Market Review & Outlook

January 2025

2024 was another banner year for US stocks, as the S&P 500 enjoyed its second straight year of 25%+ total returns for the first time since 1997-98. The Magnificent 7 stocks and the promise of artificial intelligence continued to drive the performance of the broad market, as has been the case since the launch of ChatGPT in late 2022. While there was a wide range of returns, every major asset class except for long duration Treasury bonds finished the year in positive territory. Foreign stocks were broadly higher on the year but continue to struggle on a relative basis compared to US stocks, as they have since 2009. Indeed, the near 20% outperformance of US vs. foreign stocks was the largest since 1997, as many overseas economies continue to struggle, especially relative to the US.

Moving away from stocks, precious metals, and cryptocurrency both turned in strong performances, with gold and Bitcoin up 27% and 121%, respectively. After a decent year for bonds in 2023 (up 5.53%), they struggled in 2024. Ironically, bonds were doing well for much of the year until the Fed began to cut rates in September. Because bond prices move inversely to interest rates, expectations would be for bonds to perform better once a rate cutting cycle begins, and since September 18, the Fed has now cut short-term interest rates by 1% (100 basis points or bps).

Since then, the yield on the 10-year Treasury Bond has risen as much as 100 basis points higher than before the September Fed meeting, a historically large countertrend move relative to Fed policy. Critics say this means the bond market, the so-called "smart money," believes the Fed is making a policy mistake by cutting rates while growth and inflation are still above trend. Higher rates continued to pressure fixed income through year-end, with bonds in the US declining more than 3% in Q4 and barely finishing the year positive, up 1.25%. Overseas it was worse, as the Bloomberg Global Bond Index declined 1.7% on the year. For a more detailed look at how various asset classes performed in recent periods, please refer to the table.

Index	Dec 2024	4th Qtr. Performance	One Year Performance	Description (what the index is comprised of)
S&P 500	-2.38%	2.41%	25.02%	Large Cap US Stocks
DJ Industrial Average	-5.13%	0.93%	14.99%	Large Cap US Stocks
Nasdaq Composite	0.55%	6.35%	29.57%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	0.88%	7.07%	33.36%	Large Cap US Growth Stocks
Russell 1000 Value	-6.84%	-1.98%	14.37%	Large Cap US Value Stocks
Russell 2000 Growth	-8.19%	1.70%	15.15%	Small Cap US Growth Stocks
Russell 2000 Value	-8.33%	-1.06%	8.05%	Small Cap US Value Stocks
MSCI EAFE	-2.27%	-8.11%	3.82%	Foreign Developed Market Stocks
MSCI Emerging Markets	-0.14%	-8.01%	7.50%	Emerging Markets Stocks
Credit Suisse High Yield	-0.33%	0.27%	7.89%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	-1.64%	-3.06%	1.25%	US Treasuries, mortgage-backed, investment grade corporate bonds

Given Fed pronouncements in 2021 about inflation being "transitory," questioning policy is understandable. Even according to official government statistics (Consumer Price Index "CPI"), Americans have lost more than 20% of their purchasing power since the beginning of 2020. Other unofficial inflation measures paint a bleaker picture. Consequently, it's difficult for the Fed to make a strong case for cutting rates with inflation still above its official 2% target. From their perspective, the late summer mini-growth scare justified the jumbo 50-bps point cut at the September meeting. In reality, the growth scare was just one poor employment report, and many viewed this as a Fed panic move considering the resilient economic and financial market backdrop.

Indeed, headline economic growth remains strong, as US GDP grew at a 3.1% annualized rate in the 3rd quarter, up from 3.0% in the 2nd quarter. Most estimates of 4th quarter GDP forecast growth of between 2-2.5%, and of 2% or higher next year. Not only that, the powerful rally in US stocks which began in late 2022 continued through much of the year, with 2024 returns surpassing the predictions of even the most optimistic pundits from a year ago. While stocks finished the year with a whimper (S&P 500 down 2.38% in December), many headline indices still sit near all-time highs and market sentiment remains broadly positive. Finally, though the unemployment rate has increased to 4.2% in November from 3.4% in January 2023, this is still a historically low level on an absolute basis. Based simply on these headline data points, the case for continued rate cuts in 2025 is weak, and the Fed funds futures market is now pricing in only two rate cuts for 2025.

This is because after steadily declining for more than two years and reaching a cycle low of 2.4% in September, official inflation based on the CPI has crept up for two consecutive months, reaching 2.7% in November. Fed chair Jerome Powell has repeatedly said the Fed will remain "data

dependent" when calibrating future monetary policy. Inflation remaining sticky and trending higher presents a dilemma for a Fed that had already charted out a rate cut cycle for 2025. To complicate matters, the election of Donald Trump has put further upward pressure on inflation expectations with his pledge to slap tariffs on top US trading partners. Virtually all mainstream economists believe higher tariffs mean higher prices for consumers, all else being equal. On the other hand, tariffs instituted during Trump's first term (tariffs the Biden administration kept in place) did not prove inflationary. Moreover, many analysts expect Trump to use them as an economic bargaining chip in contrast to his stronger public statements about across the board tariffs. Whatever transpires, inflation remains a headline concern for consumers. Although inflation has declined significantly, this only means prices are moving higher at a slower rate. For most Americans, it is the price level, not the inflation rate, that is most worrisome, and the price level of many necessities has moved permanently higher over the past several years.

For weeks after Trump's election, many "risk-on" assets surged, with investors expecting a new Trump administration to implement a range of business-friendly policies, including cutting regulations, extending existing tax policy set to expire, and possibly passing new (corporate) tax cuts. "Risk-on" assets here refers to US stocks generally, US small cap stocks in particular, and cryptocurrencies. Many analysts believe small cap stocks could disproportionately benefit from any "pro-America" tilt in Trump administration policy given their primary focus on the domestic US market relative to the multinational mega-cap stocks. Also, the incoming administration is viewed as more crypto-friendly than the Biden administration, whose SEC chairman Gary Gensler has been perceived as an obstacle to further cryptocurrency adoption. Since Trump's election, Bitcoin surpassed the $100,000 level for the first time (trading ~$99k as of 1/5).

Somewhat predictably, many of the so-called "Trump trades" have reversed, at least partially, over the past month. While market enthusiasm hasn't completely faded, the realization has set in that Trump's proposals could face meaningful opposition. Trump can push through significant deregulation and tariffs through executive order, but changes to tax policy and broader tariff implementation require Congressional approval. There, the Republican majority in the House is razor thin, and a few deficit hawks still exist in the GOP, meaning cutting corporate taxes from 21% to the proposed 15% may prove difficult. Small cap stocks, after soaring in the weeks following Trump's November 5 election, sank more than 8% in December, and now sit 7.1% off their all-time highs (as of January 3). Small cap stocks continue their multi-year underperformance relative to large caps, as the S&P 500 outpaced the Russell 2000 by 13.3% in 2024, the widest margin since 1998.

Furthermore, market breadth has weakened significantly over the past several weeks. At the beginning of 2025, just 19% of stocks in the S&P 500 were trading above their 50-day moving average, the lowest since October 2023. This is a marked deterioration since the end of the third quarter, when ~60% of stocks traded above their 50-day moving average. Nonetheless, most pundits are forecasting another strong year for stocks in 2025. The Q4 corporate earnings season begins next week, and consensus earnings estimates project an annual increase of 11.9% for S&P 500 profits. Moreover, according to FactSet, the estimated S&P 500 earnings growth rate for 2025 is 14.8%, significantly higher than the trailing 10-year average of 8%.

The elephant in the room is that stock price appreciation has far outstripped corporate earnings growth over the past two years, sending valuations towards historically high levels. The Price/Earnings ratio on the S&P 500 has moved up to 25 on a trailing 12-month basis, a multiple expansion of 13% in 2024. This is 28% higher than the average P/E ratio since 1989 (19.7). Whichever valuation metric one chooses, the current reading lands near the very top of all historical observations, rivaling major market tops in 1929 and 2000. Warren Buffett's favorite valuation indicator, the ratio of US stock market capitalization to US GDP, has never been higher.

The normal disclaimer here is that valuation is not a market timing tool, and smart people sometimes do believe "this time is different." What if the optimists are right and artificial intelligence really can push human productivity to permanently higher levels over the mid-term (5-10 years)? There are plausible cases to be made, and animal spirits (and trends) in the market tend to persist. Alan Greenspan famously warned of "irrational exuberance" in the stock market in a December 1996 speech. While stocks initially reacted poorly, that bull run continued for over three more years before the market top in March 2000.

Though most Americans continue to struggle with inflation, it is true that the recession fears have receded into the background, at least for now. After declining for 31 out of the 32 months through October, the Conference Board's Index of Leading Economic Indicators increased by 0.3% in November, perhaps reflecting some optimism from Trump's election. Also, while manufacturing activity has been in contractionary territory for most of the past two years, recent data has improved. To be sure, there are still plenty of risks in the market for investors. Based on their over-concentration in the headline indices, a big earnings disappointment in one or more of the Magnificent 7 stocks could roil the market. Also, given the great run stocks have been on, a correction would not be out of the ordinary, and uncertainty over a new Trump administration could increase volatility in the new year. Whatever the case, the beginning of the year is always great time to review your portfolio.

Investing involves the risk of loss that clients should be prepared to bear. If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy