

## **Q4 Market Review & Outlook**

January 9, 2025

After another year of robust equity market returns and strong U.S. economic growth, what do investors have to worry about in 2025? Several issues come to mind, but the most significant may just be adjusting expectations around market returns.

Robust corporate earnings, strong consumers, a stable labor market, and tempered inflation contributed to a 25.0% climb in the S&P 500 index last year, almost as extraordinary as the 26.3% return for 2023. The bond market's total return was essentially flat, credit-sensitive fixed income rose, and the trade weighted U.S. dollar soared to new all-time highs. The long-awaited recession never materialized, and investors took high inflation, geopolitical uncertainty, and a contentious U.S. election in stride.

Pressing issues include:

### **WILL LONG-TERM INTEREST RATES KEEP RISING?**

The Federal Reserve has a fine line to draw. The market expects continued cuts to short-term interest rates this year. But if inflation remains well above the Fed's 2% target, longer-dated bond yields may move higher, which could further crimp the housing market and other interest rate sensitive parts of the economy. At present, the Fed is signaling a temporary pause in short-term rate cuts.

Currently, goods prices are deflating, the labor supply is now relatively in balance with demand, and leading indicators seem to point to shelter cost inflation finally starting to moderate, all of which point to aggregate disinflation. Declining inflation would likely keep a lid on further increases in long-term interest rates.

### **WHAT WILL TRUMP'S SECOND TERM MEAN FOR MARKETS?**

We see potential economic and market tailwinds from deregulation and a potentially lower and/or simpler tax regime. These could be at least partially offset by the impacts of higher tariffs and less net immigration, both of which are modestly negative for real growth. In the short term, deregulation is perhaps the easiest policy to implement broadly. It should be meaningful for certain sectors of the economy including small technology companies and the financial services sector.

Debt and deficits remain too large, a potential detriment to the longer-term growth outlook. If the Musk and Ramaswamy-led Department of Government Efficiency, or DOGE, can help push the deficit's size as a percentage of GDP below the growth rate of nominal GDP, debt as a percentage of GDP could shrink modestly.

We expect the timing and scope of policy implementation, and the potential for unpredictable policy priorities, to create periods of elevated market volatility. We continue to believe that the aggregate impact of Trump policies on inflation and on earnings and economic growth will be positive, but relatively modest.

### **WHERE ARE WE IN THE ECONOMIC CYCLE?**

The underlying U.S. economy remains strong, with no real evidence of recession in sight. Although low-end consumers have been hurt by inflation, the majority continue to spend, notably Baby Boomers who as a group have remarkably strong balance sheets, and the labor market is stable. Additionally, small business sentiment

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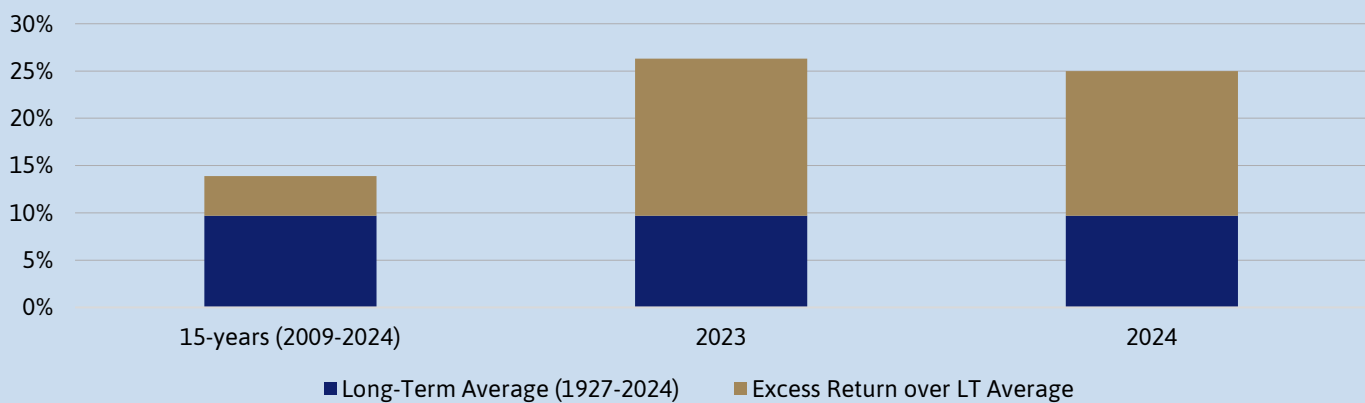
spiked upwards after the U.S. election, which could help drive continued strong economic growth through capital spending and expectations for increased merger and acquisition activity.

U.S. global leadership in technology and innovation, which has led to higher labor force productivity and outsized growth, seems likely to continue. Chinese equities have shown some signs of recovery, thanks to government stimulus and low equity valuations, but the economy continues to struggle with a housing glut and a rapidly aging population. Japan, while still contending with difficult demographics, has reasonable equity valuations and has made real strides in improving corporate governance, which has led to robust earnings growth. The largest European economies – the United Kingdom, France and Germany – are grappling with political and/or economic uncertainty.

### CAN U.S. EQUITY RETURNS SUSTAIN THEIR VERY HIGH RETURNS?

S&P 500 Index valuations are priced at around 22x earnings, well above the long-term average of around 16x. Even when stripping out the highly valued Magnificent Seven, or Mag-7, companies (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla), valuations still look high. A combination of the Artificial Intelligence, or AI, infrastructure build out (semi-conductors, data centers, electricity grid) and AI implementation could enhance overall productivity and help to broaden earnings growth beyond big tech. But starting point valuations, one of the most important indicators of future returns, suggest that U.S. equity returns over the next 5-10 years are very unlikely to meet the outsized returns of the past 15-years. (See below for further analysis.)

### S&P 500 INDEX TOTAL RETURNS



## ASSET CLASSES

### Cash and Defensive Assets

Cash remains attractive, with yields over 4%. Cash has outperformed longer-dated high-quality fixed income investments for the last few years, but we believe it is unlikely to continue to do so over the next three to five-year period. Longer-dated yields are likely to remain above shorter-dated rates (a positively sloped yield curve) for the near term.

High-quality municipal bonds are now reasonably attractive relative to Treasuries, but we will be watching for potential changes in tax policy closely, some of which (e.g. lower individual or corporate rates) could make municipals incrementally less attractive. The yield difference between Treasuries and high-quality corporate

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bonds is near an all-time low, making corporate bonds less attractive. We have been increasing exposure to Treasuries in portfolios where appropriate.

### Credit Assets

The difference (or spread) between Treasury yields and lower-quality, more credit-sensitive fixed income also declined meaningfully, mostly offsetting the rise in Treasury yields in 2024 and leading to high single digit returns for most credit-sensitive investments. Current yields for high yield corporate credit remain above 7%, still reasonably attractive but less so than a year ago. More appealing now are investments in business development corporations, which invest in floating rate private company debt, and in pools of asset-backed loans, which provide a relatively higher degree of credit quality and add to portfolio diversification.

### Growth Assets

The driving theme for the U.S. equity markets over the past two years has been the dominance of the biggest companies. The Mag-7 comprise almost 33% of the S&P 500 Index and has accounted for the lion's share of performance while pulling its weight in earnings and revenue growth. Because the S&P 500 companies with the biggest weightings have also had among the best performance, the equal-weighted version of the S&P 500 Index (which has only about 0.2% exposure to each company in the S&P) had a total return of just around 13%.

We have exposure to five of the Mag-7 but remain underweight this group in aggregate. This allocation has been a drag on our relative core equity performance. However, we remain confident that there is opportunity in the broader market, as other companies benefit from AI implementation, as well as an improving economy. We expect accelerated earnings for the S&P 500 index in 2025, notably in the health care and industrial sectors, each laggards in 2024.

International underperformance relative to the S&P 500 index continued in 2024, now a 15-year trend (the MSCI ACWI ex-US and the S&P 500 index rose 5.2% and 13.9%, respectively, between 2009 and 2024). The U.S. stock market now represents 75% of all developed country equity markets and 65% of the world's total equity markets.<sup>1</sup> Much of this dominance has been due to vastly superior earnings growth, which remains the case. But the valuation gap today is significant, making a case for increasing international exposure from low levels, especially with active managers. We have maintained our overweight to domestic markets, which has contributed to our relative performance over time.

### Illiquid Alternative Investments

After a few years of less transaction activity and lower levels of fundraising, private capital markets are likely to see some positive developments in 2025. Expected deregulation could bolster deal activity, allowing private funds to exit some of their investments made in prior years. As corporations increase usage of AI tools, related infrastructure spending should accrue at least in part to the benefit of smaller, more innovative companies in the private sector. We believe some exposure to a diversified portfolio of private equity; growth equity and venture capital should enhance risk-adjusted returns in portfolios with a reasonably long-time horizon.

Private credit managed by funds continues to take market share from banks and other regulated buyers, a trend that we expect to continue as banks both consolidate and derisk their balance sheets. A combination of middle market lending and asset backed loans with strong specialist managers can provide portfolios with income and diversification.

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<sup>1</sup> Data from MSCI Indices

### CONCLUSION

We expect the U.S. economy to stay on track and U.S. corporate earnings to grow robustly. But at current high valuations, there is less margin for error, which could lead to both more volatility and lower returns than in the recent past. Fixed income yields, both investment grade and high yield, have a positive real (inflation adjusted) yield which should lead to solid returns over the next three to five years. Private alternative investments can potentially add both diversification and high returns to a traditional liquid portfolio. We remain focused on structuring client portfolios for a range of economic and market outcomes and on maintaining appropriate levels of short-term cash and liquidity while reflecting each client's long-term financial goals.

### Disclosures:

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