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Market Review and Outlook 4Q24

Highlights

Stocks surged for the second straight year during 2024, with the S&P 500 Index rising another 25.0% for the year.

Economic growth remained robust during 2024, with GDP expanding at an estimated annual rate of 2.7%, but sustaining that above-trend pace of growth could prove challenging.

Equity valuations are elevated, as the S&P 500 Index's price-to-earnings ratio has increased at twice the rate of earnings growth over the past two years. The benchmark's forward P/E multiple closed 2024 at 21.6x—more than 34% above its 20-year average.

The extended equity valuation multiple at the capitalization-weighted index level is attributed to its disproportioned holding of richly traded mega-cap technology stocks. Equity valuations more broadly are not as extreme, as the equal-weighted S&P 500 Index trades at just a 5% premium to its historical average P/E.

Fixed income markets experienced muted performance during 2024, with the U.S. aggregate bond index returning a modest 1.3% for the year.

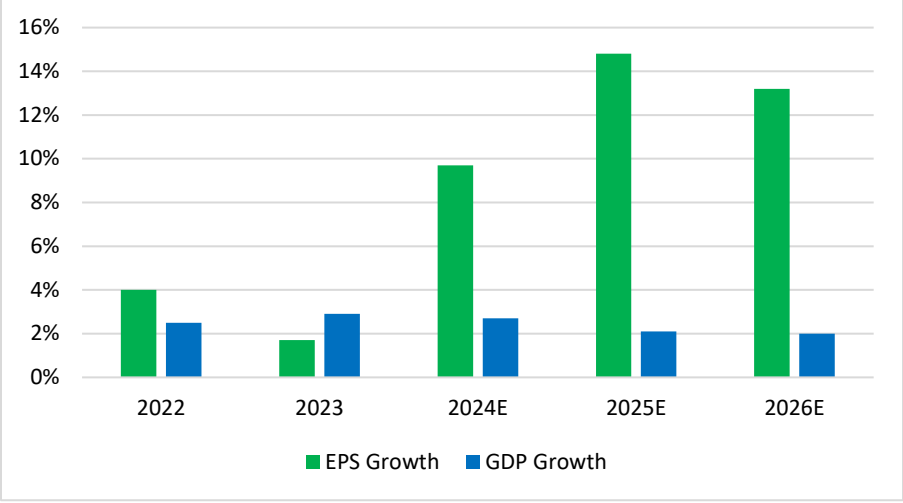
Interest rates volatility at the long end of the yield curve—due to revised economic projections and fiscal policy concerns—could continue to impede bond price appreciation over the near term.

Market Review and Outlook

Global equity markets reported another year of positive returns in 2024, adding to the robust gains generated in 2023, as lower interest rates and solid economic conditions across most parts of the world provided a supportive backdrop for stocks to march higher. While each of the major global equity indices has delivered strong returns over the past two-year period, the gap in performance between U.S. and international markets remains significant. The S&P 500 Index closed 2024 with an annual total return of 25.0% (vs. 26.3% in 2023)—the first time the benchmark index has achieved 20%-plus returns back-to-back since 1997 and 1998 (and only the fourth occurrence in history)—with the outsized gains of several mega-cap tech/tech-related stocks once again fueling the robust performance this year. International equities also extended their rally, albeit at a comparatively more measured pace than their U.S. counterparts, with developed markets (EAFE) increasing 3.8% in 2024 (vs. 18.2% in 2023) and emerging markets (EM) rising 7.5% for the year (vs. 9.8% in 2023).

For equities indices to expand upon these gains in 2025, sustained economic and earnings growth will be critical. The U.S. remains the linchpin for the global economy, with GDP growing at an estimated 2.7% rate in 2024—outrunning every other major developed economy (and its own 20-year historical average growth rate of 2.1%). Maintaining that above-trend pace of growth going forward will likely prove challenging, however, particularly as the incoming Trump administration's proposed tariff policies (the most aggressive in 100 years) and mass deportation of illegal immigrants could initially have a stagflationary impact (i.e., higher inflation, lower economic growth and higher unemployment). The prospect of pro-growth tax and regulatory policies under the new administration could partially offset those headwinds, but economic expansion still appears poised to downshift toward a more sustainable pace from here, with current consensus estimates guiding for GDP growth of 2.0% in both 2025 and 2026. On the earnings front, consensus estimates project that S&P 500 profit growth accelerated to 10% in 2024 (up from just 2% in 2023), which is forecasted to be followed by impressive growth of 15% in 2025 and 13% in 2026. An acceleration of low to mid-teens earnings growth over the next two years may prove overly optimistic, however, if GDP growth normalizes to a more measured annual pace of 2.0% over the same period.

U.S. Corporate Earnings Growth and GDP Growth
(2022-2026E)

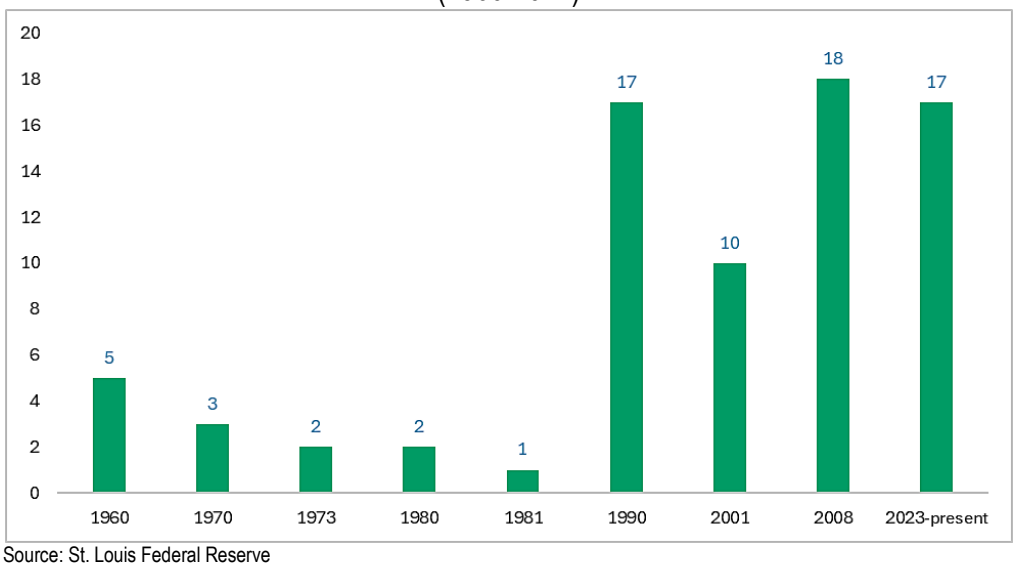


Source: FactSet

Irrespective of the rate of growth, the widely held view is that the economy (and corporate profits) will continue to expand over the foreseeable future—aided by booming investment in artificial intelligence, electricity generation expansion, and the re-shoring of domestic manufacturing activity.

Nonetheless, it would be imprudent to close the window on the possibility of a recession considering the Fed's prior aggressive tightening cycle (1Q22-3Q23). Recessions have historically started within 18 months after the last Fed rate hike—suggesting the current 17-month last-rate-hike-to-recession gap (July 2023 to December 2024) still warrants monitoring.

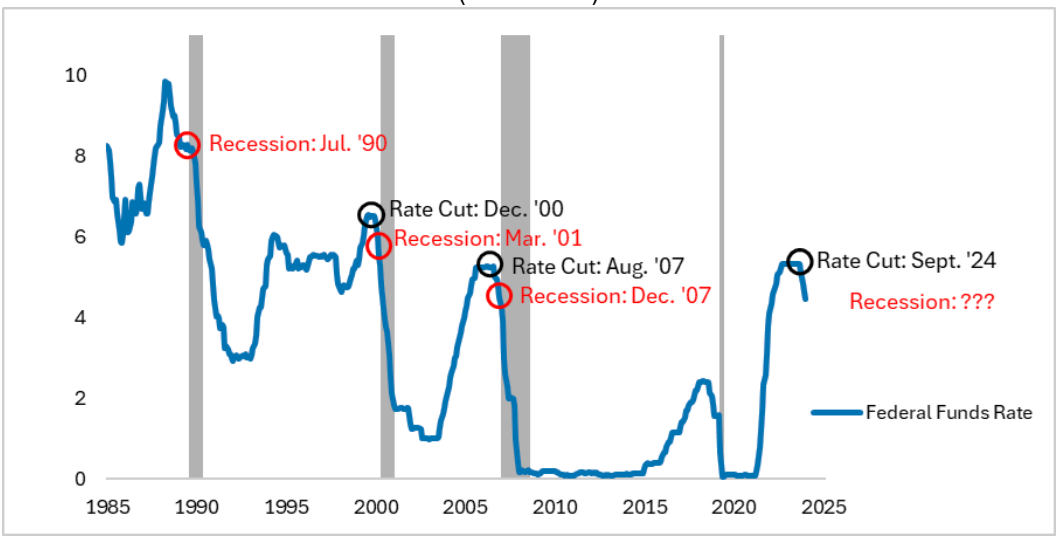
Number of months from last rate hike to start of recession
(1960-2024)



Source: St. Louis Federal Reserve

Moreover, and somewhat counterintuitively, the last several recessions all started relatively soon after the Fed initiated a rate cutting cycle (which most recently occurred in September 2024).

Recessions often start not long after the Fed begins cutting rates
(1985-2024)

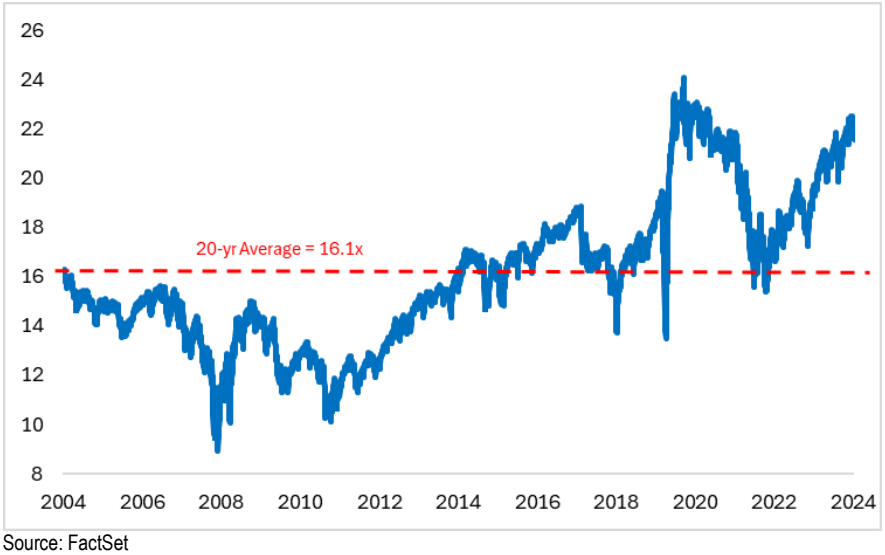


Source: St. Louis Federal Reserve, BCA Research

Correlation doesn't prove causation though, so the latest rate cut may not indicate a recession is imminent. Many of the Fed's pre-recession rate cuts were a response to an already deteriorating backdrop. With current conditions appearing to be mostly supportive, further economic expansion seems likely over the near term.

Continued signs of economic resiliency and the prospect of accelerating earnings growth could certainly push equity prices higher, but market valuations remain a concern. The S&P 500 Index's price-to-earnings ratio has increased at twice the rate of earnings growth amid the equity market rally over the past two years, pushing the capitalization-weighted benchmark's forward P/E multiple up to 21.6x—more than 34% above its 20-year average. While high stock market P/E multiples have little explanatory power of near-term returns, they typically lead to the more muted multi-year returns.

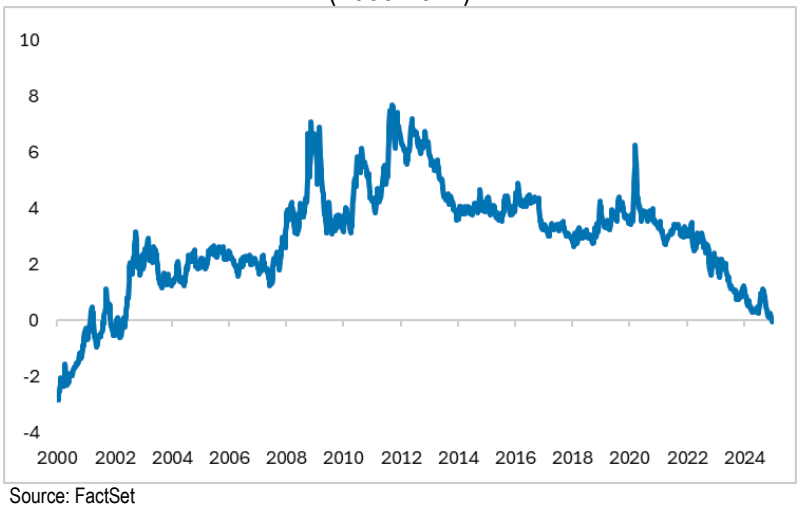
S&P 500 Index P/E multiple well above the historical average
(2004-2024)



Source: FactSet

Similarly, the index's currently miniscule equity risk premium (ERP), or amount of excess return that investors expect to earn from taking on risk in the stock market over the risk-free 10-year Treasury rate, also suggests that equity valuations are extended. Calculated by taking the S&P 500's earnings yield (i.e., inverse P/E multiple) of 4.62%, minus the 10-year Treasury rate of 4.57%, the index's equity risk premium is essentially zero. In other words, investors are demanding no premium for holding stocks relative to ultra-safe Treasury bonds—a phenomenon that hasn't occurred since 2002 (amid the aftermath of the dot-com bubble). This metric suggests the S&P 500 Index is the most overvalued it has been in over 20 years.

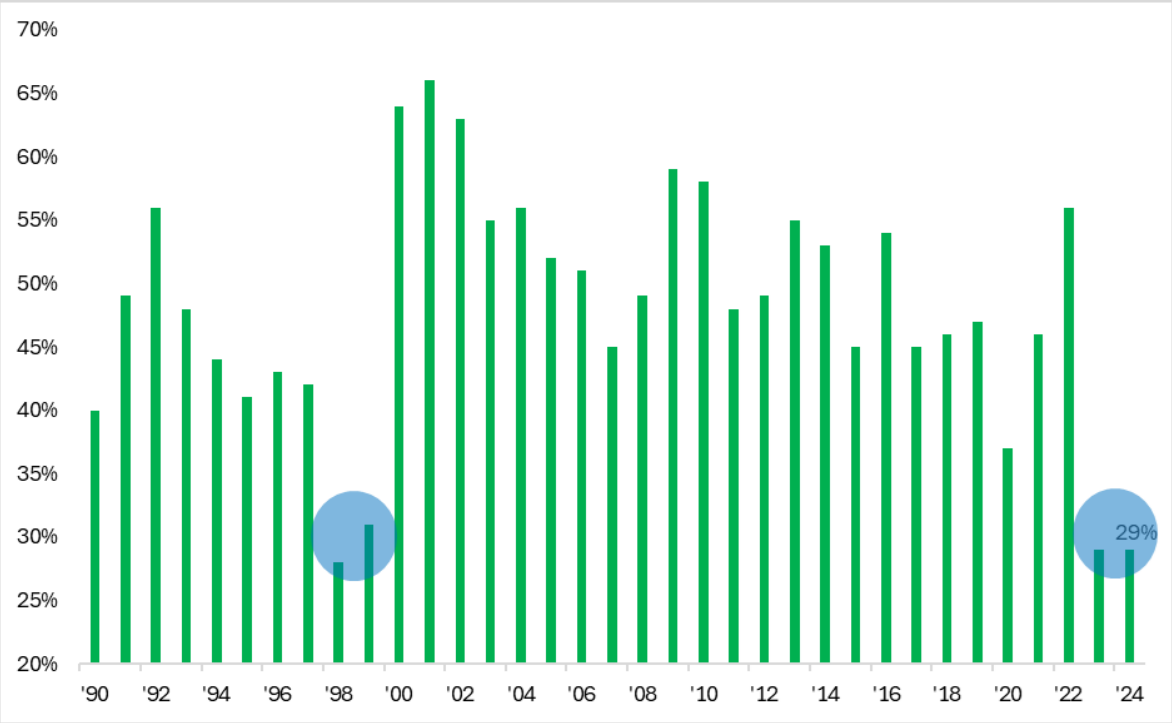
Equity Risk Premium at lowest level in more than two decades
(2000-2024)



Source: FactSet

Much of the extended valuation in equities at the index level is attributed to its ten largest holdings of richly traded mega-cap technology stocks, which now comprise a record 38% of the capitalization-weighted S&P 500 Index. Fortunately, equity valuations more broadly are not as extreme as the 34% premium to the historical P/E average referenced earlier. The equal-weighted S&P 500, which assigns the same weight to all stocks in the index and is a better representation of the equity market overall, trades at a much more modest 5% premium to its historical average P/E (16.4x current vs. 15.6x historic). And with less than 30% of the index constituents outperforming the benchmark S&P 500 Index each of the last two years (the lowest since 1998/1999), there are still a number of compelling long-term opportunities in segments that have lagged this bull market rally over the past two-plus years. As has been the case following past periods of significant return concentration in the index, we'd expect a market rotation to drive a broadening of relative outperformance participation over the next few years.

% of stocks in the S&P 500 outperforming the index
(1990-2024)



Source: BofA Global Investment Strategy, Bloomberg

After another year of extraordinary equity market performance, investors should temper their return expectations for 2025 (and beyond) relative to the outsized gains they've enjoyed over the past two years. We would not be surprised to see increased bouts of market volatility in the coming quarters, as the incoming administration's proposed policy changes to areas like tariffs and immigration could increase economic/market uncertainty—at a time when high equity market valuations may not be fully accounting for the potentially negative near-term impacts. A broad-based pullback could be seen as an opportunity to deploy capital to areas of the market that didn't fully participate in the two-year rally and where solid fundamental conditions still exist. Being selective in those allocation decisions may prove particularly valuable toward future returns amidst today's elevated equity index valuations.

Core Portfolio

During the fourth quarter, we initiated a position in Goldman Sachs (GS).

Goldman Sachs is a leading global investment banking and asset management firm. Like other Wall Street banks, Goldman is favorably positioned to benefit from an anticipated uptick in merger and acquisition and initial public offering activity, as well as regulatory rollbacks, under the incoming Trump administration. We believe Goldman offers better pure-play exposure to those catalysts than some of its other banking peers, especially as Goldman continues to wind down its foray into retail banking and refocuses on its core investment banking, capital market, and asset/wealth management businesses.

We sold our holding in Aptiv PLC (APTV) during the quarter.

Aptiv is a leading supplier of electrical software architectures, safety products, and electronics to domestic and international automobile manufacturers. The company's products serve as critical components in the automotive industry's mega trends, including the electrification of vehicles and autonomous driving features, that have contributed to Aptiv's above-market revenue growth and profit margins. The long-term prospects for Aptiv to sustain those favorable attributes remain compelling, as the secular growth of EVs and autonomous driving will continue to expand over the coming decade. However, the company's near-term outlook has been clouded by a deceleration in the electrification transition, as still-elevated EV costs and concerns about charging times/infrastructure have slowed mainstream consumer adoption of electric vehicles. While we believe those industry challenges will ultimately be mitigated with time, we decided to reallocate the capital we had invested in Aptiv to areas of the market where we saw greater near-term return potential.

Tactical Portfolio

We made no changes to our tactical investments in the quarter.

We continue to like the portfolio's long-term holding in gold (up 26% in 2024), as the precious metal has a time-tested record of providing portfolio diversification and inflation protection. Similarly, we remain constructive on our investment in uranium. While the price of the base element used to fuel nuclear power plants declined for the year, the anticipated ramp in energy-hungry AI data centers is driving increased recognition of future uranium demand. With the uranium price remaining too low to incentivize additional greenfield development projects to fully supply this growing demand, we continue to believe risks remain skewed heavily to the upside for uranium prices.

Fixed Income

Fixed income markets posted positive, but otherwise lackluster returns in 2024—particularly compared to the robust equity performance during the year. The widely tracked Bloomberg U.S. Aggregate Index, which includes investment-grade corporate bonds and mortgage-backed securities as well as Treasurys, reported a full-year total return of just 1.3%. Short-term treasury yields (which are heavily influenced by monetary policy) declined through much of 2024, as the Federal Reserve cut its federal funds rate three consecutive times (for a total of 1.0%) in the back half of the year. The 10-year Treasury proved more erratic, however, as upward revisions to economic growth estimates and concerns about fiscal policy proposals increasing inflation/deficits in 2025 pushed the 10-year interest rate higher during the fourth quarter (ending the year at a yield of 4.58%, up from 3.86% at the end of 2023 and 3.69% on the day the central bank announced its first rate cut in September). Moreover, at its December meeting the Fed indicated it would only cut rates twice in 2025, fewer than the four cuts outlined in its prior forecast. Those factors put downward pressure on long-term bond prices.

Our sustained focus on short- to intermediate-maturity bonds, which better balance interest rate risks with attractive income potential, has proven beneficial amidst this unusual volatility in the fixed income markets. Many investors were extending duration throughout 2024, in anticipation of steady interest rate cuts from the Fed, but we didn't believe longer-term bonds offered adequate yields for the duration risk of those securities. At some point, it will likely be appropriate to move out further on the yield curve in order to lock in income. For now though, we view the short/intermediate belly of the curve as the best place to ride out the current uncertainty of future interest rate movements.

Final Thoughts

As we step into 2025, we would like to extend our warmest wishes to you and express our sincere appreciation for the continued trust you place in us.

May the new year bring health and happiness!

Parkside Investments, LLC

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