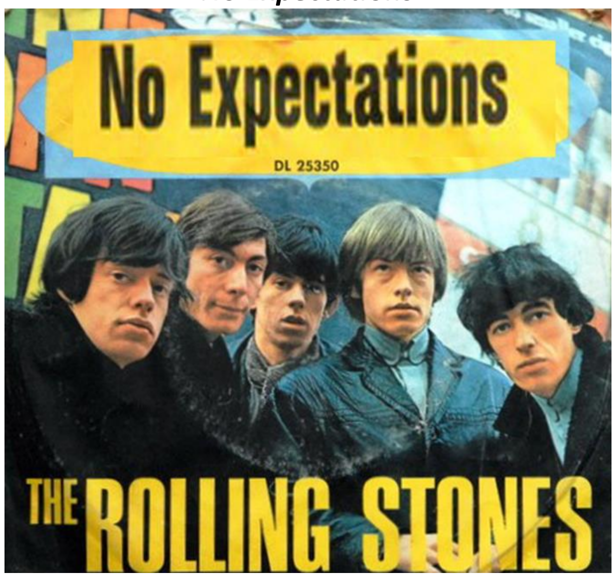
January 2025 Market Commentary

No Expectations



Take me to the station
And put me on the train
I've got no expectations
To pass through here again

https://www.youtube.com/watch?v=CVPnbOFJzFo

'Tis the season. The time of year when Wall Street strategists trot out their outlooks for the next year. These "outlooks" are widely disseminated in the financial media, but widely ignored by the financial profession. Why? Well, the media loves a good story, and the Wall Street firms pay their strategists an extravagant sum to craft a story that generates both trust and sales from their clients. Investment professionals, especially those who've been around the block a few times, generally ignore these stories because we know the job of "market strategist" was created to make fortune tellers look good.

Please, don't get me wrong, these are generally great people; highly educated, personable, and thoughtful. Unfortunately, they are just tasked with a nearly impossible duty…forecasting the future. And not just any individual's future, but the collective future of all corporations and all investors' expectations about those companies. Not to mention the actions of governments and central bankers to alter the playing field at all times.

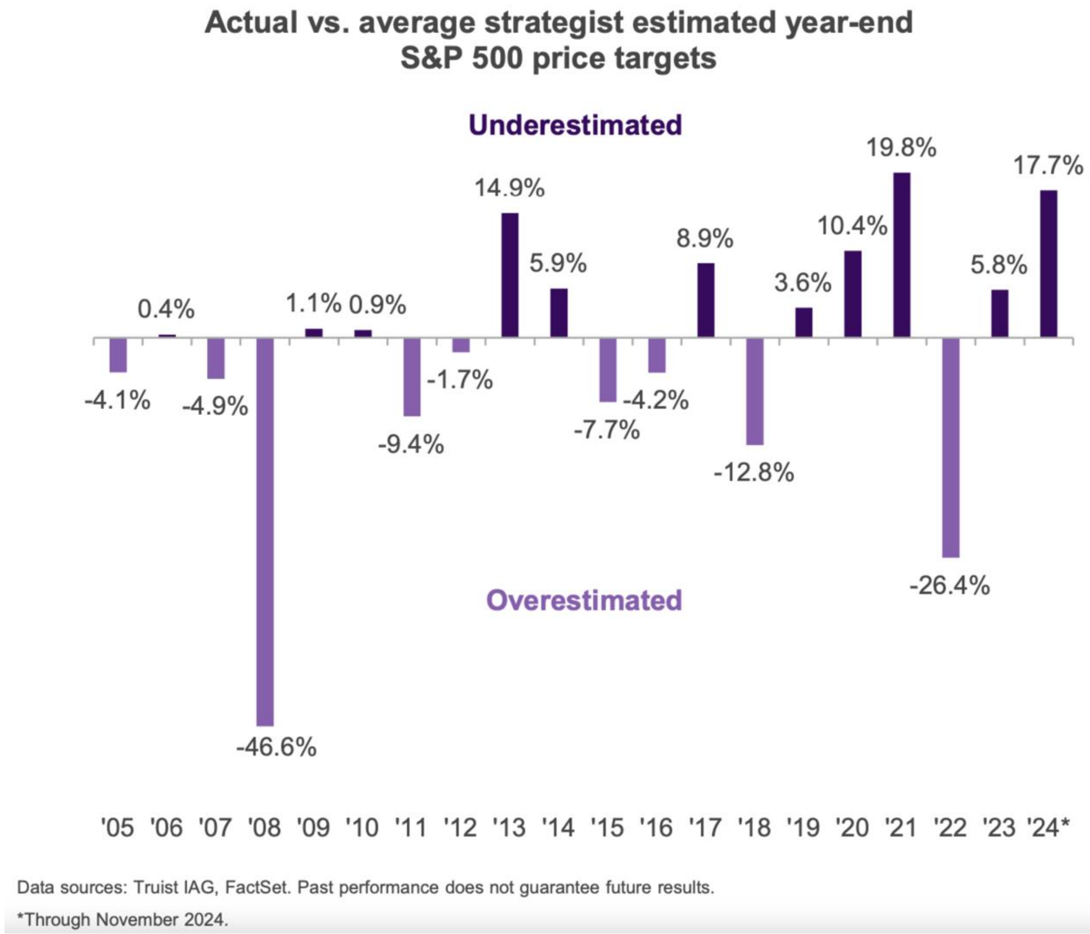
Pretty much every forecast for the S&P 500 is based on two variables; 2025 earnings expectations, and the Price-to-Earnings ratio (PE) that investors are expected to pay for those earnings. As I write this the S&P 500 is trading around a record high of 6,070, and 2024 earnings are expected to be $244, which gives us a current PE of 24.9. Here are the strategist's current outlooks for 2025.

Wall Street Firm	S&P 500 2025 Target	S&P 500 Earnings Est	Price-to-Earnings
UBS	**6,400**	**$257**	**24.9**
Morgan Stanley	**6,500**	**$271**	**24.0**
Goldman Sachs	**6,500**	**$268**	**24.3**
JP Morgan	**6,500**	**$270**	**24.0**
CFRA	**6,585**	**$272**	**24.2**
RBC	**6,600**	**$271**	**24.4**
Barclays	**6,600**	**$271**	**24.4**
BofA Merrill Lynch	**6,666**	**$275**	**24.2**
BMO	**6,700**	**$275**	**24.4**
HSBC	**6,700**	**$266**	**25.2**
Deutsche Bank	**7,000**	**$282**	**24.8**
Yardeni Research	**7,000**	**$290**	**24.1**
Capital Economics	**7,000**	**$275**	**25.5**
Wells Fargo	**7,007**	**$274**	**25.6**
Average	**6,697**	**$273**	**24.3**

From the above data we can see that the average forecast is for the S&P 500 to gain 10.3% next year, as earnings increase 11.9% and PE's contract slightly. The story they all tell is generally rooted in the following: 1) the economy will continue to be solid which will lead to decent earnings growth, 2) inflation will be contained and the Fed will be slightly accommodative, 3) the new administration will be business friendly.

While this sounds awesome, the truth of the matter is that a lot of unknown stuff will happen in 2025, just like it does every year. The graphic below shows just how inaccurate these strategists are in any given year.

This year they underestimated the S&P 500's gain by a mere 17.7%. My favorite outlook though was December of 2007, when their forecasts for 2008 ended up missing the mark by 46.6%. Not only didn't anyone forecast a decline in 2008, three of the strategists' firms (along with their jobs) actually disappeared that year.



While we're on the subject of market outlooks and valuation, let's take a closer look at the granddaddy of all valuation tools, the PE ratio. As you know by now, PE stands for price-to-earnings ratio, and while price is pretty straight forward, earnings can be a little more complicated. Should we use trailing 12-month earnings, forward 12-month earnings, or should we use something a little more exotic like CAPE (Cyclically Adjusted PE).

Without getting bogged down in the weeds too much, here's a quick explainer.

- A trailing PE is looking at what has actually happened in the last 12-months. It's accurate, but can be pretty erratic if there was a recession during that period. It is also backward looking, and the stock market is forward looking.
- A forward PE is looking at what we think might happen in the next 12-months. This tries to align investors expectations with valuations. It can also be pretty erratic if something unexpected happens in the next 12-months.
- The CAPE looks backwards 10-years and calculates the 10-year moving average of inflation adjusted earnings. While an improvement on simple 12-month trailing, it is still backward looking not forward.

For brevities sake, I'm just going to focus on Forward PE. The chart below shows 20-years worth of forward PEs. The big problem with using any of these historic PEs to determine when the market may be over or under valued is that PE is impacted by both price and earnings. The highest PEs don't happen when prices are the highest, they actually happen when earnings collapse in recessions, like 2009 and Covid.

So, the reality is that a high or low PE has absolutely no correlation to what the market might do over the next 12-months.

Source: Charles Schwab, Bloomberg. 1958-11/30/2024.

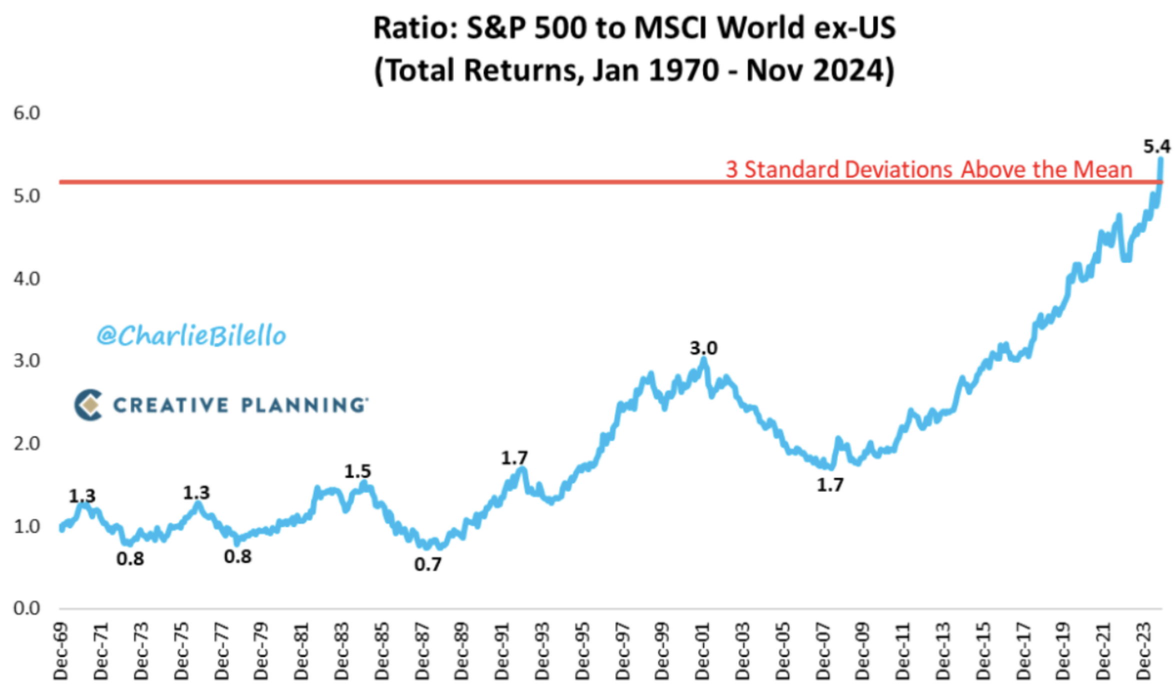
I'm not saying that using PEs for valuation purposes is useless, but I am saying that you should be really thoughtful with how you use them. Just saying that a PE of 24 is above historic averages isn't very useful, we need to compare PEs over various economic cycles. High PEs during periods of recession, when earnings are depressed, are generally good periods to buy stocks because they are depressed. Whereas, high PEs during boom times are not generally a good time to buy stocks because risks are elevated.

What type of high PE environment are we in today? Well, we haven't had a real business cycle recession since 2008, and the S&P 500 is up more than 60% in the last two years, so I'd have to say that the evidence points to boom-time valuations, not recessionary valuations.

Again, as the chart above shows, valuations are horrible timing tools, but it is important to realize that while the good times may continue to roll, we are playing in a higher risk environment.

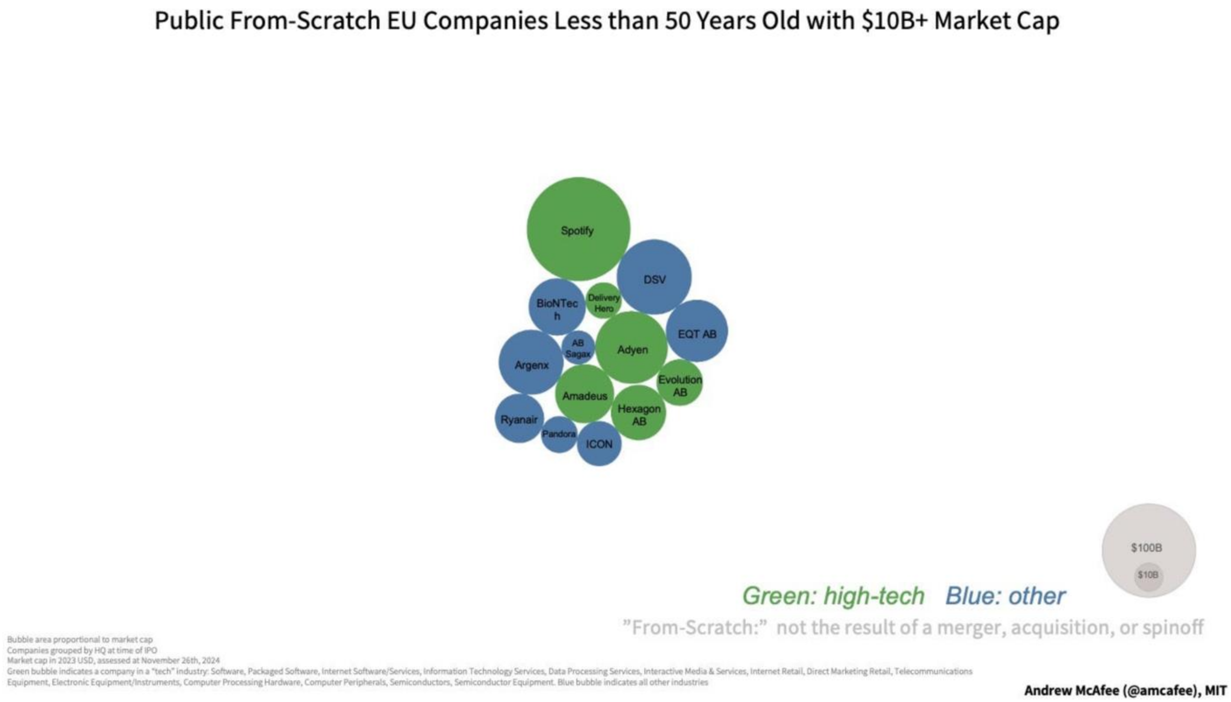
<u>American Exceptionalism</u>

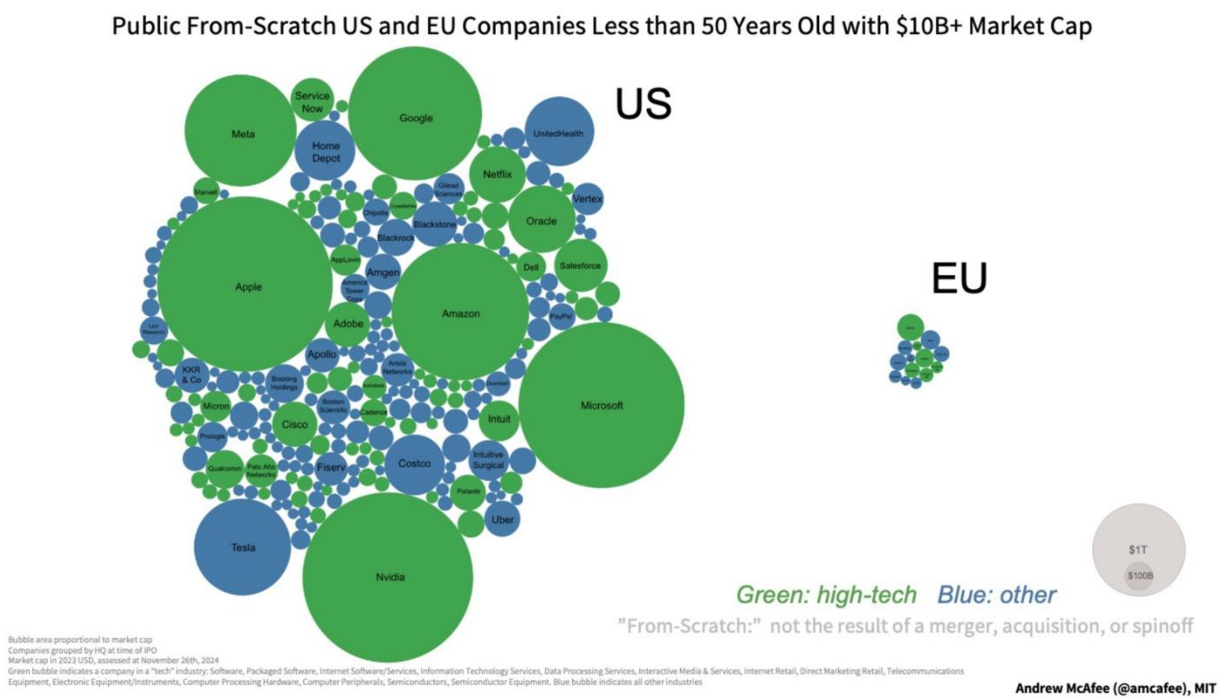
Talking about letting the good times roll, the U.S. stock market has been on a tear for decades when compared to other global markets.



While a chart like this might cause bears to salivate looking forward to a reversion to the mean, the simple explanation for this U.S. outperformance is that the United States really is exceptional.

A recent study analyzed the companies created in the European Union over the last 50-years compared to the companies created in the Untied States.



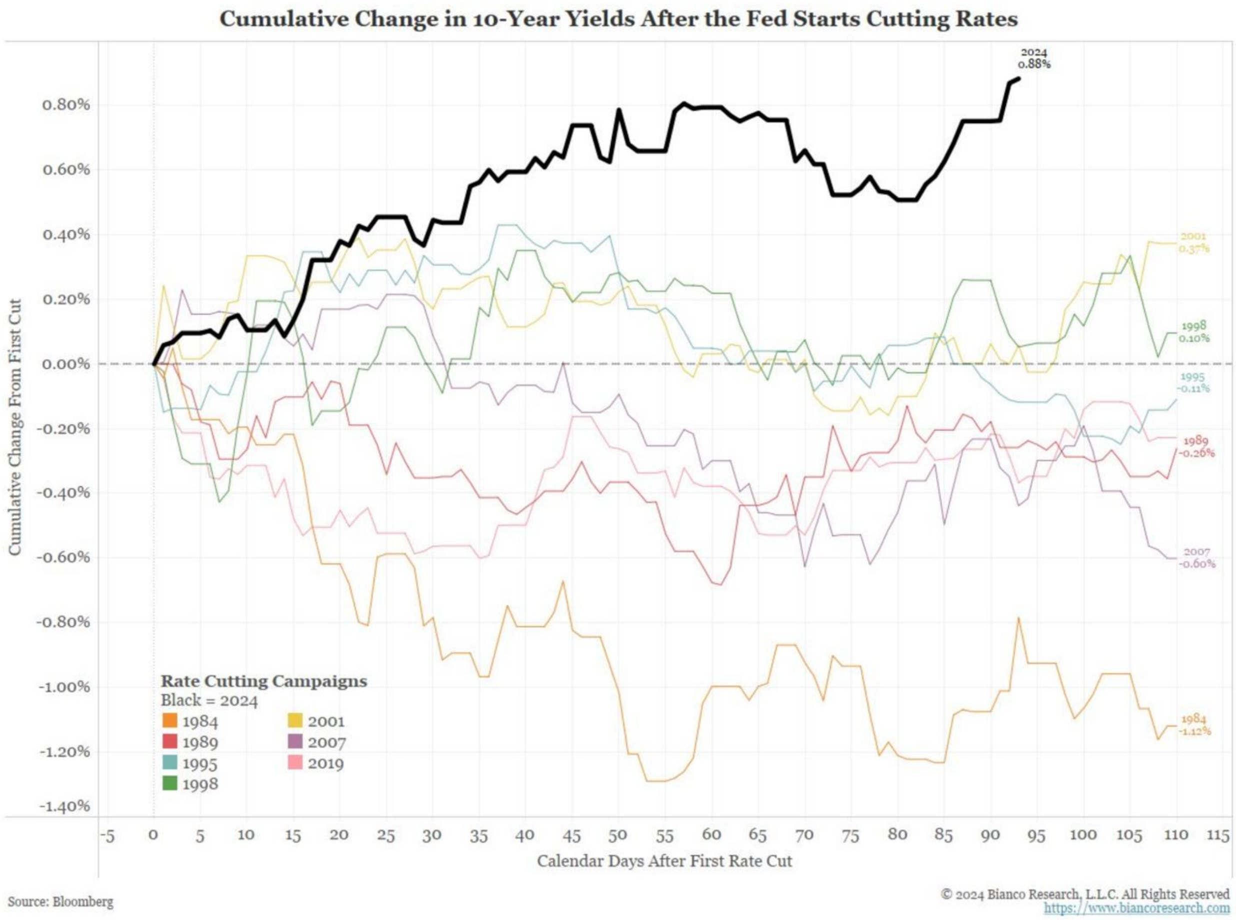


As we can see, there is a pretty good reason that US stocks have significantly outperformed international stocks, U.S. companies are vastly superior. We have created an environment where both intellectual property and personal property are protected, where risk taking is rewarded, and where government control over free markets is limited (at least relative to other countries).

These are massive advantages for both corporations and individuals here in the United States, and we should wake every day to thank our lucky stars, and work to protect and strengthen those advantages.

<u>**Interest Rates**</u>

Speaking of expectations, what the "H-E-double hockey sticks" is going on with interest rates. A normal person would believe that when the Fed cuts interest rates, interest rates would actually fall. Unfortunately, that is not the case today. **Since it's September meeting, the Fed has cut rates by 1.00%, but the bond market has reacted perversely with the yield on the 10-year Treasury actually rising 0.88%!**



The reason for this incongruous behavior in longer-term interest rates is the simple reality that the bond market vigilantes do not believe that interest rates should be cut. Why?

1. The economy is doing rather fine, unemployment is low and the Atlanta Feds GDPNow forecast for the fourth quarter is predicting a solid 3.2% growth rate.
2. Inflation continues to be stubbornly high. Consumer prices are 22.1% higher than they were in 2020 and are currently rising at a 2.7% rate. If the Fed's goal is 2% annually, and we've averaged greater that 4% annually for five years, maybe they shouldn't be cutting rates.

3. Restricting global trade is not conducive to lower prices. Whatever the rationale, restricting free market trade is inflationary.
4. On a similar vein, deporting tens-of-thousands of illegal workers, while probably the right thing to do, comes with a cost of higher inflation.

The bond vigilantes are sending a very clear message, rates will be higher for longer.

I think 2025 will be a very interesting year. The Fed and the bond vigilantes will continue to battle. Stock investors will hope that the economy continues to chug higher, supporting earnings, which are in turn supporting lofty valuations.

As for our new administration taking over Washington D.C., I wish them all the best, but I worry about an old quote from Warren Buffett, ***"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."*** I sure hope this doesn't apply to government.

Once I was a rich man
Now I am so poor
But never in my sweet short life
Have I felt like this before

As always, be careful out there.

Chris Wiles, CFA

Where trust is Earned