2025 Investment Outlook

Age Of Extremism

"Change in the weather, change in the weather, something's happening here."

– Credence Clearwater Revival – Change in the Weather

"There is nothing so disturbing to one's well-being and judgment as to see a friend get rich."

– Charles Kindleberger and Robert Aliber – Mania, Panics, and Crashes – History of Financial Crises

"A good company does not necessarily make a good stock investment if the stock is overvalued."

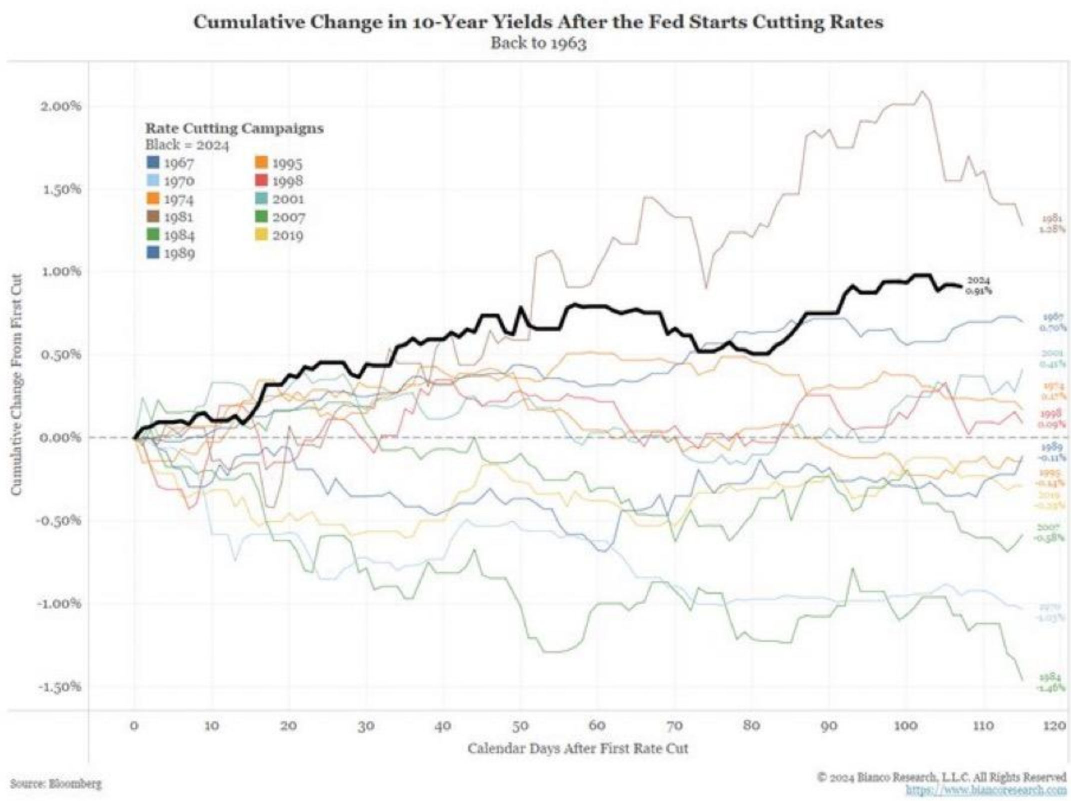
– Warren Buffett

John Fogerty was the lead singer of the popular 1960s-1970s rock band Credence Clearwater Revival. John wrote most of the lyrics to CCR songs and he had a knack for weaving societal observations into his music. Fortunate Son, one of the band's biggest hits, was released in 1969 and had a message about social inequality and opposition to the Vietnam War. The song spoke for blue-collar families, whose sons were serving and doing most of the dying in Vietnam, while the fortunate sons of the affluent were avoiding service by staying in college. Another CCR song from 1969 written by John was Change in the Weather. Lyrics included Uh-huh, you better duck and run, Get under cover 'cause a change has come, Storm warning and it looks like rain, Be nothin' left after the hurricane. Of course, John wasn't referring to the weather. Rather, the song uses the metaphor of changing weather to describe the turbulent and unpredictable nature of that time in American society. Those lyrics from 56 years ago would work as well in a song today.

It seems everywhere one turns today there is extremism. Let's start with the weather. There are increased incidents of raging wildfires (45 square miles of Los Angeles suburbs burning to the ground), rainfalls, cyclones, and tornadoes around the globe. Last summer and within several weeks, two hurricanes hit the same area on the Gulf Coast of Florida and achieved Category 4 and Category 5 status. Areas of western North Carolina and Georgia got wiped out from a deluge generated by Hurricane Helene and Asheville, NC suffered catastrophic destruction.

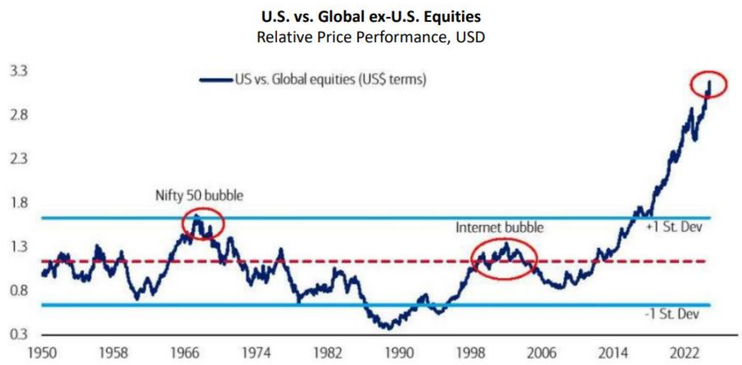
Extremists took over college campuses and once exalted academic institutions such as Harvard, Penn, MIT, NYU, Columbia, Stanford, and UCLA allowed antisemitic mobs to shut down or severely disrupt their campuses. The administrations of these institutions have failed in their basic responsibilities of ensuring the safety of all students and allowing open and free debate of ideas. Several presidents of major schools were forced out of their jobs due to their gross mismanagement of the situation. It is a sad reflection on these institutions that they no longer represent the best of U.S. academia because extreme governing policies have been allowed to prevail.

Extremism dominates national politics today as there are very few moderate Republicans or Democrats left in Congress. The extreme wings of both parties have taken control of the political process and divisiveness now rules the day. The only thing Republicans and Democrats agree on is excessive spending. The U.S. federal deficit is expected to be $1.9 trillion (that's a t) this fiscal year, which is over 6% of U.S. GDP, a level never achieved during a non-recessionary period. U.S. outstanding debt now exceeds $36 trillion or over $100,000 per citizen. With the U.S. Federal Reserve raising interest rates the past two years to rein in inflation, interest expense on the federal debt is exploding higher and surpassed $1 trillion (also a t) for the first time and will become the 2nd largest item in the federal budget. It will go even higher during 2025 as the U.S. Treasury has to refinance $7 trillion (that's another t) of maturing bonds and notes that previously had much lower interest rates. As shown in the following chart, during the 120 days following the first Fed interest rate cut, there was only one other time (1981) when longer maturity bond yields rose more than 2024 (black line). Bond investors are making more noise about the federal debt level. In another example of extremism, longer maturity bond yields have risen nearly 1.00% since September 2024 even though the Fed reduced the Fed Funds rate by 1.00%.



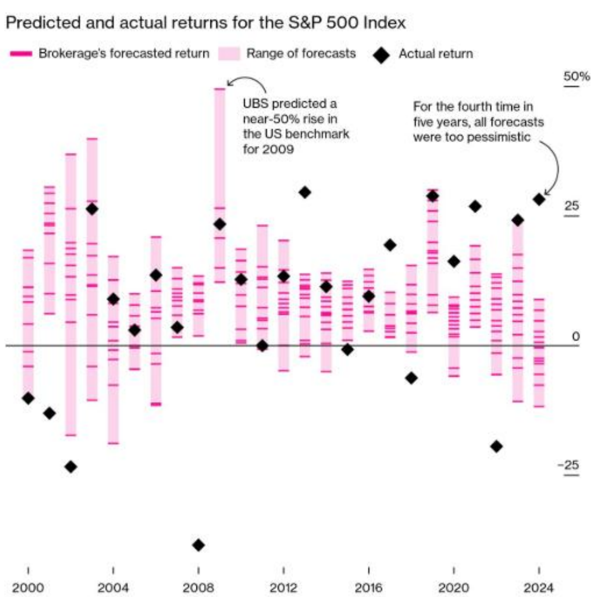
During 2024, financial markets played a part in the Age of Extremism as it was one of the most lopsided years for investment returns in financial markets history. A select group of U.S. mega cap techs stocks, aptly named the Magnificent 7 by Michael Hartnett of Bank of America, had outsized returns compared to everything else. The Russell Mega Cap Top 50 Index, representing the largest 50 stocks in the U.S. by market capitalization and including the Magnificent 7, returned 34.2%. By comparison, the median stock in the Russell 3000 Index, which captures all stocks in the U.S., returned a meager 3.8%. In addition, 1331 of the stocks in the Russell 3000 Index had negative returns during 2024. Reflecting the narrowness of stock returns during 2024, 46% of the S&P 500 Index 25.0% return came from just five stocks. Furthermore, the return spread between U.S. and non-U.S. stocks during 2024 was also extreme at 18.3% between the Russell 3000 Index (23.8%) and the MSCI ACWI-Ex U.S. Index (5.5%). The next chart provides a clear picture of this extremism and the degree of outperformance of the U.S. stocks versus the rest of the world. Keep in mind this is a 75-year chart.

75-year high in U.S. stocks versus the rest of the world.



Source: BofA Global Investment Strategy, Global Financial Data, Bloomberg

In a year when a limited number of stocks dominated returns, it's not surprising that none of the major Wall Street strategists made an accurate call on how 2024 turned out. The next chart on the left shows the range of annual return forecasts by Wall Street strategists for the S&P 500 Index from 2000 to 2024. The black diamond is the actual return of the S&P 500 Index for each year. In 2024, the bar shows the range of forecasts was well below the actual return of the S&P 500 Index, meaning not a single Wall Street strategist was even close to being accurate with their initial 2024 S&P 500 Index return forecast. In fact, the highest forecast for the S&P 500 Index level was 5,400 or a 10% gain while the S&P 500 Index level at the end of 2024 was 5,882 and had a 25.0% return. There were two main reasons why 2024 forecasts were so off the mark. First, consensus expectations were for low U.S. economic growth to occur during 2024, but the U.S. economy performed much better than expected with U.S. economic growth of 2.7% versus 1.2% forecast at the start of 2024. Second, no one predicted the massive outperformance of the Magnificent 7 relative to everything else.



Source: Bloomberg
Note: Forecasts and actual returns are for price change only.

Wall Street Braces for a 12% Year

Expectations for a strong S&P 500 are widespread, with few outliers

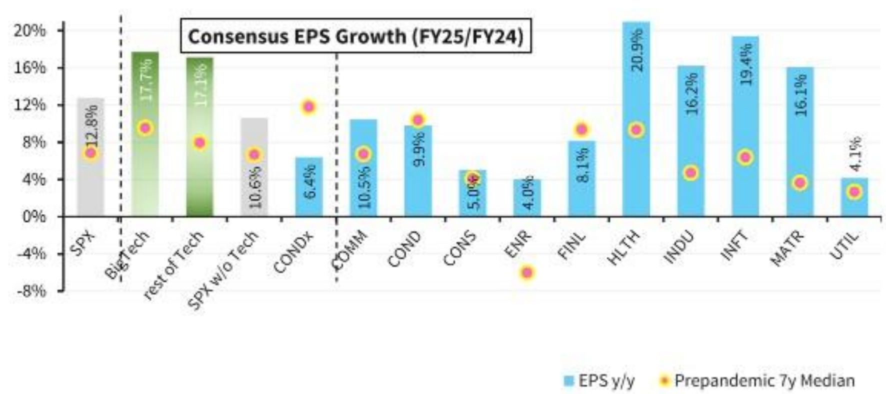
		2025 Year-End Target	2025 Percentage Gain %	2025 EPS
Oppenheimer	John Stoltzfus	7,100	20.6%	$275
Wells Fargo	Chris Harvey	7,007	19.0%	274
Deutsche Bank	Binky Chadha	7,000	18.9%	282
Societe Generale	Manish Kabra	6,750	14.6%	271
BMO	Brian Belski	6,700	13.8%	275
HSBC	Nicole Inui	6,700	13.8%	268
Bank of America	Savita Subramanian	6,666	13.2%	275
Scotiabank	Hugo Ste-Marie	6,650	12.9%	255
Average		**6,614**	**12.3%**	**269**
Barclays	Venu Krishna	6,600	12.1%	271
Evercore ISI	Julian Emanuel	6,600	12.1%	257
Fundstrat	Tom Lee	6,600	12.1%	275
Ned Davis Research	Ed Clissold	6,600	12.1%	254
RBC Capital Markets	Lori Calvasina	6,600	12.1%	271
Citigroup	Scott Chronert	6,500	10.4%	270
Goldman Sachs	David Kostin	6,500	10.4%	268
JPMorgan	Dubravko Lakos-Bujas	6,500	10.4%	270
Morgan Stanley	Mike Wilson	6,500	10.4%	271
UBS	Jonathan Golub	6,400	8.7%	257
BNP Paribas	Dennis Jose	6,300	7.0%	270
Cantor Fitzgerald	Eric Johnston	6,000	1.9%	267

Source: Bloomberg

Even experienced investment professionals have a difficult time accurately predicting the forward 1-year return of U.S. stocks and especially over the past decade with 2024 being one of the most extreme forecast misses of the past 25 years. If the accuracy of Wall Street strategists is frequently off the mark, what is the point of paying any attention to them? Well, because it's a valuable point of reference for where market sentiment stands going into a new year. As shown in the right-side chart on the previous page, sentiment towards U.S. stocks for 2025 continues to be bullish with the average S&P 500 Index return forecast of 12.3%. Not one strategist forecasts the S&P 500 Index to decline in 2025 (okay, they're paid to always see the glass half full), only one strategist forecasts a low single-digit gain, while the most bullish strategist is forecasting a third consecutive year of >20% returns (it's never happened). These forecasts imply a high degree of optimism that U.S. stocks will continue to deliver strong returns and the Magnificent 7 will outperform again in 2025.

It is important to highlight how much the U.S. stock market is dependent on the Magnificent 7 continuing to deliver high earnings growth again in 2025. The next chart shows 2025 earnings growth expectations for the S&P 500 Index (SPX) and breaks out Big Tech (Magnificent 7 ex TSLA), the rest of Tech, and the S&P 500 w/o Tech. Wall Street consensus expectation for S&P 500 earnings growth for 2025 is 12.8%. To achieve this earnings growth, Big Tech needs to generate nearly 18% earnings growth versus 10.6% for the S&P 500 w/o Tech. Other sectors with high earnings growth expectations for 2025 include healthcare (HLTH), industrials (INDU), and materials (MAT). If the U.S. economy continues to produce solid economic growth and companies continue to spend heavily on artificial intelligence and cloud computing initiatives, then the Magnificent 7 should have another strong year of earnings growth. However, with the S&P 500 Index already trading at nearly 22X 2025 earnings estimates, and the price/earnings (PE) valuation multiples of the Magnificent 7 already elevated, there isn't much room for error.

Figure 1. Current 2025 EPS growth estimates by sector compared to LT pre-pandemic medians

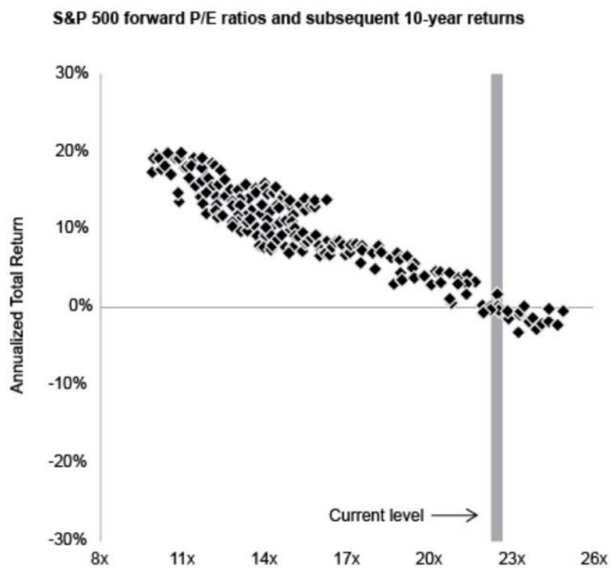


BigTech = Meta, Apple, Nvidia, Microsoft, Amazon, Alphabet. CONDx = Discretionary w/o Amazon. Data as of 1/6/2025.

Source: LSEG Data & Analytics, Bloomberg, Barclays Research

Given the current high PE valuation profile of the S&P 500 Index, what could this potentially mean for the next decade of returns? Unfortunately, it is much lower than recent experience. The following chart plots 27 years of monthly PE valuations (x axis) and the forward 10-year annualized return (y axis) for the S&P 500 Index. Each black diamond represents an actual result. The historical data shows when stocks are purchased at high PE valuations (towards the right side of the X axis), it means lower forward 10-year annualized returns (y axis) and vice versa. The grey bar on the chart shows the PE profile of the S&P 500

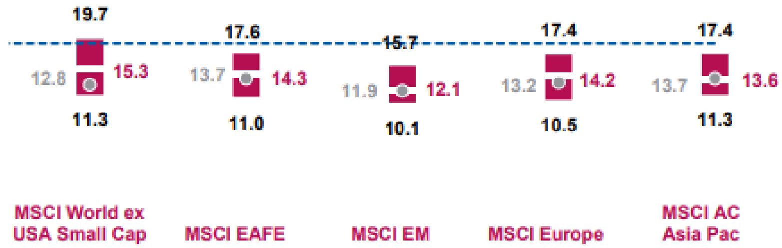
Index as of 12/31/24 at nearly 22X. Based on historical experience, the forward 10-year annualized return (ending 12/31/34) for the S&P 500 Index could land between +/- 2%. If that doesn't sound real, then consider this fact. Starting from 1/1/00, near where the tech bubble peaked, when U.S. stock valuations were at record highs, and investors were gaga over stocks, the forward 10-year annualized return for the S&P 500 Index ending 12/31/09 was -1.4%. As famous market observer Howard Marks has said, it's not what you buy, it's what you pay that counts.



Source: JP Morgan Asset Management

There is an important caveat to highlight in relation to this data. The S&P 500 Index is now dominated by the Magnificent 7, who collectively represent 33.5% of the index, which is almost double the level of five years ago. As a point of reference, at the peak of the tech bubble in early 2000, the Top 7 stocks were 22% of the index. PE valuations for the Magnificent 7 are some of the highest in the U.S. stock market. Because their collective weight in the S&P 500 Index is so high, it pushes the overall PE profile of the index higher as well. It is the stocks most beloved by investors at this moment in time that have a higher risk of delivering sub-par returns over the next 10 years. The other 493 stocks, which in aggregate trade at lower 18X PE valuation, offer mid-to-high single-digit annualized return prospects over the next decade based on the historical data in the chart above. In addition, mid cap and small cap stocks, which are not represented in the S&P 500 Index, and which have lagged large/mega cap stocks by a wide margin over the past decade, have better odds of delivering higher returns over the next 10 years too.

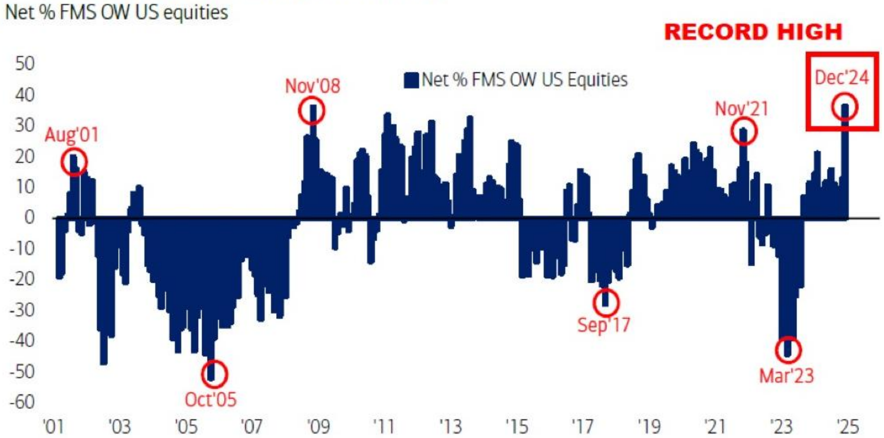
Non-U.S. stocks trade at their cheapest relative PE to U.S. stocks going back 40 years. As shown in the next chart, all regional non-U.S. stock PE valuations as of 12/31/24 were much lower than the S&P 500 Index PE of 21.8X. The forward 12-month PE valuations (grey numbers) trade at or below the median of their 10-year PE valuation range (red numbers) and well below the MSCI World Index (blue dashed line) 12-month forward PE of 19.1X, which now has an extreme level of representation of U.S. stocks (73.7%) whose valuations elevate its PE profile. Even though a select group of U.S. mega cap tech stocks trade at very elevated PE levels, most global equities do not. Over the next 10 years, returns for global stocks outside of the current market darlings in large / mega cap U.S. stocks should be attractive given the high level of negative sentiment and numerous headwinds of recent years.



In this Age of Extremism, it is very challenging to manage diversified global balanced portfolios when a limited number of U.S. stocks are outperforming all other financial assets by a wide margin. For the past two years, the only way to capture higher returns was to put more assets into investment products that had the most concentrated stock specific risk exposure in history. To keep pace with passive benchmarks, it required a disproportionate amount of a portfolio's weight to be put into investment products that have the highest exposure to the Magnificent 7 such as passive index products like the S&P 500 Index or Russell 1000 Index. However, these investment products have never been more concentrated in and reliant on the continued outperformance of the Magnificent 7. At this stage, it would folly to make portfolios even more concentrated and go against the long-held investment axiom that broadly diversified portfolios benefit investors in the long run as they expand the opportunity set and reduce portfolio volatility at the same time. The $64,000 question for 2025 is will this extreme trend continue? Most market participants and Wall Street strategists seem to be confident that it will.

Bonds had another meh! year in 2024 as the Bloomberg Aggregate Bond Index returned just 1.25%. As of 12/31/24, the trailing 3-year and 5-year annualized returns for the Bloomberg Aggregate Bond Index were negative. The past five years have been particularly difficult for bond investors as elevated inflation combined with the Fed's sizable interest rate increases starting in March 2022 really put the big hurt on bond prices. At the same time, U.S. stocks have experienced outsized gains with back-to-back annual returns of 25.0% and 26.3% and a 14.5% annualized return for the 5-years ending 12/31/24. As shown in the next chart, the allocation to U.S. stocks is now at extreme levels and the highest level of the past 25 years. Who doesn't already love U.S. stocks? EVERYONE loves U.S. stocks, and pretty much EVERYONE is negative on bonds and non-U.S. stocks.

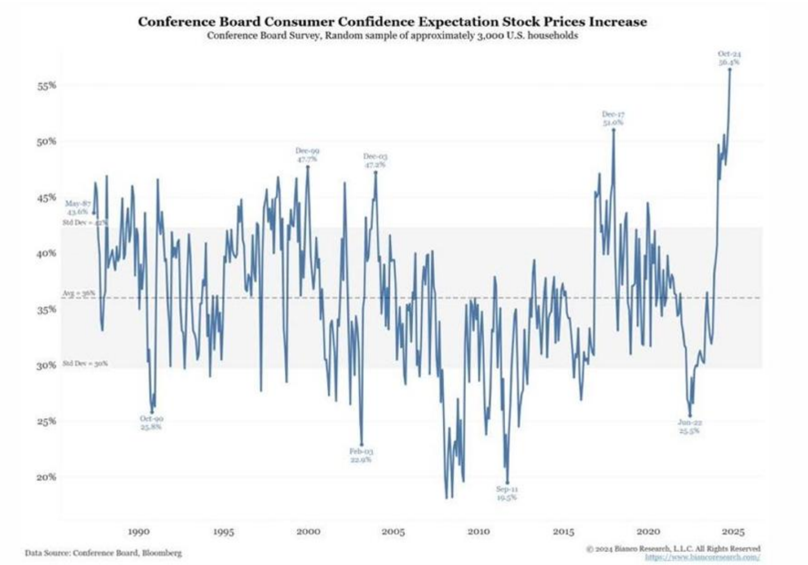
Chart 15: US equity allocation surges to record high
Net % FMS OW US equities



Source: BofA Global Fund Manager Survey.

BofA GLOBAL RESEARCH

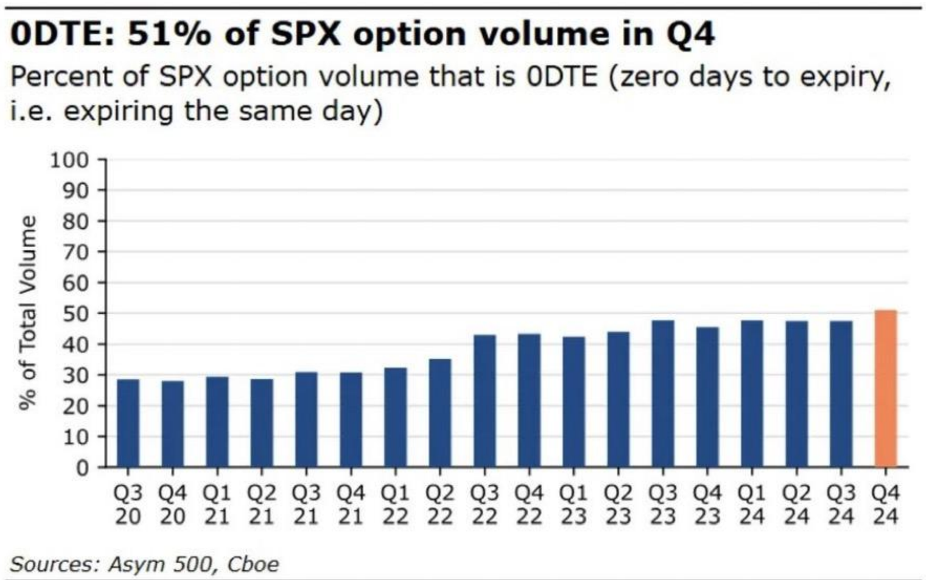
Not only are allocations to U.S. stocks at record highs, but confidence that U.S. stocks will continue to rise is also at a record high. The next chart from the Consumer Board October survey shows the percentage of respondents who believe stock prices will be higher a year from now has never been higher over the past 40 years of the monthly survey.



During this Age of Extremism, when conviction levels about higher future stock prices are elevated, speculative investor behavior has become more pronounced. This trend is reflected in the next two charts. The first chart below shows the amount of assets invested in leveraged long stock ETFs (bullish) minus assets invested in leveraged short stock ETFs (bearish). A leveraged ETF gives an investor +/- 2X or +/- 3X return of the underlying index like the S&P 500 Index. When the stock market is mostly going higher, as it has since the November 2023 low, investors become emboldened to play for bigger positive gains via leveraged long ETFs. The line in the chart shows an explosion in the assets invested in leveraged long ETFs during 2024, which reflects an overabundance of bullish investor sentiment.

The next chart shows the growth of 0DTE1 options over the past 4 ½ years. 0DTE1 is an acronym for zero days to expiration. Options are leveraged financial instruments, meaning you can invest a small amount of capital but potentially achieve a large gain if the underlying security associated with the option moves in the right direction. Day traders are increasingly using 0DTE1 options to "invest" and capture stock market or individual stock upside or downside. Since mid-2020, 0DTE1 options increased from less than 30% to 51% of daily option volumes. It is another indicator of a more extreme and speculative gambling angle to the stock market today than in the past.

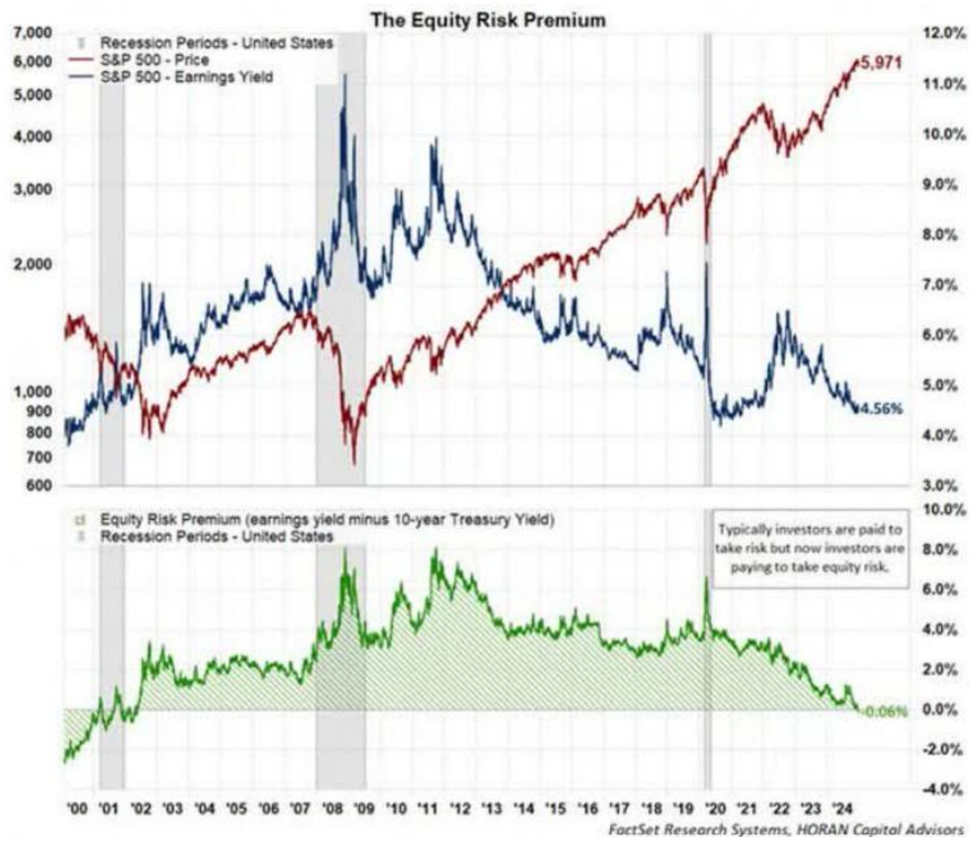
Since there is no free lunch in investing, the growth in the use of 0DTE1 options or leveraged ETFs means the broad market and individual stocks are susceptible to more frequent and larger daily price moves when more assets are "invested" in these financial instruments. It also suggests that investor timeframes have materially shortened.



Zero-day options on the S&P 500 were a majority of volume in 4Q for the first time. *Note: Before Tues/Thurs started in 2Q 2022, 0DTE were Mon/Wed/Fri contracts*

There has been an extreme level of outperformance of U.S. large / mega cap stocks over bonds the past several years. With the apathy levels towards bonds elevated and allocation to U.S. stocks at record highs, many probably wonder what's the point of holding bonds? The next chart shows the earnings yield and equity risk premium (ERP) for the S&P 500 Index. The ERP is the S&P 500 earnings yield (the inverse of the price/earnings ratio) minus the yield offered on a 10-year U.S. Treasury bond (some use a BBB rated bond index yield for this comparison). The ERP is a way to assess the relative attractiveness of stocks versus bonds. The ERP is the excess return an investor is being paid to take on stock risk versus holding a bond. The S&P 500 earnings yield (blue line) is at the low end of the past 25 years and the green section shows the ERP has only been lower during the peak of the tech bubble in 2000. Stocks are more compelling investments when the green area at the bottom of the chart is elevated and bonds become more compelling investments as the green area goes lower.

In the decade following the Global Financial Crisis when the Fed maintained a Zero Interest Rate Policy and kept bond yields suppressed on purpose, stocks were more attractive than bonds for an extended period. When inflation surged in 2021 after the U.S. economy recovered post the arrival of Covid-19 vaccines, bond yields rose, prompting the Fed to substantially hike interest rates starting in March 2022. Given much higher bond yields and the falling ERP for the S&P 500 Index over the past two years, the relative attractiveness of bonds versus stocks has substantially improved. For a 60/40 balanced portfolio, there is not a strong case to be heavily overweight large cap U.S. stocks relative to U.S. bonds. In addition, below the chart is a graphic that shows the current earnings yield for each of the Magnificent 7. Not only was the S&P 500 Index earnings yield of 4.56% at the low end of its 25-year range as of 12/31/24, the earnings yield of each of the Magnificent 7 was even lower. Of course, EVERYONE loves the Magnificent 7 and it is almost impossible to find a bearish case against them. There is no doubt the Magnificent 7 are great companies and they may have another strong year in 2025 but the Warren Buffett quote at the beginning of this Investment Outlook is sage advice to keep in mind.



Source: CDT Capital Management

Let's finish with a review of recent U.S macroeconomic data. At its December 18th meeting, the Fed released its latest Summary of Economic Projections and reduced the number of 0.25% interest rate cuts it expected to make during 2025 from four to two. Investors didn't like that news and stocks sold off and finished a strong year on a negative note during December. In early January, there were stronger than expected readings for both the ISM Manufacturing and Services Indexes although the prices paid portion of both readings was higher than expected. The December Non-Farm Payrolls report was much stronger than expected and the JOLTs report of job openings unexpectedly increased so U.S. labor market data has also been stronger than expected. Overall, the U.S. economy continues to show resiliency but inflation remains sticky and is not moving lower as much as the Fed forecast in September. With solid macroeconomic data and sticky inflation readings, bond yields continue to push higher and the market is now pricing in just one 0.25% interest rate cut during 2025. All things considered, the Fed is likely going to move to the sidelines for at least several months to assess additional macroeconomic datapoints as well as the Trump Administration's economic policy initiatives and their potential impact on the U.S. economy and inflation in 2025 and beyond.

Summary

The U.S. finds itself in the Age of Extremism, including the current setup in U.S. financial markets. There were only four times in history that the S&P 500 Index returned 20% or more two years in a row and 2023/2024 was the fifth time. In three of those first four instances, the index declined in the following two years. Even though the S&P 500 Index trades in the 7th percentile of its historical PE valuation range, consensus expectations for 2025 are for another double-digit gain for the S&P 500 Index and confidence is high that the Magnificent 7 will deliver strong earnings growth once again. However, the lofty earnings growth expectations and elevated forward PE profiles of the Magnificent 7 leave little room for error for large / mega cap U.S. stocks. In contrast, for many other segments of global equities, apathy levels are high, valuations are reasonable, and in some cases cheap. Also, as bond yields move higher, bonds become more competitive with stocks. A global balanced portfolio that isn't excessively overweight large / mega cap U.S stocks has an attractive risk/reward setup looking ahead. If there is a change in the weather and this Age of Extremism fades away, both society and investors will be better off.

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January 13, 2025