Piloting Through Noise

Q1 2025 Market Outlook

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"Fighter pilots have ice in their veins. They don't have emotions. They think, anticipate. They know that fear and other concerns cloud your mind from what's going on and what you should be involved in.'"- Buzz Aldrin

As we wrap up another year of excellent returns, investor angst continued to rise even as markets powered higher, with the S&P 500 logging back-to-back 20%+ returns for the first time since 1997-1998. With 58 new highs reached in 2024, there remains investor anxiety about the sustainability of the rally. One must be thinking of Icarus and flying too high and too close to the sun, but we caution that this is still a normal bull and has plenty of gas to run higher. Bull markets do not typically end due to high valuations or old age, and while this one will eventually end, we feel it might still be 18-24 months before it begins to roll over. BUT, and for the first time we are adding the qualifier, there are certainly risks of a policy error in 2025, either fiscal or monetary, which is a tried-and-true way to kill off a bull market. So, we remain bullish, and our base case is the rally continues, however we would be remiss not to be ready for lurking risks. The key is to remain focused on what matters in the face of increasing noise.

Our investment philosophy is to allocate towards outcomes we see as most probable, not to look to hedge or avoid all possible risks or what-if's. The market has proven time and time again that it can climb a wall of worry no matter how tall and foreboding. Valuations and magnitude of the bull market are less concerning to us than the expected paradigm shift of the Trump administration and a difficult environment for the Fed to navigate. The market cheered the red wave, anticipating and rallying on expected tax cuts, lower regulation, and a more business friendly administration. But potentially counteracting these catalysts are tariffs and DOGE, which is looking to cut government spending & employment, potentially increasing unemployment and reducing government investment both of which would pressure US GDP growth. We remain in the bull camp as the Trump administration has made it clear their priority is economic growth and prosperity. But (and its always the after the "but" that you have to pay attention) with the market anticipating so much growth, any mistakes on the tariff or government spending front could cause a market stumble. We believe firmly in the US maintaining market leadership, which is why we remain highly overweight US allocations in our portfolio as the era of US stock market exceptionalism is not over yet. Investors may need ice in their veins next year as we anticipate volatility picking up, which may test risk appetite. Time in the market is critical for long term returns, so we caution having a quick reflex to pull the emergency chute and bail on the market. -10% pullbacks are normal, and we avoided any of them in 2024. The probable outcome next year is the rally continues, but we are more aware of other possible outcomes as the year unfolds.

2025 Outlook

If it ain't broke, then don't fix it. We believe in staying with the winning trades of 2024: overweight US large cap companies, market weight small and mid, and underweight or no allocation to Developed International and Emerging Markets. We feel the equity market will continue to outperform the bond market, and within fixed income look to add more credit risk than duration risk as the Fed faces a very uncertain path in 2025. Technology and AI remain a core theme of ours and we feel investors should remain invested in their Magnificant7 and would look to add to them on significant weakness. Our bull market playbook follows the trends of the 1995-1999 internet driven rally (and eventual bubble), where the S&P logged 4 years of 20%+ returns, and a 5th year in 1999 of 19.53%. This rally is also not unprecedented, we continue to argue it's a normal bull market where it is not uncommon for multi-year positive returns.

2025 Outlook:

- S&P 500: 7,100
- Earnings: $275
- 10-Year Treasury: 4.75%
- Year End Fed Funds Upper Bound: 4.00% (50bps of cuts)

Our outlook implies a roughly 15% return for the S&P 500, which is below the 24.23% return of 2023, and the estimated 27% return in 2024 (through 12/13). However, it is in line with the 5-year average return 2019-2020 of 15.36% and is still well above the 25-year average of 7.18%. The US markets have historically shown the ability to sustain rallies while the rest of the world struggles. In the last 50 years there have been multiple periods of 3+ years where the S&P 500 has been positive for long stretches of time, without logging a negative year. While this is a bit simplistic, it's helpful to review the S&P 500 on an annual basis, and not just from the beginning and ends of bull markets. Over the last 50 years there have been 7 occurrences of 3+ years straight of positive calendar year total returns, going on 8 if we believe we can log another one in 2025. The longest stretch was 8 years in the 80's while the best performing era was the internet driven mid 1990's. History is on the side of the bull market being able to rally further. In a secular bull era, the potential this is a 4–5-year rally seems likely assuming we can avoid major policy blunders.

	Time Period	# Years	Total Return (Including Dividends)	Annual Avg. Return
1	2023-Current	2	62.28%	28.13%
2	2019-2021	3	100.29%	26.03%
3	2009-2014	6	159.27%	17.20%
4	2003-2007	5	89.92%	12.83%
5	1995-1999	5	250.87%	28.50%
6	1991-1993	3	54.48%	15.58%
7	1982-1989	8	299.87%	18.92%
8	1978-1980	3	67.49%	18.72%
	AVERAGE	**4.375**	**135.56%**	**20.74%**

2025 may showcase a power struggle between catalysts and risks as the world awaits the Trump administration. We feel there are 2 main catalysts and 2 main risks that will determine our 2025 playbook: business friendly government and AI driven (but broad) earnings growth vs. lurking inflation and weakening labor market. As bulls, we believe the fundamental growth story is intact and that profit growth will remain robust. It is rare to have a bear market in an era of expanding profit and profit margins.

Trump 2.0

As seen by the post-election rally, where November was up 5.73%, the markets are expecting a major boost from the incoming administration. But the Trump administration faces a few uphill climbs, such as the rising deficit and debt burden as well as the desire to lower taxes across the board but it may be a struggle to find offsetting cuts. The IRA (Inflation Reduction Act) is one area that is widely discussed as a potential to find large spending cuts, however 70% of the dollars have been allocated to Republican districts and the House and Senate are very slim majorities. Everyone is all for cutting spending, until it affects their constituents and their district.

We applaud the desire to rein in spending and the deficit as we are in unprecedented territory of running a large deficit during (relative) peacetime and economic expansion. However, cutting spending is difficult, especially when your majority margins are extremely thin. The current breakdown in the house is 219-211 with 5 vacancies (3 Democratic, 2 Republican) and the Senate positioned 53-47 including the independents aligned with the most similar parties. Even getting simple tasks completed such as a continuing resolution to fund the government is proving tricky as with a small majority the squeaky wheel has the ability to hijack the process.

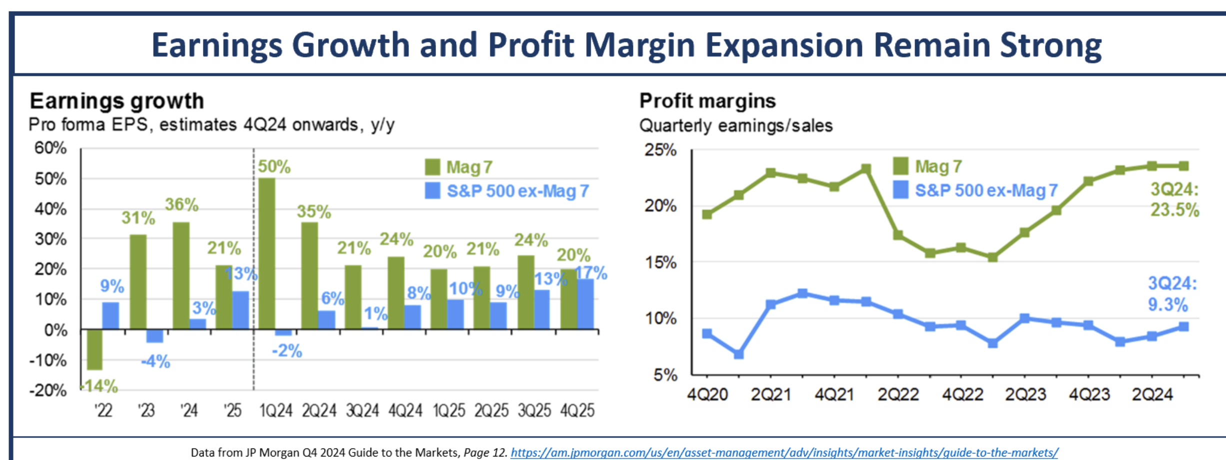
Assuming a functional system, which is a bit of a stretch, we feel there will be 5 major themes of the Trump administration:

1. **Lower Taxes:** This is likely the highest priority of the Trump Administration as it was a central theme of his campaign. We expect individual brackets to fall, estate tax exemptions to stay high if not grow, and corporate taxes to be more friendly. Higher SALT tax exemptions or possibly bringing back deductions such as entertainment could also get done. One warning, tax cuts must be paid for by spending cuts or revenue raised elsewhere and tariffs seem to be one lever the administration is eager to pull, but there are other more controversial revenue generation ideas, such as making municipal bonds taxable. Extending the 2017 Tax Cuts and Jobs Act (TCJA), or making them permanent, is a large priority for the administration. But potential key additions would include making tips exempt, exemption of social security income, and deduction of auto loan interest. The business top tax bracket of 21% is not set to expire, though the administration has indicated a desire to move that rate down to 15% for companies making their products in America.
2. **Lower Regulations:** Currently, the FTC has been extremely active in blocking mergers and acquisitions, as well as going after companies for other non-competitive or anti-trust behaviors. We feel the Trump administration appointees will be more business friendly which should benefit banks, energy, and industrial companies tremendously. Current potential regulations such as overdraft fee reductions, or swipe fee caps could be rolled back along with a much smoother permitting process for new construction and large energy infrastructure projects. All in all, we expect a much lighter touch from the Federal government towards businesses.

3. **More dealmaking:** Multiple large deals have been thwarted in recent years (KR/Albertsons and Spirit/Jet Blue are the most recent examples), and we feel the era of dealmaking is likely to make a comeback in 2025. Lower interest rates are also a catalyst for more deals, as the cost of debt would be more attractive.
4. **Contentious International Relationships:** The bill for tax cuts looks steep, so revenues must be raised from somewhere, as well as from cuts to spending. Tariffs are high on this administration's agenda. Canada, Mexico, and China are already circling the wagons and preparing responses as tariffs are one area of the government that the President can directly control and implement with little need for Congressional approval as the Trade Act of 1974 and the Tariff Act of 1930 have carved out authority to impose tariffs for a wide range of reasons. Currently, there are proposed 25% tariffs on all imports from Mexico and Canada, pending action on immigration, and 10% on China. It is unknown if energy and crude oil would be exempted, and many industry groups and lobbyists are lined up to ensure their interests are protected and carved out. How these tariffs are implemented, as well as what the indicated retaliatory tariffs cover is unknown. This is a wild card on how wide ranging and for how long these tools may be utilized. The Trump administration was also known for its more hard-nosed approach to international relations, including NATO and other allies, so many are expecting a return to a more aggressive international relations approach. With ongoing conflicts in the Middle East, including the fall of Syria, and in Ukraine, there remains some question as to how much support, weapons, and ammunition the incoming administration will give.
5. **Elon v. Donald:** This surprising new power couple have been almost inseparable the last few months and Elon certainly played a large role in funding and supporting Trump during the home stretch of the election. However, Elon and his DOGE committee may run into issues with Trump's desire to expand economically. Government expenditures are estimated to be approximately 22-23% of GDP, and the US Federal Workforce is the largest single employer in the United States. As of September 2023, the federal workforce including civilian and military personnel was 2.95mm people. Per the OPM, the average length of service for government employees was 24.9 years, and the largest departments were the Department of Veteran Affairs, Department of the Army, Department of the Navy, Department of the Airforce, and the Department of Homeland Security. And while some areas to find savings are supported on a bi-partisan basis, such as selling the roughly 14,000 vacant federal buildings, other areas are much harder to eliminate. For instance, the Department of Education employs about 4,400 people vs. the estimated 375,000 employed by Veteran Affairs. Ronald Reagan tried this back in 1982 with the Grace Commission which he authorized to "drain the swamp." Most of the reforms were ignored by Congress, though some recommendations on efficiency were implemented. DOGE is the new Grace, but cutting spending and a sprawling government workforce has thwarted politicians for over 50 years. Everybody wants efficiency and cuts, just not until it affects their department, their district, or their constituents.

Earnings Expansion

The macro and government policy priorities will have a large impact on the near-term success, or failure, of the economy and stock markets. But it's important to note that the stock market is not the economy and while they are correlated, historically, the stock market is a leading economic indicator and not the economy leading the market. The most important indicator of market health is continued earnings and profit growth. Earnings growth for 2025 is expected to be a robust 23.5%, though bottom-up consensus growth is forecast at 13.1%. This is one main differentiator between the current market cycle and the tech bubble of the mid-1990's. Actual profits earned were minimal for many of the internet-era companies. For every AMZN there were 50 Pets.com that didn't actually generate any revenue but were more a fledging idea. At the end of 1999, peak bubble, the NASDAQ 100 was trading at a 73x PE and only had a 0.76% free cash flow yield. As of December, the NASDAQ 100 has a PE of 38.57 and a free cash flow yield of 3.42%. Free cash flow yield is a handy way of looking at how much free cash a company generates relative to its market capitalization – basically showing how much cash a company has to distribute to investors or reinvest in the business. Yes, the market is expensive, but the market is also supported by growing earnings and stronger fundamentals than the tech bubble.



Data from JP Morgan Q4 2024 Guide to the Markets, *Page 12.* https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/

We continue to believe in the US markets outperforming the rest of the world, especially vs. developed international markets in Europe. The US is where innovation is happening. The Magnificent 7 (AAPL, AMZN, GOOGL, NVDA, MSFT, META, TSLA) continue to flex their scale and superiority delivering higher earnings growth and stronger profit margins than the broad markets. We feel in this market the winners will continue to win and scale up, if there is an up-and-coming technology or platform, the Mag7 have the ability to acquire it and plenty of room on the balance sheet for expansion. This keeps these companies at the forefront of AI and technology.

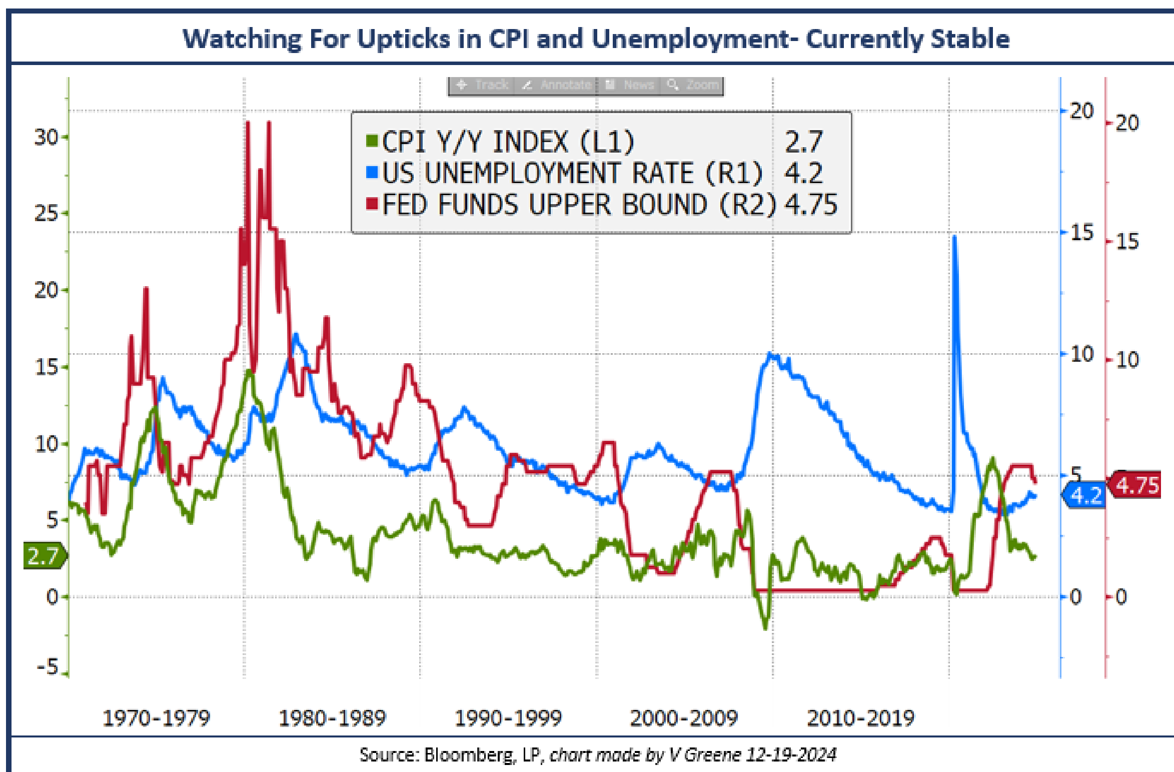
Valuations in the US are not cheap. At 22.2x Forward PE, the only 2 times in recent history the market was more expensive were 1997-2000 (43x) and 2020-2021 (35x). But the S&P 500 is heavily weighted to the top 10 stocks, at an estimated 36.2%, this is the most concentrated the index has been. However, these top 10 stocks are delivering better results, and faster earnings growth, so currently we are not concerned with the concentration of the S&P 500.

Other markets are certainly cheaper, but we consider them value traps for a reason. While markets such as China or Europe are significantly cheaper, we do not feel their growth rate and upside opportunities are significant, thus they are cheap for a reason. Look at where the profit growth remains the strongest.

Fed v. Inflation

The biggest risk to the bull market is a policy error, either on the Fiscal side with taxation, spending, and tariffs or on the Monetary side with Fed policy. The Fed has a thankless job, and they are often late and/or wrong as most of their data is backward looking with a long lag. Remember transitory? July 28, 2021, Fed Chairman Jerome Powell infamously stated "these transitory supply effects abate, inflation is expected to drop" right before inflation surged for 12 straight months to a high of almost 7% on PCE. Now the Fed is faced with a different conundrum: how to stick the soft landing. The Fed only has 2 mandates – maximum employment and price stability. And the Fed has 2 main levers to pull: they can raise or lower interest rates to stimulate or retrain economic growth, and they can add or reduce their balance sheet to provide liquidity with QE (Quantitate Easing - buying bonds) or QT (Quotative Tightening - selling bonds).

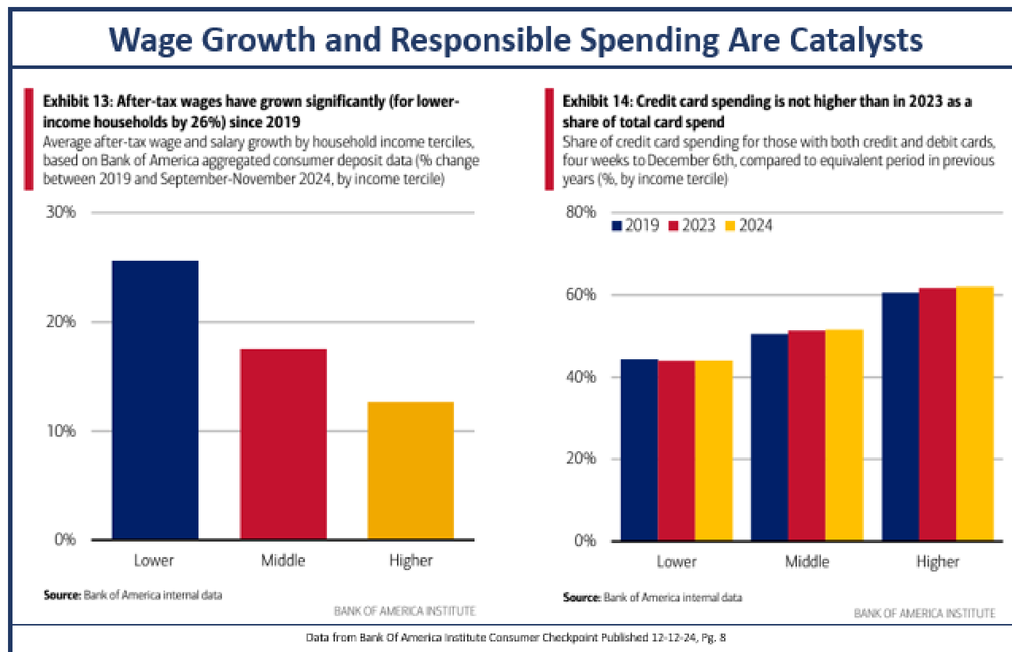
With current unemployment at 4.2% and inflation (as defined by CPI), at a 2.7% annual rate, employment and inflation are currently stable. However, PCE has been stalled and unemployment wavering, especially in the manufacturing sector. We are wary of DOGE and the potential that unemployment creeps back up as a scenario of rising inflation and unemployment is very difficult on the economy and stock market. If cutbacks in government employment are gradual (which the government tends to move at slightly below sloth speed), then the private markets could potentially absorb any downsizing in public employment, however it would be a delicate balance. Tariffs are also historically inflationary to the US Consumer, so the risk of acceleration in inflation is higher in 2025 than this year.



Our base case remains that the Fed is patient, but that we will not see as many cuts as are currently priced in on the Dot plot. We are anticipating 50bps of cuts, which would put us on par with the mid-1990's and the gradual Fed policy changes supporting the emerging tech sector. Stability in policy is key as most companies do not like abrupt change and prefer a well-telegraphed policy path and a Fed that does not knee-jerk into bad decisions.

Labor and Consumer Health

The engine driving this rally is the consumer. The US consumer has continued to grow its spending and support earnings expansion. A prolonged fall in consumer income and consumer spending would stall out economic growth and put pressure on a company's ability to grow profits. If you are not selling more widgets, you need to charge more per widget to grow profits. But the consumer only has so much elasticity in spending, meaning it's a difficult task to expand profits in a world with slower consumer spending. The consumer has already dealt with significant shrinkflation in a post-COVID world, and they are beginning to push back. WMT changed the sheet count of its Great Value Paper Towels from 168 to 120 per roll, PEP reduced the size of its Gatorade bottles from 32 to 28oz with a bottle redesign which they claimed was to make the bottles "more aerodynamic [so that] it's easier to grab." And famously, the Toblerone bar has shrunk from 170-grams to 150-grams. Corporations have passed on the bulk of the inflationary pressures to the consumer by raising prices and shrinking offerings, but coming off a difficult inflationary regime from 2021-2022, there is not a lot of wiggle room for cost increases and size decreases going into 2025.



This is one area we are watching multiple canaries for signs of decline. A pickup in unemployment and/or inflation could downshift the profit cycle from expansionary to contraction, which often signals the end of a bull market. If a policy error does not kill off the bull, a recession or significant slowdown in consumer spending are the other 2 historical reasons that a bull market ends.

The risks are higher entering 2025, but history is on the side of the bulls winning out. Our most likely scenario is continued prosperity and market growth. Yes, the signs of a bubble are here, and valuations are not cheap, but the catalysts for market growth remain intact and valuations are typically not a reason a bull market dies off. We are only 2 years removed from an average bear market, and with profit growth expected to remain robust, if we can avoid policy errors, we should see the bull continue to climb higher. However, *flying isn't dangerous. Crashing is what's dangerous*. So, we do have one hand on the eject lever in case of emergency.

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