Equities Produce Another Strong Year - Despite Cool December

Quarterly Insights

The S&P 500 rose to an all-time high in the fourth quarter and extended 2024 gains as the election results raised expectations for tax cuts and other pro-growth policies in 2025. Most importantly, the economy remained on solid footing and the Fed continued to cut interest rates – driving the S&P 500 to double digit annual returns for the second straight year.

While the fourth quarter was positive for most of the market, it did not start that way, as anxiety over the election and an increased focus on the fiscal state of the US weighed on sentiment in October. Presidential polls tightened materially in October and left the race too close to call, increasing political and policy uncertainty. Additionally, much of the financial media's focus in October was on the potentially negative fiscal consequences of both candidates' policies. The fiscal concerns, along with stronger-than-expected economic data, pushed Treasury yields higher and the 10-year Treasury yield rose from 3.75% at the start of October to over 4.20% by Halloween. This rise in yields, combined with policy uncertainty, pressured stocks and the S&P 500 finished October with a modest decline, falling -0.91%.

Those headwinds on stocks were short-lived, as Donald Trump won re-election while Republicans took control of both houses of Congress, completing a "Red Sweep." Reminiscent of 2016, the Trump and Republican victories proved to be bullish catalysts as investors embraced the idea of future tax cuts, deregulation, and a pro-business administration. That helped the S&P 500 rise above 6,000 for the first time. However, shortly following the election, investors were reminded of the volatile nature of the first Trump presidency. President-elect Trump nominated several unorthodox supporters to prominent cabinet positions. These surprises caused investors to contemplate policy risks to the pro-growth agenda and stocks dipped mid-month. The withdrawal of Attorney General nominee Matt Gaetz and the nomination of Scott Bessent as Treasury Secretary helped calm investor nerves about the president-elect's cabinet, and stocks resumed their rally in late November.

In December, renewed focus on the potential economic benefits of an incoming Trump administration, combined with the "Goldilocks" economic environment sent the S&P 500 to yet another all-time high near 6,100. The rally stalled mid-month as President-elect Trump doubled down on his support for other unorthodox cabinet nominees and lobbed tariff threats at major trade partners including Canada, Mexico, and China. Market volatility increased as the Federal Reserve cut interest rates at the December meeting and reduced the number of expected cuts in 2025 from four to two. This sparked a sharp sell-off in stocks that continued into year-end, causing the S&P 500 to finish well off its highs.

In summary, 2024 was a very strong year for the broad markets as the Fed seemingly achieved a soft economic landing and aggressively cut interest rates, while foreign and domestic political risks and drama failed to derail the rally.

Fourth Quarter and 2024 Performance Review

The Nasdaq was the best performing major index in the fourth quarter and outperformed the other major indices on a combination of earnings-driven artificial intelligence ("AI") enthusiasm and future pro-growth economic policies. For the full year, the Nasdaq was also the best performing major index although it only

slightly outperformed the S&P 500, as that index benefitted from the large weighting to tech stocks and financials.

By market capitalization, large caps outperformed small caps in the fourth quarter and for the full year, thanks mostly to strength in large-cap tech stocks on the aforementioned AI enthusiasm and strong earnings. Small caps did see a solid rally initially in the fourth quarter on hopes for pro-growth policies from the incoming administration, but the Fed's guidance to fewer rate cuts in 2025 weighed on small caps later in December and the Russell 2000 index finished the quarter with only a slight gain.

Foreign markets badly underperformed the S&P 500 in the fourth quarter and produced solidly negative returns thanks to lackluster growth prospects and surprising bouts of political uncertainty in developed and emerging markets. For the full year, foreign markets again lagged the domestic equity market, but did finish modestly positive. Emerging markets outperformed developed markets on a full-year basis thanks to Chinese stimulus announcements in the second half of 2024.

US Equity Indexes	Q4 2024	2024 Total Return
S&P 500	2.39%	25.00%
S&P 500 Equal Weighted	-1.89%	12.98%
DJ Industrial Average	0.93%	14.99%
NASDAQ Composite	6.36%	29.60%
Russell 2000 (Small Cap)	0.33%	11.53%
MSCI EAFE (International Developed)	-8.06%	4.43%
MSCI Emerging Markets	-7.85%	7.97%

Source: Bloomberg Professional (12/31/2024)

On a sector level, only four of the 11 S&P 500 sectors finished the fourth quarter with a positive return, although all sectors ended 2024 with gains. The Consumer Discretionary sector was, by far, the best performing sector in the fourth quarter thanks in large part to a big Tesla (TSLA) rally post-election. The Communication Services and Financials sectors also performed well and benefited from expectations for less regulation with the incoming administration. For the full year, Communication Services and Financials were the best performing sectors and both benefited from strong earnings as well as general AI enthusiasm. Financials also benefited as Treasury yields increased and the yield curve uninverted.

US Bond Indexes	Q4 2024	2024 Total Return
Bloomberg US Aggregate Bond	-3.06%	1.25%
Bloomberg US T-Bill 1-3 Month	1.19%	5.32%
ICE US T-Bond 10-20 Year	-7.67%	-3.96%
ICE BofA US High Yield Index	0.16%	8.22%

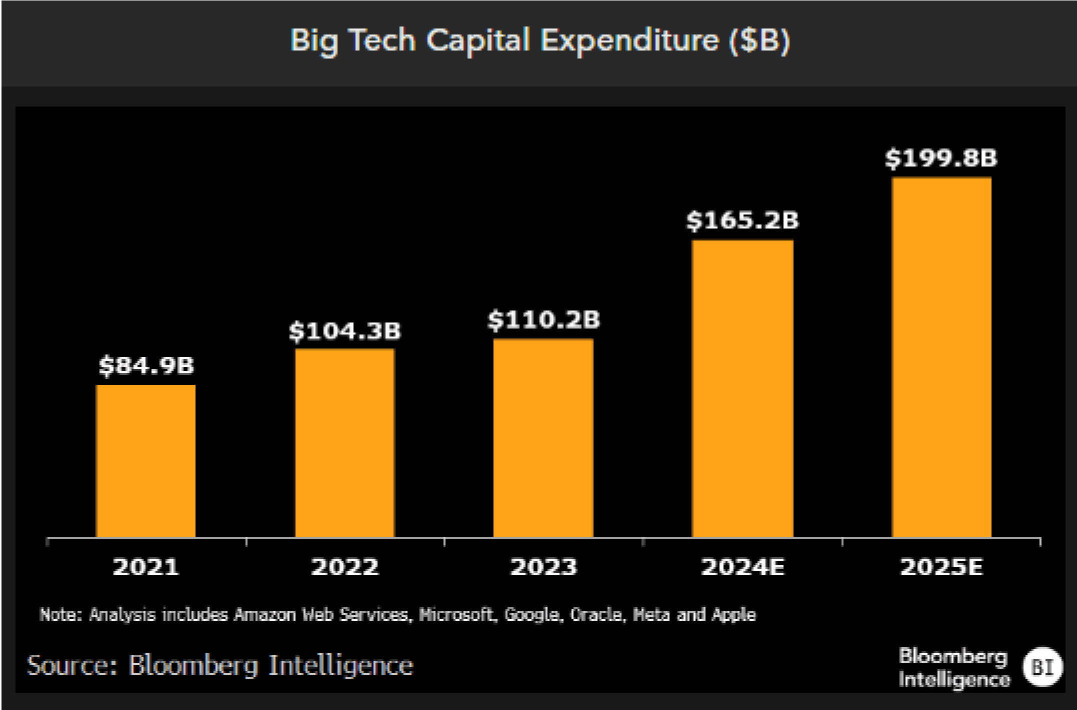
Source: Bloomberg Professional (12/31/2024)

Regarding fixed income, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized a moderately negative return in the fourth quarter. Concerns about U.S. federal deficits combined with expectations for fewer rate cuts in 2025 pressured bonds, although the benchmark did log a slightly positive gain for 2024. Longer-duration bonds declined solidly in the fourth quarter while shorter-duration debt logged a small positive return. The outperformance by shorter-duration debt was driven by continued Fed rate cuts as well as more resilient inflation and growth metrics – both metrics pressured longer-duration debt. Regarding corporate bonds, high-yield bonds outperformed higher-quality but lower-yielding investment grade debt in the fourth quarter as the election results boosted investor confidence for continued economic growth, resulting in investors accepting higher yields in exchange for greater risk.

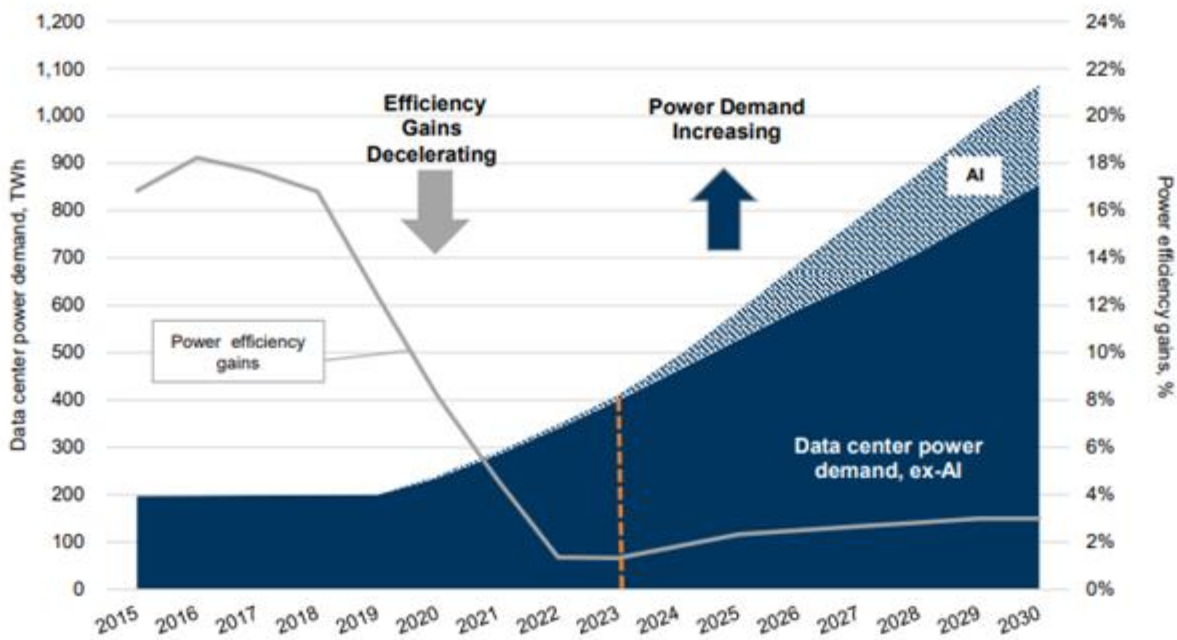
Sidebar: Thoughts on AI

We live in the era of technological innovation. As time goes by, modern civilization will less and less resemble the conditions of our ancestors, grandparents, or our parents. In the past, our greatest advances were industrial technology such as the railroads, electricity, the telegrams, commercial airplanes, and the atom bomb. Today, the greatest advances are in communication technology. At the core of this ongoing technological advancement is AI – Artificial Intelligence!

AI has had many various cycles throughout history, starting with its formal naming at the Dartmouth Conference in 1956 by John McCarthy. AI has also gone through several boom-bust cycles since the 1950s. The current age of AI began approximately in spring 2023 with the release of large language models ("LLMs") and ChatGPT. It was at this point that the AI buildout cycle began. The AI buildout consists of new datacenters – a warehouse full of computer servers -- in addition to an upgrade of older data centers. The AI spending cycle is primarily focused on the acquisition of Nvidia graphic processing units ("GPU"). Nvidia GPUs have been the biggest winner in this capital expenditure cycle, along with ancillary purchases in real estate construction, power generation, liquid cooling for servers, and numerous other data center components. Capital expenditures, commonly called CapEx, for Amazon, Microsoft, Google and other hyperscalers increased by approximately 50% or approximately $50 billion in 2024, and it is estimated to broach $200 billion in 2025.



AI will also bring other notable changes to our economy. Within the buildout of datacenters, one of the biggest structural changes is grid power demand. Grid power demand has been effectively flat over the past 20 years. AI may change this fact. With the buildout of GPUs, power demand for data centers has and will increase substantially.



Source: Masanet et al. (2020), Cisco, IEA, Goldman Sachs Global Investment Research

2025 Outlook

Markets begin 2025 with great expectations about the incoming administration. Politically, investors are eagerly awaiting the implementation of pro-growth policies, which includes an extension of the 2017 Tax Cuts and Jobs Act. This includes hopes of additional corporate and personal tax cuts, along with sweeping deregulation. If executed, those policies could result in increased corporate earnings, personal incomes, and spending - all of which are positive for stocks.

Regarding growth, the Federal Reserve appears to have achieved the elusive economic soft landing as economic activity is solid, unemployment is historically low, and inflation has declined substantially. That has allowed the Fed to aggressively cut interest rates in 2024 and investors expect the rate cut cycle to continue in 2025, albeit more modestly than previously anticipated.

Finally, geopolitical tensions remained high in 2024, but investors finished the year with hopes for progress on ceasefire agreements between Israel and its antagonists Hamas and Hezbollah, and between Russia and Ukraine. If all these expectations are realized, we should expect another positive year for markets.

As we all know, nothing in the financial markets is guaranteed. While the outlook is positive as we begin 2025, there are significant risks to the outlook we must acknowledge. In Washington, Republicans hold small majorities in the House and Senate and large, complicated tax cut bills could easily be delayed or derailed. Additionally, while investors have focused on potential positives of pro-growth policies, increased trade tensions and possible tariffs could create unanticipated market and economic headwinds.

Presently, the economy remains in a “sweet spot” with solid, but not spectacular, growth. However, growth can still slow as rates remain higher than recent historical norms and elevated stock valuations imply contentment in the capital markets. Additionally, global bond markets are anticipated to have a larger influence on stock returns in 2025. If bond vigilantes think aggressive tax cuts or fiscal spending will dramatically increase the deficit or national debt, bond yields will likely rise and present a headwind for stocks.

While the market outlook is positive to start the year, we will not allow that to create a sense of complacency. As the past several years have shown, markets and the economy do not always perform according to Wall Street’s expectations. As such, while we are prepared for the positive outcome currently expected by investors, we are also focused on managing both portfolio risk and return potential. The past several years have demonstrated that a well-planned, long-term focused and diversified investment portfolio can withstand virtually any market surprise and related bouts of volatility - including multi-decade highs in inflation, massive Fed rate hikes, and geopolitical unrest.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment. Please do not hesitate to contact us with any questions, or to schedule a portfolio review.

Sincerely,

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