

### “The End Is Where We Start From”

The 2024 election results kicked off a dramatic rebalancing of cross-asset prices and allocations as market participants attempted to handicap the perceived “winners” and “losers” in the wake of a second Trump term.

Now as we progress through the final month of the year, history suggests that global markets should return to a calmer footing as volumes typical decline amidst a light economic and corporate calendar.

Our focus in this issue will be to turn to the outlook for the year ahead while reviewing a few particularly thought provoking themes which we believe will be front and center during 2025.

#### Macro focus

2024 has been an extraordinary year for US equity markets by many measures. But it is perhaps best encapsulated by the chart on this page which displays the

S&P 500’s maximum drawdown throughout the year. The market experienced only two peak-to-trough drawdowns through the year which were greater than 5% and spent a mere 8 trading days within a 5% drawdown.

We expect returns in the year ahead to be: 1. harder to come by, 2. more broadly disbursed across sectors, and 3. rewarding to discerning stock-pickers.

#### Top-of-mind Themes

Digging a layer below the macro, we turn to what we believe are likely to be particularly important thematic developments during 2025. Specifically:

1. The “show me” moment for the 2023 - 2024 AI arms race.
2. A potential surge in capital markets activity (M&A and IPOs).
3. The inevitable need to clear structurally underwater CRE assets (office and multifamily).

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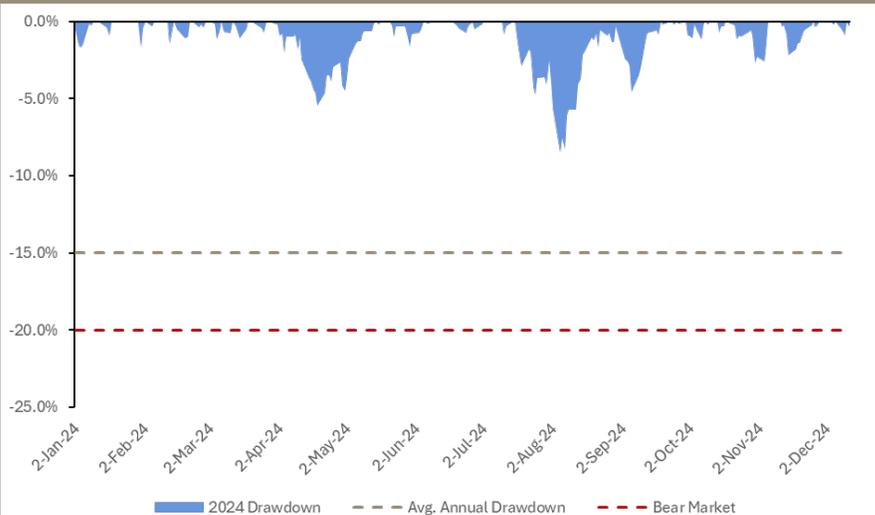
#### RECENT DEVELOPMENTS

- FOMC cut rates an additional 25 bps on Nov. 7, bringing the total to 75 bps since the initial cutting cycle began in September. Global central banks continue to follow suit, firmly staying in easing mode
- Toppling of the Assad regime in Syria leads to an increased focus on potential geopolitical changes, particularly evolutions in the Ukrainian and middle eastern conflicts
- Major M&A deals continue to be blocked in the waning days of the Biden administration, with Kroger’s acquisition of Alberstons blocked and guidance that Nucor’s acquisition of US Steel will be denied on national security concerns

#### KEY UPCOMING EVENTS

- December FOMC meeting: Dec. 18

S&P 500 Cumulative Drawdowns



## MACRO FOCUS - 2024, Issue 3

### Year in review

It's that time of year—time to take stock of what has transpired and ponder on what may lie ahead. Let's start with the easy part—what happened in 2024?

**Equities:** 2024 was another strong year for equity returns with the US continuing to outperform. The S&P 500 and Nasdaq indices both returned around 28% thus far in 2024. US Small caps measured by the Russell 2000 index are just shy of 20%. Some returns outside the US: China (HSI) +24%, Japan (NKY) +20%, Europe (SX5E) +13%, and Brazil -3%.

Looking under the hood of the US equity market, large cap growth and momentum generated the strongest returns, while both large and small cap value continued to lag the market. The US saw positive performance across all sectors. Leading sectors were Communications, Financials, and Consumer Discretionary. The worst performing sectors were Health Care, Materials, and Energy. Looking at industries semiconductors had the best year followed by a host of other strong performers (Internet, Airlines, Software, Insurance). The only negative spots on the year were found in Clean Energy, Agriculture, and Oil Services.

**Interest Rates:** The US 10 year rate sits about 30 basis points higher today than where it started the year (3.9% vs 4.2%). The US 2 year rate sits about 10 basis points lower than where it started the year (4.25% vs 4.15%), resulting in the curve steepening roughly 40 basis points. Assuming the Fed delivers one more cut at the December meeting, that will mark 100 basis points of interest rate cuts on the year.

**Credit:** HY Cash credit spreads are 65 basis points lower on the year, from 370 to 305. IG Cash spreads are 17 basis points lower from 110bp to 93bp.

**Commodities:** One of the best performing assets on the year was gold, +30%, as it continued to make new highs throughout the year. Oil (WTI) is hovering around \$68, about 5% lower from the start of the year. Copper is finishing the year about 9% higher.

**FX:** The US dollar is finishing the year 5% higher relative to foreign currencies as measured by the DXY Index.

**Econ:** GDP printed 1.6%, 3.0%, and 2.8% annualized growth rates for the first three quarters of the year, headline inflation has slowed from 3.4% to 2.7%, and the unemployment rate has increased from a very low level of 3.7% to 4.2%

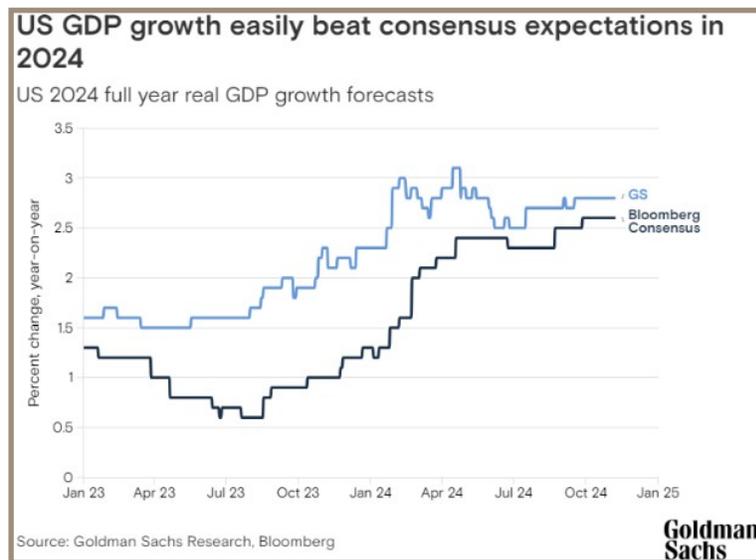
### Looking forward

As we look forward to 2025 an important principle in investing comes to mind—one related to expectations. Howard Marks said, "It's not what you buy; it's what you pay. And it's not what something's worth; it's how its value compares to expectations." Ray Dalio commented, "You have to

think in terms of probabilities, and you have to understand that markets reflect what is known. It's surprises relative to what's discounted that move them."

Keeping that in mind, in 2025 we could have stellar economic growth and fantastic company earnings, *but*, if that is fully expected and "priced in" then returns could in theory be zero. Therefore, when thinking about future returns, before discounting what may or may not happen it is important to first understand, what is the expectation?

Think about how well equities performed in 2024 and then think back on what was expected going into 2024. There were no shortage of calls for a recession and growth was expected to remain tepid, with economists predicting around 1% in GDP growth with the lagging impact of interest rate increases finally expected to catch up. But in December of 2023, we had the "Powell Pivot", and the market priced in 7-8 interest rate cuts. Not only was there no recession, but the economy has been running at a near 3% clip for most of the year.



### Expectations for equities

At the end of 2023 estimates for next year's earnings growth was around 9% and the SPX Index was valued at ~19.7x P/E. Using Q4 estimates, SPX EPS are indeed set to grow around 9% on the year. Hang on a second. Didn't we say that if markets delivered what was expected then you wouldn't expect any real returns? How then, did we end up with a nearly 30% return this year? Well, it's because the market is expecting even higher growth in 2025 (markets are forward looking) and applying an even higher multiple to those earning estimates. The consensus earnings growth is now 14% for 2025 and the market is assigning a 22.15x multiple to the index. As everyone is well aware, we haven't seen a P/E multiple this high since the infamous 2000 Dotcom era.

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S&P 500 Forward P/E Multiple



Not the kind of company we like to keep. In addition to the high earnings expectations, most participants are expecting a solid 2% GDP growth rate for 2025, in contrast to 2024's weak expectations for GDP growth.

Let's walk through a possible scenario for 2025 for illustrative purposes. Suppose that earnings grow at a steady historical clip of 10% and at the end of 2025 the market expects another 10% of earnings growth for the year ahead. Let's also assume a slightly higher than average forward P/E ratio of 20x. Now, a 10% growth rate is a good rate of growth by historical standards, and a 20x multiple would reflect a positive view on the future. What then would the 2025 return be in this scenario? **(4.5)%**.

To be clear, this is not a prediction for the SPX Index in 2025, but simply illustrates that expectations are sky high! In fact, the Consumer Confidence Expectation Stock Price Increase Index (a subcomponent of the Consumer Confidence Index which measure consumer expectations) is at the highest level seen this millennium.

Consumer Confidence Expectations Stock Prices Increase (%)



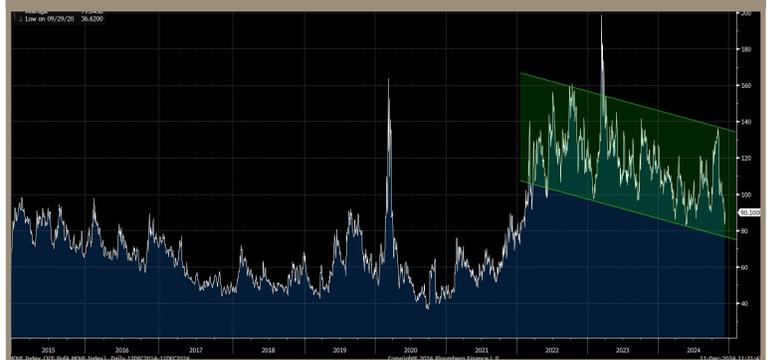
While 2023 and 2024 saw strong gains at the index level, these broad based returns may be harder to come by in 2025 and could represent an opportunity for stock picking as relative performance between "winners"

and "losers" becomes a stronger driver of returns.

Interest rates

In 2025 we would expect interest volatility to remain subdued. The MOVE index tracks 1-month option volatility for various tenors, and can be used for a general gauge of interest rate volatility.

S&P 500 Forward P/E Multiple



We are not technicians, but you can see the trend on the accompanying chart. While we may stop making lower lows given we are not going back to a world of zero interest rate policy, we believe that we should continue to see lower highs as the distribution of possible outcomes continues to shrink, i.e. fed rate policy reaches a normalized level.

Focusing on the front end of the curve, in 2022 and 2023 you had a meaningful two sided distribution as the market was not sure if the Fed would keep hiking, pause, or start a new cutting cycle. We are now quite firmly in a place where there are only two real choices—pause or keep cutting. In addition, as inflation becomes less volatile this also dampens the volatility of interest rates. Inflation may remain sticky, but few people are worried about a resurgence to 9%.

US Inflation Rate (percent)



Source: tradingeconomics.com | U.S. Bureau of Labor Statistics

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But keep in mind that this doesn't mean the long end of the curve can't move higher if we continue to get strong growth. While the longer end of the curve does have a two sided distribution, the range of outcomes are tighter than the previous two years in our view, and this should be positive for businesses and the economy. More certainty around financing rates is generally positive for business lending, making capex and investment decisions, lower interest rate volatility leads to tighter mortgage rate spreads and lower housing costs, and on the margin it should help support expectations for increased M&A in 2025.

### Fixed income in a portfolio

When looking at interest rates and portfolio construction, 2025 should have quite a different value proposition relative to the past three years. Specifically, interest rates (particularly lower duration instruments) were not a good portfolio hedge over the last three years.

This is clear for 2022 and 2023, and while some might argue that the dynamic had shifted by 2024, the amount of cuts priced in at the outset of the year left little room for further portfolio protection.

Currently, the market is pricing in 3 cuts (80 basis points to be more precise) for 2025, which seems reasonable. In our last newsletter we talked a bit about the correlation between risk and interest rates, and we think that lower duration notes should offer the correct correlation to hedge equities in 2025 as a slowdown in growth (which would be negative to equities) should result in cuts coming earlier and deeper than what is currently priced in.

Implied Overnight Rate & Number of Hikes/Cuts



## 2025 THEMES - 2024, Issue 3

## 2025

The S&P 500 is likely to finish 2024 with back-to-back +20% returns, a rare feat which has only been achieved a handful of times over the past +100 years. Participation in these gains has been broad based across many underlying industries, however we believe that a host of factors will lead to much more disparate outcomes moving forward. Below is a review of three particular themes which we expect to play out in the year ahead.

### 1. The Moment of Truth for AI (Monetization)

The explosive introduction of ChatGPT in November of 2022 created massive first, second, and even third order impacts through financial markets.

The amount of capital deployed in the AI arms race has been incredible by any standard. Morgan Stanley expects that the mega-cap tech hyperscalers (e.g. Microsoft, Alphabet, Amazon, and Meta) will spend a combined +\$300 billion in capex in 2025, up 25% from 2024 and double the amount of 2023. And according to PitchBook, investors had poured \$26.8 billion into 498 AI venture capital deals by September 2024, already ahead of the \$25.9 billion which was invested during 2023.

The second order effects of the AI boom span even wider. In September of 2024 it was announced that a shuttered nuclear reactor from the infamous Three Mile Island site would be reactivated in order to meet the massive amount of electricity demand from the rapidly expanding network of datacenters.

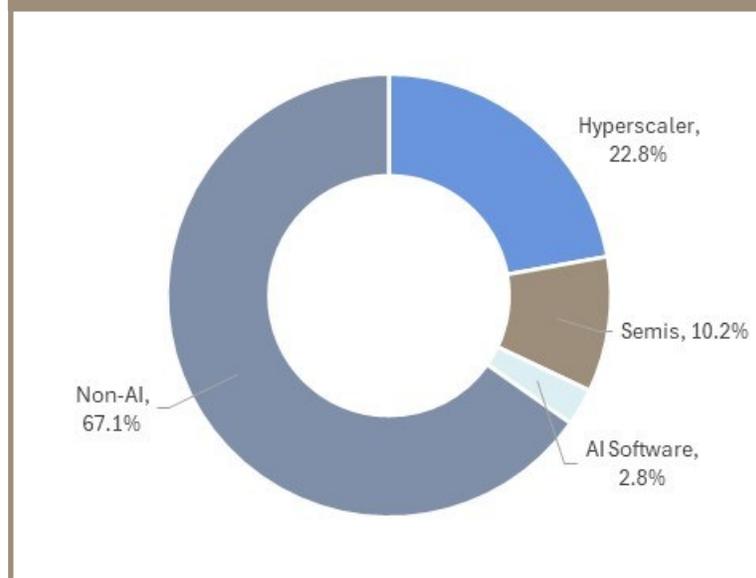
But despite the impressive and novel feats achieved by generative AI, we have so far seen very little to show in monetizable end use cases, and the hyperscalers have been lacking in their articulation of how this investment is paying off. Meta for example has spoken to "in-house" effects and increasing engagement across ad delivery. Then there is Microsoft's co-pilot product which has struggled to gain traction.

Prospective end use cases for AI is a hotly debated topic, and it is not our intention to make a long-term prediction on the outcome. But in the short-term, we believe that we are approaching the point where markets will begin to demand specific revenue streams which are directly attributable to the massive investment into AI capex and R&D. The implications for broader equities markets are material. As of November, 2024, roughly one third of the S&P 500's market cap is directly related to "the AI trade".

#### Potential impact on hyperscalers

If AI efforts fail to live up to expectations, the mega-cap tech firms could experience three particularly negative consequences. First (and most obvious) would be the failure to meet elevated sell-side revenue and earnings expectations which carry some form of embedded AI benefit. Second, is the fact that the massive amount of capitalized AI spending

S&amp;P 500 Constituent Weights (%)



will result in increased depreciation and amortization expense going forward, and while this is a non-cash expense, it nevertheless would result in lower GAAP EPS going forward. In an extreme case, it is possible that one-time impairment charges would need to be recognized.

Third, mega-cap tech firms have been active participants in funding various AI startups. These startups in turn have signed on to contract cloud capacity from their respective investors (e.g. AWS, Azure, etc.). In the event that operations for these startups were to cease for whatever reason, certain firms could potentially see a decrease in cloud related revenues.

#### Potential impact for semiconductor stocks

Semiconductor manufacturers and equipment companies would almost certainly feel the most pain from an AI bear market. Nvidia would likely witness a dramatic decline in revenues and margins and would possibly not approach recently witnessed results for some time. The universe of chips (e.g. GPUs, CPUs, DRAM, etc.) would likely see steep price declines, oversupply, excess inventory, and overcapacity. Demand for semiconductor fabrication (TSM) and capex (AMAT, ASML, LRCX) would likely see large declines as investors rediscover the fact that semiconductors have traditionally been a highly cyclical industry.

#### Potential impact on private markets

Private capital employed into AI investments spans beyond the amount of venture capital equity which was previously mentioned. Companies have also been raising debt capital which is backed by the Nvidia GPUs which are then purchased with the borrowed funds.

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A Financial Times article from November, 2024 highlighted one particular raise by CoreWeave, a firm which rents out GPU capacity on an hourly basis:

*The debts are secured against CoreWeave's stock of Nvidia GPUs and the capital is used to buy thousands more. It plans to have 28 data centers across the US and Asia by the end of 2024, nine times its footprint at the start of last year.*

*The financing means CoreWeave is extremely highly leveraged. When it announced its first \$2.3bn debt financing in August 2023, which included about \$1bn of loans from Blackstone, it had annual revenues of just \$25mn and negative ebitda of roughly \$8mn, said two people close to the company. Revenues have since surged to about \$2bn this year, one of the people said.*

This arrangement adds a further risk of excess capacity in the event demand for GPU compute is less than anticipated. As we get into 2025, it will be important to monitor how quickly these start-ups may need to return for additional capital and if new funding rounds are possibly completed at lower valuations. Which makes for an opportune transition to the next major theme we expect for 2025.

## 2. Significant Increase in Capital Markets Activity (IPOs and M&A)

Several ingredients are present which will like be conducive towards a sharp uptick in capital markets activity. Front and center is the new political administration which is expected to take a much more laissez-faire approach to regulating corporate M&A. Particularly within the FTC department which challenged and rejected many high profile M&A transactions under the Biden administration.

Equally important is the heightened need for private capital (specifically private equity and venture capital) to exit legacy holdings through either a private sale or IPO in order to return capital to their investors. The spike in the fed funds rate from near zero in 2022 to +5% in 2023 resulted in a freezing up of capital market activity. As a result, average private equity buyout holdings periods jumped to +7 years in 2023, according to Preqin, the longest holding period in two decades, and certainly on the longer end of the typical 3 to 5 year holding period.

The trend is equally as stark in the land of venture capital. According to Carta, nearly one third of VC funds raised in 2017 (over six years ago) had not returned any capital to their investors as of March 2024. And of 2018's vintage, only 57% of funds had made distributions. Investors our doubtless eager to get their money back.

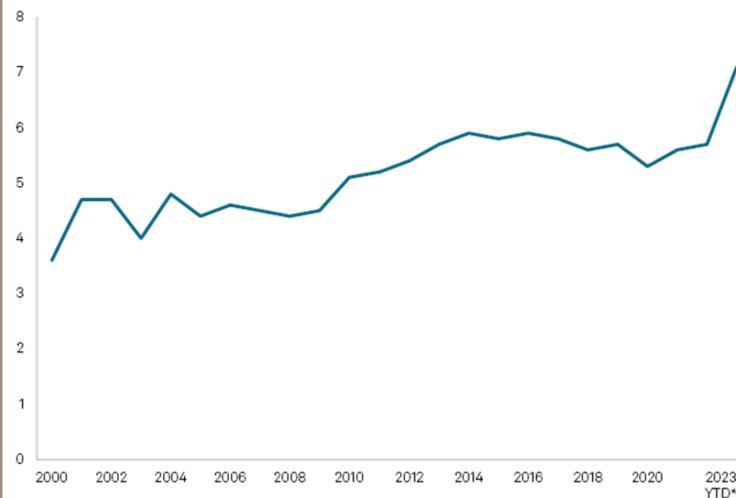
### Implications for private company valuations

One of the appeals of private equity has been the fact that the value of

### Average Buyout Holding Period (source: S&P Global)

#### Average buyout holding period of US and Canada private equity buyout funds, 2000-2023

Number of years



Data compiled Nov. 15, 2023.

\* Year to date through Nov. 15, 2023.

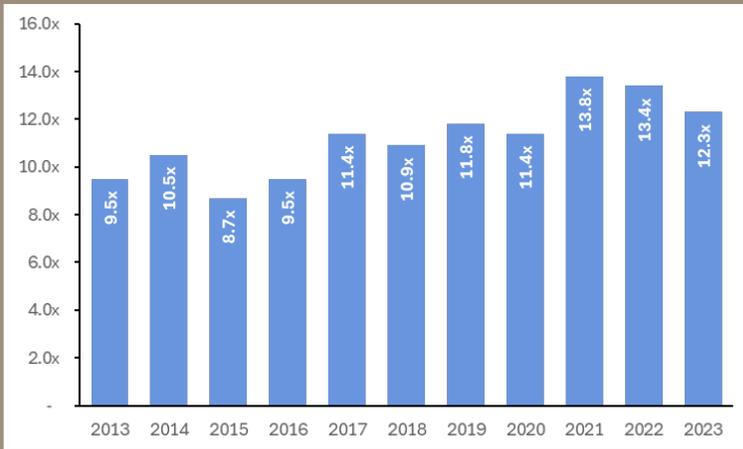
Analysis includes average holding period of US and Canada buyout funds that exited between 2000 and 2023.

Source: Preqin Pro.

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the underlying companies witnesses less volatility (on paper at least) relative to their public counterparts. These private valuations will be put to the test as investors look to exit these holdings, particularly for the vintage of deals which were completed from 2021 to 2022 at relatively high multiples and record low interest rates.

### U.S. Private Equity Median EV/EBITDA Multiples (source: Pitchbook)



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And the figures in the land of venture capital are downright daunting. The term “unicorn” was dubbed in 2013 to describe start-ups valued at north of \$1 billion dollars and was chosen in part to convey its elusive rarity. Today there are collectively over 1,200 global unicorns at a combined value roughly \$3.8 trillion dollars. The five largest U.S. start-ups would be ranked as the 44th, 60th, 157th, 246th, and 391st largest companies within the S&P 500.

### Sampling of Unicorns (source: Navigate Ventures)

Enterprise tech 372 unicorns	Consumer & retail 213 unicorns
iPassw@rd, Sire, sense, AI21labs, Abnormal, Acronis, ActiveCampaign, ada, A DEPT, afiniti, AICEE, Airbyte, aircall, airSlate, Airtable, aiven, Alation, alchemy, Aleo, algolia, AlphaSense, Amperity & andela, ANTHROPIC, anyscale, Apollo.io, AppDirect, Arctic Wolf, APTOS, aqua, Arcadia, ARCTIC WOLF, articuloite, ASAPP, Asterai Labs, attentive, AppDirect, AVASTIX, AXELAR, AXONIUS, AXTRIA, 百度云, Beamery, Beisen, betterfly, BetterUp, BEYOND IDENTITY, BeZero, BigD, BigPanda, Bluebird, BITFURY, BITMAIN, BITSIGHT, Bluebird, bobo, branch, Brex, BRINGG, BrowserStack, calendly, CaptivateIQ, CATO, CELESTIA, colis, Corebrn, CERTIK, checker, CHEO, chinac, chronosphere, circleci, Clari, CLAROTY, ClickHouse, ClickUp, Clio, CloudBees, Cockroach Labs, cohere, COHEISITY	天鹏到家, Age of Learning, Ankorstore, ApplyBoard, ADUS, assembly, Argonne Clark, AURA, AWAY, BackMarket, 贝壳找房, BlaBlaCar, bloombeach, Bluecore, boat, BREWDOG, BYJU'S, carousell, Cell, CIDER, Cirkul, ClassDojo, CommercialIQ, Course Hero, DAILY HARVEST, DealShare, deliverect, dubizzle, dutchie, 易美之家, cater, fabric, FABRIC, FAIRE, Fanatics, first, Flink, flipdish, track safety, Gelato, getir, GET YOUR GUIDE, GlobalBees, GOAT, gopuff, GoStudent, gousto, Grover, GrubMarket, GYMSHARK, HARRY'S, HAYDON, heyday, HEYTEA, happens, hotmart, houzz, ibotta, ID.me, IMPOSSIBLE, Jollychic, 卷皮, JUUL

During the SPAC boom of the early 2020's, FTI Consulting estimates that SPACs raised a collective \$210 billion from 2019 through 2022 across roughly 750 deals. Total IPO volumes were \$626.6 billion and \$179.7 billion in 2021 and 2022 respectively.

The ability for public markets to absorb the inevitable supply of private company exits should be closely watched along with the valuations realized at exit. The previously mentioned AI darling CoreWeave has floated plans for an IPO in the first half of 2025 and could make for an important yardstick.

### Implications for financial equities

The most obvious beneficiary of a new M&A / IPO wave would be the major investment banks and publicly traded alternative asset managers, with the former poised to collect billions in fee revenues if we witness a similar boom as seen in 2021 and 2022. However at this juncture, it is arguable that markets have already “priced in” this potentiality. Major investment banks like Goldman Sachs and Morgan Stanley are trading at the highest price to tangible book value ratios seen in decades.

### 3. Price Discovery For Commercial Real Estate Accelerates (Office and Multifamily)

If one were to look at the price action witnessed by publicly listed commercial real estate (CRE) REITs, one would likely conclude that the worst

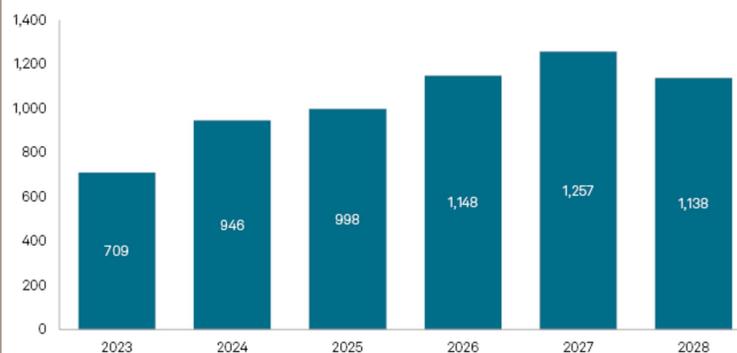
of the CRE bust is now behind us. But there are several reasons to expect more turbulence ahead.

There has been no shortage of headlines highlighting instances of office properties transacting at 50%, 60%, and even +70% discounts to their pre-covid valuations. Many participants have attempted to ride out the storm, essentially waiting for the fed to begin easing interest rates while hoping that return-to-work policies result in new leases and higher occupancy. In the meantime, lenders have been accommodative with maturity extensions as they are loathe to take over properties or force a sale which would result in a principal loss.

But with maturities snowballing, it is becoming increasingly obvious that many CRE loans have no hopes of refinancing at today's cap rates and that properties are severely underwater, even in instances where borrowers have successfully operated at positive to break-even debt service coverage ratios.

### Upcoming CRE Maturities (Source: S&P Global)

Roughly \$950B of US commercial real estate mortgages are estimated to mature in 2024 (\$B)



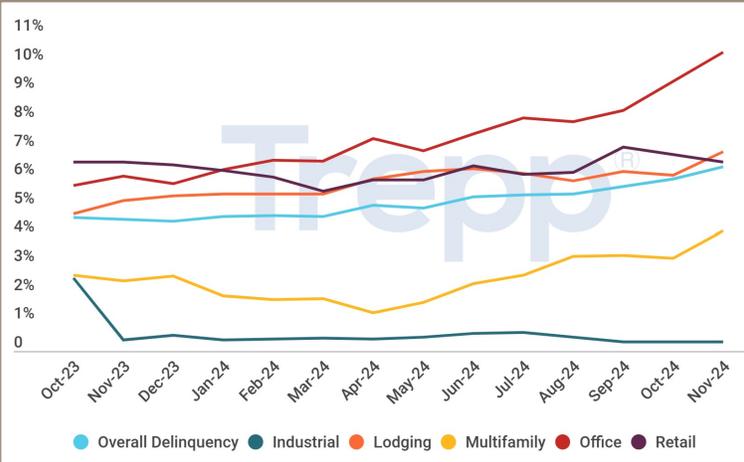
Data compiled Aug. 19, 2024.  
Data represents the aggregation of 3.6 million commercial real estate property mortgages, sourced from various tax filings from approximately 75% of US counties. While roughly 60% of the loans were originally missing a maturity date, analysis uses a random forest model to impute the missing values. Since the random forest model varies each time it is run, the values shown represent averages across five runs.  
The raw data does not include roughly 25% of counties, so we created another model using gross county product and the number of properties in the county to estimate the total mortgage amounts in the missing counties. Ultimately, these were relatively minimal amounts compared to the overall market.  
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For some time now, market observers have also been pointing towards the CRE pain spreading from office to multifamily, particularly the vintage of transactions completed in 2021 and 2022 during the trough in interest rates and cap rates. Much of this associated debt is now coming due and is similarly struggling to get the math to pencil out.

In the meantime, delinquency rates continue to trend in an unfavorable direction. Trepp reports CMBS delinquencies making new recent highs as of November 2024 with office and multifamily delinquencies at 10.34% and 4.18% respectively.

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CMBS Delinquency Rates by Property Type (Source: Trepp)

**Implications within markets**

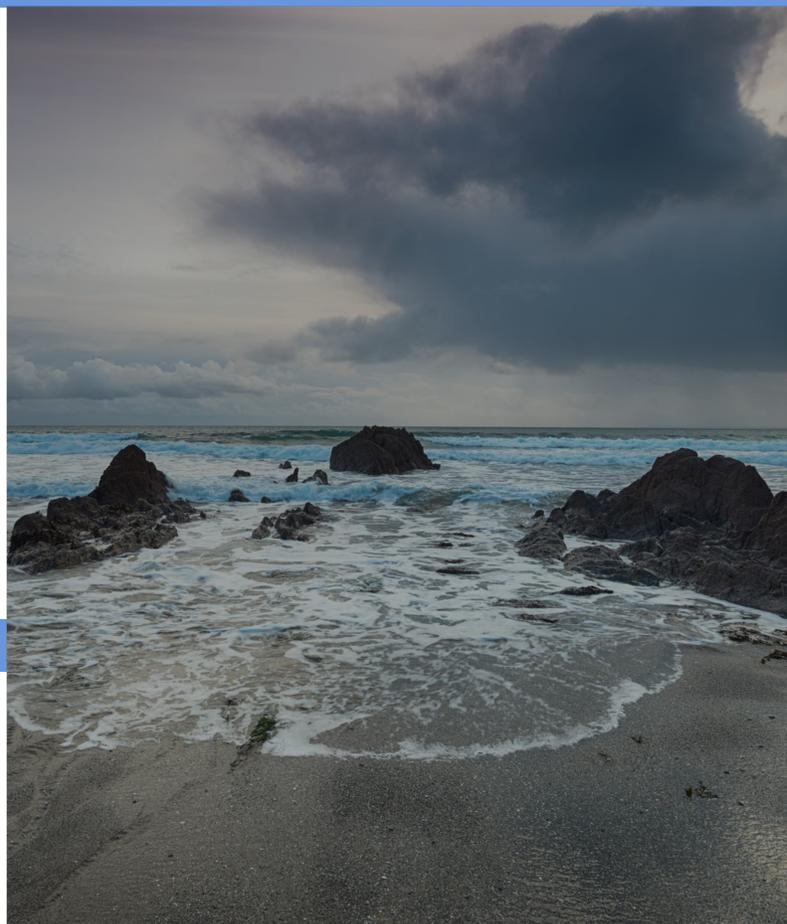
While we expect the pain to grow within the CRE space, we do not expect it to result in wider dislocations and stresses within the context of broader markets. It continues to be a well telegraphed problem and market participants are proactively addressing the issue. However that isn't to say that lenders could have additional loan loss reserves to take and that there are further surprises around the corner for CRE REITs and mortgage REITs. There may be opportunities for discerning analysts to identify winners and losers, and for opportunistic CRE investors as a whole.



## ABOUT FLOOD TIDE CAPITAL MANAGEMENT

Flood Tide Capital Management was founded in 2024 by William Hyde and Matt Rouse. We follow an opportunistic equities strategy which employs a top-down oriented perspective to identify core themes, from which industry and company specific fundamental analysis is then deployed to identify targeted investment candidates on an ongoing basis. This approach capitalizes on the unique experience and skillsets brought to the table by our co-founders.

Inspiration for the Flood Tide name came from William Shakespeare's Julius Caesar: "There is a tide in the affairs of men, which, taken at the flood, leads on to fortune". This line neatly encapsulates a key component of our investing philosophy: **market opportunities exhibit ebbs and flows between favorable and hazardous conditions, and it is up to the skilled navigator to guide the path to fortune.**



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