Q4 2024 MARKET COMMENTARY

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Introduction

We reiterate our perspective from our previous commentary that although near-term market risks are manageable and long-term prospects remain attractive, we posit that the existing state of financial markets remain vulnerable- stemming from stretched valuation multiples, high earnings expectations, concerning rise in long term interest rates, and a middling fundamental backdrop. Additionally, it is our belief that policy decisions (eg: trade, immigration, regulations, monetary) are likely to further drive investor sentiment and volatility in 2025. However, the boom in AI-related investments which we believe is an exogenous event not tied to the business cycle, has acted as a major pillar of support for equity markets. The AI "gold rush" does not seem to be abating, with industry leader NVIDIA communicating that demand for its new Blackwell chips will exceed supply for several quarters. This is reinforced by NVIDIA's largest customers (Microsoft, Meta, Google, Amazon, and Tesla) all indicating plans to increase AI capex spending for fiscal year 2025. Additionally, the trickle-down effect of this spending into other industries such as utilities, data center REITs, and electrical components have emerged and could drive further economic value output. Outside of a recession, trade war, or major shift in attitude about the monetization opportunities of AI, the AI theme seems likely to retain their leadership in driving earnings growth in the foreseeable future.

The global expansion proved resilient in 2024 as better than expected economic growth, falling inflation, Federal Reserve interest rate cuts, and healthy corporate earnings drove much of the stock market's upside. For 2025, the US is expected to remain a global growth engine with its business cycle in expansion, labor market steady, broadening of AI-related capital spending, and prospects of a stronger capital market and deal-making activity supporting further upside. However, uneven disinflation progress, a potential de-coupling of central bank paths, and heightened geopolitical uncertainty surrounding government policy agendas introduce complexities and potential for greater range of outcomes for investors this year.

Fundamental backdrop

The economy today is extraordinarily strong by nearly every historical benchmark, including relative to the years immediately preceding the pandemic. Anecdotal evidence of unhappiness about the economy's performance can mostly be attributed to a hangover induced by the extreme shocks and aftereffects of the pandemic. These shocks led to a pronounced "bullwhip effect"- the economy saw aggregate demand collapse due to Covid-19 which led to unemployment spiking, and then demand snapped back as supply chains broke down which caused inflation to spike. High unemployment and high inflation experiences in such a short time exacerbated their effects. By the end of 2022, the pandemic shocks have largely subsided, and their economic effects were quickly dampened. A serious assessment of how the economy is performing today should look past these short-term bullwhip effects and focus on comparisons of the pre- and post-shock "normal."

The table below compares economic performances using various measures across three time periods: since the end of 2022 (current period), the last full business cycle before the pandemic (2007 – 2019), and between (2017 – 2019) the tail end of that business cycle expansion that coincided with the Trump administration before the pandemic began.

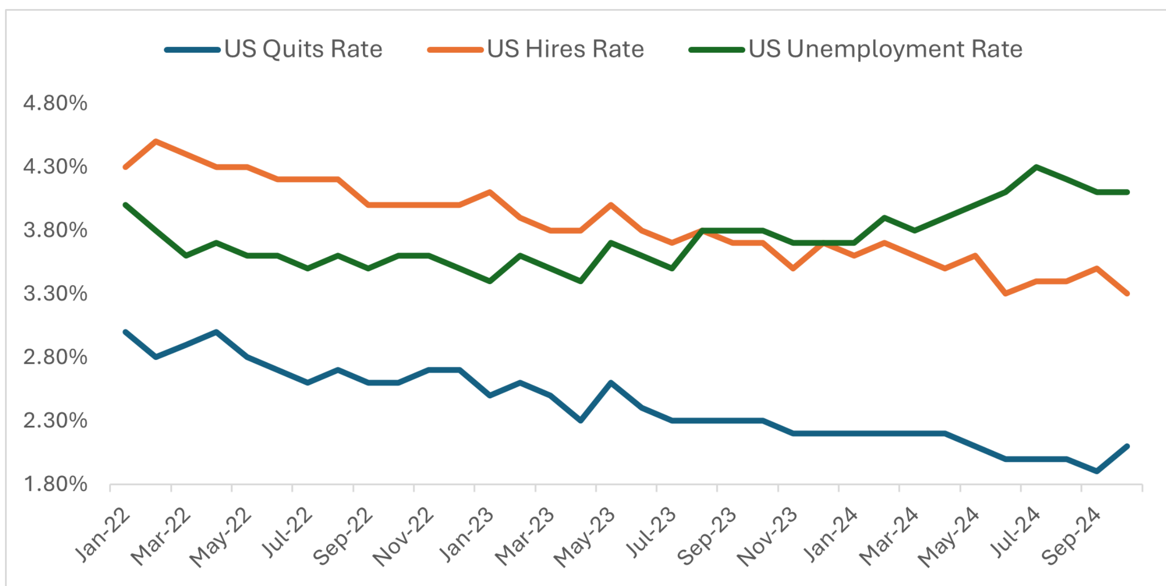
	Since End of 2022	2007-2019	2017-2019
Average hourly earnings (inflation adjusted)	$35.36	$34.52	$34.52
Average Unemployment Rate	3.8%	6.4%	4.0%
Average Monthly Job Growth	217,000	93,000	176,000
Employment-to-population ratio (%)	80.7%	77.2%	79.3%
Real GDP Growth (average annualized %)	2.9%	1.8%	2.5%
Applications for New Businesses	144,206	102,157	105,580
Average CPI Inflation	3.7%	1.8%	2.1%

Source: Economic Policy Institute, Bureau of Labor Statistics, Liberty One, December 2024.

Hourly wages for all workers adjusted for inflation are not only higher today but have also grown more rapidly. Since 2022, real wages rose 1.2% annually, compared with a 0.8% rate from 2007 to 2019, and 0.9% from 2017 to 2019. Strength in real wage growth can be attributed to a tighter labor market that favored workers, reinforced by the average 3.8% unemployment rate since the end of 2022 vs 6.4% and 4.0% in the other periods. Unusually strong new business applications also drove additional labor demand, resulting in robust average monthly job growth and high employment-to-population ratios, further reinforcing the strength of the labor market. This strength gave consumers the ammunition to drive the economy, from buying cars, restaurant meals, concerts, or vacations, resulting in a very resilient US economy. Since the end of 2022, real GDP has grown at a faster pace than its pre-pandemic trends, surprising even some of the most optimistic forecasts. The bottom line is that as long as people have a job and their wages are rising faster than inflation, that forms the basis of strong spending.

Although the data in aggregate appears strong, not all consumers are spending so freely. Consumers are increasingly becoming more price-conscious, and this rings true across all income cohorts. Messages from major US retailers during the most recent earnings season echoes this point. Walmart (WMT) continues to see higher engagement across income cohorts, with households earning $100,000 or more making up 75% of their market share gains. Consumers continue to seek value to maximize their budgets and have reduced purchases on big-ticket discretionary items. According to national grocer Kroger's (KR), their middle- and higher-income shoppers have begun mimicking lower income cohorts by buying less, narrowing their focus to essentials, and choosing less expensive cuts at the meat counter. Meanwhile, Target's (TGT) healthy guest traffic growth of 2.4% was largely offset by a 2% decline in average ticket. The decline was driven primarily by softness in discretionary categories. In the previous quarter, TGT's same-store sales grew by just 0.3%, and they slashed fourth quarter guidance by nearly 20%.

We believe that the change in spending behavior could be a consequence of a softening labor market outlook. Despite the strength in numbers highlighted in the previously mentioned table, we have seen a decisive downward shift in quit rates, hire rates, and monthly nonfarm payroll growth in recent months. Monthly non-farm payroll growth averaged 215,000 in 2023 but has only averaged 132,000 over the last two months.



Source: Bureau of Labor Statistics (BLS), Liberty One, December 2024.

The unemployment rate troughed in April 2023 and is now 0.9% higher at 4.20%. We note that the number of unemployed that are new entrants or re-entrants to the labor force is up +589k (labor supply) since April 2023 but the number of permanent job losers (labor demand) is up +711k. This suggests that both expanding labor supply and weakening labor demand have played a role in pushing up the number of unemployed. Although recent job prospects have moderated, the labor market remains relatively healthy, so long as general demand stays strong, inflation continues to moderate, financial conditions remain relatively loose, and potential geo-economic conflicts stay contained.

Uncertainty Surrounding Government Policy Agendas

Government policies define the legal and regulatory framework within which economic players (businesses, consumers, and investors) operate, shape priorities, and influence outcomes. As the US embarks on the transfer of power from the Biden Administration to the incoming Trump Administration, several policies are likely to garner significant change and attention- key among them include fiscal, trade, immigration, and deregulation policies. According to the promises made by Trump during his campaign trail, the President-elect and his administration are very likely to implement a moderate expansion of the fiscal deficit, induce some form of deregulation, and intensify trade and immigration rhetoric, primarily with key trading partners that include China, Mexico, and Canada.

Investors are split on whether Trump's fiscal policy will be bullish or bearish this time, given that too large a fiscal expansion could cause inflation to reaccelerate and long-maturity government bond yields to rise. Barring that, the view of most investors is that Trump's fiscal agenda is likely to be positive for growth and corporate profits, partly explaining the rise in the stock market and government bond yields since the election. The extension of tax cuts, increase in infrastructure spending initiatives, and regulatory reforms would be bullish for growth, but too bullish of a fiscal policy could expand an already inflated fiscal deficit and cause a significant rise in Treasury yields via higher inflation expectations, higher term premiums, or both. In other words, the bond market may limit the amount of fiscal thrust that can be inserted into the economy and the impact of stronger growth could be offset by higher interest rates. Additionally, it is our expectation that pro-growth fiscal policies are likely to be coupled with the imposition of tariffs, which could be negative for both global and US economic growth.

There are two reasons why we believe tariffs are likely to be implemented in the coming years. Firstly, they are likely to be viewed by the administration and Congress as a source of revenue that could help offset the impact of planned tax cuts on the deficit.

Tariffs Make Up A Substantial Amount Of Potential Revenue Gains Under Trump's Plans

SUMMARY OF TRUMP PLAN, SAVINGS/COSTS(-) (BILLIONS, 2026-2035)			
Policy Proposals	**Low**	**Central**	**High**
Establish a Universal Baseline Tariff and Additional Tariffs*	$4,300	$2,700	$2,000
Reverse Current Energy/Environment Policies and Expand Production	$750	$700	$550
Reduce Waste, Fraud, and Abuse	$250	$100	$0
End the Department of Education and Support School Choice	$200	$200	$0
Subtotal, Revenue Increases and Spending Reductions	$5,500	$3,700	$2,550

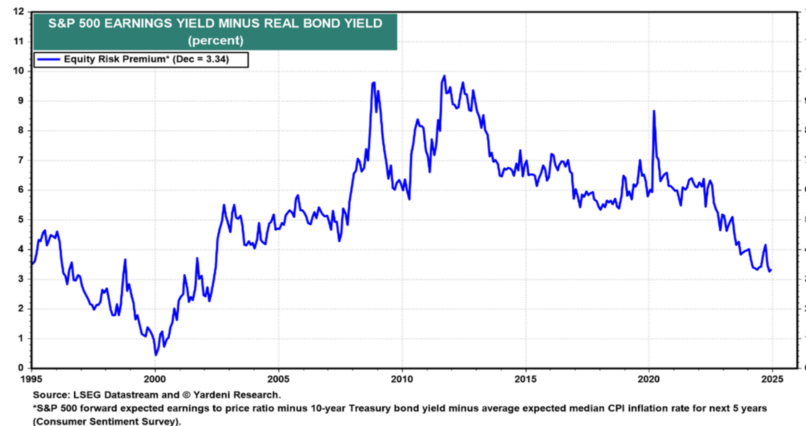
* THE UNIVERSAL BASELINE TARIFF IS ASSUMED TO BE 20% IN THE LOW-COST ESTIMATE, AND 10% IN BOTH THE CENTRAL AND HIGH-COST ESTIMATE. THE CHINESE TARIFF IS ASSUMED TO BE 60% IN ALL SCENARIOS. THE HIGH-COST ESTIMATE ALSO INCORPORATES REVENUE LOSS FROM POTENTIAL DYNAMIC EFFECTS, SUCH AS A REDUCTION IN GDP.
NOTE: FIGURES ROUNDED TO THE NEAREST $50 BILLION.
*SOURCE: COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET.

According to the table above presented by the Committee for a Responsible Federal Budget (CRFB), tariffs account for 70-80% of the total amount of revenue increases and spending reductions across all three scenarios. Secondly, even if Congress refuses to pay for the tax cuts and expanded fiscal deficits with tariffs, tariffs can still be implemented by the Executive branch without Congress. Judging by his first term, Trump is serious about levying tariffs. Therefore, we could expect to see either one major broad-based unilateral tariff on all US imports (eg: 10%), a large tariff import from China, or both. Retaliation by trading partners becomes a risk in this scenario, which could translate into a shock to the global economy and likely impact global financial markets.

The first trade war was clearly negative for global economic activity and risk asset prices. In response to a massive rise in global trade uncertainty, the ISM manufacturing index declined significantly between 2018 and 2019, the Fed cut interest rates, Treasury yields fell, and US stocks approached bear market territory.

Source: Ycharts, December 2024.

It can be argued that part of the market's response to tariffs in 2018 and 2019 was due to the spike in uncertainty tariffs created, and we are unlikely to see a similar response this time round because we have seen this movie before. However, what Trump has proposed on the campaign trail goes well beyond what was implemented in 2018 and 2019. Moreover, the S&P sold off close to 20% in 2018 from a starting 12-month forward P/E ratio of 17, versus 22 today. Equity risk premiums are also at a 22-year low using Yardeni's Research as a proxy, which underscores that stocks are highly vulnerable to a selloff in the case of a major economic shock.



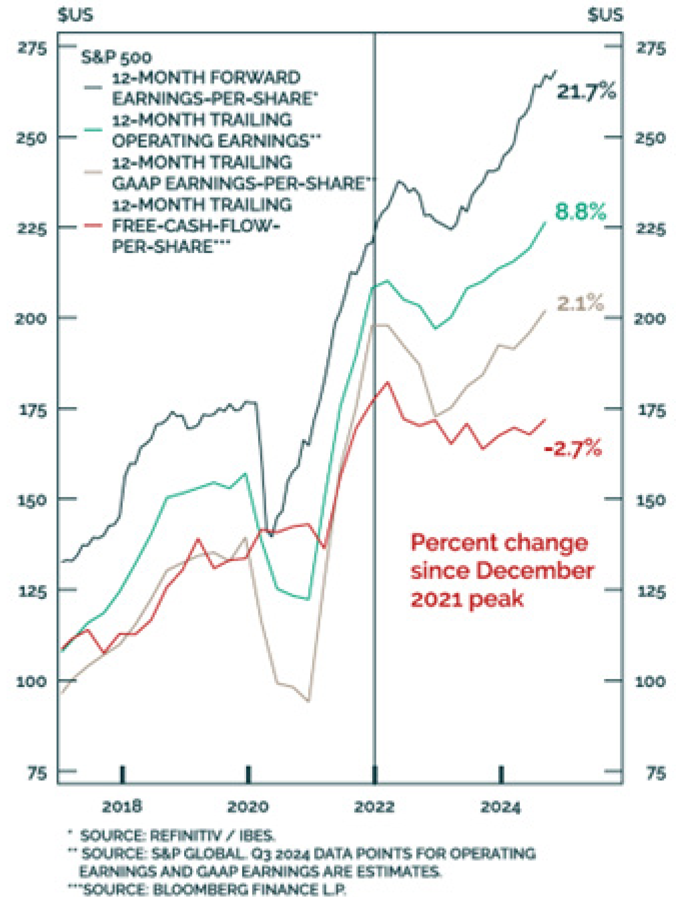
Source: LSEG Datastream and © Yardeni Research.
*S&P 500 forward expected earnings to price ratio minus 10-year Treasury bond yield minus average expected median CPI inflation rate for next 5 years (Consumer Sentiment Survey).

Equity Market Impact

Until tariffs are announced or seem imminent, positive earnings momentum will likely continue unless the labor market deteriorates further or stimulative fiscal policies do not come to fruition next year. Positive earnings growth is our baseline scenario, though we remain skeptical on whether forward earnings will grow as much as actual earnings.

Since the peak in December 2021, forward earnings per share have outpaced free cash flow per share, actual operating EPS, and GAAP EPS significantly. Consequently, current forward earnings expectations raise a high earnings bar for corporations to meet, setting up an environment of possible disappointments which could create a pullback.

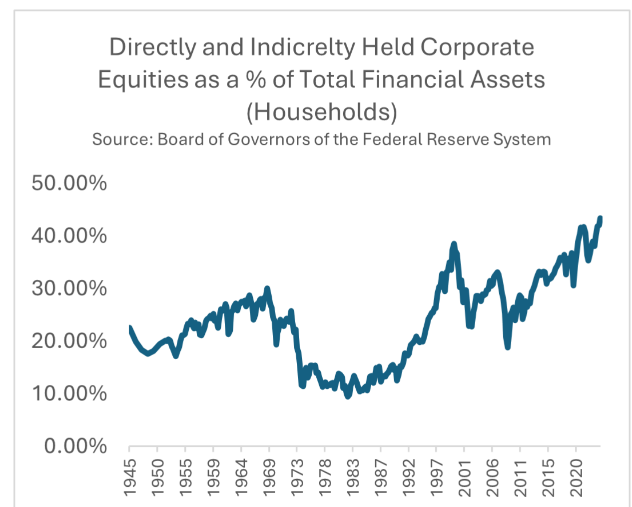
Additionally, a substantial portion of the market's expected earnings growth is driven by Big Tech companies. Introducing the likelihood of tariffs into the picture complicates this. Companies like Tesla, Nvidia, and Apple are substantially more exposed to the tariffs because they import a large part of their products from Asia or have significant operations in countries like China. However, it is possible that the Trump administration would alleviate some pressure by offering exemptions to tariffs under certain conditions (eg: reshoring manufacturing). Software-focused companies like Microsoft, Google, and Meta are less exposed to the tariff impact, though they are exposed to other types of risks like product restrictions due to national security concerns. With solid fundamental growth prospects offset by geopolitical and valuation risks, we remain neutral on Big Tech for now.



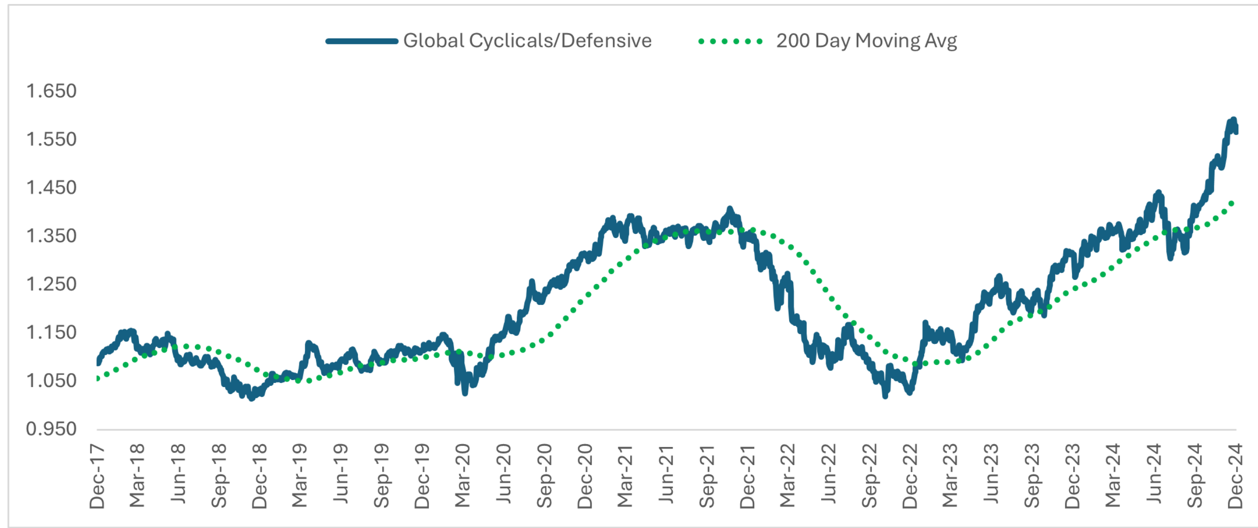
* SOURCE: REFINITIV / IBES.
** SOURCE: S&P GLOBAL. Q3 2024 DATA POINTS FOR OPERATING EARNINGS AND GAAP EARNINGS ARE ESTIMATES.
***SOURCE: BLOOMBERG FINANCE L.P.

Portfolio Positioning

Investments in the stock market by households and nonprofit organizations are currently at an all-time high, above levels seen during the dot-com bubble and the peak of 2021. Although arguments can be made that the democratization of information and capital markets innovation has helped encourage investments in public markets, extreme levels of retail engagement have historically been a contrarian indicator that markets may begin to appear frothy. Couple this with historically low credit spreads, increase in FINRA margin debt, extreme bullish investor sentiment, 22-year low equity risk premiums, and below average VIX levels, investors may be complacent about the potential embedded risks in the market.



Additionally, progress in disinflation has slowed recently, which may limit the Fed's ability to provide support in future crises. The potential for increased volatility from a trade war also keeps us cautious from increasing risk exposures in clients' portfolios. During the first trade war, the classical global cyclical sectors underperformed their defensive counterparts as measured by the MSCI Global Cyclical and Defensive Indexes. Cyclical sectors have outperformed defensives since the trough in December 2022 and has rallied even more significantly since the election. This gives investors a better opportunity to shift in a more defensive direction should geopolitical tensions pick up steam.



Source: MSCI, Liberty One, December 2024. Global Cyclical represented via MSCI ACWI Cyclical Total Return Index. Global Defensive represented via MSCI ACWI Defensive Total Return Index. Figures above 1 indicate cyclical outperformance while figures below 1 indicate defensive outperformance. Past performance is not indicative of future results.

Outlook

After two straight years of incredible growth, returns for the stock market in 2025 could be a little more muted as valuation multiple expansion becomes a little harder despite steady earnings growth. Although valuations are on the higher side historically, we do not believe that they are excessive. Earnings growth from the Magnificent 7 group of stocks is also likely to moderate from its blistering pace over the last 2 years, with our expectation that earnings growth would moderate to below sub 30% year-over-year (still very impressive for the size of the companies). However, barring a recession, earnings growth of the remaining 493 stocks could shine and close the gap on the Magnificent 7 companies. This could appear attractive as these stocks are also trading at a much more reasonable multiple (price to earnings ratio of 19x) versus the average Magnificent 7 stock of 30x. Additionally, we'd expect there to be fewer rate cuts in 2025 as the Fed employs more diligence in bringing short term rates back down to its long-run neutral rate. Nonetheless, we still do think that short term rates have room to move down in 2025 (current median Fed projections are 50 basis points) should disinflation continue to progress. The biggest wildcard in 2025 would be fiscal policy priorities which may introduce higher volatility because of the uncertainties that come with it. Should fiscal policy come in too bullish, the Fed may have to hike interest rates instead of cut, risking a potential selloff as a result. Staying risk-neutral in a well-diversified liquid portfolio would be most appropriate for conservative investors.

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