with the **Euro Stoxx 50** up **7.98%, MSCI EAFE** up **4.82%,** and **S&P 500** advancing **2.70%.** The **S&P 500 equal-weighted inde**x outperformed the cap-weighted version, suggesting a broadening of market participation.

The **Magnificent 7** stocks declined as a Chinese tech firm introduced a lower-cost AI platform, raising concerns about their long-term dominance. This group has driven market returns in recent years—accounting for **53.7% of the S&P 500's total return in 2024**—but their high valuations warrant caution. Goldman Sachs' research indicates market concentration alone isn't a sell signal, but when coupled with overvaluation, downside risks increase.

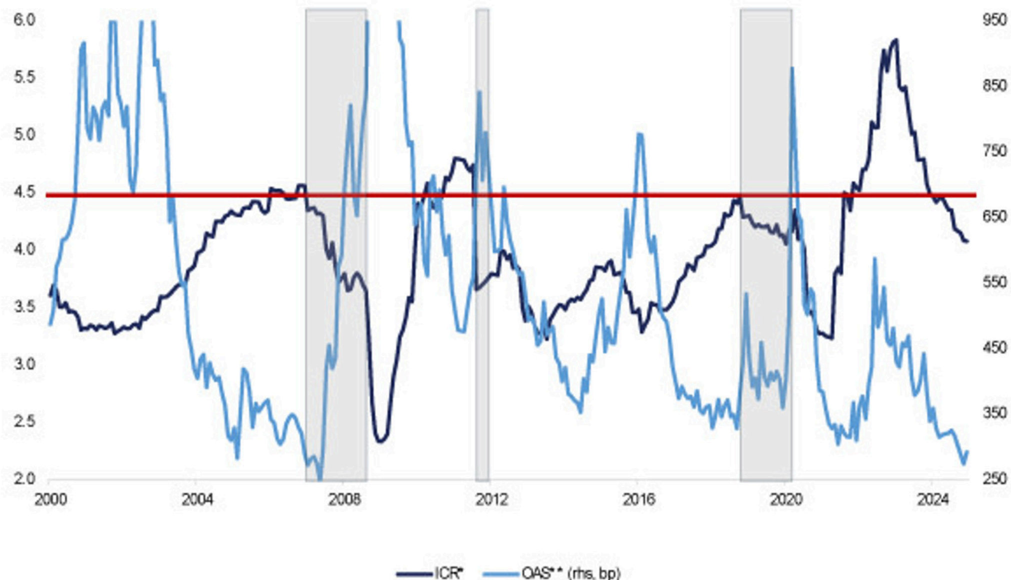
Historical comparisons suggest that concentrated markets can remain stable if growth expectations are met. Currently, markets anticipate **20%+ annual revenue growth for the Magnificent 7 over the next decade,** a threshold historically achieved by just 3% of **S&P 500 companies.** Given this backdrop, investors may benefit from diversifying beyond large-cap growth stocks. Supporting this view, Jason Goepfert of Sentiment Trader noted that the **S&P 500's six-month Sharpe Ratio exceeded 1.2,** a level historically signaling market peaks. This environment could favor Kensington's tactical strategies, designed to navigate heightened volatility.

A shift toward **lower capitalization and value stocks** may be underway. Sectors that were overlooked in 2024—such as industrials, energy, and materials—may see renewed investor interest. With bond yields stabilizing, dividend-paying stocks may also gain favor, particularly as economic growth moderates.

Fixed Income: Cautious Optimism

Bond markets also posted positive returns in January. The **10-year Treasury gained 0.59%,** while the **Bloomberg US Aggregate Bond Index rose 0.53%.** Bloomberg US Corporate High Yield Index continued their outperformance, up **1.37%**, despite signals that credit risk may be underpriced.

Bank of America's analysis highlights that when **interest coverage ratios (ICR) fall below 4.5x,** widening credit spreads typically follow (chart below). While investors seem to anticipate a policy-driven ICR rebound, the margin for safety appears slim, warranting a more tactical approach in 2025.



Source: BofA Merrill Lynch Global Research, RBA

Macroeconomic data suggests a moderating but resilient economy. Inflation remains elevated but stable, job openings and quits have leveled off, unemployment hovers around **4%,** and **ISM data** signals a shift, with manufacturing gaining traction while services slow. The **Atlanta Fed's GDPNow model** projects **2.9% real GDP growth for Q1 2025**, reinforcing a soft-landing narrative.

Fixed income markets are adjusting to the evolving macro landscape. While long-term yields remain historically high, expectations of rate cuts later in the year could support bond prices. Investors may consider a **barbell approach,** balancing shorter-duration instruments with high-yield credit, as the yield curve remains inverted.

Federal Reserve: Navigating Political Pressures

Chairman Powell has emphasized that rate decisions will remain data-dependent. However, Trump's calls for lower rates set up a potential clash with the Fed. Powell's resistance to political influence could drive volatility, particularly if rate cuts are perceived as politically motivated.

History suggests that excessive political pressure on monetary policy risks destabilizing markets. The correlation between stocks and bonds is at its highest since the Clinton era **(chart on next page),** recalling James Carville's famous remark about the bond market's power. Should rates remain stubbornly high, the risk of a market correction increases, particularly as seasonality turns less favorable. Goldman Sachs' Scott Rubner warns that "flow dynamics are shifting," with broad investor participation heightening risks of a pullback.

Source: Bloomberg, RBA

Despite this, the Fed may be forced into action if growth slows sharply. Corporate earnings expectations remain key, as declining profit margins could trigger market volatility. Investors should monitor wage growth, inflationary pressures, and central bank commentary for clues on future policy moves.

Conclusion: A Tactical Approach for 2025

As markets navigate geopolitical uncertainty, shifting equity leadership, and evolving monetary policy, a tactical approach can potentially be a prudent step. Kensington's strategies are designed for environments where volatility increases and diversification beyond concentrated market leaders becomes critical. Investors should remain adaptable, focusing on risk-adjusted opportunities across asset classes, including underappreciated equity segments, high-yield credit, and tactical fixed-income allocations.

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Advisory services offered through Kensington Asset Management, LLC, Barton Oaks Plaza, Bldg II, 901 S Mopac Expy – Ste 225, Austin, TX 78746.

Definitions:

Bloomberg US Aggregate Bond Index: An unmanaged index comprised of US Investment grade fixed rate bond market securities, including government agency, corporate and mortgage-backed securities. Investors cannot invest directly in an index. It is also known as US Aggregate Bond Index.

Bloomberg US Corporate High Yield Index: An unmanaged market value-weighted index that covers the universe of fixed-rate, non-investment grade debt in the US. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded.

Euro Stoxx 50 Index: A market capitalization-weighted stock index that represents the 50 largest blue-chip European companies operating within the eurozone nations

MSCI EAFE Index: An international equities market index that consists of large and mid-cap stocks across developed markets in Europe, Australasia, and Far East Asia. Excludes US and Canadian equities.

S&P 500: A capitalization weighted index of 500 stocks representing all major domestic industry groups. The S&P 500 TR Index assumes the reinvestment of dividends and capital gains.

S&P 500 Equal Weight Index: Equal weight to each of the 500 companies in the S&P 500, ensuring that each company has the same impact on the index's performance, regardless of its market capitalization

S&P US Treasury Bond Current 10Y Index: The S&P US Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year US Treasury note or bond.

Sharpe Ratio: A risk adjusted measure of a fund's performance that indicates a fund's return per unit of risk, defining risk as volatility (standard deviation).

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