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Investment Insights Monthly

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Navigating High Valuations: A 2025 Market Playbook

Reflecting on 2024, it has been a historic year for equity markets, delivering the "Goldilocks" scenario investors had hoped for—a rare confluence of lower inflation, strong economic growth and a pivot by the U.S. Federal Reserve (Fed) into a rate-cutting cycle. The favorable macroeconomic environment has propelled the S&P 500 into the top 10% of annual performances since 1928. During 2024, the large-cap index has notched more than 55 new record highs and surpassed the 6,000-point level for the first time. Political clarity, robust consumer spending, and strong corporate earnings have driven investor sentiment and gains upward of 20% for six of the 11 S&P 500 sectors. Investors benefited not only from macroeconomic stability, but also from a broadening of market participation. This marks the second consecutive year of strong gains, with the S&P 500 up more than 55% since 2023, and leaves investors questioning—can above-average gains continue? Have valuations gotten ahead of themselves? What's a reasonable outlook for 2025?

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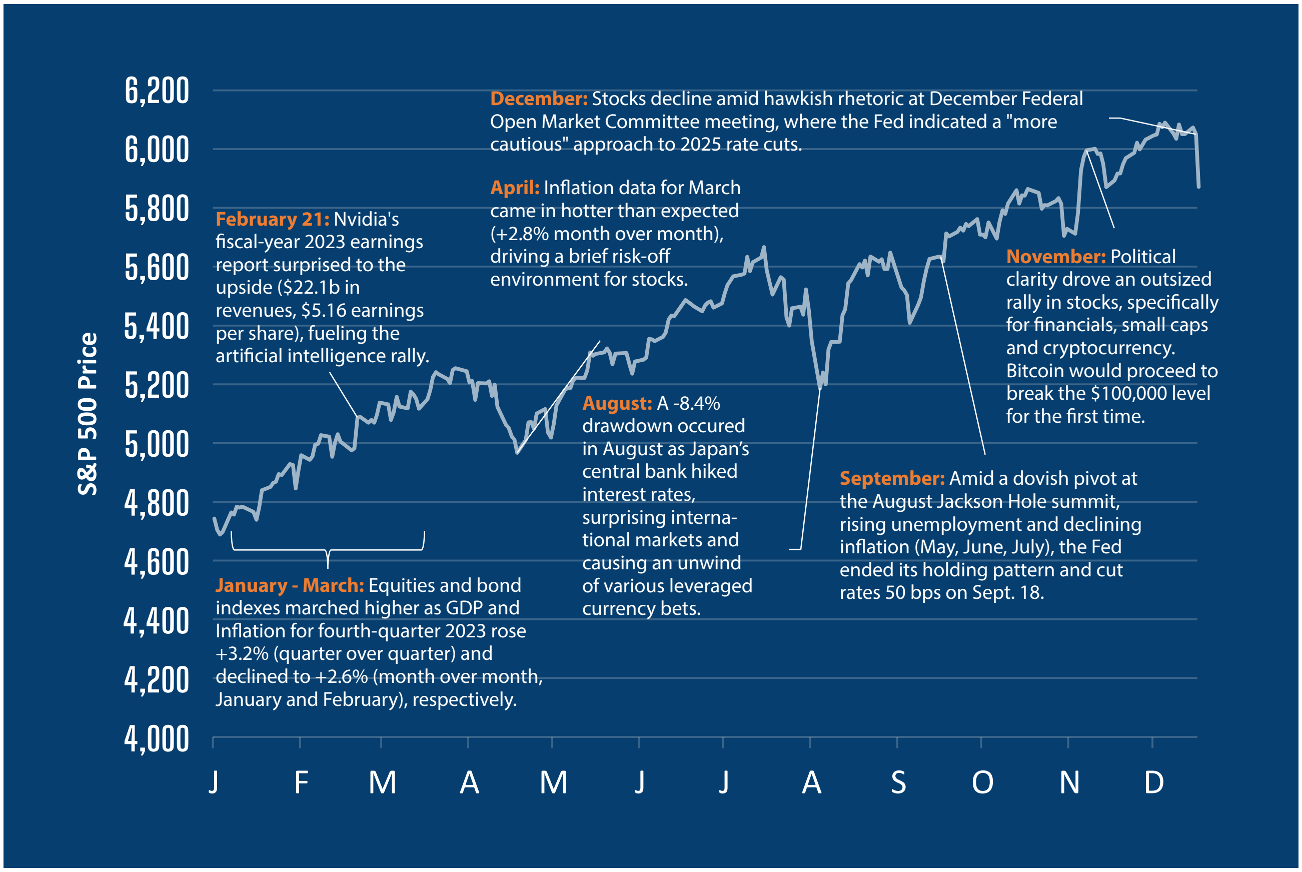
S&P 500 Events – 2024



Source: Morningstar Jan. 1, 2024 – Dec. 18, 2024

Investors shouldn't be overly optimistic that these 20% yearly returns will continue for a third consecutive year in 2025, however, as back-to-back years of returns at these levels are exceedingly rare. They have only happened three times in history: 1935-1936, 1954-1955 and 1995-1998. Equity returns are derived from three components—earnings growth, multiple expansion and dividends. This year the S&P 500 has seen a mix of all three with the most notable being multiple expansion. The median multiple for large-cap stocks over history is 16 times NTM (next 12 months) forward earnings. During the market low of October 2023, stocks were trading slightly above this at 17.3 times NTM earnings. Fast forward to today, the multiple has expanded 30% to almost 23 times NTM, which ranks in the 99th percentile of expensiveness relative to history. This leads us to believe that valuations will be a headwind next year with little room for expansion, while earnings growth will need to drive the majority of gains going forward.

The current setup of strong earnings growth and elevated valuations bears similarities to late 2021 and early 2022, when market exuberance pushed valuations ahead of fundamentals. However, 2021–2022 ultimately led to an earnings recession, marked by consecutive quarters of negative earnings growth and contributed to a nearly 25% market decline.

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In 2025, earnings across the broader market are expected to grow, but the challenge of navigating high valuations remains, which increases the risk of valuation compression. One risk we see in 2025 is the re-acceleration of inflation, causing the Fed to push out rate cuts or pause cuts all together. At the latest policy meeting, Fed Chairman Jerome Powell emphasized a "more cautious" approach to easing monetary policy in the future. This was reflected in the dot plot that showed a median projection of two cuts in 2024, down from the previously expected three cuts prior to the December meeting. Less clarity on what the Fed will do next year opens the door for more volatility and should bode well for defensive sectors like consumer staples, utilities and health care, which may offer more stability. These sectors are less sensitive to valuation pressures and trade at a discount to the overall market. Additionally, they provide consistency in earnings, making them attractive options for investors seeking to mitigate downside risk.

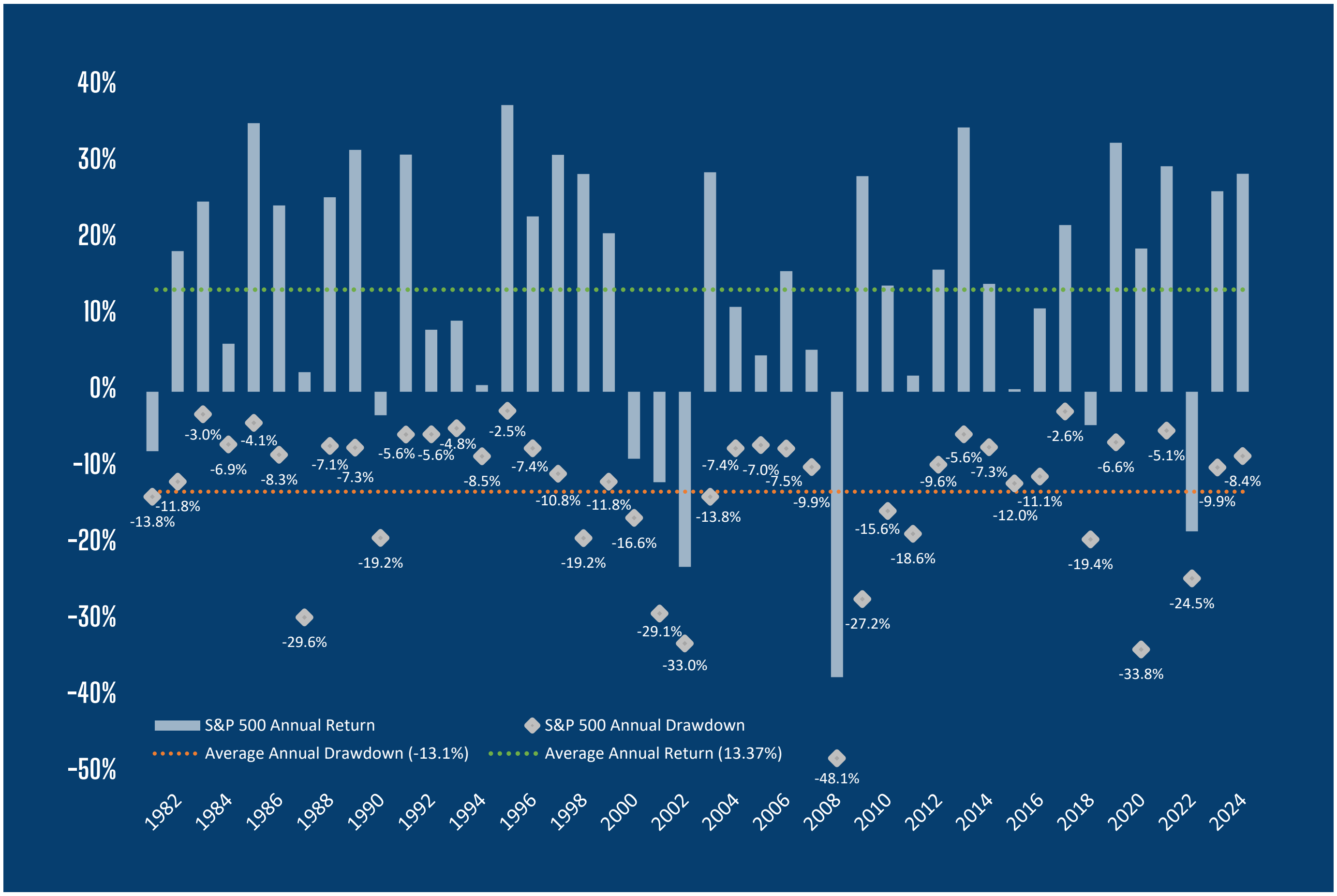
Additionally, mega-cap technology stocks—often referred to as the "Magnificent Seven" (MSFT, AMZN, META, AAPL, GOOG, NVDA and TSLA)—may serve as defensive plays during periods of heightened market volatility. These companies benefit from high liquidity, durable competitive advantages and robust earnings growth. While the law of large numbers suggests their earnings growth will moderate in 2025, it is still expected to remain roughly double that of the S&P 500, excluding the Magnificent Seven. According to UBS, consensus estimates for the Magnificent Seven are expected to decline from roughly 35% this year to 19.2% in 2025.

Looking at the setup for 2025, there are plenty of reasons to remain optimistic, such as an upbeat corporate profit growth, a healthy labor market and easier monetary policy—to name a few. Furthermore, the incoming administration's push for deregulation and a reduced corporate tax rate of 15% are expected to act as a tailwind for equity markets. This tax cut could provide a 2%-3% boost to earnings per share, with small and mid-cap companies benefiting more due to their higher domestic revenue exposure and limited international tax offsets. These factors collectively help explain why investors may be willing to pay up in price in the face of high stock valuations.

Additionally, it is common for equity valuations to overshoot during the later stage of a business cycle. Despite this playing out in 2024, market strategists are doubling down on stocks with the average S&P 500 price target set for 6500 by the end of 2025. Bullish investor sentiment can be attributed to consensus estimates for earnings growth in 2025 and 2026, which stand at 10.4% and 13.2%, respectively. This reflects an expansionary U.S. business cycle that is likely to support these above-average equity valuations.

As equities enter 2025 at elevated levels, it's essential to remember that pullbacks are a part of the long-term plan of investing. Look to take advantage of these drawdowns and add risk when they happen. Over the last 20 years, a decline of at least 10% happened 50% of the time, with the average pullback being 15%. The chart below shows the impact of these pullbacks, but also the market's ability to rebound by year-end.

S&P 500 Annual Returns and Drawdowns



Source: Morningstar Jan. 1, 2024 – Dec. 18, 2024

When looking at year-to-year performance, we think it's important to zoom out and keep it simple. One of the best ways to add value for long-term investors is to revisit their financial plan and goals in relation to time horizon. Time in the market prevails over trying to time the market. Wishing you a prosperous and successful year ahead—Happy New Year!

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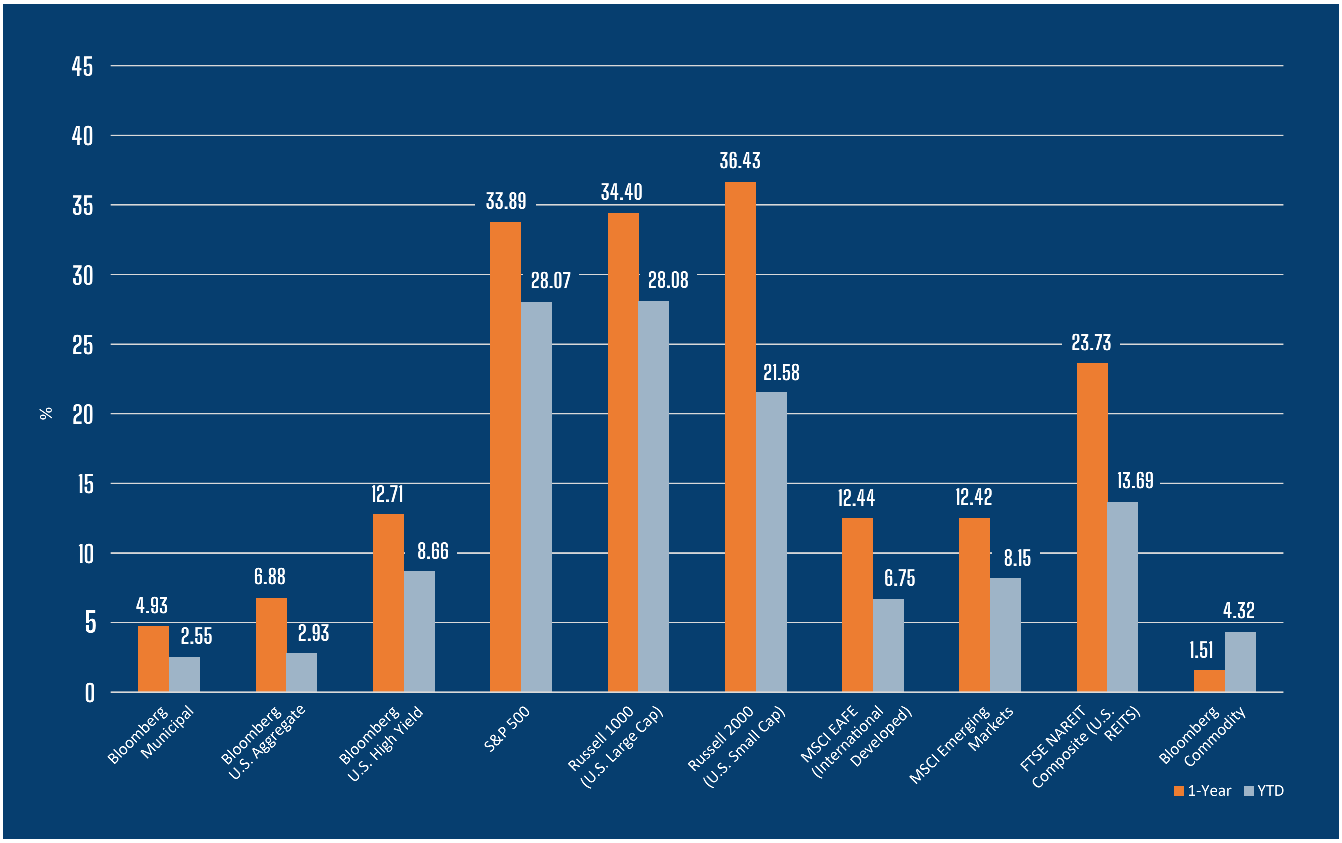
Asset Class Returns

Comparing Recent 1-Year and Year-to-Date Total Returns



As of November 30, 2024
Source: Conway Investment Research

Fixed Income

- After perhaps overshooting on the upside, U.S. Treasury and other sovereign debt yields fell in November, leading to gains in core fixed income and munis.
- Credit spreads tightened further on the heels of the strong rally in risk assets following the presidential election.
- Bonds outside the U.S. posted positive returns but were held back by the stronger U.S. dollar.

Equities

- U.S. equities raced higher in November once Donald Trump was declared the 47th President of the United States.
- Small caps were the real winners, and growth outperformed value across all market caps.
- U.S. equities have led the world again in 2024 and it is positive seeing the market broaden out over the past few months.
- Developed markets outside the United States exhibited broad weakness in November, largely due to the stronger U.S. dollar.
- Japan was positive although Europe and Asia were negative. Similar to the U.S., small caps beat large caps and growth beat value.
- U.S. dollar strength cost investors 114 basis points (bps) in EAFE markets and 347 bps in emerging markets.

Alternatives

- Hedge funds broadly gained 2.6% in November, led by solid gains across all major strategies. Equity long/short and event-driven led the way, but macro and relative value returned 1%-2% each.
- Real assets posted solid gains in November, led by strength in master limited partnerships, real estate investment trusts and listed infrastructure. Commodities were positive but lagged other real assets.

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November 29, 2024	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Bloomberg U.S. Treasury Bill 1-3 Month	0.39%	0.79%	4.90%	5.39%	3.84%	2.44%	1.71%
Bloomberg Municipal	1.73%	0.24%	2.55%	4.93%	-0.01%	1.35%	2.45%
Bloomberg US Govt/Credit Intermediate	0.34%	-0.23%	4.13%	5.38%	1.56%	1.58%	1.58%
Bloomberg U.S. Aggregate	1.06%	-1.45%	2.93%	6.88%	-1.95%	-0.01%	1.52%
Bloomberg U.S. High Yield	1.15%	0.60%	8.66%	12.71%	3.70%	4.72%	5.06%
Bloomberg Global Aggregate	0.34%	-3.02%	0.47%	4.64%	-3.87%	-1.42%	0.30%
U.S. Equity Indices							
DJ Industrial Average	7.74%	6.39%	21.21%	27.19%	11.44%	12.14%	12.17%
S&P 500	5.87%	4.91%	28.07%	33.89%	11.44%	15.77%	13.35%
NASDAQ Composite (Price)	6.21%	5.66%	28.02%	35.09%	7.34%	17.27%	14.90%
Russell 1000	6.44%	5.69%	28.08%	34.40%	10.89%	15.58%	13.16%
Russell 1000 Growth	6.49%	6.13%	32.19%	38.04%	10.92%	19.46%	16.55%
Russell 1000 Value	6.39%	5.22%	22.76%	29.56%	10.39%	10.84%	9.32%
Russell Mid Cap	8.82%	8.24%	24.07%	33.66%	7.77%	12.05%	10.45%
Russell 2500	9.84%	8.82%	21.12%	34.10%	6.24%	10.95%	9.85%
Russell 2000	10.97%	9.37%	21.58%	36.43%	4.96%	9.90%	9.05%
Russell 2000 Growth	12.26%	10.77%	25.42%	40.44%	3.25%	9.19%	9.34%
Russell 2000 Value	9.65%	7.93%	17.88%	32.55%	6.35%	9.93%	8.37%
Non-U.S. Equity Indices							
MSCI World	4.62%	2.57%	22.34%	28.39%	9.31%	12.96%	10.63%
MSCI ACWI	3.77%	1.48%	20.84%	26.68%	8.19%	11.88%	9.84%
MSCI ACWI Ex-U.S.	-0.89%	-5.70%	8.16%	13.62%	3.40%	5.92%	5.13%
MSCI EAFE	-0.55%	-5.95%	6.75%	12.44%	4.68%	6.40%	5.58%
MSCI EAFE Growth	-0.35%	-6.50%	5.25%	11.29%	0.05%	5.51%	6.14%
MSCI EAFE Value	-0.75%	-5.39%	8.35%	13.66%	9.34%	6.92%	4.78%
MSCI Europe	-1.66%	-7.44%	4.97%	10.23%	4.89%	6.87%	5.41%
MSCI Japan	0.66%	-3.26%	9.03%	13.81%	3.95%	5.70%	6.50%
MSCI AC Asia	-1.90%	-6.08%	11.11%	15.40%	0.93%	4.70%	5.40%
MSCI EAFE Small Cap	0.09%	-6.18%	4.70%	12.35%	-0.62%	4.10%	6.13%
MSCI ACWI Ex-U.S. Small Cap	-0.42%	-5.61%	6.08%	12.86%	1.12%	6.24%	6.19%
MSCI Emerging Markets	-3.58%	-7.75%	8.15%	12.42%	-0.82%	3.62%	3.56%
MSCI EM Asia	-3.70%	-7.96%	12.24%	15.94%	-0.79%	4.80%	4.97%
MSCI China	-4.43%	-10.08%	16.54%	13.73%	-7.74%	-2.25%	1.90%
MSCI EM Eastern Europe	-0.56%	-7.82%	-0.22%	6.66%	-35.80%	-21.35%	-7.23%
MSCI EM Latin America	-5.49%	-10.34%	-21.29%	-14.69%	6.87%	0.28%	0.41%
MSCI EM Small Cap	-2.20%	-6.19%	6.28%	11.05%	4.39%	10.59%	5.94%
MSCI Frontier Markets	-0.75%	-1.30%	9.70%	13.05%	-2.61%	3.00%	2.17%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	2.21%	1.84%	9.04%	11.71%	3.85%	3.80%	2.98%
Real Assets Indices							
FTSE NAREIT Composite	3.59%	-0.23%	13.69%	23.73%	1.26%	4.75%	6.62%
Alerian MLP	14.60%	13.07%	34.05%	31.13%	32.00%	19.23%	3.84%
Bloomberg Commodity	0.41%	-1.45%	4.32%	1.51%	4.91%	7.60%	0.38%
S&P Global Infrastructure	3.42%	2.10%	20.49%	25.61%	11.05%	7.16%	6.35%
Other							
Oil Price Brent Crude	0.50%	1.82%	-5.82%	-12.40%	0.93%	3.05%	0.37%
CBOE Market Volitility (VIX)	-41.67%	-19.25%	8.51%	4.57%	-20.80%	1.37%	0.13%

Source: Morningstar

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