TRUSTPOINT

Issue No. 48

# MARKET POINT

Fourth Quarter of 2024

*Quarterly Economic and Market Commentary by the Trust Point Investment Team*

## An Overview of the Fourth Quarter of 2024

This quarter, markets once again demonstrated resilience. Stocks benefited from continued interest in growth companies exposed to artificial intelligence, while bonds provided stability, even as the Federal Reserve adjusted its rate-cut trajectory. Read on to explore how these factors are shaping portfolios and the economic outlook for 2025.

For more information, scan this QR code or visit **www.trustpointinc.com/market-point/**.

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# An Economic and Market Update from Trust Point

TRUSTPOINT

Q4 2024

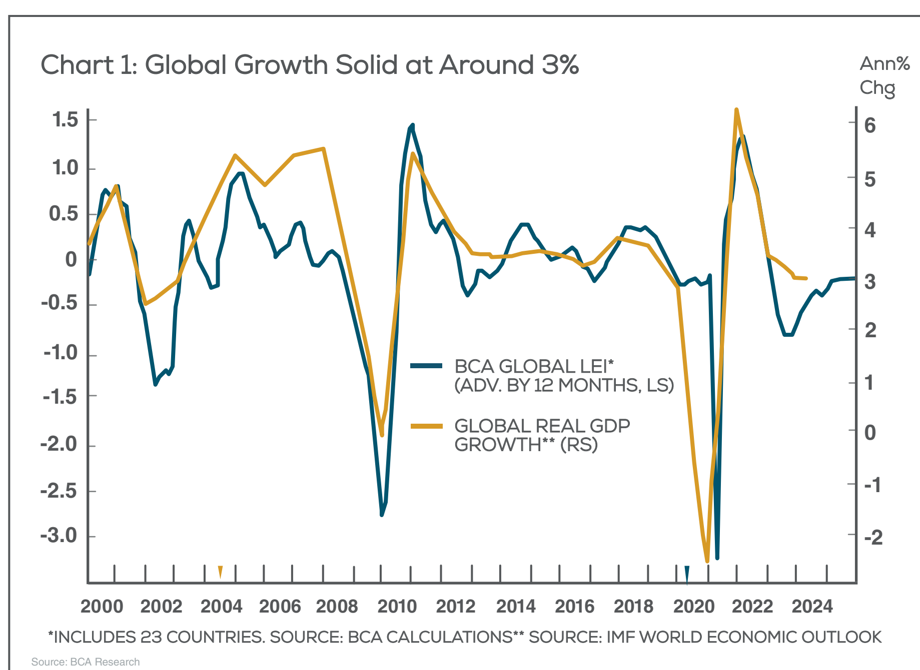
The world economy, led by the U.S., showed economic resilience all year. As a result, equity markets surprised on the upside while bonds only posted small gains. This past quarter, investors' attention was clearly on the U.S. election. A Republican-led Congress suggests potential shifts in policies that could influence a number of sectors and regions. Investors will also have to pay attention to growth, monetary policy adjustments, corporate profitability, geopolitical risks, inflation, and other factors in the year ahead.

| KEY ECONOMIC DATA | As of | Actual | 3 Mos. Ago | 1 Year Ago |
|---|---|---|---|---|
| Dollar Index Level | Dec | 108.5 | 100.8 | 101.3 |
| ***US Economic Activity*** | | | | |
| ISM Manufacturing (>50 = Expansion) | Dec | 49.3 | 47.2 | 47.1 |
| ISM Non-Manufacturing (>50 = Expansion) | Dec | 54.1 | 54.9 | 50.5 |
| Non-Farm Payrolls | Dec | 256k | 255k | 290k |
| Unemployment Rate | Dec | 4.1% | 4.1% | 3.8% |
| CPI Ex-Food & Energy (yoy) | Nov | 3.3% | 3.2% | 4.0% |
| ***Global Economic Activity*** | | | | |
| JP Morgan Global Manufacturing Index (>50 = Expansion) | Dec | 49.6 | 48.7 | 49.0 |
| JP Morgan Global Services Index (>50 = Expansion) | Dec | 53.8 | 52.9 | 51.6 |

Source: Bloomberg

## "U.S. Exceptionalism" on Display

Recent data strongly suggests that the world economy is steering towards a soft landing, avoiding a recession (Chart 1). Central banks are also cutting rates, signaling a shift from restrictive to neutral monetary policy. In most economies, inflation has moved lower after peaking in 2022 (Chart 2) and is slowly approaching central banks' targets, an important catalyst allowing for easier monetary policy. While most countries have experienced similar disinflationary trends over the past couple years, trends in economic growth have, however, diverged greatly. In the U.S., strong consumer and fiscal spending have been the main catalysts for growth. In Europe, however, political instability and geopolitical tensions have been important headwinds, while China has also largely underwhelmed investors' expectations due to a struggling housing market and a rapidly aging population. The legacy of the "one-child policy" in China has resulted in a shrinking workforce, which has put a strain on social security programs. More recently, these issues have also been exacerbated by persistent inadequate stimulus measures that have neglected more direct support for consumers.

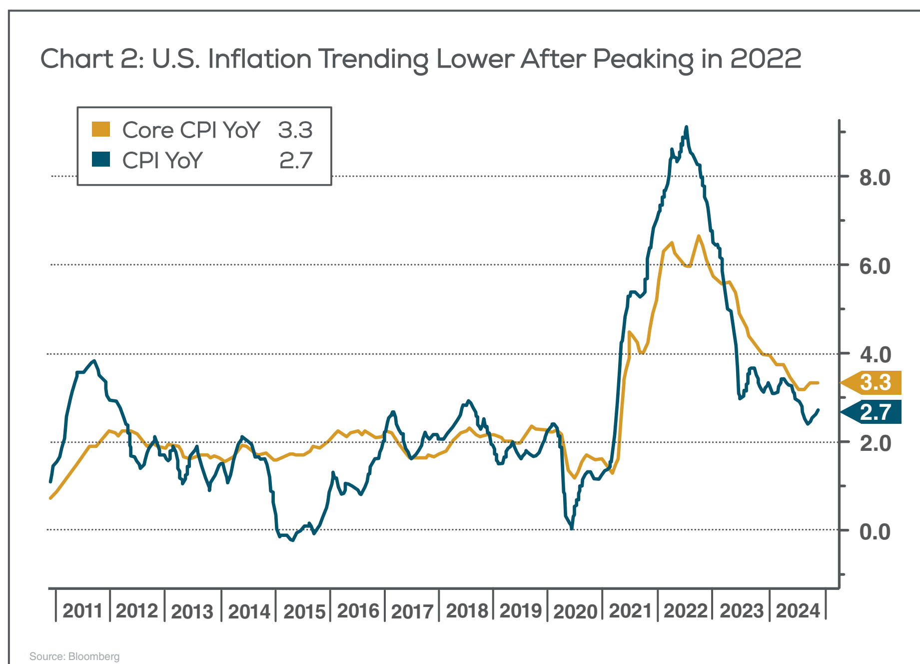


Source: BCA Research

## Trump's Policy Priorities and Their Potential Impact on Growth and Inflation

Much has been written over the past few months about the potential impact of the recent U.S. presidential election on the economy and markets. The table presented in Chart 3 summarizes the potential effects of four main policy proposals. Regarding tax cuts, we believe that expectations should be somewhat tempered given the fact that Republicans only have a small majority in the House, and many House Republicans have ongoing concerns about the debt/deficit. On deregulation, tariffs and deportation/anti-immigration, however, we recognize that the President alone has greater authority to make changes. Therefore, investors should expect some action in these areas as we move into 2025. As the table indicates, some of the proposed policies could stimulate growth and investment, while others might act as headwinds, increasing uncertainty and slowing growth. On the inflation front, most proposed policies appear to be inflationary. Given that inflation was one of the main concerns for voters leading up to the election, the Trump administration will have to carefully consider the potential negative impact of these policies on prices and voter sentiment.

Chart 2: U.S. Inflation Trending Lower After Peaking in 2022




Source: Bloomberg

## Extending Goldilocks

In October, changes were made to portfolios. Our allocation to U.S. mid- and large-cap stocks was increased at the expense of longer-duration bonds, which are more negatively impacted by higher inflation expectations. From an asset allocation standpoint, we are currently slightly overweight stocks relative to bonds. Strong corporate profitability, along with global monetary easing, is expected to support continued growth in equity markets in the coming quarters. By many measures, equities seem richly valued, but the reality is that overvaluation is mostly concentrated in the U.S large-cap growth space, where many of the companies at the forefront of artificial intelligence reside. To be fair, we continue to believe that bonds also offer attractive potential returns as real yields (the yield earned after accounting for inflation) are still historically high. In fact, when analyzing future expected returns from bonds relative to stocks, we conclude that the gap in return expectations between stocks and bonds has significantly narrowed in recent years, a positive attribute for investors looking to capture returns from a diversified portfolio of both stocks and bonds.

Chart 3: Main Policy Proposals and Potential Impact on Growth and Inflation

| | Economic Impact | |
|---|---|---|
| **Policy** | Growth | Inflation |
| Tax Cuts | UP | UP |
| Deregulation* | UP | – |
| Tariffs* | DOWN | UP, then DOWN |
| Deportation/Anti-Immigration* | DOWN | UP |

**Areas where the President alone has more authority to make changes*

Source: Trust Point

# An Equity Market Update from Trust Point

TRUSTPOINT

Q4 2024

Continued strong equity market returns have pushed market valuations higher, approaching their recent peaks of the last 30 years. High valuations are not an immediate concern, as corporate profit growth remains strong, although further increases in how much investors are willing to pay for stocks is unlikely. A market correction could happen at any point, but as long as the economic cycle remains positive and profits continue to grow, we anticipate continued positive returns from stocks as we head into 2025.

**EQUITY BENCHMARK TABLE**

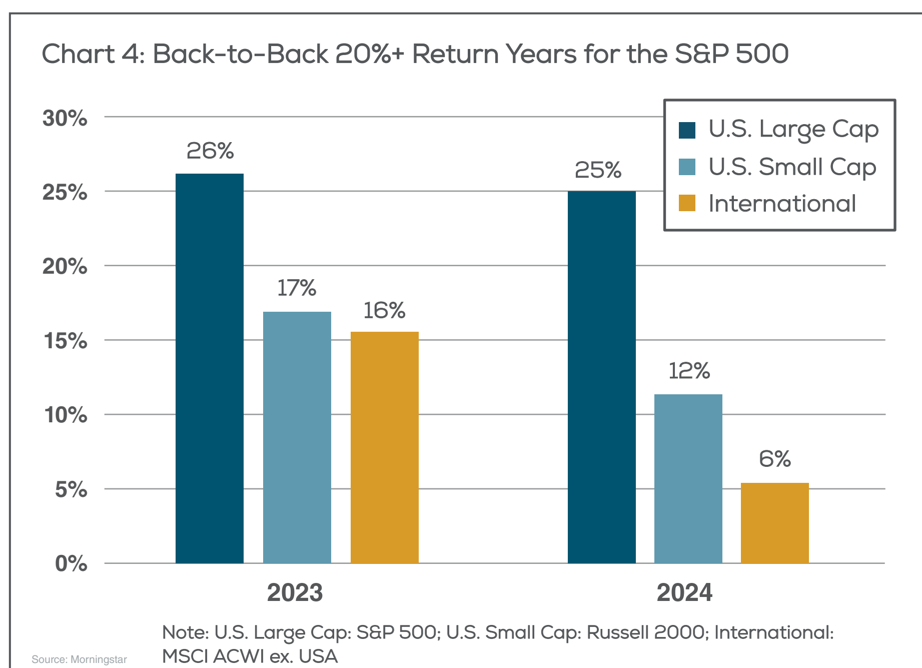
| ***US Economic Activity*** | Quarter-End | 3 Mos. Ago | 1 Year Ago | 3 Years Ago | 5 Years Ago |
|---|---|---|---|---|---|
| S&P 500 | 5,882 | 5,762 | 4,770 | 4,766 | 3,231 |
| Dow Jones Industrial Average | 42,544 | 42,330 | 37,690 | 36,338 | 28,538 |
| NASDAQ | 19,311 | 18,189 | 15,011 | 8,973 | 8,973 |

| ***Equity Returns (%)*** | 3 Month | YTD | 1 Year | 3 Year (Ann) | 5 Year (Ann) |
|---|---|---|---|---|---|
| US Large Cap Growth | 7.1% | 33.4% | 33.4% | 10.5% | 19.0% |
| US Large Cap Value | -2.0% | 14.4% | 14.4% | 5.6% | 8.7% |
| US Mid Cap Growth | 8.1% | 22.1% | 22.1% | 4.0% | 11.5% |
| US Mid Cap Value | -1.7% | 13.1% | 13.1% | 3.9% | 8.6% |
| US Small Cap Growth | 1.7% | 15.2% | 15.2% | 0.2% | 6.9% |
| US Small Cap Value | -1.1% | 8.1% | 8.1% | 1.9% | 7.3% |
| International Large Cap Developed (US Dollar) | -8.1% | 3.8% | 3.8% | 1.6% | 4.7% |
| International Small/Mid Cap Developed (US Dollar) | -8.4% | 1.8% | 1.8% | -3.2% | 2.3% |
| Emerging Market (US Dollar) | -8.0% | 7.5% | 7.5% | -1.9% | 1.7% |

Source: Bloomberg, Morningstar

## Another Strong Year for U.S. Equity Returns

Stock markets finished a strong year with the S&P 500 returning 25%, with each quarter producing positive returns. This follows a strong 2023, when the U.S. large-cap-focused index was up 26%. While U.S. large-cap stocks continued their robust performance, U.S. small-cap and international stocks lagged behind, generating returns of 12% and 6% in 2024, respectively (Chart 4). During the year, investors continued to pile into stocks with ties to artificial intelligence. This perpetuates a trend of the largest companies producing most of the index returns. In fact, similar to 2023, fewer than 30% of the stocks in the S&P 500 outperformed the index in 2024. These types of market anomalies are rare, and we anticipate a return to more normally distributed returns in the future. We believe the key to broader market participation will be continued strengthening of global economic growth and easing of interest rates globally. We believe our diversified portfolios, with allocations to mid- and small-sized U.S. companies and exposure outside the U.S., are well-positioned to deliver benefits over time.

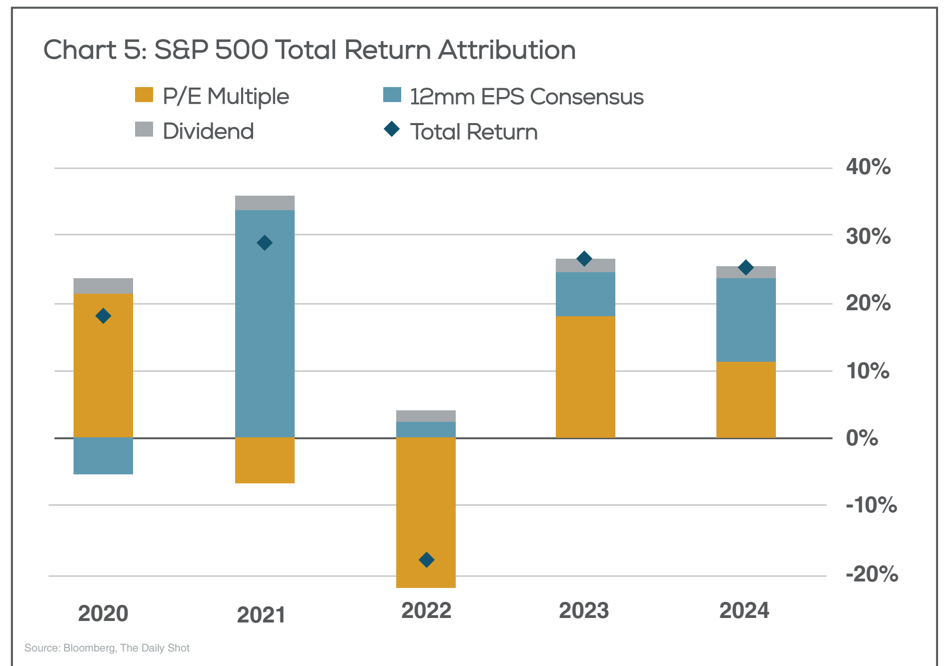



Note: U.S. Large Cap: S&P 500; U.S. Small Cap: Russell 2000; International: MSCI ACWI ex. USA

Source: Morningstar

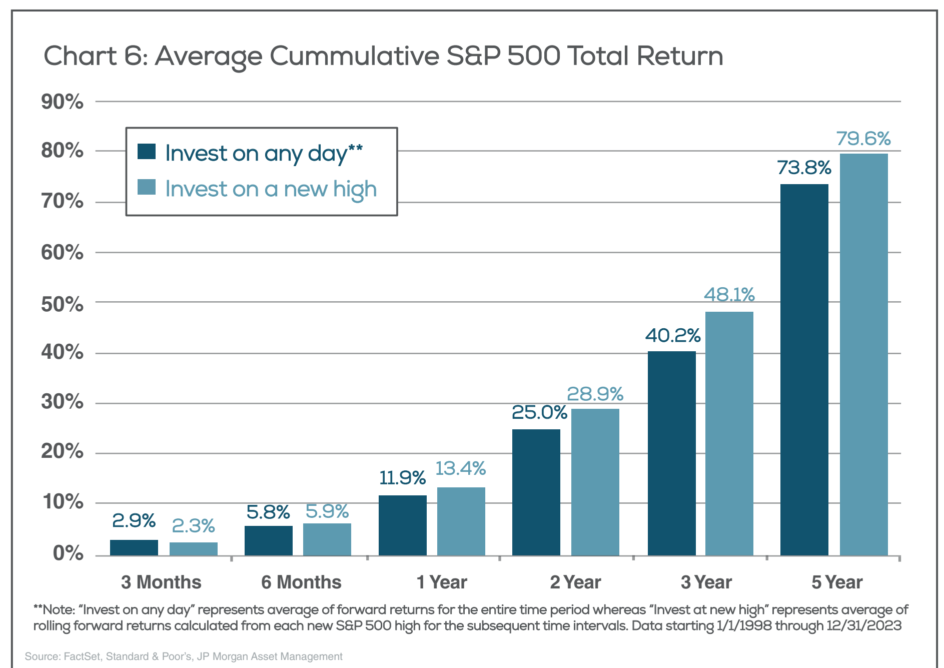
## Earnings Growth Will Be the Driver of Returns

Over the last two years, investor optimism about the market has driven the forward-looking price-to-earnings (P/E) ratio for the S&P 500 Index up to 22 times earnings. This means that the market's price is 22 times the expected earnings for next year. A valuation of this degree has only been exceeded twice in the last 30 years: during the tech bubble and the post-COVID rally. Looking back at the last two years, earnings growth contributed only a small portion of the market return, while P/E expansion explains the rest (Chart 5). Looking forward, earnings growth rates of the mega-cap tech names are slowing, as profit margins are already near all-time highs. This environment is less favorable for continued expansion in the P/E ratio. Therefore, we expect market returns to more closely follow earnings growth rates in 2025 and beyond. This means that after back-to-back 20%-plus return years, we should expect more modest returns going forward. On a positive note, earnings growth expectations for the All-Country World Index (ACWI) are currently at 10%, according to data aggregated by FactSet. So, while high stock market valuations put a ceiling on long-term return expectations, returns can still meet long-term averages if earnings growth rates remain strong.




## Markets Do Not Die of Old Age

The S&P 500 ended the year near its all-time high and reached a new high 57 times during the year. This has led some investors to ask, "How long can this last?" While it never feels easy investing new money at all-time highs, history has shown that returns are nearly identical when investing at all-time highs compared to any other time periods (Chart 6). As the saying goes, markets do not die of old age, nor do they die because valuations are too high. Rather, it is the economic cycle that drives corporate profits, which in turn tend to push stock prices higher. The continued expectation of positive economic growth leading to profit growth supports our decision to remain slightly overweight stocks. That being said, we would not be surprised if stocks experienced a correction at some point in the near term. On average, stocks fall by 10% or more at least once per year. The last 10% correction in the S&P 500 happened back in 2022. To address this, we typically recommend that clients with new money to invest use a dollar-cost averaging strategy to spread investments over time, reducing the risk of investing right before one of those corrections. While we cannot predict when the next correction will come, we remain prepared to take advantage of any opportunities it may create.



# A Fixed Income Update from Trust Point

TRUSTPOINT

Q4 2024

In the fourth quarter, interest rates rose in response to stronger U.S. economic data. Increased expectations for tariffs and greater fiscal stimulus under the new administration also led the market to scale back expectations for deep Federal Reserve (Fed) rate cuts in 2025. These factors pushed bond prices lower over the past three months, but high starting yields and a strong first half provided a cushion, resulting in a second consecutive year of positive returns for bonds. Interest rates remain attractive, and we expect fixed income to continue offering solid income and portfolio stability.

**FIXED INCOME BENCHMARK TABLE**

| ***US Yields (%)*** | Quarter-End | 3 Mos. Ago | 1 Year Ago | 3 Years Ago | 5 Years Ago |
|---|---|---|---|---|---|
| 3 Month T-Bill | 4.3% | 4.6% | 5.3% | 0.0% | 1.5% |
| 2 Yr US Treasury | 4.2% | 3.6% | 4.3% | 0.7% | 1.6% |
| 10 Yr US Treasury | 4.6% | 3.8% | 3.9% | 1.5% | 1.9% |

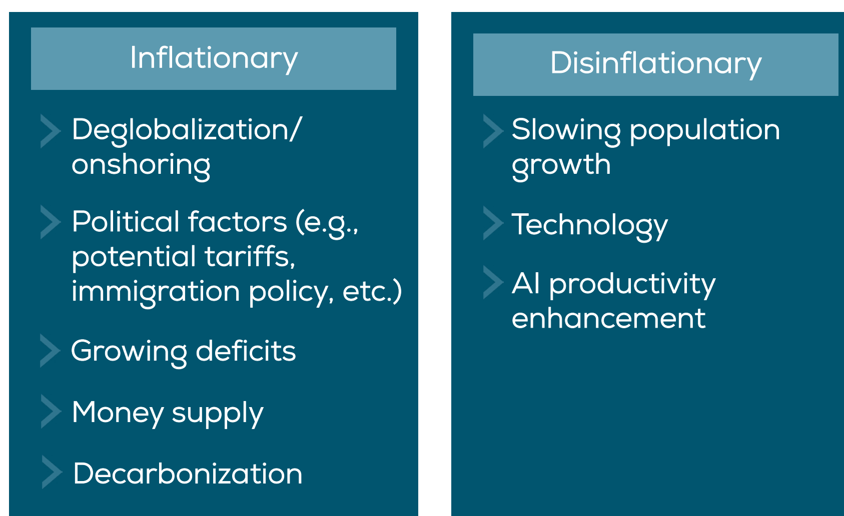
| ***Fixed Income Returns (%)*** | 3 Month | YTD | 1 Year | 3 Year (Ann) | 5 Year (Ann) |
|---|---|---|---|---|---|
| US Intermediate Treasuries | -3.9% | 0.2% | 0.2% | -3.0% | -0.7% |
| US Treasury Inflation Protected Sec. | -2.9% | 1.8% | 1.8% | -2.3% | 1.9% |
| US Mortgages | -3.2% | 1.2% | 1.2% | -2.1% | -0.7% |
| US Short-Intermediate T/E Munis | -1.0% | 1.4% | 1.4% | 0.0% | 0.9% |
| US Investment Grade Corporates | -3.0% | 2.1% | 2.1% | -2.3% | 0.3% |
| US Senior Bank Loans | 2.3% | 9.0% | 9.0% | 7.0% | 5.9% |
| US High Yield | 0.2% | 8.2% | 8.2% | 2.9% | 4.0% |
| Int'l Bonds Ex-US (Hedged) | 0.7% | 5.0% | 5.0% | 0.9% | 1.0% |
| Int'l Bonds (Unhedged) | -5.1% | -1.7% | -1.7% | -4.5% | -2.0% |
| Emerging Market Debt (US Dollar) | -2.1% | 5.7% | 5.7% | -1.2% | -0.1% |

Source: Bloomberg, Morningstar

## Path of Rate Cuts is Likely to Stall Out

After the Fed kicked off the easing cycle with a half-percent Fed funds rate cut back in September, it followed with another quarter-percent reduction in both November and December. Easing inflationary concerns and weaker labor market data from last summer triggered the Fed to start cutting rates, lowering the policy rate by a full percent from a peak of 5.38% to 4.38% in just three months. However, we expect this shift in monetary policy to slow considerably in 2025, as the Fed is likely to moderate the pace of easing and possibly hold the Fed funds rate steady for an extended period. The Fed has acknowledged the resilience of the U.S. economy, as growth expectations have been revised higher throughout the year. In addition, inflation risks remain (Chart 7). Current market expectations for Fed funds rate cuts have been scaled back to only one, or possibly two, quarter-percent cuts in all of 2025. We believe the new path of forecasted rate cuts is reasonable, but our expectations and positioning will change if inflation begins to rise.

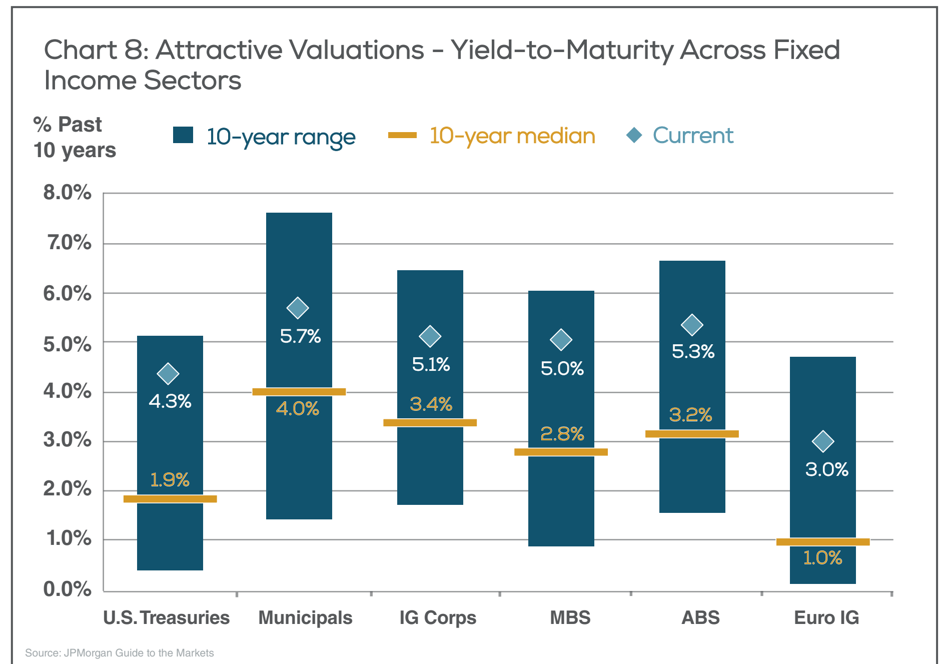
Chart 7: Near Term Risks to Inflation are Rising




Source: Fiducient Advisors

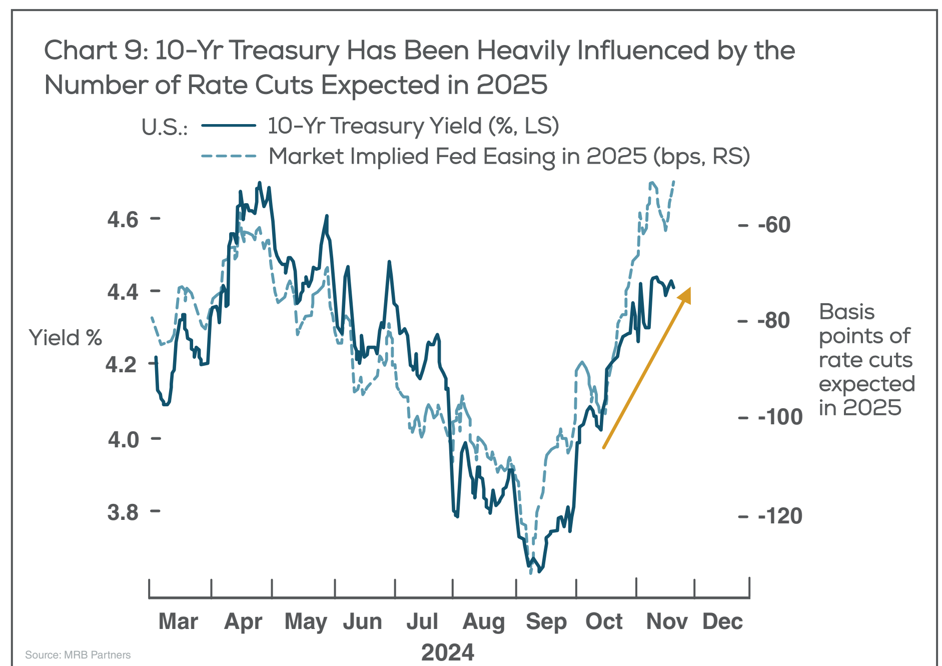
## Fixed Income Opportunities – Attractive Yield

The benefit of fewer interest rate cuts for fixed income investors is that yields are likely to stay at attractive levels for the foreseeable future. Opportunities are easy to find, as interest rates in many sectors of the bond market remain at the upper end of the 10- and even 20-year ranges (Chart 8). The high starting point for yields offers compelling return expectations in the upcoming years. This is especially the case in high-quality core fixed income areas of the market, like treasuries, municipal bonds, and mortgage-backed securities. These sectors offer compelling yields with very little credit risk to the underlying securities. We especially like short-term bonds, as the slope of the yield curve continues to offer attractive valuations and risk/return characteristics at the front end. Conversely, credit-sensitive sectors remain expensive, and investors are not getting paid enough additional yield over treasuries to compensate for the additional risk. We are taking a cautious approach to credit markets, as we can achieve similar yields with less risk in high-quality core bonds.




## Higher U.S. Treasury Yields as Fed Rate Cuts Get Priced Out

The ten-year U.S. treasury bond is one of the most observed and studied fixed income securities as its yield heavily influences mortgage rates and can also indicate long-term expected economic growth and inflation. It is also thought of as the "risk-free" rate and is compared to yields offered by other fixed income securities. The ten-year yield has been trading in a range between 3.7% and 4.6% for most of the year. Throughout the year, the yield traded at both the upper and lower ends of that range, as changing economic and inflation data led to adjustments in expectations for rate cuts in 2025. This relationship has been closely linked for most of the year (Chart 9), until recently. Post-election, it is possible that a shift to tighter monetary policy may be required if the new administration quickly and aggressively pursues pro-growth and pro-inflation policy proposals. As a result, the likelihood has grown that treasury yields may surpass last year's trading range. We continue to take a cautious approach to duration by positioning fixed income portfolios with less interest rate risk than the global bond market.



# Market Point

Market Point is a quarterly market commentary designed to provide you with an overview of economic conditions, as well as equity and fixed income market summaries for the quarter.

This commentary is offered by the Investment Management team. The individuals contributing to Market Point are pictured from left to right: Randy Van Rooyen, CFA®, CEPA®; Yan Arsenault, CFA®, CAIA®; Steve Brudos; Brandon Hellenbrand, CFA®; Christine Doll; Nolan Gaffney, CFA®; and Matthew Wittenberg. Please feel free to contact any team member with questions.

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