Capital Market Outlook

Our Thoughts Are With You

The team at AMI extends our heartfelt condolences to all those affected by the recent devastating fires in Los Angeles and the surrounding areas. To our clients, friends, families, and neighbors, please know that we are here to provide support and help in any way we can during this challenging time.

Fourth Quarter 2024

The stock market, as defined by the S&P 500, rose 2.4% in Q4 and 25% for 2024. The S&P 500 is now up more than 53% from the end of 2022. The underlying themes remain the same: a less restrictive Fed against the backdrop of a moderate economy, and continued excitement around artificial intelligence. The outcome of the election was also widely cheered by investors welcoming a more business-friendly administration. We remain cautious on the outlook into 2025, especially considering the significant returns over the past two years. The gains in the stock market remain highly concentrated in just a few companies, and the S&P 500 is trading near a record high valuation. We continue to believe that equities remain the best place to invest for long-term gains, but we are approaching the current situation with prudence.

The outcome of the U.S. Presidential election in early November spurred a strong rally in stocks, with the S&P 500 up 2.5% on November 6, the day following the election, and the Russell 2000, an index of small caps, up close to 6%. The reasons for optimism are relatively clear: less regulation and a more business friendly environment that should be helpful for corporate earnings and thus the stock market. However, in our view the moves in certain stocks in response to the election were overdone, especially the moves in some of the big banks. In addition, there are some nuances in the policies of the new administration that could be negative for the economy and thus the stock market, namely curtailment of Government spending.

The Elon Musk-led Department of Governmental Efficiency (DOGE) has pledged to cut government spending, which generally is needed given the current near $2 trillion budget deficit and $1 trillion in annual interest payments. However, lower government spending and potential layoffs of government workers could be headwinds to economic growth in the near term, in our view. In addition, the administration's pledge to deport undocumented immigrants could be a headwind to certain sectors like homebuilding and food processing unless some sort of guest worker plan can be implemented. Tariffs, if designed as a bargaining tool and successful in creating a level playing field for global trade, could be a positive for U.S. based exporting companies. However, this could also raise prices further if companies pass along increases to consumers or if other countries retaliate and we end up in a trade war.

The labor market continues to look mixed, with signs of weakness lingering below headline numbers that have generally appeared decent. The October jobs number came in well below estimates, but this data was largely brushed off as the month was impacted by storms and labor strikes. November was better, and December was a blowout, at least on the surface, with the economy adding 256k jobs vs. the 165k estimate. However, the BLS survey has become a less reliable source for a true picture of employment. Response levels to the survey are at record low levels and while headline numbers may look good, investors rarely pay attention to the negative revisions. For example, the Q2 2024 headline jobs announcement amounted to over 600K jobs added but is now estimated by the Philly Fed to be revised negative based on State level data. In addition, many jobs created in 2024 were government and healthcare jobs, which is not indicative of a healthy job market and could be at risk with the incoming administration. In addition, the survey is designed so that if an individual is laid off from a full-time job and then takes on two part-time jobs, that is considered a net addition, a methodology that is inherently flawed. We suspect many people that lose their jobs are taking on multiple Uber, Doordash, Instacart, etc. jobs that can amount to higher pay than unemployment benefits.

The Fed continued to dial back its restrictive policy throughout the course of the quarter, cutting 25bps in both November and December, with the current policy rate set at 4.25-4.5%. However, inflation has remained stubbornly above the Fed's 2% target, with November CPI above 3% when backing out Food and Energy, and November PCE up 2.9%. As a result, when the Fed cut in December, Fed Chair Powell struck a decidedly hawkish tone, and the number of cuts forecast for 2025 was lowered from four to two. This shift was not well received by investors, leading to a sharp sell-off on the day of the Fed meeting. In fact, December 18 saw the largest surge in 10-year Treasury yields on a Fed Day since 2013 and the biggest drop in the S&P 500 on a Fed Day in over 30 years. Given the Fed's focus on inflation, it doesn't seem far-fetched to see the Fed hold rates steady for the first half of 2025, which would be a headwind for stocks.

The economy remains mixed, in our view, with the Fed projecting 2.1% GDP growth in 2025. November retail sales were somewhat weak when backing out new car sales, although consumers did spend on Black Friday and Cyber Monday as retailers enticed spending with significant discounts. Consumer confidence data has also been mixed, especially as inflation expectations moved higher throughout Q4. Services are still growing per ISM Services index, but Manufacturing, which makes up about 1/3rd of the economy, has been contracting for more than two years aside for one month. With rates likely to stay elevated into 2025, new housing construction could come under pressure as new housing starts have been on a consistent down trend throughout all of 2024, which could be a significant hindrance to growth and start to have an impact on employment.

A more hawkish Fed, the prospect of pro-growth policies from the incoming administration, and concerns about the Federal deficit, all combined to push yields materially higher, with the 10-yr hitting 4.7% in early January. Elevated yields combined with elevated valuations create a substantial risk for stocks in 2025. Estimates call for S&P 500 earnings to grow 10% in 2025 and accelerate to 13% growth in 2026 and while these numbers could be achievable, the question becomes whether that type of earnings growth can really justify what investors are being asked to pay for stocks, especially with the

concentration in the market. Currently, the largest 10 stocks in the S&P 500 make up close to 40% of the total market cap of the index, a level of concentration not seen since immediately before the start of the Great Depression.

Looking forward, we remain bullish on U.S. equities for the long-term but we remain cautious in the near term given elevated valuations, security concentration, and an uncertain outlook for the economy in 2025. The darlings of the stock market can quickly lose their luster, and we continue to focus on companies that we believe have more durable and proven business models. While Consumer Staples and Health Care have been some of the biggest laggards in the market over the past two years, the underlying stability of demand for these products and services as well as undemanding valuations make them an exciting place to invest entering 2025 in our view. At AMI, we continue to focus on the long-term, staying disciplined and not chasing the market, with the underlying goal of performing in all business cycles.

Sincerely,

Your AMI Investment Management Team

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