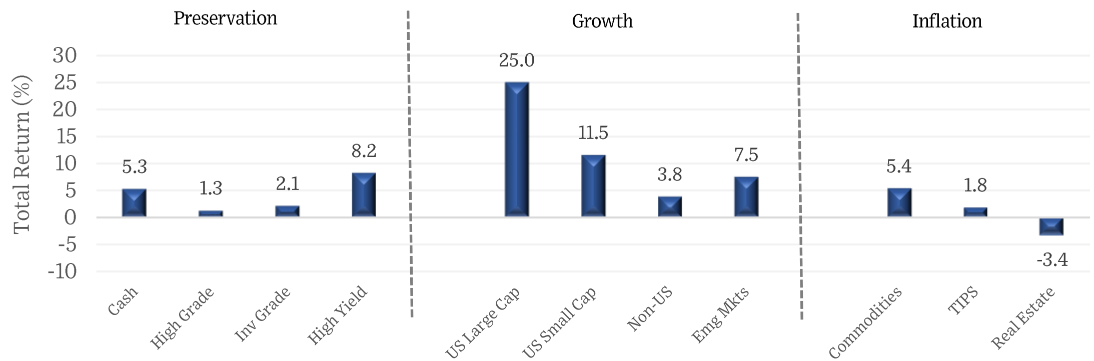
Summit Trail Advisors

Year 2025 Investment Strategy Outlook

2024 Summary

Markets continued their robust performance in 2024, delivering above-average returns in US equity markets. Investors got less Fed cuts, less earnings, and less disinflation than expected but "Magnificent 7" earnings, continued optimism over Artificial Intelligence, and the 2024 election kept US markets buoyant.



2024 Calendar Year Market Index Performance
Source: Bloomberg, S&P, MSCI, NCREIF. Real Estate is as of 3q24.

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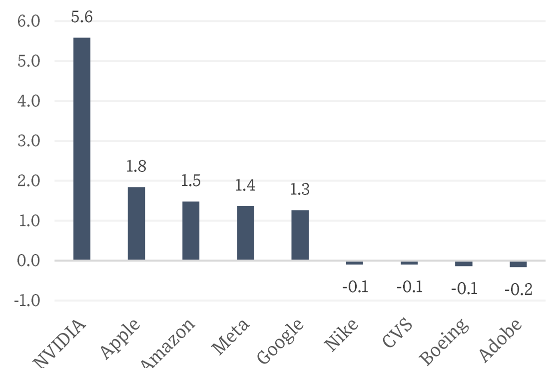
Year 2024 Market Recap

Markets delivered a second straight year of robust performance in 2024, driven by US mega cap technology names. The S&P 500 Index added 25.0% in 2024, creating the best two-calendar year stretch for US markets since 1997 and 1998. Global markets as defined by the MSCI All Country World Index delivered 17.5% for 2024, pulled down by Non-US Developed and Emerging markets which added only 3.8% and 7.5%, respectively in US Dollar terms. Smaller companies in the US also failed to keep up with S&P 500 momentum, adding 11.5% for the year. S&P 500 performance in 2024 continued to be driven by its largest names, but Nvidia was in a class by itself. Nvidia began 2024 as just over a 3% weighting in the S&P 500 Index and finished the year more than double that weighting at 6.6%. Nvidia's 171% total return for the year contributed 22% of the S&P 500's gain, more than tripling the next nearest contributor in Apple. Unlike many



Top & Bottom Contributors to S&P 500 2024 Performance
Source: FactSet

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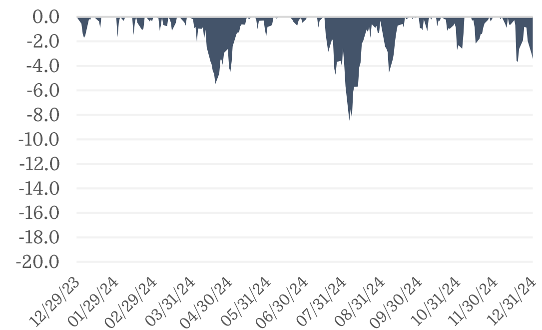
aspects of the market in this post-Covid world, Nvidia was not just hype in 2024. The company's fundamental performance in more than doubling revenue and earnings for the year meant despite the eye-popping returns, Nvidia's stock valuation declined slightly. Nvidia's 2024 performance was also the highest return of any of the S&P 500's constituents, which is unusual when the strongest stock in the index also happens to be one of the largest holdings. Coincidentally, and hopefully not a forebearer of the future, year 2000's version of Nvidia, Intel Corporation, was the worst contributor in 2024 to the S&P 500, losing 60% of its value and finishing as just a 0.17% weighting in the S&P 500 index.

An increase in interest rates since the Fed's first rate cut in September put a damper on fixed income returns for 2024. The 5 Year Municipal Bond Index returned 1.2% for the year while the broad US Aggregate Bond Index returned 1.3%. Each index performed well below its yield as higher interest rates pressured bond prices. Other areas of the fixed income markets like short duration bonds or lower-quality credit (or the combination of short duration credit) performed far better. The US Corporate High Yield Index returned 8.2% while the Morningstar Leveraged Loan Index (and its floating-rate coupons) added 9.0% for 2024. The 10-Year Treasury Yield started the year at 3.87% and spent most of 2024 trading above 4%. As the Federal Reserve telegraphed rate cuts throughout the year, interest rates began receding in the 3rd quarter, troughing in September. The Fed announced a 50-basis point rate cut on September 18th, which was close to a low point in interest rates. The Fed cuts combined with stronger 4th quarter jobs and inflation data as well as the US election, caused investors to question how far the Fed could cut and for how long. As expectations for Fed cuts decreased, longer-term rates rose, ending the year at 4.57%.

Equity markets saw little risk and volatility in 2024 outside of an early August period with concern over the deleveraging on the yen carry trade. The S&P 500 was negative in only 3 of the 12 calendar months and did not see a meaningful correction greater than 10% during 2024. While the "VIX" or market fear index did see its highest level since 2020, the elevated reading was only for about a week in August and the fear index spent most of 2024 in-line or below long-term averages expressing investor's optimism for artificial intelligence, technology and other related investments. Earnings growth in US large companies and the Fed's anticipated rate cuts kept a bid for stocks throughout the year. 4th Quarter 2024 earnings season is just starting here in early 2025 to wrap up full year 2024 earnings, but FactSet is estimating 9.5% 2024 earnings growth for S&P 500 earnings over year 2023. Earnings leadership was driven by Technology and Communications predictably, but also saw above average growth from Consumer, Financials and Utilities. Companies grew both their top and bottom-line as revenues for the S&P 500 look to finish up at 5.0% growth for 2024.



Cumulative Drawdown in S&P 500 Index for Year 2024
Source: FactSet

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Strong financial performance from Nvidia, Meta, and Google kept market concerns at bay for any issues that arose during the year.

Markets also spent much of their time focused on the US election outcome in 2024. President-elect Trump saw two periods of surging election odds in his favor in July and October and in each period the 2016 “Trump trade” playbook was revisited by markets. The market’s views on Trump policies are that they will lead to a stronger dollar, higher interest rates, and better performance from small companies, banks, and industrials. Initially, Trump’s polling improved in July after President Biden’s weak debate performance. July brought the best single-month relative performance for the small company Russell 2000 Index versus the S&P 500 index since early 2000. Trump trades pulled back after President Biden withdrew as Trump odds leveled off with the more formidable opponent in Vice President Harris. But by October, markets were moving in-line with an expectation that Trump’s odds of winning were better than polls suggested. And after the election outcome, and confirmation of another period of media polling being unable to account for Trump voters, markets rallied on the perceived improvement in US economic policy and likely relief that the election outcome was not in doubt.

Investors ended 2024 analyzing Trump economic cabinet selections and reminding themselves how to stay on their toes from Trump’s social media usage and press conferences. Interest rates initially took comfort from Trump’s selection for Treasury Secretary of Scott Bessent, but tariff talk and improving economic data moved rates higher into the end of the year. Since the Fed began hiking in early 2022, markets have struggled when long-term rates approach 5%. As the 10-year Treasury crossed 4.5% in late 2024, markets took notice and equity markets sold off to end the year. Risk of overheating, or a second wave of inflation will be a primary topic as investors evaluate early data in 2025.

Markets outside the US generally did not enjoy 2024 nearly as much as US investors. Europe and Japan are suffering from many of the same challenges as the US fiscal circumstances but without robust economic growth, the reserve currency, and the global corporate champions of the Magnificent 7. European markets saw turnover of the ruling party in the UK, France, and Germany as voters expressed frustration with anemic growth and high inflation. Yields rising on government bonds have not just been a US event, most developed markets saw increases in their sovereign rate given deficits and stubborn inflation. French bonds traded at a higher yield than Greece in late 2024, which would have been difficult to predict in 2012 when Greek yields peaked above 35%. The pressure and lack of excitement for European stocks caused the MSCI Europe to trade at its widest discount (37%) to the multiple on US stocks on record at the end of 2024. Emerging markets had a more mixed 2024 and China’s equity markets rallied almost 20% in US dollars, although the entirety of the return was contained to September. China’s economy continues to sputter and headline growth numbers from the country’s government data of 5% GDP growth show no relationship to much weaker real-time independent economic data. A prominent Chinese economist recently said this at a US economic forum and was promptly suspended from speaking publicly on orders from

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President Xi according to press reports[1]. Muzzling dissent is typically not a strong sign of being on the right side of a dispute on data, but China likely is not alone in that regard. Argentina was 2024's market darling. The country has undergone a radical change in economic policy under President Milei and astonishing progress in reducing rampant inflation. The result was a huge rally in Argentine bonds and equity markets, especially Financial and Natural Resource companies. Argentina still has work ahead of them after decades of mismanagement but the 109% MSCI Argentina Index return in 2024 was a vote of market confidence. Outside of Argentina and the cordial Milei-Trump relationship, most foreign investors are holding their breath (and investments) as they see what a second Trump administration will mean for non-US markets.

Overall, 2024 markets were most rewarding for US equity investors in the S&P 500 and its current leadership. While there were brief bouts of contention for new leadership and change in markets, the story of 2024 was not dissimilar to 2023. Technology is everywhere and investor appetite for its growth story remains in place. Market valuations ended 2024 at recent peaks similar to 2021 and option volume and risk-taking is even higher. Bitcoin surpassed its previous high after Trump's election and even meme stocks made a brief return. Consensus is that the party should continue. We will turn our attention to 2025 and whether the significant change in US economic policy could mean a different path for markets.

Year 2025 Market Outlook: Base Case is Positive

There is broad agreement among analysts and market prognosticators about continued US equity strength in 2025 and expectations the S&P 500 Index should set new highs for the foreseeable future. The positive consensus is based upon expectations that S&P 500 earnings should grow roughly 15% in 2025 from 2024 levels driven by the Magnificent 7 names. Year 2025 earnings growth is supported by a rare occurrence of a Federal Reserve that is cutting interest rates while the economy and earnings are growing at healthy levels. Few periods historically of 10%+ corporate earnings growth have been combined with a supportive Fed. Typically, Fed cuts have taken place in periods of economic distress and declining corporate earnings. Positive expectations also exist around a shift in US economic policy towards a more pro-business posture with the inauguration of President Trump on January 20th, 2025. Trump's economic policy includes deregulation and an extension or reduction of current tax rates that are viewed positively by businesses and markets. While Trump has other aspects to his economic policy like tariffs and deportation that are less corporate-friendly, markets place a higher certainty and priority on the positive policies. This was the pattern from Trump's first administration that drove strong positive markets in 2017.

The consensus view is not an unreasonable position, even if consensus opinions are often incorrect on a calendar year basis. Very few investors (including this one) were expecting the almost 58% cumulative return in the S&P 500 for 2023 and 2024 in the face of Fed hikes and recession expectations. So we will spend a moment on the consensus market view and why it seems

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[1] *https://www.wsj.com/world/china/xi-jinping-muzzles-chinese-economist-who-dared-to-doubt-gdp-numbers-2a2468ef*

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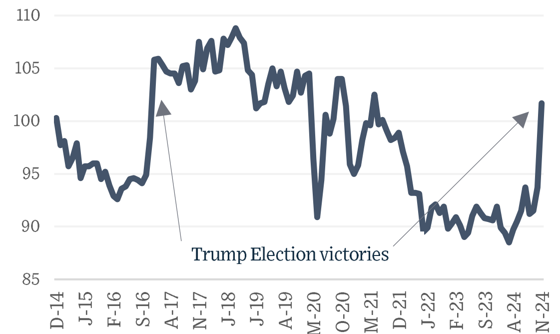
reasonable before focusing on the more interesting discussion of less likely outcomes in terms of what could go wrong for markets in 2025.

Markets began rallying in July and October of 2024 when President Trump gained in election polling against initially President Biden and then Vice President Harris. Each of those rallies, as well as the immediate period after Trump's election victory, had a notable pattern of strong overall market returns but with a shift towards smaller companies, cyclical sectors, and US Dollar strength. Business confidence increased dramatically after Trump's election in 2016 and we have seen a similar initial response since the recent election. Business owners and leaders feel the Trump administration and their policies will be better for the overall economy and their profits. While markets performed quite well during the prior Biden administration, gains were primarily concentrated in mega cap technology stocks. And CEOs likely will not be yearning for the prior period of government spending, higher regulatory costs, pro-union policy, and a historically hostile Federal Trade Commission (FTC) challenging any and every merger or acquisition. A shift in US economic policy in 2025 then adds a surge in business confidence to the existing economic environment of 2-3% GDP growth, double-digit earnings growth, and Fed rate cuts. The Federal Reserve is less likely to cut interest rates as much as the market expects and may be on hold as early as the January Fed meeting, but monetary policy seems very unlikely to take actions that are not supportive of risk assets in 2025. Given the change in leadership at the FTC, we expect a substantial pickup in corporate merger and acquisition strategies outside of the very largest US companies, which will likely remain under regulatory scrutiny even as they snuggle up to the new administration. We have already heard from numerous investment managers and other sources that businesses are ramping up acquisition plans broadly with a view that they have a four-year window to go on a corporate buying spree. Equity markets can benefit from acquisitions as it creates a bid for companies that are potential candidates for purchase and a re-opening of the IPO market would support private equity exits that allows for new fund investments. The existing outlook for corporate earnings could also benefit from possibly lower tax rates, higher capital investment from companies given business confidence and a stable labor market that keeps consumers spending.



US Small Business Confidence
Source: Trading Economics, NFIB

FactSet expects S&P 500 earnings growth to accelerate in 2025, growing 15% from 2024 levels with Technology, Health Care, Industrials, Materials, and Communications leading the way. Calendar year 2024 S&P 500 earnings only grew 10% from 2023 levels to support 2024's robust market gains. Analysts have been too optimistic in recent years on actual earnings levels, and 15% 2025 earnings growth with 6% revenue growth expectations implies a healthy increase in corporate margins. We are skeptical but a modest decrease in earnings expectations has done nothing to derail markets in

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past years even with elevated valuations and there is no obvious reason why 2025 would be different.

What could derail the base case of strong earnings growth, increased business activity, and a more accommodative Fed for markets? There is always room for negative geopolitical events to happen suddenly, but in recent years those events have taken place in regions with little economic contribution to global output. Our starting points for why one would look back at a less positive outcome for 2025 would be interest rates and tariffs and their impact on the US Dollar. We would add some longer-term thought exercises on the fate of the non-US economic world given US economic policy and non-Magnificent companies' roles as the main employers in our economy.

Interest rates have the market's attention as we enter 2025. Longer-term interest rates tend to be market voting machines on the neutral rate for the Fed Funds policy rate in the US but there are other factors that can come into play. The 10-year Treasury spent most of late 2023 and 2024 oscillating between the negative supply and demand dynamics of funding massive US federal deficits versus an expectation that the Fed was going to reduce rates in 2024 (i.e. that the neutral rate for the Fed was lower). Stronger economic data as we end 2024 calls into question the amount the Fed can continue to lower interest rates. With strong jobs data and inflation still above long-term targets more accommodation is difficult to defend. Markets are anticipating higher growth in 2025 and the yield curve has steepened dramatically from early 2024. With the Fed Funds rate between 4.25% and 4.50% and the 10-Year Treasury above 4.5% as we enter 2025, markets are saying the Fed is done, or should be done. Higher interest rates mean less support for the economy, especially interest rate sensitive areas like manufacturing and housing that have suffered the most since the Fed hiking began. And higher interest rates also mean higher discount rates on future cash flows, meaning those cash flows are worth less or should be although equity markets have supported some long duration assets (i.e. unprofitable companies) since 2022 in the face of higher rates.

10-Year Treasury Yield Less Federal Funds Rate
Source: St. Louis Federal Reserve (FRED)

Despite market resilience overall, equity markets have struggled in periods where the 10-Year Treasury has increased rapidly. Just last month in December of 2024, the 10-Year Treasury spiked by almost 40bps, and markets sold off modestly. But more rate-sensitive areas of the market like Small Cap stocks and Real Estate Investment Trusts (REITs) were down over 7% for the month. The recent peak level for 10-Year Treasury yields took place in October of 2023, following an earlier

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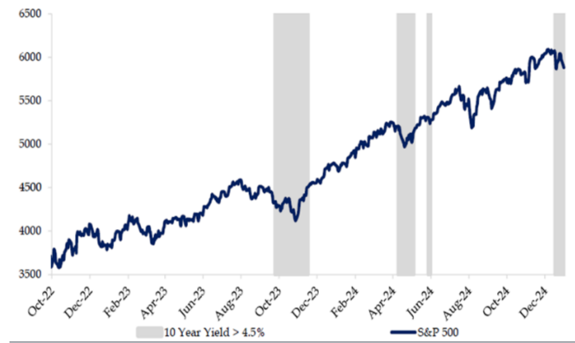
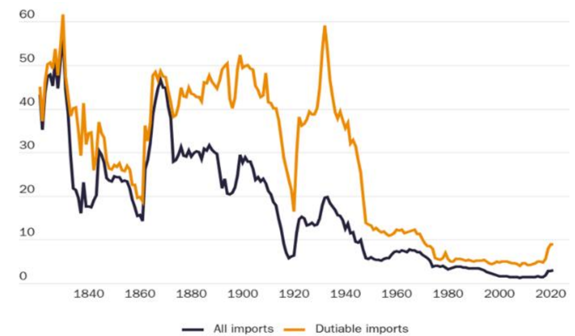
announcement from the Treasury Department they were planning to extend duration on US outstanding debt, meaning more longer-maturity Treasury issuance (or supply). Treasury yields surged from July to October 2023 by over 100bps peaking right at 5% for the 10-year and markets swooned with the S&P 500 dropping over 8% from August to October 2023 while Small Cap was down over 16% and REITs lost over 13%. Higher interest rates may pressure markets but do not have to be a negative signal for the economy as positively sloping yield curves are signs of a healthier economic outlook and growth expectation. The 10-year Treasury only recently surpassed the Fed Funds rate after an extended period of inverted yields, which as the opposite of a "normal" positive yield curve, inverted curves are often a harbinger of impending recessions. But an interest rate for the 10-Year Treasury well above current levels would be a prediction by markets of future Fed rate hikes and could return markets to their Fed anxiety we last saw in 2022.



S&P 500 Index During Periods of Treasury Yields > 4.5%
Source: Strategas

A day rarely passes since the election where tariff policy is not a focus of markets or news cycles. President Trump campaigned on increasing tariffs on China similar to his first administration and also introduced the concept of a universal tariff on US imports. Markets took these threats in stride given their experience with Trump tariff policy from 2017 to 2020. Tariffs overall did indeed increase slightly in Trump's first administration but the vast majority were targeted at China. And the market's general view is that Trump uses tariffs as a negotiating tool to achieve other strategic gains rather than his actual intention to implement the tariff threat. If that is the case, Trump 2.0 is certainly going to test the market's belief with his rhetoric early on in 2025. In addition to China, neighbors like Canada and Mexico have received tariff threats along with most of Europe. A shift to a universal tariff on US imports would be far more impactful to the economy than the limited Chinese tariffs in 2018. Given the frequency and breadth of tariff threats, it is important to review how tariffs have been portrayed in terms of their economic impact.



Average US Tariffs (% on Goods Imported)
Source: Bureau of the Census, Cato Institute

The common refrain on tariff policy is it is likely to add to inflation. Numerous media articles have linked tariff policy with possibly higher interest rates and inflation. We understand that is the easy connection, but tariffs are taxes and taxes are not inflationary. A tariff is technically the legal responsibility of the person or firm importing a good. Economists debate whether tariffs are fully

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paid by consumers, importers, competitors, or some combination of all three. But as a tax, a tariff is creating a cost barrier to what would otherwise be normal economic activity. For example, that a business may decide it is cheaper to produce a particular good outside of a country and then import that good rather than producing the good in the country where it is consumed. The tax then impedes that natural relationship of global trade, and will lead to less global trade, and therefore less productivity in each economy. The risk therefore of a tariff over a more reasonable timeframe is that it leads to less output. Very sudden and high tariffs could create a substantial drop in output or activity, which would actually subdue economic activity like we see during recessions. And recessions do not lead to inflation.

It is impossible to know what Trump will do in his second term with regards to tariff policy. Reasonable arguments have been made that he is more focused in his second term of implementing his views and creating more permanent impact, thus tariffs may play a larger role. He is certainly talking as if this is the case. But President Trump is also uniquely focused on markets and the economy as a barometer of his Presidency. It is also reasonable to think he is not likely to force the economy into recession with something in his control. Time will tell, but our 2025 outlook focuses more on what we know versus what we do not. Earnings are poised to grow substantially. Earnings growth is coming from mega cap technology stocks that have created an almost self-fulfilling loop of AI spending that is less dependent on the traditional economy. And Trump policies of deregulation and lower taxes have spurred business confidence which has positive implications for corporate activity. Market valuations and two straight years of mid-20% market returns in the S&P 500 Index could create some valuation headwinds. But risk appetite remains strong, and 2025 earnings should deliver support even if we ultimately see more volatility and less overall return than 2023 and 2024.

Our **portfolio themes for 2025** are mostly reflective of shifts that took place over the course of 2024 as recession risk declined and economic policy appeared likely to change post-election. In Preservation portfolios we have a **more favorable view of credit** entering 2025 and are **more guarded on duration risk.** Credit spreads remain unattractive overall when one looks at corporate bonds but there are more specific opportunities in both public and private credit markets. Credit areas we prefer like structured credit tend to have lower durations closer to 2-3 years versus broad market indexes like the Bloomberg US Aggregate Bond Index with a duration over 6 years. Our expectation that interest rates will be higher for longer with possible upside risk led us to close longer duration Treasury positions in 2024. While higher interest rates can create a cost burden for leveraged companies, strong earnings growth should help maintain a relatively low default environment that is supportive of credit investments.

In Growth portfolios, there is tension between the deceleration but overall dominance of Magnificent 7 earnings and the acceleration but more cyclical earnings of mid and small companies. We believe new administration policies should be more supportive of small to mid-capitalization stocks and have **restored modest allocations to small cap** in Growth portfolios. We

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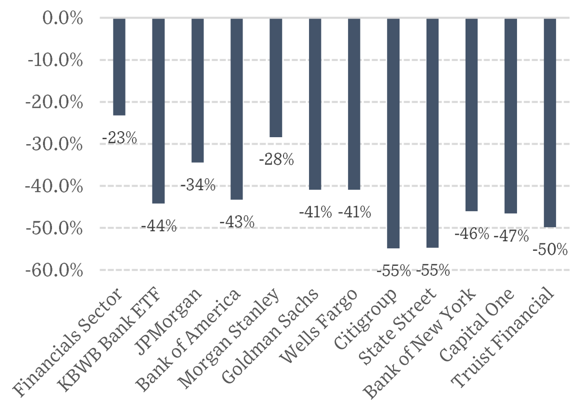
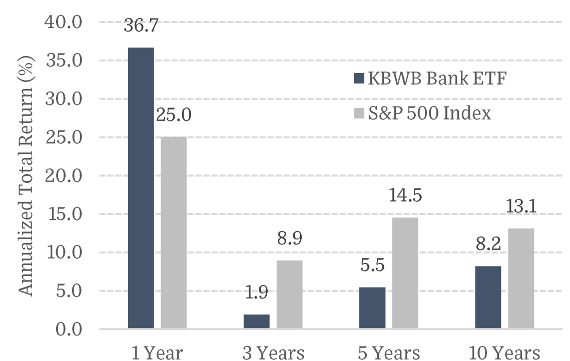
recognize higher interest rate and market risk associated with smaller companies and believe allocations should likely be built out over 2025. US equities should remain leaders relative to non-US developed and emerging markets, despite the difference in valuations. We maintain our view that non-US equity markets are more fertile for adding value to indexes through active management than US markets.

We began **adding US Banks to equity portfolios** over the course of 2024 via the Invesco KBWB Bank ETF (Ticker: KBWB) as we anticipated the benefits from a Trump election victory for the sector. Financials and banks are likely to benefit as much as any sector from the Trump agenda of deregulation and tax cut extensions. We do not believe the regulatory environment is likely to change markedly for mega cap technology companies given bipartisan concerns (or political punching-bag opportunities) for the group. Whereas former punching-bag candidates like banks would benefit from less red tape and capital relief as we move further away from the Financial Crisis. Banks also tend to have higher tax rates than many S&P 500 companies given they are less able to play shenanigans with the US tax code the way companies like Apple and others have positioned certain businesses in low-tax countries like Ireland. We expect large cap investment banks to benefit from an increase in merger, acquisition, and IPO activity for 2025 and beyond that has been subdued over recent years. Banks performed well overall in 2024 but have been weak performers since the Financial Crisis and over long-term periods as investors focused on more exciting sectors. That underperformance has led to significant discounts of earnings multiples to the S&P 500 index and the Financial sector is the second cheapest sector only to Energy. To be clear, Goldman Sachs and Citigroup should not trade with an Apple or Microsoft valuation, but the level of discounts for bank valuations leave room for upside if we see continued earnings momentum. When we think about 2025 risks related to interest rates and tariffs, banks can be insulated from higher interest rates as they tend to benefit from increased net interest margin when longer rates exceed short rates. Banks do not import goods given their financial service model and will not be a focal point of tariff concerns. In addition, US banks have a much higher proportion of US-based revenue if foreign economies remain weak with just 14% of non-US revenue according to FactSet for the KBWB Bank ETF. This modest proportion of non-US



Price/Earnings Discount to Overall S&P 500 Index
Source: Factset, Yahoo! Finance



Trailing Returns as of 12/31/24: Banks vs. S&P 500
Source: eVestment

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revenues compares to 41% of non-US revenue for the S&P 500 Index and 53% for the Magnificent 7 companies. Banks do have risks, notably they are considered cyclical and exposed to any pullback or decline in US economic growth. Especially with respect to credit issues that could impair bank balance sheets. Yet, our base case believes a credit cycle in 2025 is less likely.

Inflation portfolios remain important given much of our fiscal and monetary policy in the US remains inflationary. While 2024 brought enough progress in the disinflation fight that the Fed began cutting rates, assets like **Gold** appreciated over 26% in 2024. Gold is not outperforming the S&P 500 index because investors feel the Fed has a solid grasp on inflation. **Real Assets like Core US Real Estate** can also serve as inflation hedges and saw stabilization in 2024 after significant declines in office property values in prior years. We also continue to believe **Carbon Allowance markets** deserve allocations in Inflation portfolios given their unique characteristics, despite poor performance in 2024 in California Carbon Allowances after delays from regulators in updating participants on expected future allowance issuance.

We do think there are two issues that investors should be considering for 2025 and beyond. US dominance relative to non-US economies and markets continues and we do not see an obvious end in sight or catalyst for change. But our concern is whether the US growth story can remain intact with such limited contribution from outside the US? As we mention above, S&P 500 revenues include 41% from outside our borders, and the fastest-growing companies and market leaders of the Magnificent 7 receive more revenue from outside the US than domestically. We would be curious how many investors would get a Jeopardy question right on that topic. If our neighbors and trade partners see continued political turmoil, currency depreciation relative to the US Dollar and weak growth does it ultimately spill over into the US? Especially as US Dollar strength makes US businesses and goods more expensive and earnings outside the US less valuable when converted back to the US currency for financial reporting. Does the state of play in the global economy force non-US countries, even allies, into less rational economic or political decisions just to change the current course? One could argue that the US went down this path with our 2016 election. Deglobalization is a real theme for markets and now a clear policy of the Trump administration. Despite the lack of interest outside of US borders, investors cannot ignore what is happening overseas, even if it has been a good strategy to not invest there.

Our other longer-term question is on employment, not the more common question of whether AI is going to replace everyone, but more about what the ramifications may be for earnings and overall leadership coming from companies that employ so few people. Employment in the US has always been relatively spread out with small companies employing the vast majority of our labor force. But the disparity in market capitalization to employment is getting even larger, and that employment differential is now combined with a massive earnings and financial differential. Small companies defined by the Russell 2000 Index have seen a significant earnings recession since 2021, with the index's earnings declining more than 30%. At the same time, Magnificent 7 companies have been

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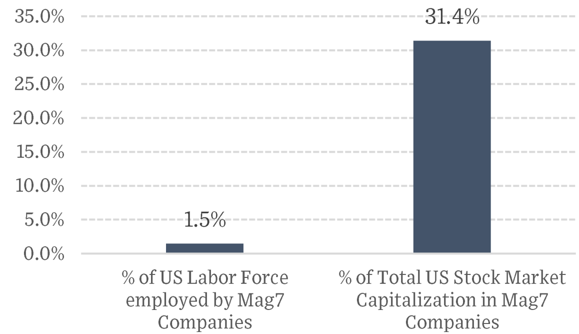
growing already massive earnings 20%+. Apple, Microsoft, Nvidia, Google, Amazon, Meta, and Tesla are estimated to employ just 1.5% of the US labor force, and the vast majority of that is at Amazon. Each of these companies is investing heavily in *not* hiring more employees and their businesses have scale in a manner we have not seen in other dominant US companies historically. While the companies that make up a much larger proportion of our labor force, mid cap and small cap companies as well as private companies throughout the US are generally seeing much more challenging financial performance which then inhibits their ability to grow headcount. Labor market resilience has been a major surprise since the Fed began hiking in 2022 and US unemployment is at a healthy 4.1% rate as of December 2024. Government, health care, and leisure-related sectors have driven job gains after the initial Covid recovery. Can our consumer-driven economy thrive if the largest and most successful companies represent so little of our labor force? The answer was "yes" in 2024 and is likely the same in 2025, but our sense is at some point in the future the answer could get more complicated.



Magnificent 7: Employment vs. Economic Impact
Source: eVestment

Wishing everyone a healthy and prosperous 2025,

Summit Trail Investment Team

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