Independence | Asset Advisors

MARKET MATTERS: 2024 YEAR IN REVIEW

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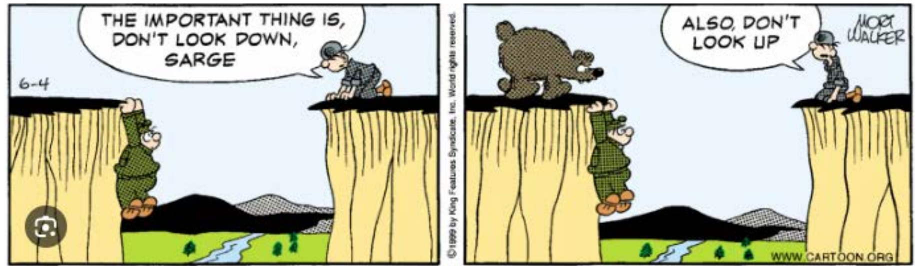
"Roll with the Punches, Cut through the Noise" – Brian Portnoy, "The Geometry of Wealth"

TAKEAWAYS

- Markets have repriced upward, but fell off the all-time high.
- Inflation is lower, but stubborn.
- Employment is cooling.
- The Mag 7 soared, others notched gains.
- Yields are volatile, but coupons pay.
- When stocks are up, don't look down.



Beetle Baily by Mort Walker

HOW WE GOT TO NEW ALL TIME STOCK MARKET HIGHS

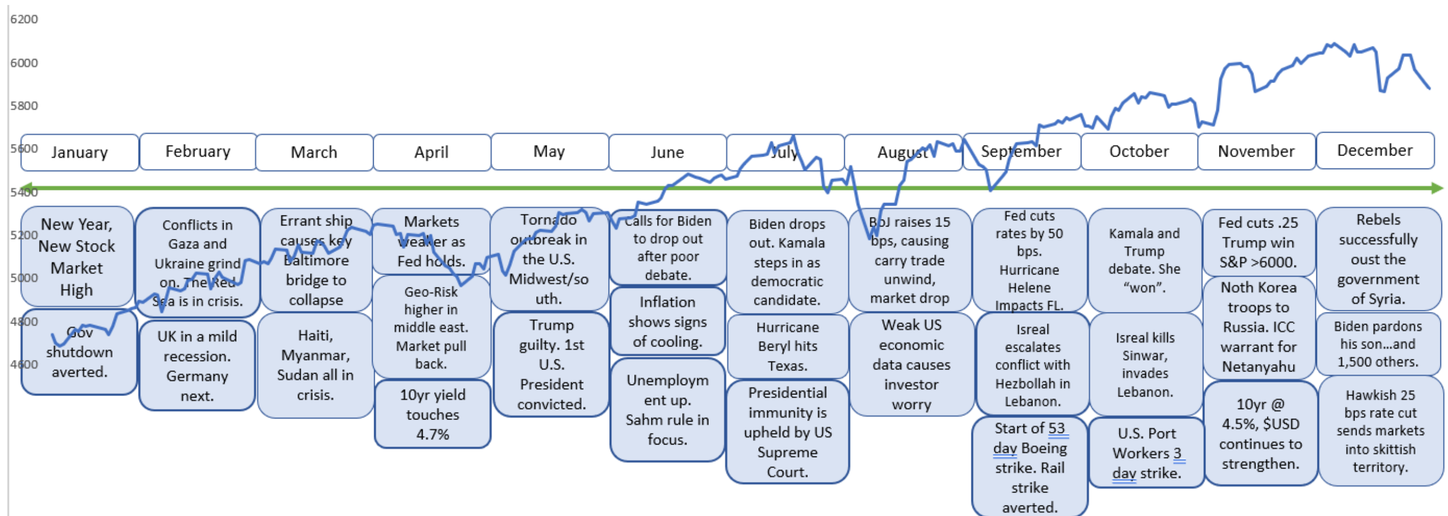
We started the year at an all-time high for the S&P 500, though in retrospect the value looks diminutive compared to current pricing. 12 months ago, the stock market, having gained 22+% for the year, had just finished its recovery from the 2022 double-drawdown of the stock and bond markets. Finishing the year at 4,770, the S&P had caught up to its previous peak, though interest rates remained high and a soft landing was uncertain. Over the course of the year the big names again gained, sending large cap indexes skyward. Stocks were unfazed by global conflicts and inspired by U.S. economic dynamism and a conclusive presidential election. The end of year "hawkish cut" by the Fed brought rates to 4.25-4.5%, a percentage point below where they held until September. Guidance, however, suggested a slower path for cuts going forward. Peak valuations and less-than-good news are a recipe for tumult, and volatility spiked. Nonetheless, the S&P finished up +23% (again!).

Investors, being human, seem to be afraid of heights. It is the rare individual who reaches the top of a mountain or skyscraper, looks straight down, and doesn't find themselves at least a bit uneasy. To err on the side of safety is normal, as is the question on many minds: Can the climb continue or is it downhill from here?

EQUITIES: A TALE OF TWO STOCK MARKETS

The markets were impervious to all but the strongest of headwinds over the course of the year. Earnings drove prices higher, AI trades betting on future payoffs propelled a chosen few tickers to stratospheric gains, and the "Trump trade" encouraged the upswing with bets on deregulation and tax cuts. Some of the top winners looked impervious to reality, soaring to price perfection in the face of decidedly *okay* actual performance (Ahem, Tesla), though most non-growth stocks saw more modest performance. Geopolitics, climate risks, and other exogenous factors did little to dissuade investors who were focused heavily on purchasing power. Employment remained fairly steady, and earnings were solid. S&P 500 earnings rose 10% higher in 2024, a good result considering the modest economic growth and elevated interest rates. There was some turbulence in April as rate cuts got postponed, and notable drawdowns during the year occurred in July/August when employment numbers began to wane, rising to 0.5+% year-over-year to 4.2% and triggering worries over the Sahm rule, and in December when Fed guidance turned hawkish and projections for rate cuts next year went from a total of 100 bps to only 50 bps.

Sources: Beetle Baily (by Mort Walker), US Bank, PortfoliosLab, Earst Asset Management, LESG, MarketWatch, Schroders, Fiera Capital, FRED St. Louis Fed., Macquarie, Lazard, BlackRock, Vanguard, EMarketer



S&P 500 Performance over the course of 2024 (IAA proprietary in conjunction with data from Nasdaq)

The end of year malaise should not distract investors from the fundamental sources of positive equities returns, many of which are compatible with a "higher-for-longer" Fed stance. Tail winds for equities revolved not only around positive earnings reports, but also the U.S. presidential election, which played out throughout the year and culminated with President Trump's win in November. Promises of lower taxes, lower regulation, and continued fiscal laxity enthused investors to spend big on stocks. They brushed aside the effects inflationary factors may have.

Equities were a tale of two markets. In one, the Magnificent 7 returned ~70% over the course of 2024. These top megacaps (Tesla, Amazon, Google, Apple, Meta, Microsoft and Nvidia) have outperformed in the bull market, lifted especially by Nvidia, whose earnings rose and got bought up by traders betting on further profitability from AI implementation. These 7 accounted for $16 trillion of the S&P 500's $46 trillion market cap. Overall, ~70% of stocks in the Index performed positively, and 10 had over 100% returns. On the flip side, 167 stocks (one third of the Index) performed *negatively*, 7 had returns around -50% or worse. Even amongst the strongest stocks by market cap, there were many losers. Dispersion has been especially high in the more cyclical Tech and Consumer Discretionary sectors. Equity valuations overall are stretched in the top decile of historical multiples (30x+ for the top winners). The non-Mag-7 S&P equities notched gains in typical growth-stock fashion, with multiples still ~20x. The equal weight S&P 500 has returned a much less impressive (but normal) ~10% over the year.

The Magnificent 7 vs. the S&P 500 Total Return 2024 Full Year (PortfoliosLab)

Sources: Beetle Baily (by Mort Walker), US Bank, PortfoliosLab, Earst Asset Management, LESG, MarketWatch, Schroders, Fiera Capital, FRED St. Louis Fed., Macquarie, Lazard, BlackRock, Vanguard, EMarketer

However, the tides may be turning. On a forward looking basis, the Mag 7 are expected to have sustained growth, but the rest of the market is looking to catch up as earnings broaden, competition increases, and traders begin to focus more on profits than potential.

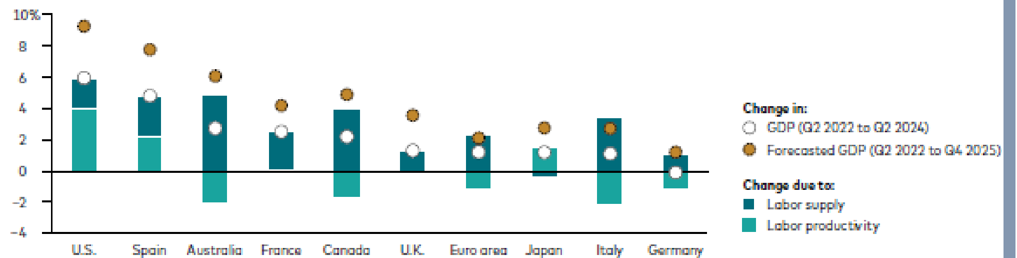
Expected S&P 500 earnings growth	Q3 2024	Q4 2024	Q1 2025	Q2 2025	Q3 2025
The Magnificent Seven	17.9%	16.3%	15.2%	14.5%	16.6%
The other 493 companies	1.7%	13.9%	14.2%	13.0%	15.6%

Source: FactSet

U.S. Exceptionalism

Domestic equities have dominated global markets in earnings and returns, driven by fundamentally strong growth (Right). This should be no surprise, given that the U.S. economy has shown dynamism and resilience in growth that has significantly outpaced the rest of the developed world. It is expected to continue. On our watch list will continue to be the labor supply, which is sector specific. Decreased immigration could pinch labor supply in key sectors like construction and hospitality. AI could prove to be a boon to the economy if it continues the increase in labor productivity and the overall efficiency that has propelled us through this short-and-sweet economic cycle.

Cumulative change in GDP since Q2 2022



Notes: The bars show the cumulative change in labor supply (as measured by hours worked) and labor productivity (as measured by output per hour worked) between Q2 2022 and Q2 2024. The white dots show the cumulative change in GDP for each economy between Q2 2022 and Q2 2024. The tan dots show the forecasted cumulative change in GDP for each economy between Q2 2022 and Q4 2025.
Sources: Vanguard calculations, based on data from Bloomberg, the U.S. Bureau of Economic Analysis, Eurostat, the Australian Bureau of Statistics, Statistics Canada, the Economic and Social Research Institute (Japan), the Office for National Statistics, the European Central Bank, the U.S. Bureau of Labor Statistics, and CEIC, as of October 30, 2024.

Graphic Sourced from Vanguard

FIXED INCOME: A SIGNAL IN THE NOISE

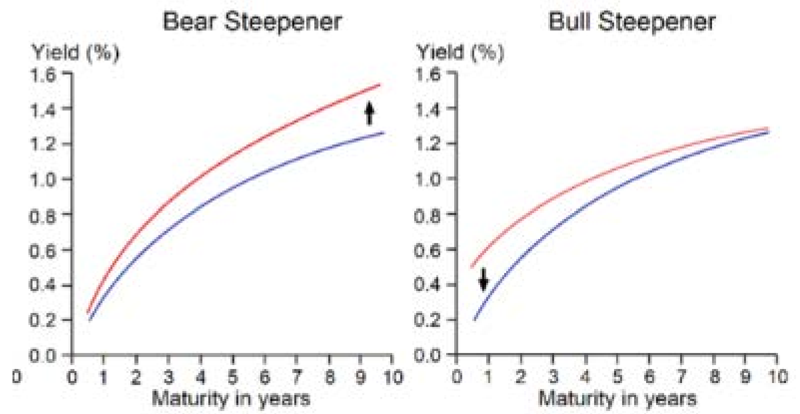
While equities embodied optimism, bonds were the pessimists. Initial gains from rate cuts on the horizon turned to rising yields and falling prices in the third quarter. Aggregate bond prices (shown as the blue line) were volatile, reaching a peak in September after the first Fed rate cut and then declining sharply. Yields, on the flip side, began by rising as rate cuts were postponed, then dropped over the course of Q2 and Q3 to price in the first 50 bps cut. What stood out was the precipitous *rise* in yields in Q4 even as rates continued to decline. Returns ended up muted.

Barclay's Aggregate Bond Index performance vs. U.S. 10 year Treasury Yield (YCharts, overlayed by proprietary charting)[1]

During the late election cycle and after the election, we saw a pronounced divergence between stocks and bonds. Equities rallied, while fixed income markets slumped as long-term yields rose from 3.95% at the beginning of the year, passing through a low of 3.63% in September to 4.58% at the end of 2024. To put this rise in context, consider that over the 4th quarter short term yields **decreased** by 100 bps, while long term yield **increased** by almost the same amount.

[1] This chart is intended for illustration, not as a precise comparison. Note that the duration of the Barclay's Agg is ~6 as of this writing. The duration of a 10 year Treasury Bond is between 7-8 years, depending on yield.

Bonds are broadcasting that we are still stuck in a "higher-for-longer" environment. The short end of the yield curve is stuck for longer, with only 50 bps of cuts expected in 2025, and the long end of the yield curve is higher from organic price declines on the expectation of more inflation risk, and more U.S. risk premium due to fiscal uncertainty. The yield curve for 2 vs. 10-year Treasuries went from inverted by roughly 39 bps to upward sloping by about 32 bps (a total reversal) over the course of the year. When this occurs due to short term rates declining, it is often referred to as a "bull steepener" because lower short rates are bullish (good) for growth. When it happens because long rates are rising, this is known as a "bear steepener", because high long-term yields signal bearish (unfavorable) future capital conditions. Currently, the bond market's unusual reversion out of inversion signals two main considerations:



Graphic sourced from Erste Asset Management

1) Inflation is expected to be sticky. High long-end yields reflect a premium for inflation over the tenor of the bond.
2) Government debt risk premium. U.S. debt is thought of as a risk-free asset, but investors may still command higher yields when fiscal policy is out of balance and debt issuance is high.

In the High Yield space, investors are able to clip good coupons on debt, but bond investors aren't being compensated for risk. Spreads around 270 bps are extremely compressed. By some measures, spreads like this are the lowest since before the 2008 great financial crisis. The yield in high yield is currently largely derived from elevated base rates. Spreads are likely to only rise from here, which means prices may tick down if risk signals increase and cause investors to demand compensation.

Are stocks and bonds signaling two different economic realities?

The divergence between stocks and bonds towards the end of the year stemmed more from anticipated economic policy than divergent views on current fundamentals. Government spending outpacing revenues is good for stocks in the short term. In the bond world, continuous deficit spending raises long-term risk. Along with more stimulative fiscal spending potentially making inflation stickier, a higher supply of government debt means higher yields. Moderate inflation meanwhile isn't bad for stocks, as long as it can be passed through to consumers.

Trump's Tariff Plans Will Likely Drive Consumer Costs Up and Decrease Spending Power

% change in US consumer prices and billions in lost consumer spending power, by category and scenario, Nov 2024

	Scenario A*		Scenario B**	
	% change in consumer price	Lost consumer spending power	% change in consumer price	Lost consumer spending power
Toys	36.3%	$8.8	55.8%	$14.2
Household appliances	19.4%	$6.4	31.0%	$10.8
Footwear	18.1%	$6.4	28.8%	$10.7
Travel goods	13.0%	$2.2	21.5%	$3.9
Apparel	12.5%	$13.9	20.6%	$24.0
Furniture	6.4%	$8.5	9.5%	$13.1

*Note: *Scenario A represents a 10% tariff on all imports and an additional 60% tariff on imports from China; **Scenario B is a 20% tariff on all imports and an additional 100% tariff on imports from China*
Source: National Retail Federation (NRF), "Estimated Impacts of Proposed Tariffs on Imports: Apparel, Toys, Furniture, Household Appliances, Footwear, and Travel Goods" prepared by Trade Partnership Worldwide, LLC, Nov 4, 2024

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Stocks appear to be discounting the risk of tariffs and appreciating the promise of lower taxes and less regulation. Specific policy measures like these may be impactful. Tariffs are an additional tax for American companies. In order to import goods or components, companies will need to pay more. This will either get passed on to consumers or reduce profits - either rising prices or slowing growth. If the average effective tariff rate jumped from ~2.7% to 12% or more, it would cost US consumer housholds thousands of dollars each, on average. Such increased costs would threaten consumer confidence, dampen afforability and curtail household discretionary expenditures.

LOOKING AHEAD (NOT UP, NOT DOWN)

Investors can be forgiven for being fearful. The economic cycle appears to be nearing its apex. After the 2023 recovery and a bullish 2024, stocks have notched back-to-back annual gains of 20+%. Is there anywhere to look, but down?

Sources: Beetle Baily (by Mort Walker), US Bank, PortfoliosLab, Earst Asset Management, LESG, MarketWatch, Schroders, Fiera Capital, FRED St. Louis Fed., Macquarie, Lazard, BlackRock, Vanguard, EMarketer

Looking on the bright side: Economic fundamentals in the U.S. are good. Unemployment has ticked up but is currently relatively stable at 4.2%. Growth is projected to continue at a moderate pace. Consumer confidence is stable and business confidence has waned but remains near normal levels. President Trump has promised low taxes and deregulation, which would benefit smaller sized companies and banks especially. Lower corporate tax rates would be a boon for equities.

Peering into the shadows: There are many "To Be Announced" risks that could add significant froth to markets. Tariffs could be a minor nuisance or a migraine headache, depending on how forcefully they are implemented and how rash the retaliation is. Decreased immigration and increased deportation would exacerbate this by increasing labor costs and lowering growth. Economic data surprises have begun to cause larger market swings for both stocks and bonds. It doesn't take an economic crisis to send markets into a short-term tailspin. Data we don't have yet could do the trick.

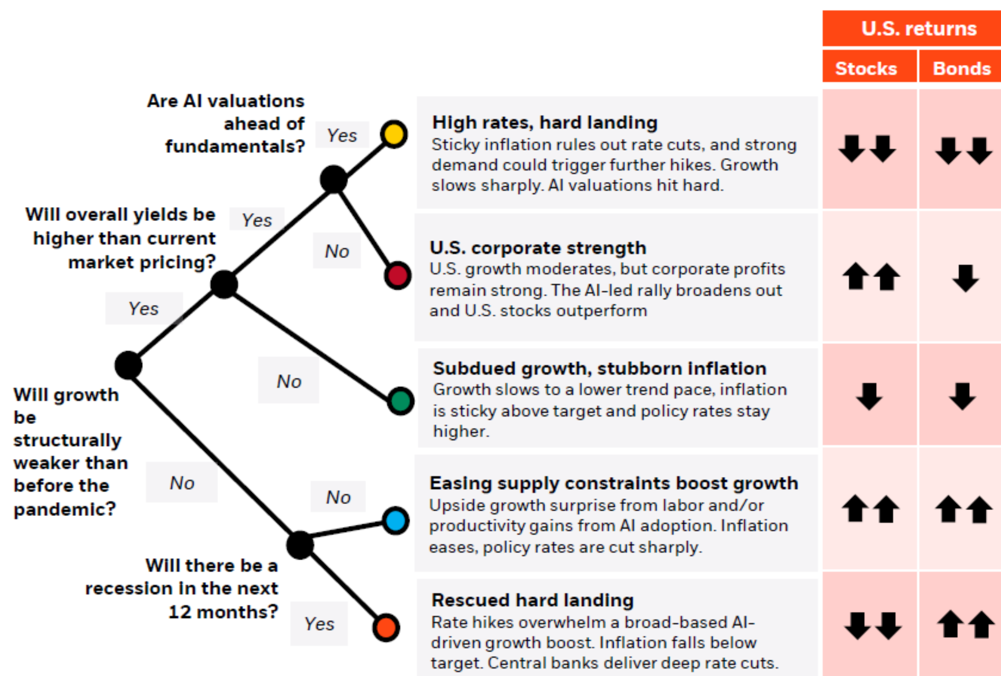
Outlook for Equities

- Equities are still a source of favorable return. U.S. markets remain in favor.
- Earnings are projected to broaden out, potentially lifting quality and value stocks.
- Less regulation will be favorable to small- and mid- caps, as well as private equity.
- Skilled active management on the international side can identify opportunistic mispricing.

Outlook for Fixed income

- Yields may remain volatile, especially at the long end. Duration risk is high due to fiscal/inflation uncertainty.
- Bonds are for coupons, not for hedging. High correlations to equities are expected to continue.
- Deregulation may help banks, increasing credit availability but possibly bringing in yield on loans and private credit.
- With spreads historically tight, loans and private credit give more cushion against prices correcting.

BELOW ARE SOME POSSIBILITIES, PUT TOGETHER BY BLACKROCK, FOR WHAT 2025 MIGHT HAVE IN STORE:



The worst scenarios to the left largely depend on poor growth (yellow, green and red terminal points are most likely the worst for balanced investors). This could come from government policy, exogenous shock, or economic surprise. Economists believe current fundamentals are favorable. Lower inflation, more rate cuts than expected, and productive AI implementation, would all be supportive of good outcomes for investors. This choose-your-own-adventure set offers just a few of many possible paths. Reality will always offer surprises.

It's likely that an increased correlation between stocks and bonds will continue, where there is no safe haven in traditional fixed income. Going into a mature and very fully priced market, there is a good amount of consensus about diversification bets. Below are some diversification trades that smart money institutional managers are making:

Sources: Beetle Baily (by Mort Walker), US Bank, PortfoliosLab, Earst Asset Management, LESG, MarketWatch, Schroders, Fiera Capital, FRED St. Louis Fed., Macquarie, Lazard, BlackRock, Vanguard, EMarketer

- Dividend paying, low volatility, and high-quality U.S. stocks: Return may come more from dividends and broader earnings in the market than the Mag 7. Focus on free cash flow, earnings growth, pricing power, profitability, and balance sheets.
- Infrastructure: Digital infrastructure, data infrastructure, and power infrastructure are all in top demand, but there is need for investment across a diversified variety of sectors and geographies.
- Non-Energy Commodities: While oil prices may remain muted, energy infrastructure and non-oil-and-gas commodities can help diversification.
- Private Credit: Illiquid credit, with risk mitigated by senior secured covenant-heavy loans, provides a favorable spread on top of high base rates. Elevated primarily floating rates and muted defaults are tailwinds.
- Bank Loans and Securitized Credit: Business ABS, MBS, CLO's and other instruments, along with high-carry investments like floating rate loans that sit high in the capital structure.
- Private Equity: Better valuations with good underlying fundamentals provide high risk adjusted return for investors who can tolerate illiquidity. Valuations could increase if an AI toolkit can be implemented to help smaller companies. Deregulation could be beneficial for growth, but uneven across sectors.
- Volatility: "Be greedy when others are fearful." Buy into market corrections when skepticism rears its ugly head.

Here's what many managers are avoiding:

- Cash: Stay fully invested. Add cushion with diversification.
- Long Duration: Stay in the "belly" of the yield curve.
- Investment Grade debt: Excess returns minimal, while sensitivity to unexpected inflation and higher rates.
- High Yield Debt: Low compensation for risk requires active management and selectivity, more sensitivity to rates/inflation than securitized/asset backed debt, more downside in recessionary environment.
- Consumer ABS, Office MBS: The risk of consumer or commercial weakness is not worth the reward.
- Emerging Markets and China: Sustained lower-growth combined with other risk-heavy trends is unfavorable.
- International Developed Equities Indexes: Lower projected returns, though lower buy-in multiples. Skilled active managers may be able to use these opportunities to generate return, but buying passively is out of favor.
- Crypto/Bitcoin: Deregulation favorable, but crypto remains highly speculative and momentum driven.

There are several themes that present risks that neither market participants nor policy makers can control. Climate change is a more robust economic theme than ever before: Wild fires, floods, tornadoes, and hurricanes have a more pronounced economic impact as they become stronger and more frequent. Geopolitical risk is high, with the Middle East, China, and areas of Africa in states of tension, internal conflict or outright war, any of which could escalate and have global impacts.

Our approach at IAA is **all weather**. We favor assets that offer downside protection and diversification, and we prefer high quality assets to high octane returns. If and when there are shifts in the market, investors do best to "stay the course" - roll with the punches and don't look down.

Sources: Beetle Baily (by Mort Walker), US Bank, PortfoliosLab, Earst Asset Management, LESG, MarketWatch, Schroders, Fiera Capital, FRED St. Louis Fed., Macquarie, Lazard, BlackRock, Vanguard, EMarketer

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