Quarterly Market Outlook

January 2025

2024 Economic Recap

U.S. economic growth handily beat expectations last year, with real GDP growing an estimated 2.7%, while inflation continued to normalize, bottoming in the mid-2% range before ticking up slightly in Q4. With the labor market loosening and inflation seemingly under control, the Fed cut interest rates 100 bps to ease policy that it saw as overly restrictive. [1]

2024 Market Recap

Against a backdrop of robust growth, stable inflation, and rate cuts, the S&P 500 posted another banner year (+25%), led by AI enthusiasm, strong earnings, and hopes for Trump's second term. Meanwhile, gold rallied 27%, boosted by central bank purchases, geopolitical tensions, and perhaps more secular concerns around deficit spending and fiat currencies. Non-U.S. equities were up only 6% for the year in aggregate, underperforming the U.S. by a wide margin on weaker fundamentals and dimmer prospects for Europe and China. Corporate debt rallied as spreads tightened, with high-yield bonds up 8.2%. Finally, Treasury prices declined in Q4, as investors reduced expectations of further easing following an uptick in inflation stats, sending the 10-year yield to 4.57% – 65 bps higher than when the year began.[2]

Trump Policy Agenda

With the Republican election sweep, Trump's policy agenda is likely to have significant implications for the economy. For one, Trump has proposed significant tax reform, including extending tax cuts for individuals, exempting certain benefits, lifting the cap on deductions for state and local taxes (SALT), and reducing corporate tax rates – changes that could collectively boost household and corporate spending and corporate profitability. Trump has also proposed rolling back financial and environmental regulation, which could ease compliance burdens and access to credit more broadly, while the new Department of Government Efficiency (DOGE) could potentially curb inefficient government spending. On the other hand, proposed tariffs – as high as 60% on imports from China – would increase the cost of goods for businesses and consumers alike; Trump's hawkish foreign policy raises the specter of renewed commodity and supply-chain shocks; and curbs on immigration – including possible mass deportations of illegal immigrants – could potentially reduce the labor supply. Overall, we see Trump's policies as pro-growth, but with material risks of re-igniting inflation and a wide range of outcomes depending on how they are implemented. [3]

Positive Growth Outlook for 2025

U.S. growth is strong with multiple tailwinds at its back, including modestly lower rates, a favorable tax and regulatory environment, growing capital expenditures on data centers and AI, a relatively strong consumer with rebounding sentiment (despite rising credit-card and auto-loan delinquencies), and healthy corporate and household balance sheets. These factors should support consumption as well as capital markets activity. While conditions abroad are weaker, so is inflation, and normalizing policy rates should be supportive. [4]

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Great Expectations

While the economy appears to be on solid footing, much of this strength seems to be priced in, with virtually no room for disappointment. The S&P 500 now trades at a forward P/E of 22 (compared to 13 for international equities), with aggressive expectations of 13% annual earnings growth this year and next and 18% longer-term – highs not seen historically outside market peaks (e.g., 2000, 2021) or coming out of recession (when expectations of recovery are high off a low base). Corporate spreads have bounced off their lows but remain tight relative to history and have continued tightening in the private markets. Meanwhile, the 10-year breakeven inflation rate still sits at 2.3% despite current inflation tracking in the mid-to-high 2% range and trending higher; indeed, inflation may well upend the Fed's plan to cut another 50 bps this year. In contrast, we see 2.2% real yields on 10-year TIPS as more attractively priced. [5]

Portfolio Implications

Historically, valuations – and how conditions unfold relative to the expectations those valuations imply – tend to be the best predictors of future returns over the long term. Today, with U.S. equity-market valuations at record highs by most measures and expectations aggressive, we see heightened risk that future returns may disappoint. Signs of speculative fervor abound, with bitcoin eclipsing $100,000, day trading and options volume at records, and implied volatility near lows. At the same time, with strong momentum at its back, the current rally could easily continue. We think it's important for investors to stay diversified and take advantage of active management to enhance returns, both in public markets and on the private side, where top managers can leverage their differentiated positioning and skillsets to add value in markets that tend to be less efficient. [6]

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Notes

All data as of 12/31/2024.

[1] Economic Outlook U.S. Q4 2024: Growth And Rates Start Shifting To Neutral | S&P Global Ratings; Inflation Ticks Up Slightly Ahead of Fed Meeting - The New York Times; US labor market steadily cooling amid higher job openings, low layoffs | Reuters; The Fed - December 18, 2024: FOMC Projections materials, accessible version; Bloomberg: DOTS.

[2] Source: Bloomberg (SPX Index, XAU Curncy, MXWDU Index; LF98TRUU Index; USGG10YR Index); S&P 500 posts 23% gain for 2024 as stocks close slightly lower in final session of year – NBC New York (note this is a 23% price gain, before dividends); Central bank gold statistics: November 2024 | Post by Krishan Gopaul | Gold Focus blog | World Gold Council.

[3] Wall Street girds for Trump 2.0: Tariffs, tax cuts and volatility | Reuters; Donald Trump eyes Doug Burgum as new 'energy tsar' to slash regulations; Banks Eye Trump Regulatory Reprieve, Starting With Capital Rules – Bloomberg; Trump to appoint former ICE director Tom Homan as US 'border czar' | Reuters; The Great DOGE Reversal – WSJ.

[4] 2025 Outlook: Building on Strength; American household net worth sets record, bringing debt-to-asset ratio to 50-year low; Companies Belly Up to Cash Buffet, in Five Charts – WSJ; US consumer sentiment ticks up, shows post-election partisan flip | Reuters; Daily: Global easing cycle set to continue after Swiss cut | UBS Global. Source: Bloomberg (USDECRED Index, PRBI AUTO Index).

[5] YRI Earnings Outlook - Yardeni Research; S&P 500 Sectors Long-Term Earnings Growth - Yardeni Research; Forward P/Es - Yardeni Research; LTEG, STEG & STRG - Yardeni Research; Summary of Economic Projections, December 18, 2024; Bloomberg (USGGBE10 Index; GTII10 Index; DOTS).

[6] Ring Out, Wild Bells - Hussman Funds; 2024 was another record-breaking year for options trading. What's on tap for the industry in 2025; ICE Shatters Trading Records: Q4 Futures Volume Surges 22%, Energy Markets Hit All-Time Highs | ICE Stock News; Experts react to bitcoin's $100,000 milestone | Reuters.

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