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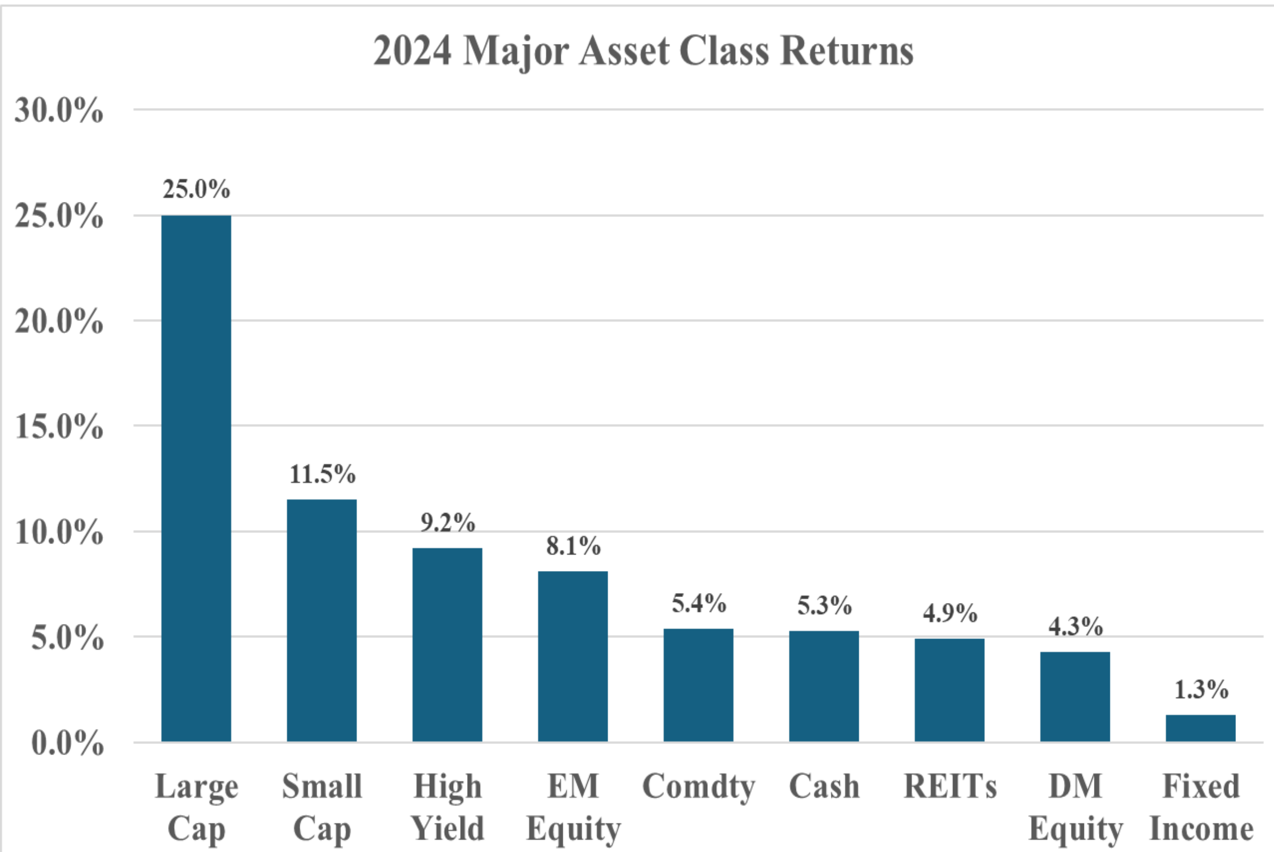
2025 Investment Outlook

For the first time in five years, all major asset classes posted positive returns in 2024. The Bloomberg Aggregate Bond index eked out a barely positive return of just 1.3%; but REITs, high yield bonds, commodities, small cap stocks and international equities – each of which has generated losses at one time or another in the wake of the COVID recession – rewarded their investors with positive returns ranging between 4% and 11% last year.



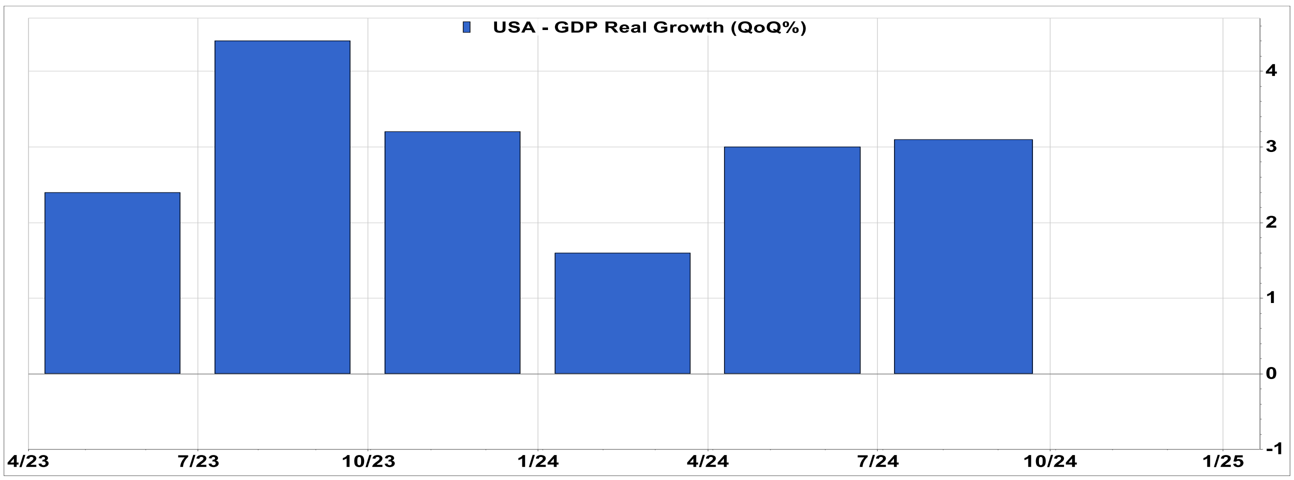
The most widely watched index, the Standard & Poor's 500, was also the best performing index in 2024 by a wide margin, generating a total return, including dividends, of 25%. 2024's result came in the wake of 2023's even more generous return of 26.3%, marking the first time in 26 years that the S&P index had risen more than 20% in consecutive years. It was only the 6th time in the last 95 years that the S&P had accomplished such a feat, and the combined return of 53.2% during 2023-24 period was the 6th highest on record, going back to 1929.

In case you're wondering, the only time the market has risen by 20% or more in *3* consecutive years was the period of 1995 to 1998, when the S&P 500 produced gains of more than 20% for *4* years in a row. And it barely missed a 5th straight year in 1999 when the index was able to rise just 19.5%.

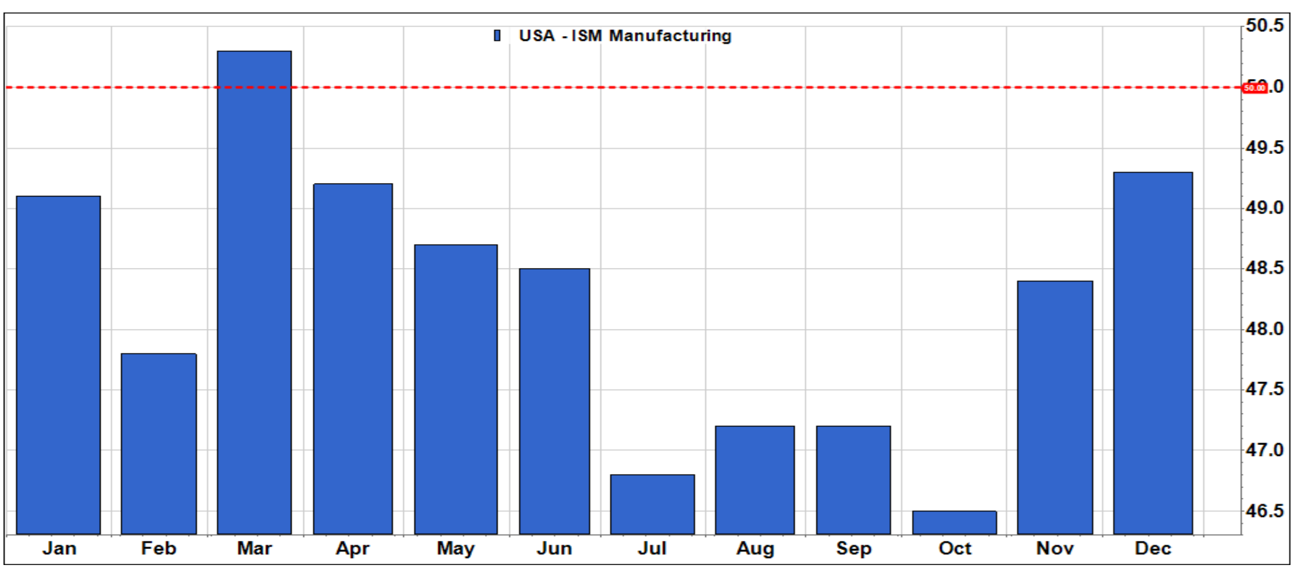
The Economy and Inflation in 2024

While rising interest rates served to dampen returns for bond investors, particularly in the last 4 months of the year, the economic climate could not have been more ideal for risk markets in 2024. It seems that everything that could go right did go right.

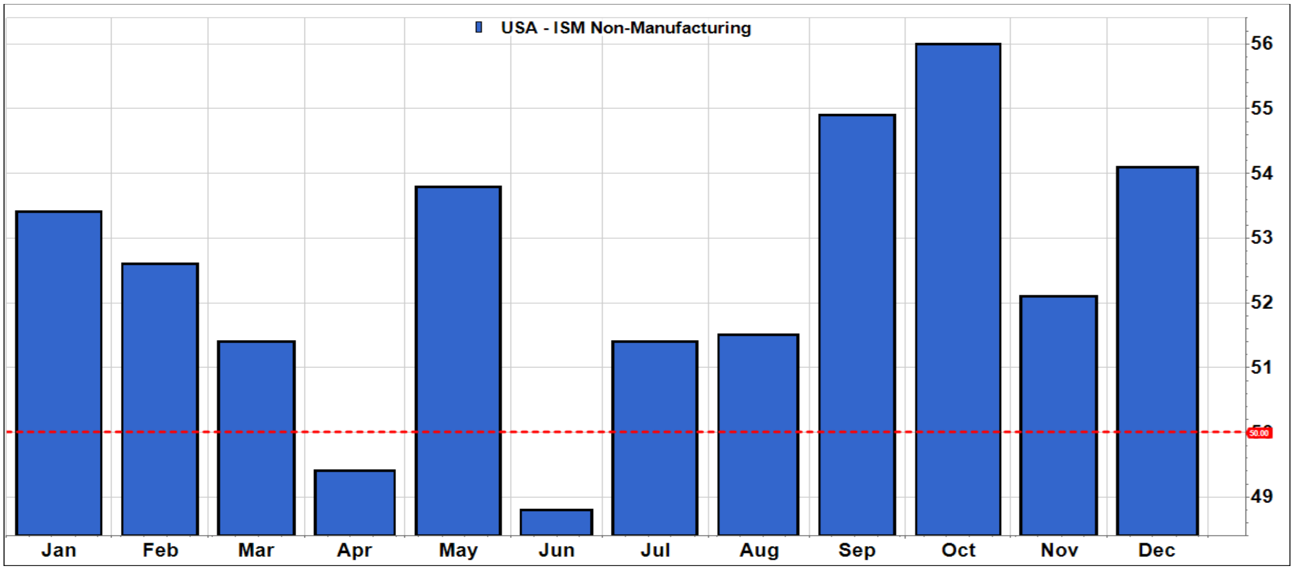
The economy achieved exactly the soft landing investors were hoping for. Real GDP grew in each of the first 3 quarters of the year, from 1.6% in the first quarter to 3.0% and 3.1% in the 2nd and 3rd quarters, respectively. The 4th quarter result won't be released until January 30th, too late for this writing. But in November, the Federal Reserve Bank of Atlanta raised its estimate for the 4th quarter from 2.5% to 2.6%. These are not bad numbers for an economy that was supposed to be in a recession in 2024, according to most year earlier forecasts.



The manufacturing Purchasing Managers Index (PMI) remained in contraction mode (below 50) for most of the year, but improved in the fourth quarter. The New Orders index of 52.5 (not shown) was particularly strong, reflecting the strongest level of demand for new goods in almost a year, and suggesting that the extended period of lower goods output may be bottoming. It may also be that the uptick in manufacturing activity in November and December was an attempt to undercut the effects of the proposed tariffs that are on the new President's to-do list.

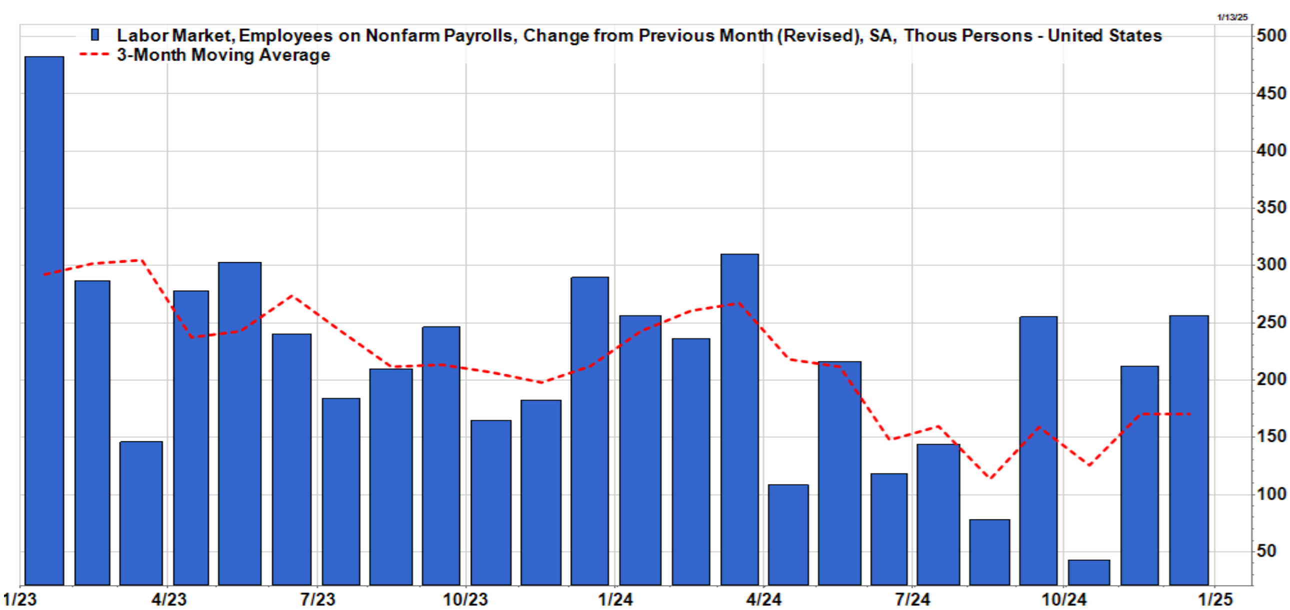


Services PMI, unlike its manufacturing counterpart, remained comfortably in expansion mode for most of the year, and also strengthened as the year went on. The services sector, which accounts for 78% of the economy, has expanded for 52 of the last 55 months since the COVID induced recession began in June 2020.

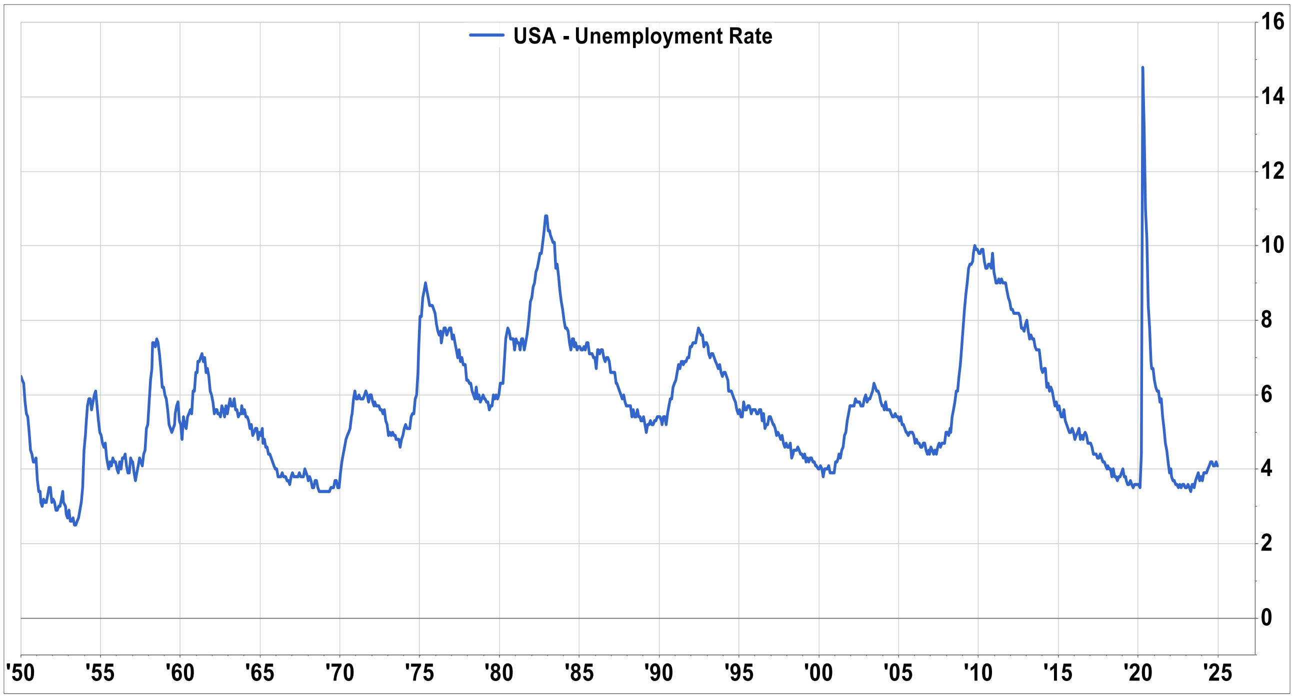


Both the jobs market and inflation cooled off enough in 2024 to allow the Federal Reserve to begin lowering its Fed Funds rate, thus reversing its restrictive policies that had been in place since the first quarter of 2022.

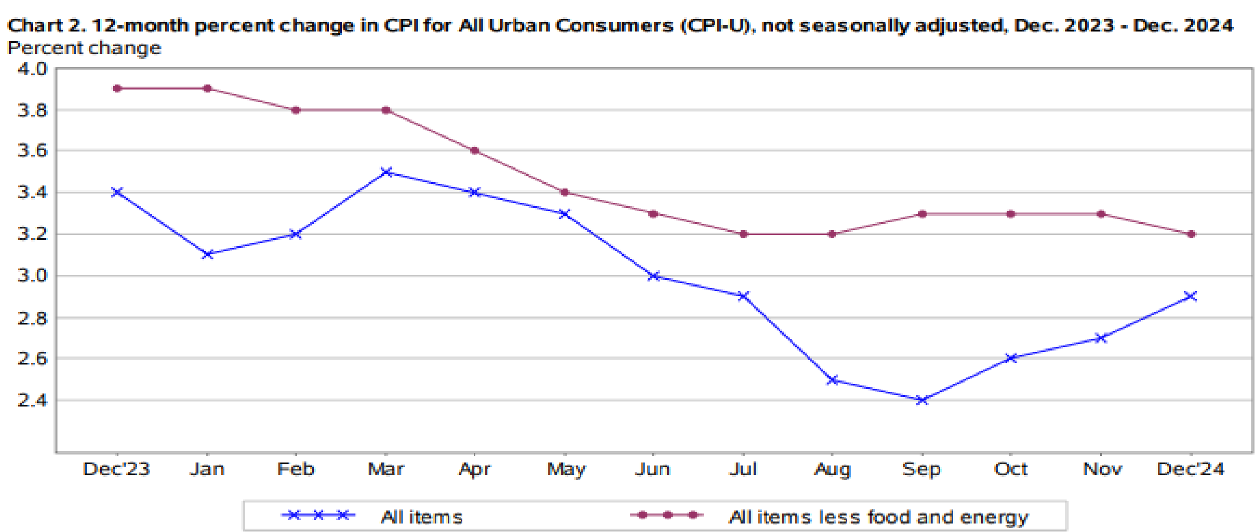
The economy added 2.2-million new jobs in 2024, an average of 186,000 new jobs per month. As strong as those numbers were, they nevertheless represented a decline from 2023's average monthly gain of 251,000 new jobs. The December report was particularly noteworthy with 256,000 new jobs added, almost 100,000 more than the consensus expectation of 165,000. Equally impressive was the fact that the December report wasn't inflated by government hiring, as private sector payrolls accounted for 223,000 new jobs, almost 90% of the monthly increase.



The unemployment rate edged down to 4.1% from 4.2%, above its cyclical trough reached in mid-2023, but still low on a historical basis and moving sideways, not up.

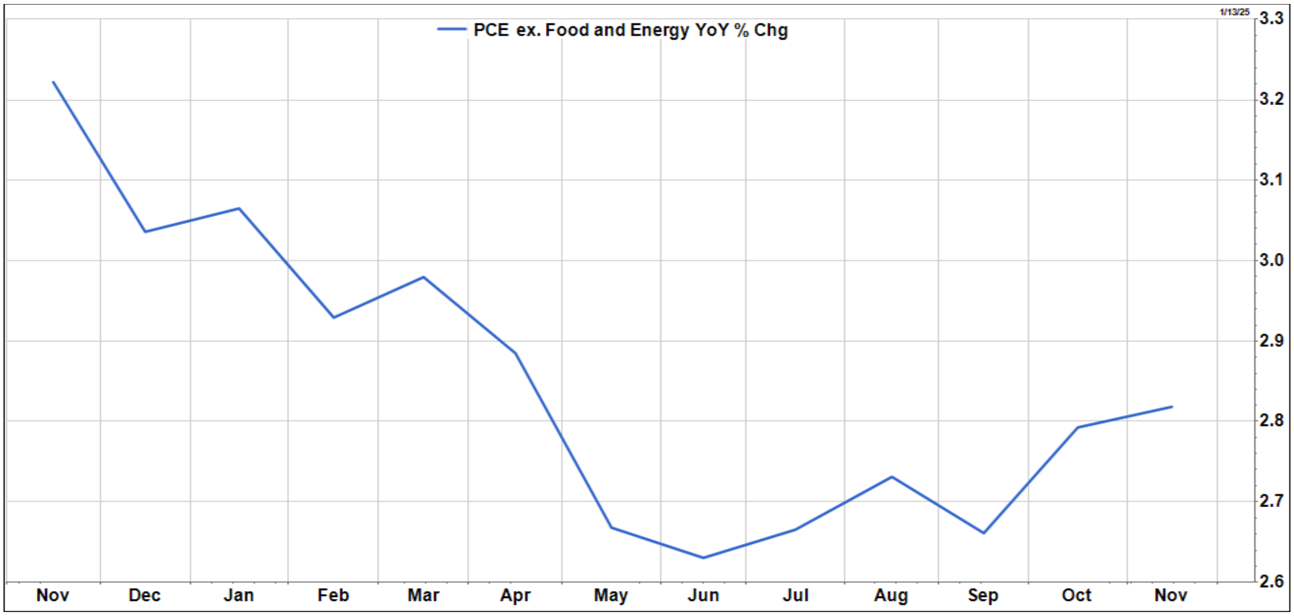


Headline inflation has come down dramatically from its 2022 peak of 9.3% to just 2.9%, but *core* inflation still remains above the Federal Reserve's target rate of 2%. Food price increases have moderated and energy prices have actually declined year-over-year, but core inflation (ex. food & energy) remains elevated at 3.2%. The good news is that core inflation did decline in the December report from the November level of 3.3%, and the month-over-month increase of just 0.2% was down from the 0.3% posted in each of the prior four months. Equity markets rallied following the release of the December report, and Treasury yields tumbled.



As encouraging as the December CPI was, we always point out that the Federal Reserve looks at the Personal Consumption Expenditures (PCE) index rather than the CPI in measuring inflation, and the

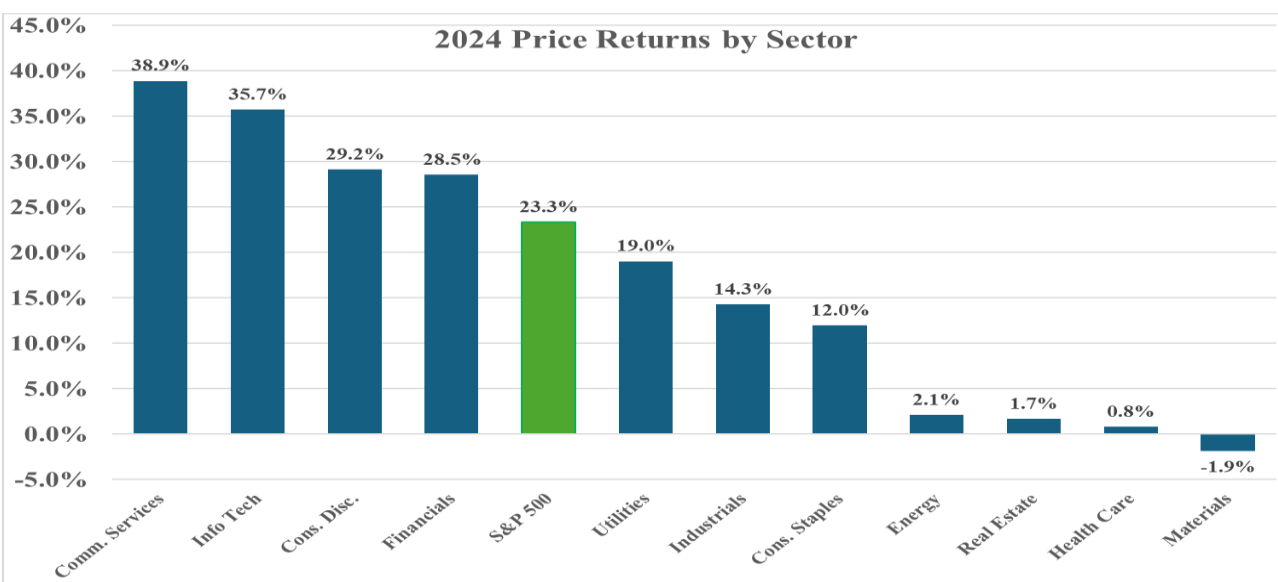
PCE has trended upward in recent months following a sharp decline in the first half of 2024. Still, the progress already realized in the fight against inflation was enough for the Federal Reserve to reverse course and begin lowering interest rates. The December PCE won't be released until January 31, too late to include here.



<u>The Stock Market: The Magnificent 7 Rides On</u>

In addition to posting nearly identical returns in each of the last two years, 2024 very much resembled 2023 in a couple of other ways, as well.

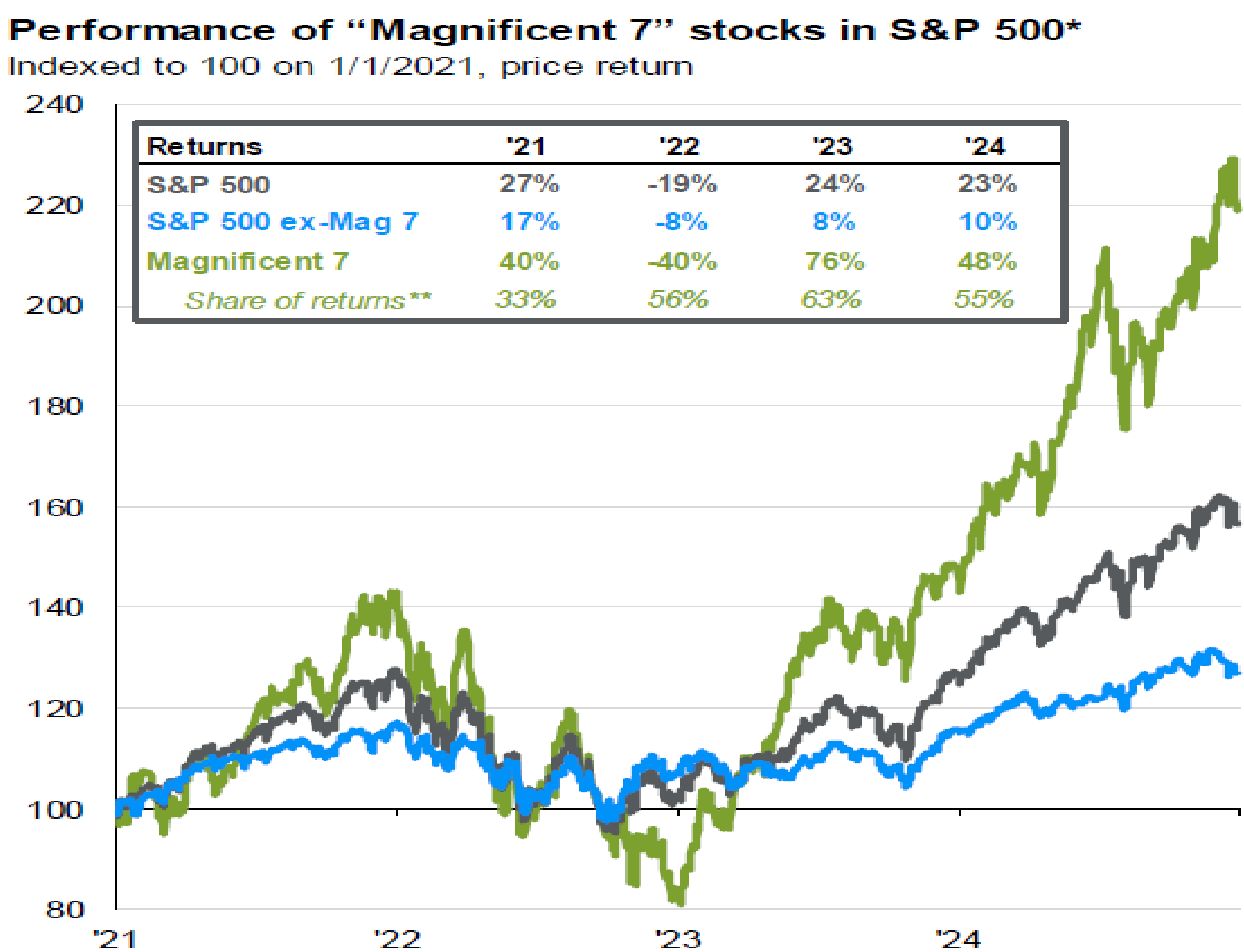
Of the 11 sectors represented in the index, only 4 sectors managed to outperform the index, while the other 7 trailed. What is noteworthy is that 3 of the sectors – communications services, consumer discretionary and information technology – were the *only* sectors that also outperformed the index in 2023. And these also happen to be the sectors where all of the companies that comprise the so-called Magnificent 7 reside.



We have written about this phenomenon repeatedly over the last 2 years, and frankly expected that the Magnificent 7 bubble would have burst by now.

For the record, the Magnificent 7 stocks and their weighting in the S&P 500 index are: Apple (7.2%); Nvidia (6.6%); Microsoft (6.3%); Amazon (4.1%); Alphabet (4.1%); Meta Platforms (2.7%); and Tesla (2.3%). They account for fully one-third of the capitalization of the S&P 500, up from 20% two years ago. The impact of their historic weightings in the index and their outsized gains vs. the rest of the market means that most of the index's returns have been concentrated in those few large high-tech names, while the vast majority of stocks in the index have lagged.

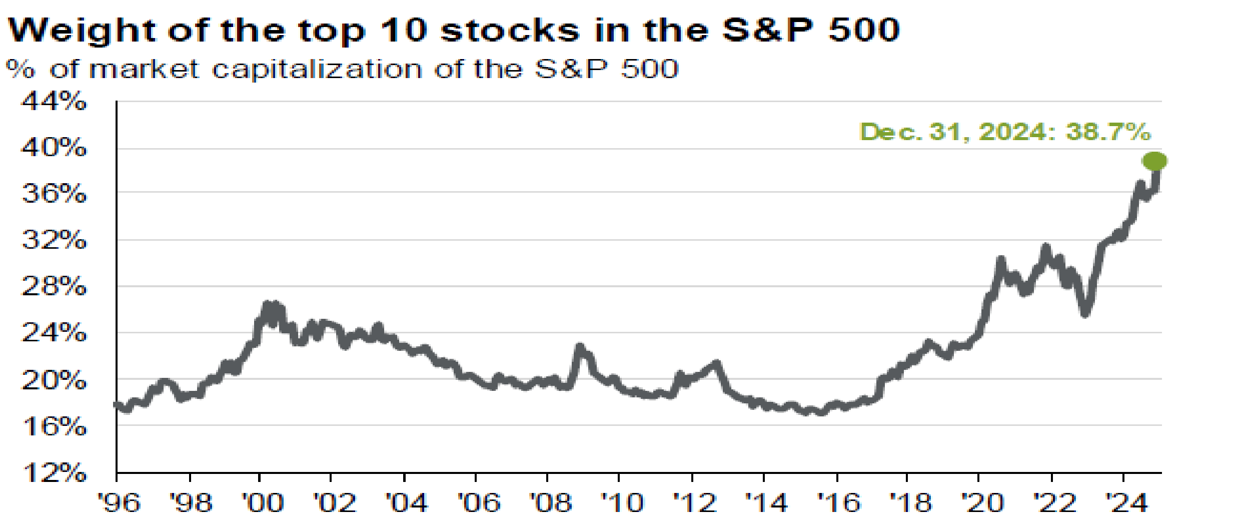
The Magnificent 7 stocks, alone, accounted for 55% of the market's price gains in 2024, with average gains of 48% while the other 493 stock rose by an average of just 10%. This disparity is admittedly narrower than what occurred in 2023, when the Mag 7 and the "Meh" 493 were up 76% and 8%, respectively, with the Mag 7 accounting for 63% of the market's gains. But the bubble continued to inflate, nonetheless.



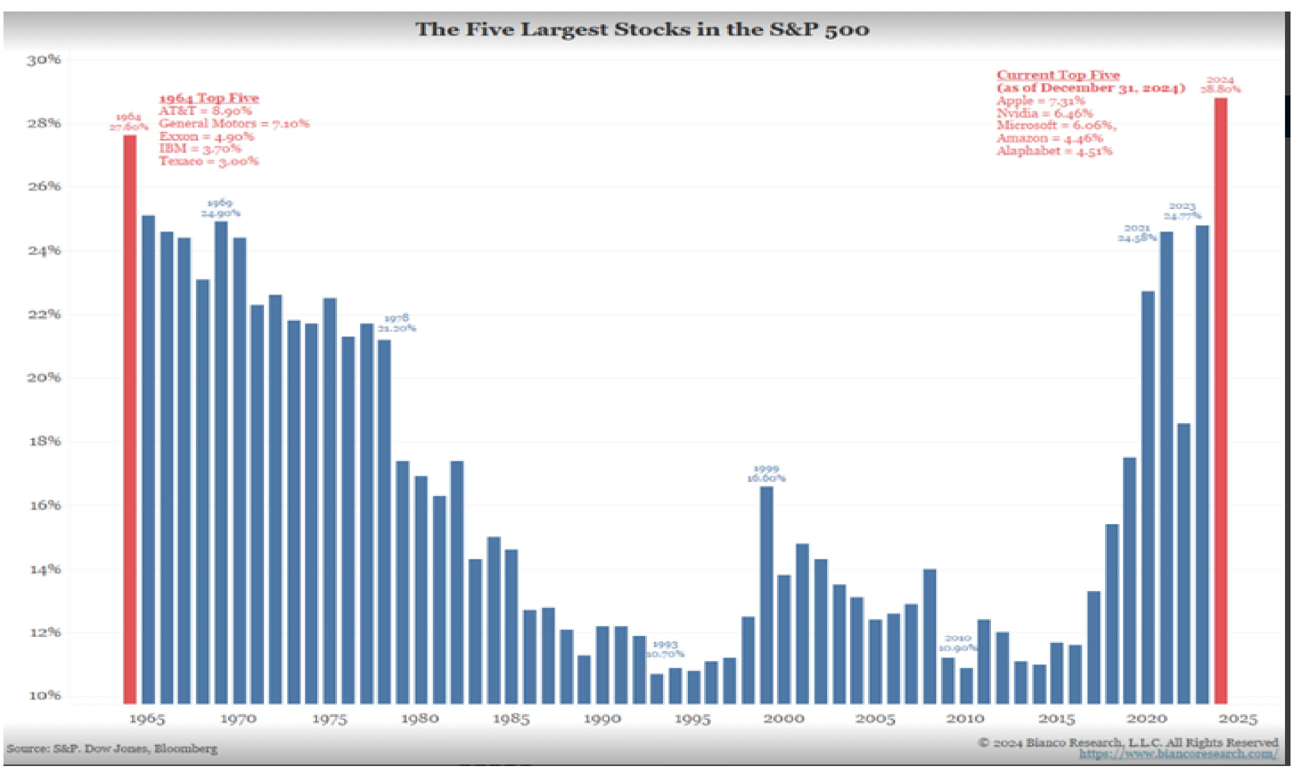
Returns	'21	'22	'23	'24
S&P 500	27%	-19%	24%	23%
S&P 500 ex-Mag 7	17%	-8%	8%	10%
Magnificent 7	40%	-40%	76%	48%
*Share of returns***	*33%*	*56%*	*63%*	*55%*

As a side note, the moniker "Magnificent 7" may be going away. Broadcom, which has risen 218% over the last 2 years and is the 8th largest company in the S&P index, is being considered by many analysts to be part of that group with a new acronym, the BATMMAAN stocks. Check out the initials of the 8 members and you'll see that the acronym works.

The Standard & Poor's 500 index is now more concentrated than it has ever been. The 10 largest companies in the index – just 2% of its constituents – account for almost 39% of the index, more than double what it was 10 years ago, and well above the level reached during the dot.com bubble of 2000-01. The combined market value of the Mag 7 has grown to more than $18-trillion, which is greater than the gross domestic product of Germany, Japan, India, the UK and Canada, combined.

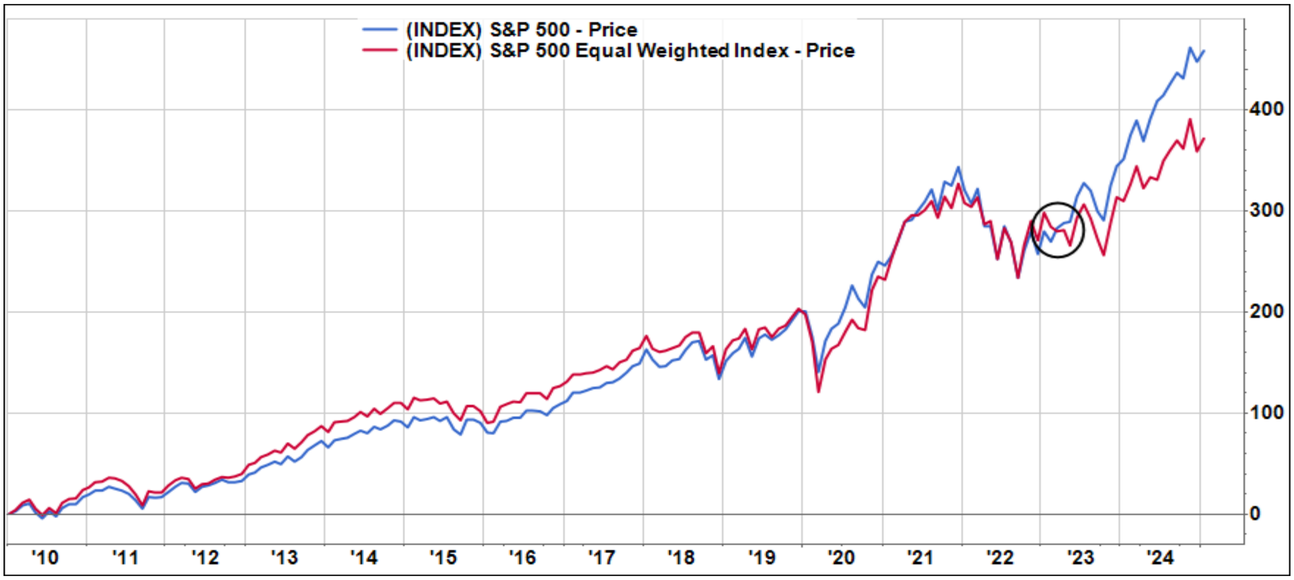


Charting the concentration of just the 5 largest companies is even more dramatic. At the end of 2024, the 5 largest companies – Apple, Nvidia, Microsoft, Amazon and Alphabet – comprised 28.8% of the S&P 500 index. This is the greatest concentration since at least 1964, when AT&T, General Motors, Exxon, IBM and Texaco accounted for 27.6%. It should be noted that the S&P 500 was down more than 5% over the ensuing 2 years, and generated gains of less than 2% annualized over the following 5 years from 1965 to 1969.

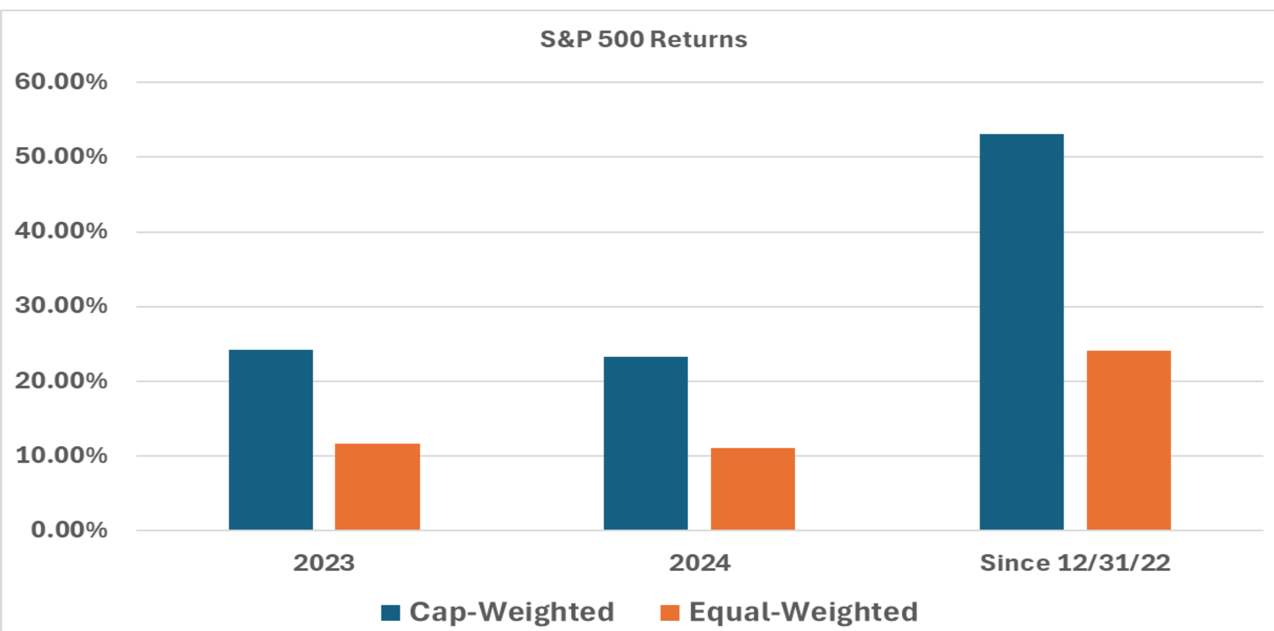


The growing dominance of the Magnificent 7 in the S&P 500 changes the way we have to look at the "market" in terms of forming an outlook or evaluating performance.

The index was designed to reflect overall market conditions, and it closely mirrored the average performance of the 500 companies that comprise it until 2023 (chart, following). At that point, as the market capitalizations of the Mag 7 stocks grew almost exponentially - based largely on the promise of a new technology, artificial intelligence (AI) – the index and the market began to diverge dramatically.



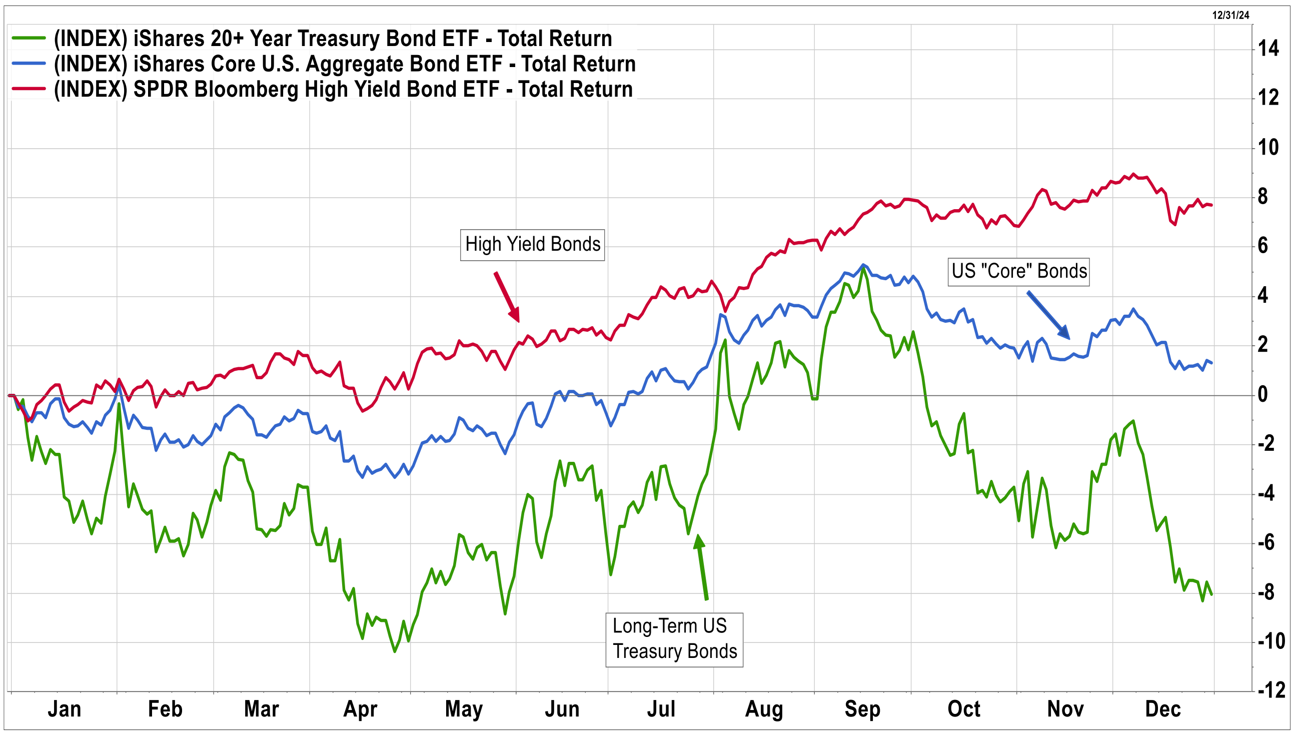
While the S&P 500 index rose 23% last year (price only), an equal-weighted index of the same 500 companies was up just 11%. More than 70% of those stocks were up less than the index. Over the entire 2023-24 period, during which the cap-weighted S&P 500 rose 53%, the average stock was up just 24%, and 74% of all stocks failed to match the index. Until this bubble bursts, the index is just that – the index – and not reflective of the broader market.



Finally, proponents of index investing who have reaped the lion's share of the returns generated over the last 2 years, should be concerned that almost 40% of their portfolio is now invested in just 7 or 8 highly appreciated securities of companies with expectations based, in large part, on the promise of artificial intelligence, a technology whose potential risks and benefits are largely unknown. It is increasingly likely that these expectations have grown – or will grow – to the point where just meeting them will be a disappointment to investors. Holders of Cisco Systems or Intel in 2000-01 can attest to the pain that ensues when valuations are excessive and expectations are just met. Both fell 75% or more in the two years following their peak, and neither has fully recovered even to today.

The Bond Market

Unlike equity investors, investment grade bond holders were likely disappointed with their returns in 2024. While bonds generated a positive return for the year, every other major asset class performed better. The Bloomberg US Aggregate Bond index returned 1.3% for the year, but when the positive effect of the income produced by the bonds is removed, bond prices actually fell 2.4%.



Investors that tend to focus on longer duration bonds, like pension funds and insurers, fared even worse than core fixed income investors. Long-term treasury bonds, which are most sensitive to interest rate movements, declined by 8%. Again, if the positive income effect is removed, long-term treasuries declined by almost 12%.

As has been the case in every year since 2021, high yield bonds outperformed the broader fixed income market. On a cumulative basis, high yield bonds have now outperformed core bonds by a margin of almost 20% over the last four years. For context, the S&P 500 has outperformed mid-cap stocks by a similar margin during the same period, although this outperformance has received substantially more attention.

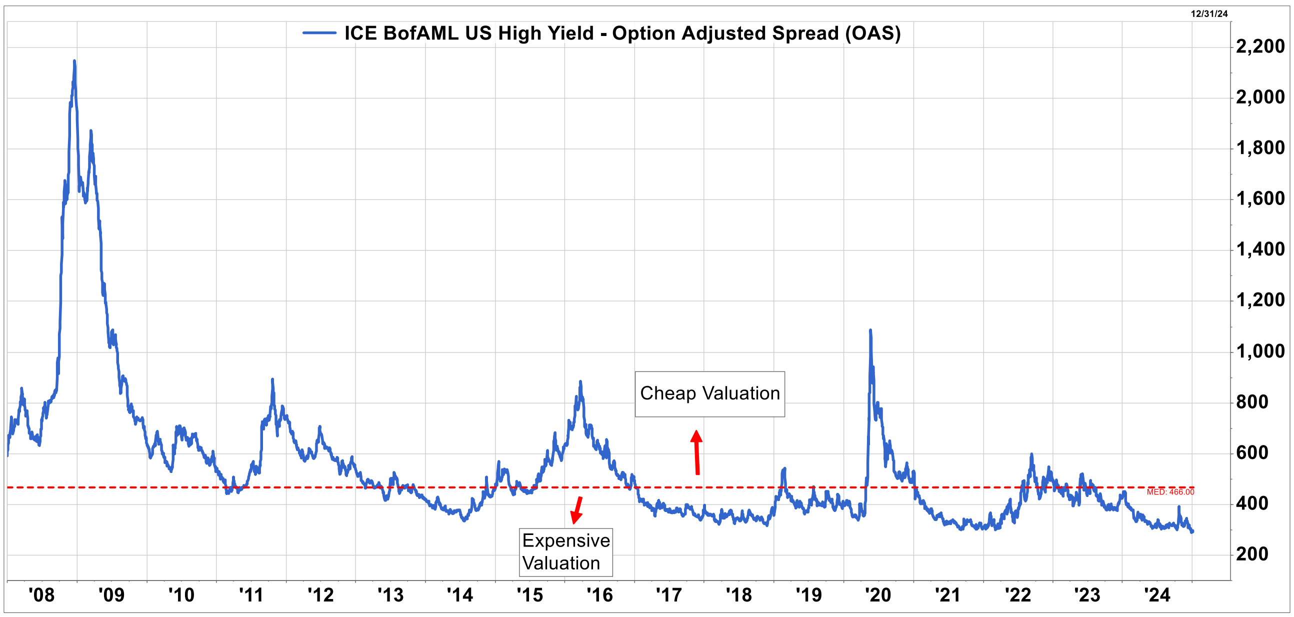
The challenge that the fixed income market faced throughout the year was the volatility, and ultimately, the increase in yields. The 10-year US Treasury yield began the year at 3.88% and ended the year at 4.57%, however the trip was anything but linear. After the 10-year yield peaked in April at 4.70%, yields declined for almost five months, only to end the year with a 1.00% rebound that began in October. The resurgence of yields late in the year stemmed from stronger than expected nonfarm payrolls reports, bolstering the belief that the US economy was healthier than many had feared.

In conjunction with the strong economic data, bond markets were also jarred after the Federal Reserve tempered expectations for future rate cuts at their December FOMC meeting, putting more upward pressure on yields. It should be noted that the Fed does not set the level of long-term interest rates. Inflation, the Fed's current focus, is one of the key determinants when it comes to the level and direction of long-term interest rates, especially when inflation is proving to be sticky.

One of the few tailwinds for fixed income returns in 2024 was the decline in credit spreads throughout the year. In simple terms, a spread is the additional yield investors demand for assuming the greater credit risk of lower rated bonds.

At first glance, the decline in credit spreads seems like it would be negative for bond markets, not positive. But, a lower spread, and in turn, a lower yield means that the price of credit risky bonds increased, when all else is held equal.

While the narrowing of spreads in 2024 may have helped provide some support to fixed income returns, it is a double-edged sword insofar as future return expectations are concerned, especially for lower rated bonds. On the one hand, narrower spreads reflect greater optimism for continued economic growth and thus lower default rates. But on the other hand, credit spreads can be viewed in a similar manner to equity valuations. A higher spread means that lower rated bonds are more attractively valued relative to higher rated bonds - and vice versa.

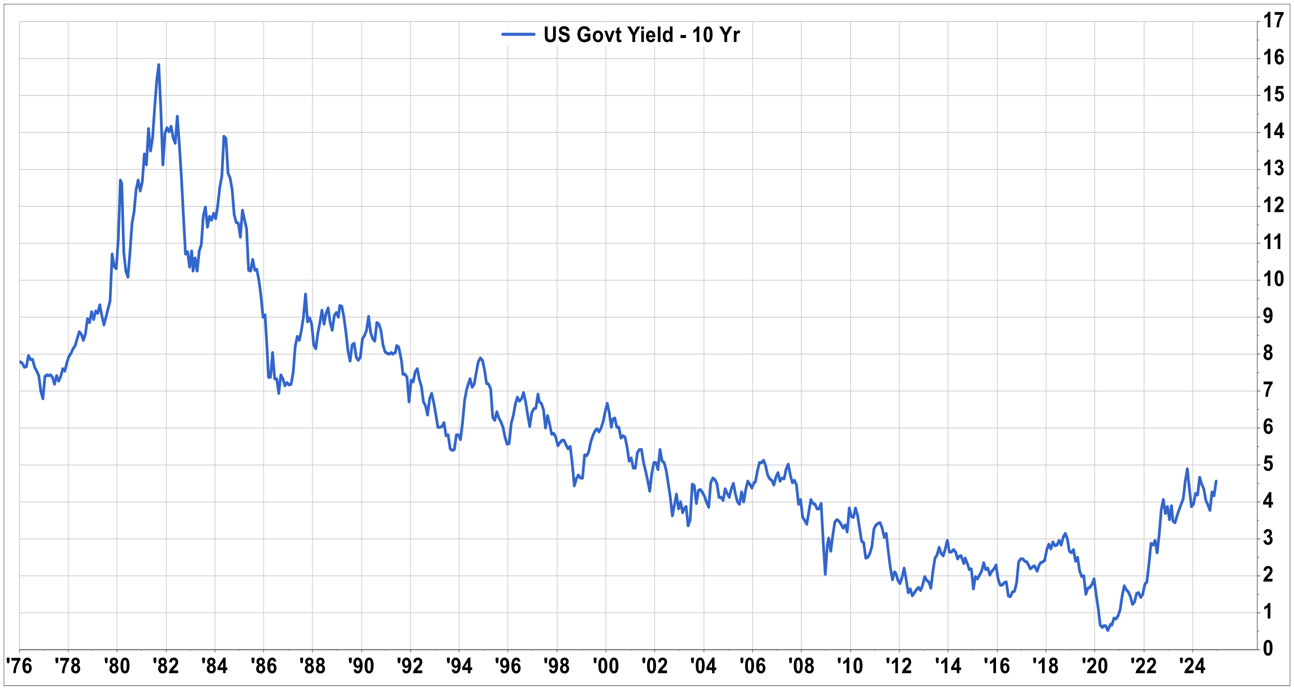


2024 marked the lowest level of credit spreads that we have witnessed in the high yield markets since before the financial crisis of 2008. These extremely tight spreads indicate that future returns are likely to be lower than if bonds were trading closer to their long-term average levels. It's important to point out that historical high yield spread comparisons may be somewhat skewed. The emergence and prevalence of private credit markets means that companies no longer need to access public markets to issue debt. Companies at the riskier end of the high yield spectrum are more frequently bypassing public markets when looking for funding, which puts downward pressure on yields at the index level. This means that the current composition of the high yield market may no longer be directly comparable to years past.

<u>This is Not Your Grandfather's Bond Market</u>

No fixed income commentary would be complete without a reflection of how different the current fixed income markets are compared to the years past.

Prior to 2022, fixed income investors had enjoyed a 40-year bull market in bonds. The 10-year US Treasury yield peaked at almost 16% in late 1981, then declined in a fairly orderly manner from that level to a COVID-era low of 0.5%.



From its inception in 1976 to date, the Bloomberg US Aggregate Bond Index has generated an annualized return of 6.5%. The bulk of that return was generated during that 40-year decline in yields, during which bonds generated an annualized total return of 8.0%. It's highly unlikely that the bond market will be able to generate a return similar to the previous 40 years on a sustained basis moving forward. This is not in any way a forecast, but more an acknowledgment that the conditions that aided historical bond returns no longer exist. US Treasury yields cannot decline by 15%, when they are starting at 4.5%. Bond returns are no longer supported by the generous income production of past years. While coupon rates have risen dramatically from the COVID lows, they are still nowhere near the levels that were experienced even 20 years ago.

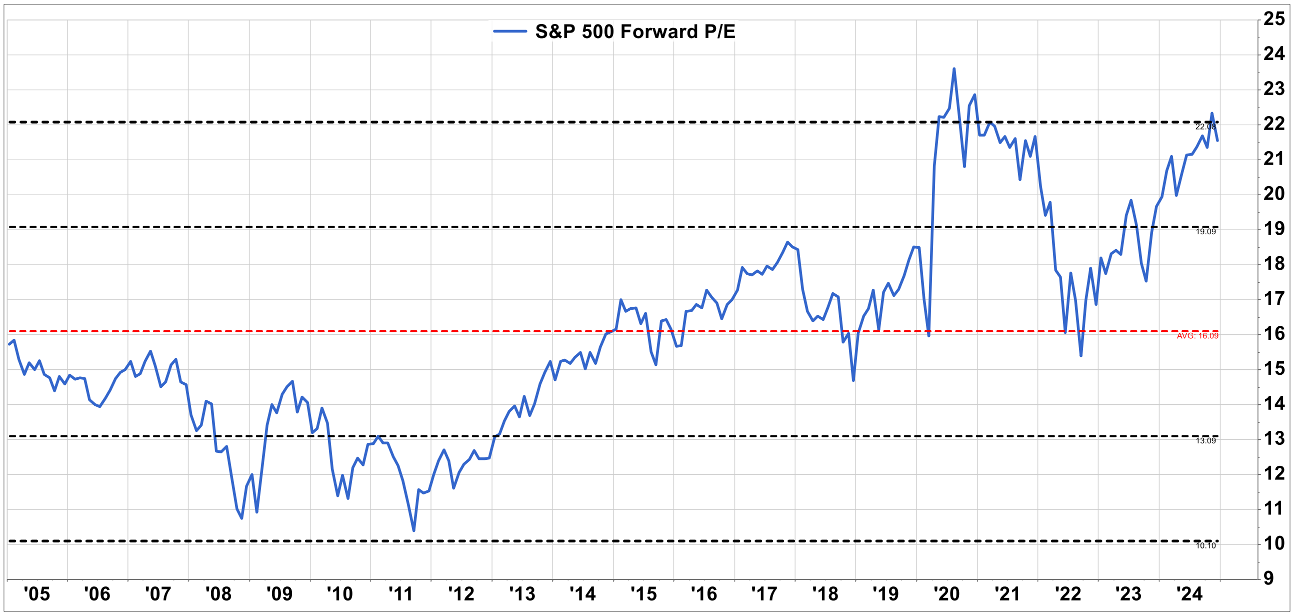
Bonds should now be viewed as an equity diversifier first, as opposed to an income producing asset. Equity securities of many companies in the utilities, real estate, and health care sectors offer dividend yields that equal or exceed current bond coupon rates. Even though these high-yielding stocks typically have a lower volatility than the equity market as a whole, they still carry a significantly higher degree of principal risk when compared to bonds. While bond market returns have been sub-par over the last several years, the real value of bonds will not be realized unless or until the next equity market downturn occurs.

Equity Market: Headwind #1 - Valuations

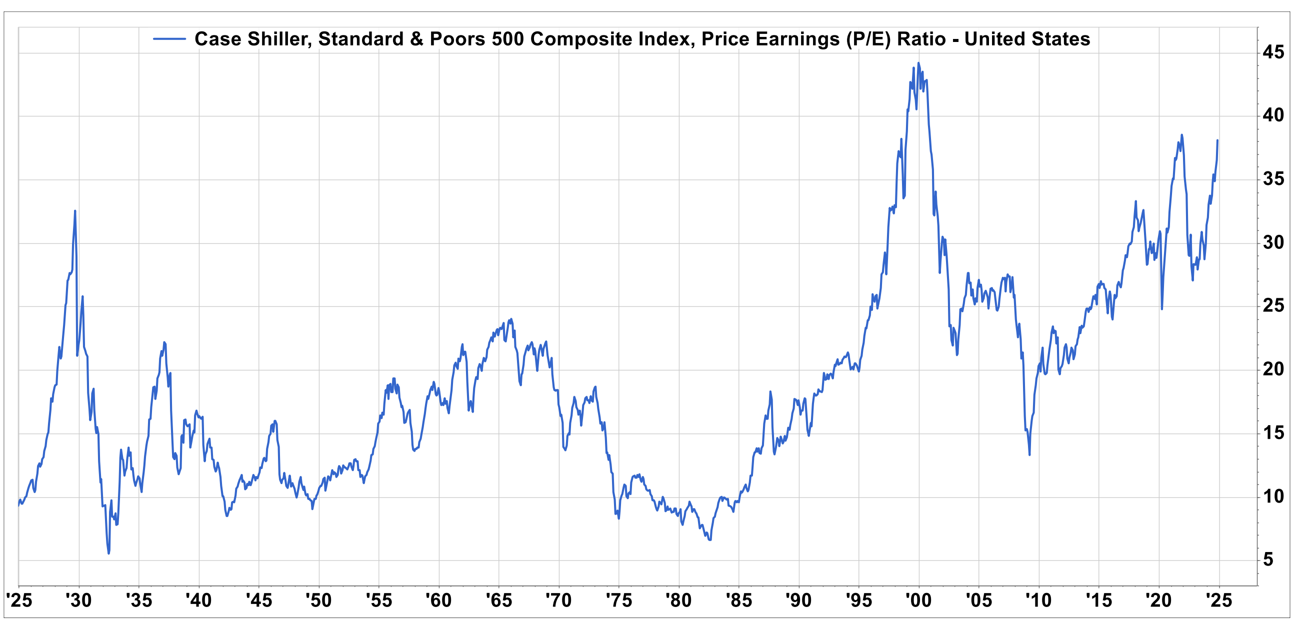
In our view, equity markets face several headwinds looking to 2025 and beyond, the first of which is that the market is richly valued relative to historical norms.

The S&P 500 Index is trading at around 21.6 times its year-forward earnings estimates, which is nearly two standard deviations above its 20-year average of 16 times earnings. The tech-heavy Nasdaq 100 index trades at a significant premium even to the S&P 500, at almost 27 times its earnings estimates. The expectations implied in price/earnings (P/E) multiples at this level render stocks vulnerable to potential earnings disappointments in the short term.

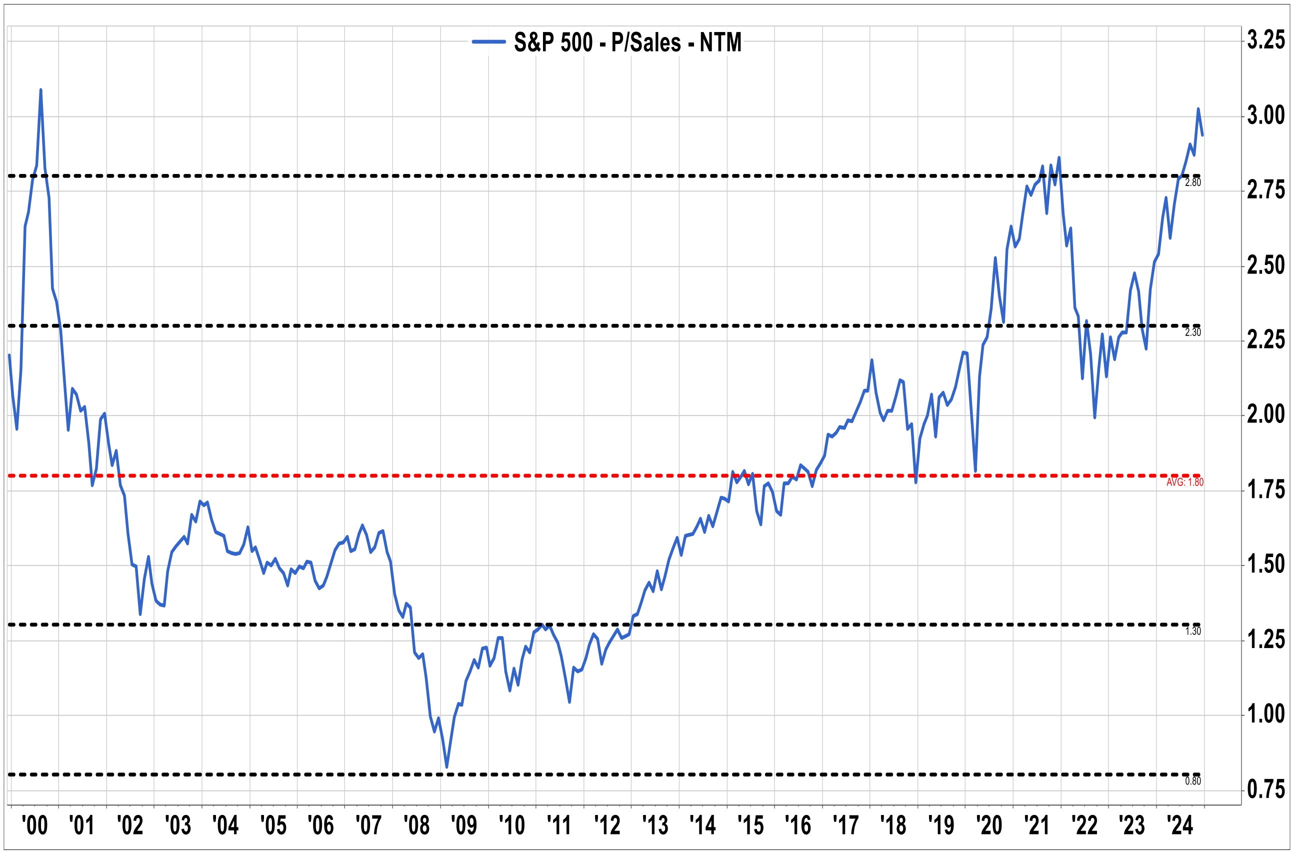
Longer term, as worrisome as this level of over-valuation is, using a static P/E multiple has a serious flaw, in that prices are very volatile and earnings are very cyclical. We need only to look back to 2020 and 2021 to appreciate this.



To account for the cyclicality of earnings, economist and academician Robert Shiller pioneered the use of cyclically adjusted earnings as a more reliable measure of valuation. Specifically, the current market price is measured by the moving average of the last 10 years' earnings, adjusted for inflation, and it is commonly known as the Shiller P/E, or the CAPE (Cyclically Adjusted P/E.) Earnings are smoothed out and adjusted for inflation to give a more reliable long-term indicator. **Currently, the CAPE ratio is at its third highest level in the last 100 years**. Only the dot.com bubble and COVID era experienced more extreme valuations by this measure. While comparisons to 100 years ago may not be entirely relevant, it is important to view the current valuations in a historical context.



Valuation concerns don't diminish, even if other financial ratios are used. On a price-to-sales basis, the S&P 500 is trading at almost 3 times its forward sales estimate. This is more than two standard deviations above the long-term average of about 1.8x sales. Only during the dot.com bubble of the early 2000's did the S&P 500 trade at a higher price-to-sales ratio. Other valuation measures – dividend yield, price-to-book, price-to cash flow and earnings yield minus bond yields – are all more than one standard deviation above historical norms, as well.

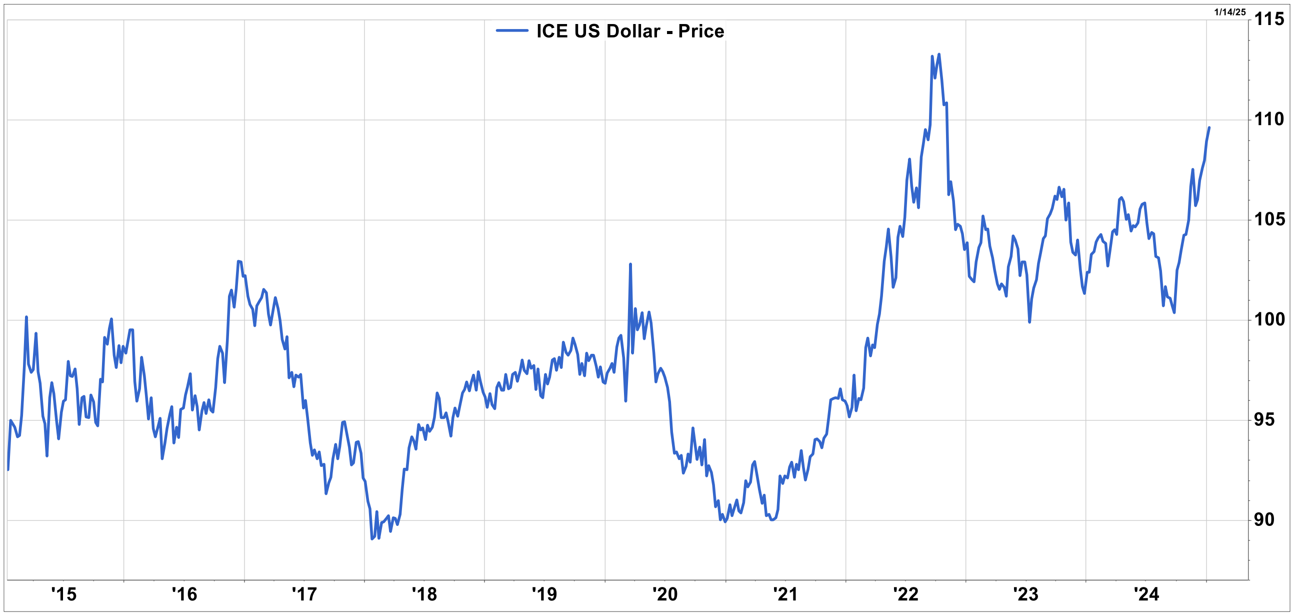


Barring earnings disappointments or estimate downgrades, markets can remain expensive for a long period of time before correcting, as we have witnessed over the last several years. But there are potential concerns on the earnings front as well, despite (or perhaps because of) the prevailing optimism. A market "priced for perfection" is susceptible to disappointment whether it be relative to earnings expectations or interest rates.

Calendar year 2024 earnings have not been finalized, but analysts are expecting that the S&P 500 will post earnings that are about 9.6% higher than last year. Regardless of the exact number, earnings growth of almost 10% for stocks is impressive. The consensus among analysts is that earnings will grow even faster in 2025, with projections that are 15% higher than 2024's level. Estimates for 2026 are not far behind, with an early expectation for earnings that are 14% higher than the estimates for 2025. While creating any precise forecast for earnings in 2026 seems akin to predicting the weather months in advance, it's been our experience that analysts are generally an optimistic lot. But the higher expectations grow, the more difficult future comparisons will become, increasing the risk that earnings may fall short of the lofty expectations.

Equity Market Headwind #2 – The Dollar

High expectations, particularly for the Mag 7 stocks, are two concerns going forward. Another recent and significant risk to future earnings is the rapid appreciation in the US Dollar. Even though the current dollar level is not at an absolute peak, it has appreciated by 9% in a matter of only three months.



When the US Dollar appreciates, American goods become more expensive in the global marketplace. It takes more of a foreign currency to complete a purchase when a good is based in US dollars. The natural reaction is for consumers to shy away from purchasing these relatively "expensive" dollar-denominated goods and services. This is most impactful for companies where a large portion of their sales are from exporting goods.

US-based companies who earn revenues in foreign currencies are also hurt by a strong dollar. When foreign sales are converted back into dollars, the value of these revenues are lower if the dollar has been appreciating against the foreign-revenue currency. Many companies will use derivatives to hedge their currency exposure, but this is not a fool-proof solution. According to FactSet, about 40% of the revenue for the S&P 500 constituent companies is generated internationally.

Equity Market Headwind #3 – Future Policy Uncertainty

As is the case whenever monetary policy is being adjusted, there is the potential that the Federal Reserve will make a policy error. The Fed continues to deal with inflation that is proving to be resistant to returning to the 2% policy target. Although core PCE inflation is nowhere near the peak in 2022, there has been no significant improvement in inflation over the past six months. The Fed has committed to holding short-term interest rates higher to suppress inflation. This elevates the risk that the economy will slow and fall into a recession due to the restrictive monetary policy stance. The other risk that results from elevated policy rates relates to equity valuations. Most practitioners use a discounted cash flow valuation method when determining a fair value for financial assets. Higher interest rates mathematically reduce the value of future cash flows, and in turn, reduce the value of equities.

If interest rates remain high for a longer period of time than most investors were expecting, there is likely to be downward pressure on stock prices. The December payrolls report that was released on January 10th showcased this risk. This report was much stronger than the market was anticipating, with the addition of 256,000 jobs. But it also raised concerns that the Federal Reserve will not cut interest rates again until their October meeting, far later than was previously expected. The equity markets sharply sold off after the payrolls report was made public, even though the immediate conclusion is that the labor market and US economy are on a solid footing.

Future trade policy for the United States is highly uncertain. It remains to be seen whether tariffs will be implemented, and if so, to what extent, or whether the threat of tariffs is purely a negotiation strategy. If tariffs are implemented, how much will this increase inflation, and detract from economic growth? Will these tariffs improve the balance of trade with our global partners? While these are unanswerable questions for the moment, they are real issues that will need to be considered throughout 2025 and beyond.

There are also concerns about how potential immigration reform will impact the labor supply in the economy. The labor supply is a critical input when determining the potential GDP or output of a nation. Even though the relationship is somewhat theoretical, changes to the labor supply certainly have the ability to alter future economic growth expectations.

Our Market Outlook for 2025 & Beyond

From time to time, we feel compelled to point out that this piece is deliberately called an “outlook”, not a “forecast.” An outlook is a discussion of what *might* happen, while a forecast is a prediction of what *will* happen and, as J.K. Galbreath has said: “The only function of forecasting is to make astrologers look respectable.”

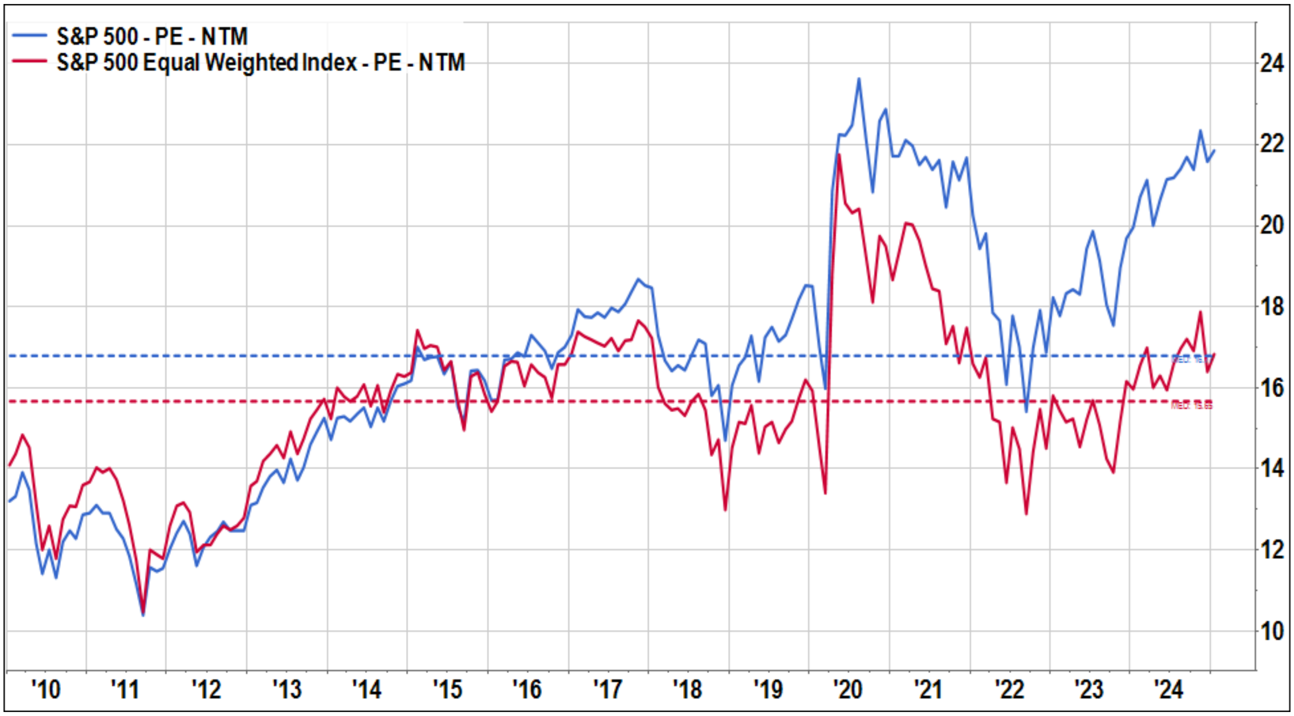
The markets at the moment are reacting to economic and jobs reports almost solely for what they foretell about the prospect of continued interest rate cuts. The Federal Reserve has relaxed its policies in recent months, but its primary goal has not changed.

Restoring price stability, which the Fed defines as bringing core inflation down to its target rate of 2%, remains the Fed’s focus. Progress toward achieving that goal has given the Fed the credibility to lower rates without raising future inflation expectations. But positive surprises on jobs and other economic reports, such as we experienced in December, would likely be unwelcome news for both stocks and bonds as the prospect of further easing by the Fed would be diminished or delayed.

A soft landing, with the economy slowing but not stalling, and inflation falling is currently priced into both markets. But from the beginning of its rate hike cycle in March 2022 to its reversal last year, the Fed signaled repeatedly that even a hard landing was preferable to a no landing scenario, in which continued robust economic growth coincides with a failure to bring down inflation. It has said nothing that would indicate that its view has changed.

As for the equity market, we wrote earlier, at length, about how most of the market's recent rise has been concentrated in the historic gains of the Magnificent 7 stocks, which now occupy vastly disproportionate weightings in the S&P 500 index. For the sake of simplicity, we'll continue to refer to the S&P 500 as the "market," but it stands to reason that any market outlook needs to look at the Mag 7, first, before it considers the rest of the market.

For example, if more than half of the market's performance the last two years was concentrated in just 7 stocks, then it is equally true that lofty valuations of those same stocks inflate the market's current valuations to a large extent. The S&P 500's cap-weighted performance of 53% over the last two years did not reflect the average stock's rise of just 24%. But so, too, does the market's current price/earnings multiple of 21.6 not reflect the average stock's P/E of just 16.4 (chart, below).



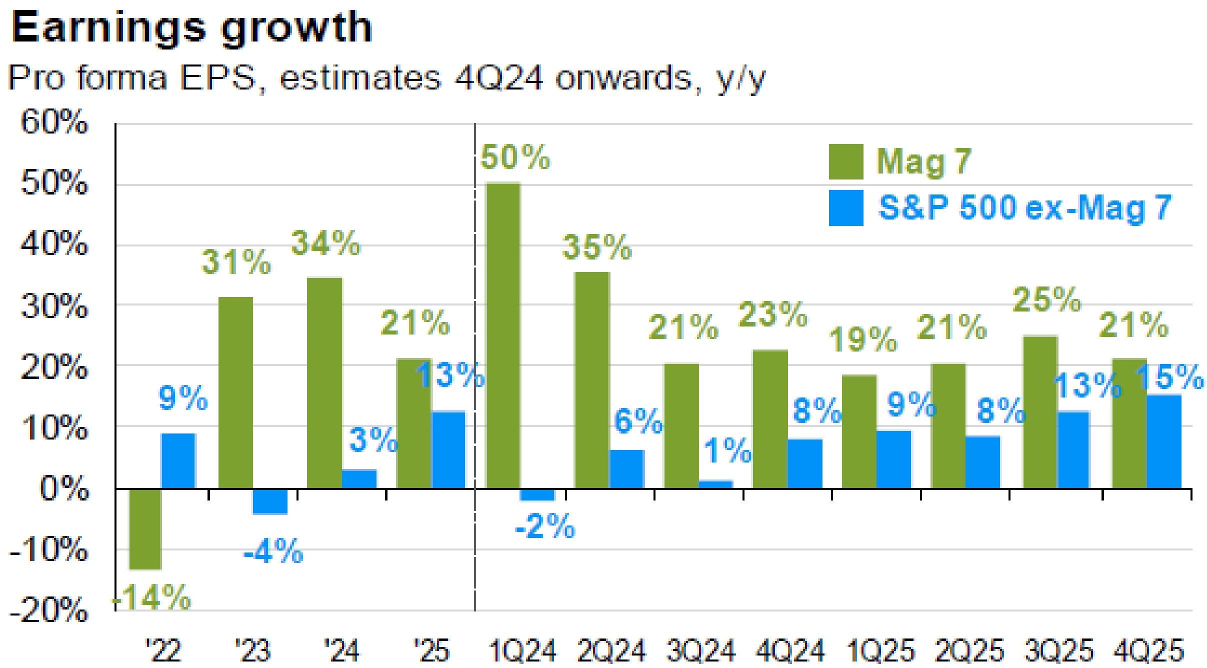
And while the P/E of the index is almost two standard deviations above its long -term average, as we pointed out earlier in this piece, an equal-weighted index of the same stocks is barely above its long-term average.

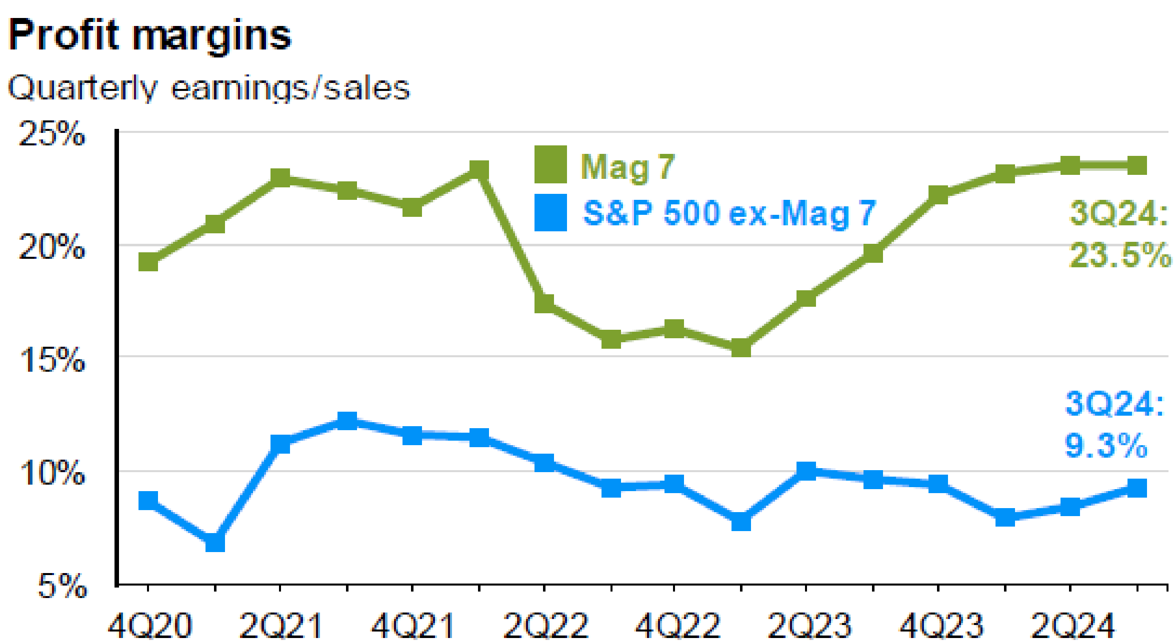
The conclusion is that the Mag 7 effect has caused the index to be overvalued, but the market is not.

The Magnificent 7 valuations have grown to the point that some are drawing comparisons to the dot.com bubble of 2000-01, and the market's 40% decline that ensued from 2000 to 2002. But unlike the dot.coms, Nvidia, Broadcom, et al. are truly great companies with pristine balance sheets, rapidly growing revenues and huge profit margins; and none of them have a sock puppet as a corporate mascot as pets.com had during the tech bubble.

As a group, they have accounted for virtually all of the S&P 500's earnings growth over the last two years. In fact, S&P earnings ex-Mag 7 actually declined in 2023, and grew only 3% last year, while Mag 7 earnings rose 31% and 34%, respectively. Their net profit margins over the same period have generally hovered in the 20-25% range, while S&P 500 margins seldom rise above 10%.

Incredibly, Nvidia's earnings for the most recent quarter were higher that their *revenues* were just 4 quarters ago!





That disparity is expected to narrow in 2025, as Mag 7 earnings decelerate in the face of tougher comparisons to last year's numbers, and overall corporate earnings improve. Still, every one of these stocks, save Apple, has continued to rise in January, outperforming the index by a considerable margin. The relative value in the stocks that have been left behind in the market's recent rise has yet to be exploited.

It's often said that price is what you pay, while value is what you get. Stock prices rise or fall on expectations, and the question is what is discounted. Are the expectations reflected in market prices of these admittedly great companies too high or too low?

Bill Miller, legendary fund manager at Legg Mason, has said that, "It is often the case in financial markets, that when the opinions are all on one side, the opportunities are on the other."

We can't think of a better way to characterize our view of the current state of the equity market.

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