Q4 2024 Quarterly Review & 2025 Outlook

January 2025

ELEMENT	TREND	COMMENTS
VALUATION	Negative	Valuations are higher, certainly for the largest companies.
INTEREST RATES	Negative	Besides short-term rates, interest rates have been rising sharply.
INFLATION	Neutral	Inflation is much lower but still slightly above benign levels.
VOLATILITY	Neutral	Price volatility has been creeping higher.
MONETARY POLICY	Positive	The Fed will likely continue cutting rates, but the pace is unclear.
DOMESTIC POLICY	Positive	Domestic economic policy now seen as decidedly pro-business.
GEOPOLITICAL	Neutral	Conditions favorable, though tariffs likely to impact global trade.

A Complete Unknown

One does not have to be a music lover to appreciate the Bob Dylan biopic film *A Complete Unknown*, released in late December. Besides the remarkable performances by Timothée Chalamet, Ed Norton and others, the movie offers a fun if fabled portrayal of Greenwich Village in the 1960s and, by extension, a portrait of America six decades ago during a time of particularly acute upheaval. While Dylan and Joan Baez roam the Village, the Cuban Missile Crisis erupts, President Kennedy is assassinated and the civil rights movement shakes the country to its foundation. There's a lot going on. Of course, Dylan's music stars, and it's gratifying to watch the world discover it.

What's also rewarding for viewers is just seeing New York, and the country, as it was back then. The street names are the same, sure, but one can't help but observe how much the city, and the country, has changed. Dylan's MacDougal Street looked like a block in a small town compared to the city streets of today. On the other hand, some aspects of New York were readily recognizable—pretentious patrons, opportunistic agents and young people generally striving to make something of themselves. While places change, human nature stays the same.

Speaking of staying the same, the fourth quarter closed out another extremely impressive year in the financial markets. While most equity indices were lower in December, quarterly performance, at least in the U.S., was still mostly positive, due in large part to November's large market gains. Large-cap growth again led the equity markets higher, while small-cap strategies surrendered November's gains. Even ending on a bit of a sour note, 2024 was another year of extraordinary market performance, with the S&P 500 up 25%. Globally, stocks were up 17.5%. The S&P 500 returned more than 50% between the end of 2022 and the end of 2024, making the last two years one of the best such periods in market history.

Global Equity Index Performance

	2023	1Q24	2Q24	3Q24	Oct.	Nov.	Dec.	4Q24	2024
MSCI All Country World	22.2	8.2	2.9	6.6	-2.2	3.7	-2.4	-1.0	17.5
S&P 500	26.3	10.6	4.3	5.9	-0.9	5.9	-2.4	2.4	25.0
DJIA	16.2	6.1	-1.3	8.7	-1.3	7.7	-5.1	0.9	15.0
NASDAQ	44.7	9.3	8.5	2.8	-0.5	6.3	0.6	6.4	29.6
Russell 2000	16.9	5.2	-3.3	9.3	-1.4	11.0	-8.3	0.3	11.5
Russell 2000 Value	14.6	2.6	-3.7	10.1	-1.5	9.7	-8.5	-1.1	7.6
Russell 2000 Growth	18.5	7.5	-2.9	8.4	-1.3	12.5	-8.4	1.7	15.0
Russell 3000	25.9	10.0	3.2	6.2	-0.7	6.7	-3.1	2.6	23.8
Russell 3000 Value	11.6	8.6	-2.3	9.5	-1.1	6.5	-6.9	-2.0	14.0
Russell 3000 Growth	41.2	11.2	7.8	3.4	-0.4	6.8	0.4	6.8	32.4
International*	15.6	4.7	1.0	8.1	-4.9	-0.9	-1.9	-7.6	5.5

Source: Bloomberg
*MSCI ACWI ex USA Net Total Return USD Index

Of course, much of these gains are directly attributable to the continued outperformance of a handful of extremely large technology companies, blessed not only with astonishing current profitability but impressive prospects for future earnings growth. Like Bob Dylan's controversial set at the Newport Folk Festival in 1965, this market seems to have gone electric, leaving traditional valuations and expectations in the dust. Is this market A Complete Unknown? Maybe not, but it is definitely not exactly the same.

For the times they are a-changin'

There are some good reasons to believe this historic rally can continue. A new, business-friendly administration with an eye for deregulation and lower taxes seems like a great backdrop for continued market gains as AI unlocks a new wave of productivity and profitability for businesses around the world. There are also strong reasons to believe that 2025 could be a more challenging year in the markets. Sky-high valuations have raised the bar so high for corporate earnings that it doesn't take Bob Dylan's imagination to envision a scenario in which earnings growth disappoints and stock valuations fall back to earth. The S&P 500 now trades at more than 21x forward earnings, far higher than its average over the last 30 years of just less than 17x.

S&P 500 Valuation Measures

Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since February 1999 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $245. Average P/E and standard deviations are calculated using 30 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 30 years for each measure. *Averages and standard deviations for dividend yield and P/CF are since November 1995 due to data availability.

Guide to the Markets – U.S. Data are as of January 2, 2025.

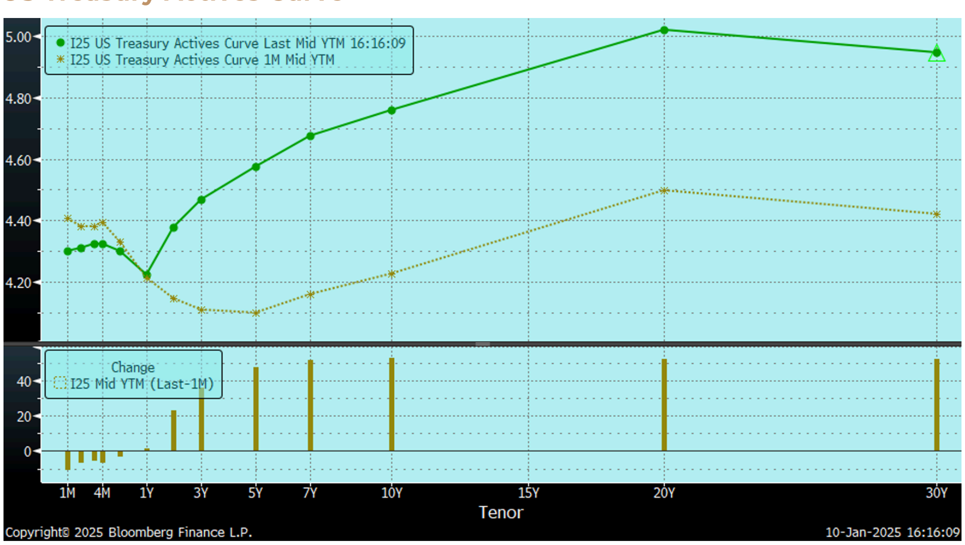
The point is, if the rally continues, it will mark a continued departure from historical norms, and if it falters, then it will mark a departure from the rosy outcomes investors have enjoyed for the last two years. Either way, we seem poised for a season of change.

One change in the financial markets has become increasingly difficult to ignore, and that is the level of interest rates. At the beginning of 2022, the Fed began the most significant rate hike campaign in decades, raising short-term rates from zero to 4.5% by the end of the year in response to post-pandemic inflation that reached 9%. A new era of much higher interest rates seemed to be upon us; famed value investor Howard Marks wrote a notable memo about this called A Sea Change, in which he noted that equity-like returns were becoming available in bonds. However, these higher rates remained limited to the extreme short-end of the yield curve; while higher Fed Funds rates seemed to help dampen inflation and slow the economy, the curve remained highly inverted. Fast forward two years, however, and Marks' Sea Change is becoming a reality. Ironically, just as the Fed finally began to lower short-term interest rates, longer-term rates took off. Since the Fed's 50-point rate cut in September, longer-term rates have jumped by more than 100 basis points.

Why is this happening, and why does it matter? The market seems to be assigning a higher risk rate to the future, whether due to the possibility that inflation could reignite or that increased protectionism could have unexpected impacts on the global economy. It matters because as interest rates rise, investors demand higher returns from all financial assets. If a 20-year Treasury bond is yielding 5%, as it is today, that means other assets of similar duration need to have a yield higher than 5% to be competitive, and while 5% certainly is not historically high, it is a lot higher than what we have seen for the last few years.

One can see the dramatic change in forward rate expectations just in the last month in the chart below.

US Treasury Actives Curve



Source: Bloomberg

Warren Buffett likes to compare interest rates to gravity; higher rates are like stronger gravity; they exert some control over asset prices and keep them from flying away.

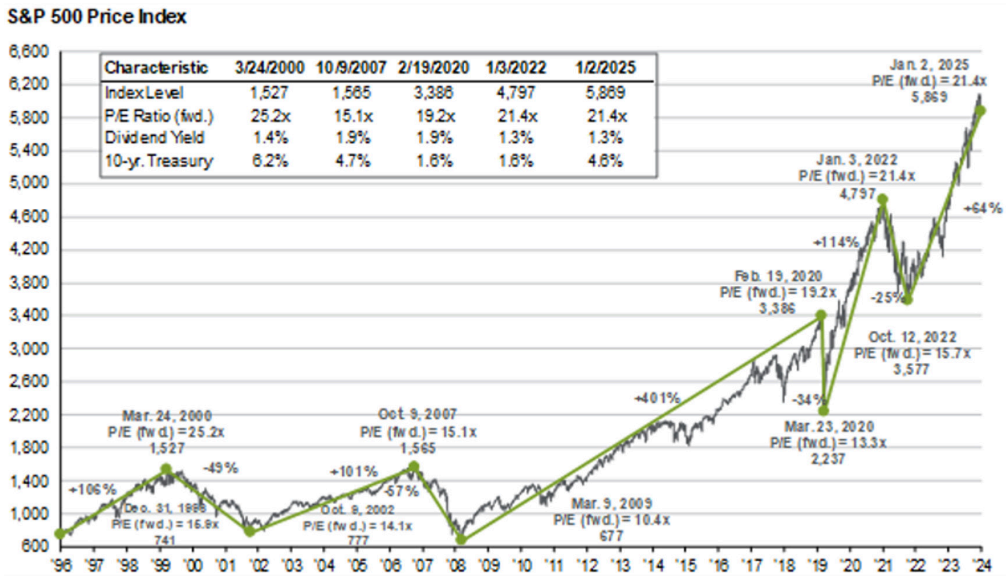
If this environment persists, we would expect slower economic growth, and we would expect companies that use debt, such as many smaller ones, to be more impacted than larger, unleveraged companies. The market seemed to agree with this position in December, as shares of smaller companies gave back much of the gains they enjoyed in the November "Trump rally," and large companies with little debt, such as the Magnificent Seven, outperformed.

On the other hand, we would also expect higher-valuation (i.e., more expensive) stocks to be more impacted by higher interest rates than lower-valuation (i.e., less expensive) stocks because their stock prices are less attractive on a risk/reward basis.

"Businessmen, they drink my wine, plowmen dig my earth
None of them along the line know what any of it is worth"

We've written on numerous occasions about how expensive the S&P 500 Index has become. A slightly more nuanced take is that it's really just a handful of super-pricey stocks with colossal market capitalizations that are distorting the price of the index, but either way, the index is rich by historical standards. What makes this particularly important now is not just that the index is expensive on absolute terms but that it is even more expensive versus bonds, which have sold off as interest rates have risen. Consider the chart below. If we think of the price/earnings ratio in yield terms, the same way we think of bonds, a 21.4 P/E works out to an earnings yield of 4.7% (1/21.4 = 4.67%). That just happens to be right on top of the 10-year Treasury yield of 4.6%. So, an investor can now earn almost the exact same yield on a riskless 10-year Treasury as they can earn on the S&P 500. Of course, an equity investor is anticipating earnings growth, and one can argue that earnings yield is already inflation-adjusted, so it's not a perfect comparison. However, as a sanity check, the large-cap stocks of the S&P 500 look particularly expensive compared to Treasuries and, by extension, to bonds in general at the moment. Ordinarily, one would expect earnings yields to be higher than Treasury yields, given that corporate earnings are not contractually guaranteed, unlike fixed interest income. **Earnings yields (again, which are simply P/E ratios, just inverted)** have been higher than Treasury yields going back to the year 2000 when earnings yields were actually inside of Treasury yields. That condition did not last long, as the S&P 500 languished for a decade.

S&P 500 Inflection Points



Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management.

Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.

Guide to the Markets – U.S. Data are as of January 2, 2025.

Shelter from the storm

Regrettably, we do not possess Bob Dylan's gift for observation, so we are not in a position to make a radical market call about some kind of impending sell-off. Furthermore, while we talk a lot about the S&P 500, it's just because of its popularity, not because it represents our entire opportunity set. Our portfolios are designed to reflect global asset allocation opportunities, so we normally use a global benchmark for client accounts. This perspective, and the global diversification that comes along with it, supports our ability to ride out occasional storms, whenever they happen to occur. We do not need to make wholesale changes to client portfolios; they already reflect an expectation that we live in a world of constant change and periodic rough weather. While the S&P 500 may have grown more expensive and vulnerable, our portfolios, generally speaking, have not followed that trend. We have continued to employ a margin of safety by adhering to a value discipline. Will 2025 be a year when maintaining a strict value and quality discipline compares favorably to going with the flow? We do not know. But what we believe is that owning shares of thousands of businesses all over the world and being careful not to overpay for a single one of them is a great way to build and preserve wealth over the long term.

We are by no means hoping that a hard rain is going to fall; it's just that we are not overly concerned about the weather. While it may be that "you don't need a weatherman to know which way the wind blows," we have been carrying around an umbrella for years.

The Times They Are A-Changin'

Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone
If your time to you is worth savin'
Then you better start swimmin' or you'll sink like a stone
For the times they are a-changin'

Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin
And there's no tellin' who that it's namin'
For the loser now will be later to win
For the times they are a-changin'

Come senators, congressmen
Please heed the call
Don't stand in the doorway
Don't block up the hall
For he that gets hurt
Will be he who has stalled
There's a battle outside and it is ragin'
It'll soon shake your windows and rattle your walls
For the times they are a-changin'

Come mothers and fathers
Throughout the land
And don't criticize

What you can't understand
Your sons and your daughters
Are beyond your command
Your old road is rapidly agin'
Please get out of the new one if you can't lend your hand
For the times they are a-changin'

The line it is drawn
The curse it is cast
The slow one now
Will later be fast
As the present now
Will later be past
The order is rapidly fadin'
And the first one now will later be last
For the times they are a-changin'

For more information, please reach out to:

M. Burke Koonce III
Investment Strategist
bkoonce@trustcompanyofthesouth.com

Daniel L. Tolomay, CFA
Chief Investment Officer
dtolomay@trustcompanyofthesouth.com