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Quarterly Market Perspective

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Looking back, 2024 was a year filled with significant geopolitical and economic uncertainties that could have negatively impacted markets and added greater volatility. Instead, markets were generally tame, and these macro concerns—such as the U.S. election and Federal Reserve interest rate cuts—ended up having a relatively minor influence. As we turn the page to 2025, the year brings a new set of risks, the most prominent for U.S. investors being the direction of policy under a new president and a narrowly led Republican Congress.

Following the November election, markets reacted by resetting expectations in asset prices and bond yields to reflect campaign proposals related to immigration, tariffs, and taxes. The S&P 500 finished 2024 up 25%, marking its third year out of the last four with a return of 25% or more.[1] This has led to a near doubling of the index since the start of the decade. While earnings of S&P 500 companies increased by 50%—explaining half of the index's appreciation over this period—the other half was due to investors' willingness to pay higher valuation multiples.

Outside of U.S. large cap stocks, returns from other segments of the equity market were more pedestrian. Categorically, other segments of the U.S. market experienced low-to-mid teen returns with small companies returning 9% and mid-sized companies returning 14%.[2] Outside of the U.S., international equity markets generally provided mid-single-digit results. Lastly, bonds, while positive, were up roughly 1%. While large U.S. stocks were the standout performers of 2024, diversified portfolios saw more moderate yet still respectable results.

There is no mistaking that recent market gains have been supported by elevated sentiment among investors, resulting in large-cap U.S. stocks carrying valuations now outside historical norms. This doesn't mean stock prices will abruptly fall, but it does suggest that further expansion of valuation multiples is unlikely to drive returns going forward. As such, over the next five years, we believe investors should expect more modest returns than the 14.5% annualized return the S&P 500 has delivered over the past five years.[3]

An outsized portion of the S&P 500's returns over the past five years has come from what is now routinely referred to as the "Magnificent 7" stocks (Apple, NVIDIA, Amazon, Alphabet, Microsoft, Meta, and Tesla). Each of these companies has demonstrated remarkable innovation and growth, but also possessed enviable balance sheets, and generated significant cash flow. However, the last two years have been challenging for diversification, as the Magnificent 7 accounted for the majority of overall market returns. Several of these stocks now represent over 5% of the overall market. Any investor underweight in these stocks has faced a headwind. Prudence and experience suggest that diversification is beneficial, and such heavy concentration adds unnecessary risk.

The earnings growth rates of the Magnificent 7 stocks may, however, be reaching a tipping point. Analyst forecasts indicate a moderation in growth expectations, while growth rates for non-Magnificent 7 companies are projected to improve. Should this narrowing of growth rates lead to a shift in sentiment around these seven stocks, we would expect to see a broadening of the market, with improved relative performance from segments outside of large-cap U.S. equities.

(1) Standard & Poors, Bloomberg. As of 12/31/24. (2) Small cap companies represented by the S&P 600 index, Mid cap companies represented by the S&P 400. Source: Bloomberg, as of 12/31/24. (3) Standard & Poors, Bloomberg. As of 12/31/24.

In such an environment, asset selection—such as geographic, sectoral, and thematic trends—may play a more significant role in outpacing the broader market.

What makes the near-term especially challenging to forecast is the extreme bullish sentiment across markets. As 2024 progressed, speculative trading returned in markets such as Bitcoin and cocoa futures. Surveys of both individual and institutional investors point to bullish expectations heading into 2025. Among major Wall Street strategists, bullishness is the consensus, with no strategist forecasting flat or negative returns for 2025. Within bond markets, investment-grade credit spreads—the incremental yield investors require over comparable Treasury bonds—reached their lowest level since 1998.

Investor optimism, while supported by the strength of current economic conditions, leaves little room for unfavorable outcomes around policy uncertainty. For instance, expectations largely discount any economic or corporate earnings degradation from proposed Trump administration tariffs. The International Monetary Fund projects that a 60% tariff on Chinese goods could reduce annualized U.S. GDP growth by 0.5%, and a broad-based 10% tariff on all other imports could add an additional 0.6% drag on U.S. economic growth.[4] Additionally, expectations for a gradual easing of inflation do not account for potential immigration policies that could tighten labor supply and drive higher wages. While the ultimate outcomes of these policies are uncertain, the elevated bullish sentiment leaves little margin for error.

Despite these risks, we maintain an optimistic outlook for the economy and markets. However, we acknowledge that the current environment is less predictable in the near term and that the path forward may include some volatility. The heightened positive sentiment among investors suggests that any event triggering a shift in sentiment could lead to an exaggerated decline in the prices of favored assets, which have become increasingly crowded trades.

Under this backdrop, where it is more challenging to forecast in the near-term, we are electing to emphasize compelling opportunities that we have increasing conviction in over the intermediate and long-term. Below we highlight some of these high conviction opportunities.

1. **Digital Infrastructure** – The advancement of Artificial Intelligence (AI) is likely to drive a technological renaissance. While much remains uncertain regarding the timing and monetization of AI adoption, beneficiaries will include industries like semiconductors, software, and even insurance, where AI can drive material efficiencies.
2. **Capital Reallocation** – The pandemic and subsequent interest rate increases resulted in low corporate deal activity. An optimistic economic outlook, clarity around political expectations, and recent Federal Reserve rate cuts may unlock a backlog of deal activity for both public and private companies, benefiting investment banks, rating agencies, and investment managers.
3. **Physical Infrastructure** – Trends such as deglobalization, electrification, and increased demand for data centers support meaningful investment in physical infrastructure, including energy generation, electrical grid enhancements, and industrial facilities.
4. **Higher for Longer** – Although the Federal Reserve began cutting interest rates in late 2024, they signaled that further cuts may not occur soon. With inflation above target and fiscal policies suggesting upside inflation risks, we expect interest rates to remain higher for longer. In this environment, bonds offering mid-single-digit yields are attractive.
5. **Broadening of U.S. Markets** – Market concentration in the Magnificent 7 stocks has overshadowed smaller equity segments, such

(4) International Monetary Fund World Economic Outlook, 10/31/24.

as mid-cap stocks, which now trade at their largest discount to large-caps in 25 years. Improving earnings expectations for mid-caps in 2025 present an opportunity for attractive returns.

Concluding Thoughts

We enter 2025 with optimism about the intermediate- and long-term opportunities ahead. First, the divergence in valuations presents attractive opportunities beyond large-cap U.S. stocks. Second, a less active Federal Reserve enhances bonds' role in providing diversification and respectable yields. Finally, emerging thematic trends are poised to benefit investors over a multi-year horizon.

While volatility is likely as uncertainty around government policies persists, we recommend avoiding reactive decisions to market noise. Instead, focus on long-term trends and opportunities that offer attractive return potential. The strong economic foundation and healthy corporate and consumer balance sheets provide confidence in the path ahead, even as we navigate inevitable challenges.