WestStar
Wealth Management

WEALTH WATCH

2024 Fourth Quarter Review &
2025 First Quarter Outlook

Fans of movies of the 1980's will remember the Robert Zemeckis classic, *Back to the Future*. In the movie a young man inadvertently travels back in time 30 years in a time machine created by his eccentric scientist friend. Hijinks ensue while he contends with the ways his actions might impact the future of his friends and family as he strives to return to his own, proper time. The "past is prologue" concept can be applied to the market of 2025.

Back to the Future

The movie is in many ways a simulacrum of the events of 2024. For example, the main character was not originally played by Michael J. Fox, but by Eric Stoltz. The recasting of the character happened mid-filming—similar to the replacement of Joe Biden with Kamala Harris as presidential candidate mid-campaign. Furthermore, the role of President itself was "recast" as Donald Trump was once again elected. That aspect in and of itself can also be analogous to "back to the future," as we might glean future economic expectations based on the actions of his past administration.

In this edition of the Wealth Watch we will take a look back to review what happened in the market in 2024 and outline what may be in store for the future given the current state of the economy and the proposed policies discussed by the incoming administration.

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What You Need To Know:

- Stocks had a stellar 2024, posting 57 all time highs and the second consecutive 20%+ year
- 2025 may be a third positive year despite recent strength
- Current bond yields are above money market yields and suggest future 5-year annualized returns may be solid
- The economy is quite strong on multiple levels and should continue into 2025
- Future Fed action may be affected by the impact of the new Administration's policies on inflation
- Historically high stock valuations and a preponderance of economic conditions suggest returns will be slightly lower in the coming years

Asset Class Index Performance* 2024

US Large Cap Stocks
25.02%

US Small Cap Stocks
11.54%

High Yield Bonds
8.19%

International Emerging Market Stocks
7.50%

Commodities
5.38%

Money Market (Cash)
5.18%

Alternative Investments
4.33%

International Developed Market Stocks
3.82%

Real Estate (REITs)
2.00%

US Investment-Grade Bonds
1.25%

International Bonds
-4.22%

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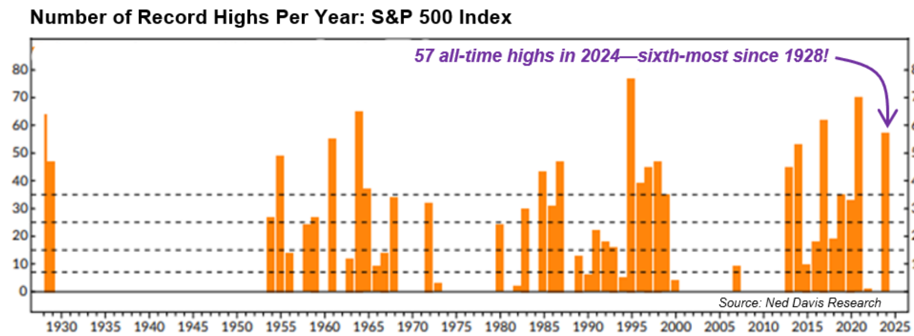
2024 Market Recap

All major investment categories were positive in 2024, save International Bonds. As we expected, stocks outperformed all other asset classes—our clients benefiting accordingly via our tactical overweight to the category which we have maintained since February of 2023. Indeed, the S&P 500 Index recorded two consecutive years of 20%+ performance for only the fifth time in history. US markets outperformed the rest of the world for the 13th time in 15 years and Large-cap stocks outperformed Small-cap for a record eighth consecutive year with the largest spread between the two since 1998. The Large-cap Growth style continued its dominance, led by the "Magnificent 7" companies (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), and outpaced Large-Value by a 19% margin—the fifth-largest spread since 1979.

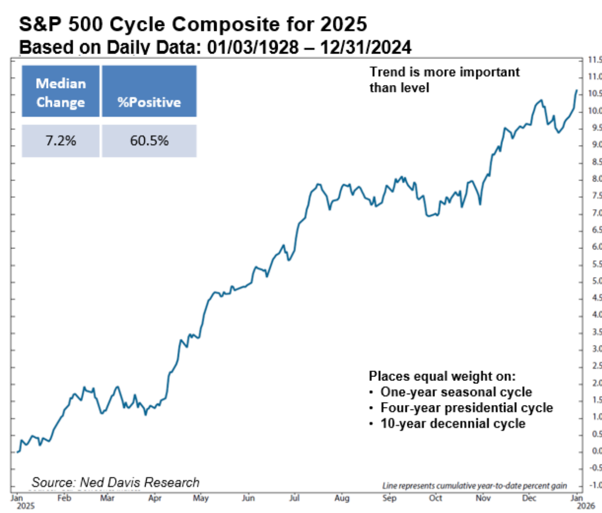
As the chart below reflects, the S&P 500 set 57 record highs—the sixth most since 1928:



Given the tremendous market strength over the past two years, what might be in store for 2025?

Stocks: What's Past is Prologue?

Historically there have been seven other instances of 50+ record high markets. Among the seven, five have seen a negative following year, which might suggest that 2025 is likelier to be negative as well. If we analyze the two positive years, however, one in particular stands out. As in *Back to the Future,* we will travel back 30 years into the past.



In 1995 there were 77 record highs on the S&P 500 and the index was up +37.6%. The following year the market was up an additional +23%. Why did 1996 defy what might typically be a negative year? There were three primary factors in play:

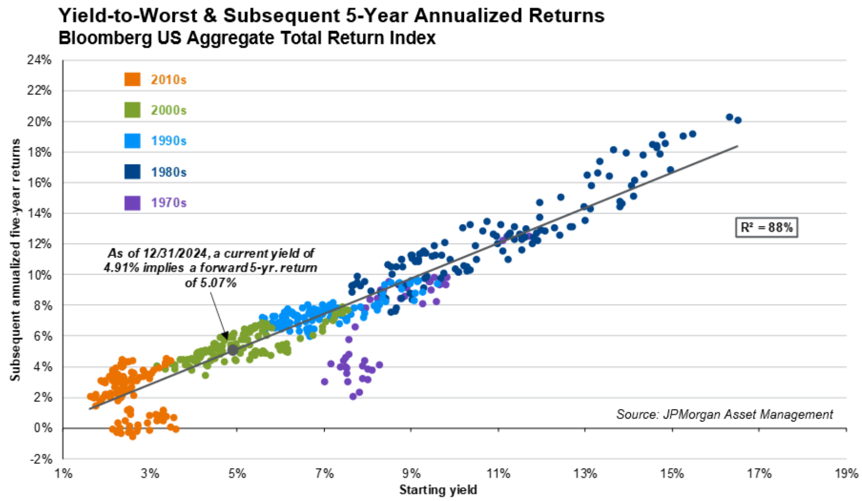
1. Sub-3% inflation allowing the Fed to cut rates and delay hikes
2. Strong corporate earnings
3. Productivity boom resulting from the advent of the Internet

These three factors are quite similar to what we're experiencing in 2025. Inflation was 2.9% in 2024 and the Fed was cutting rates. Earnings growth was in the 9% range in 2024 and is expected to increase into the double digits in 2025. Finally, the advent of artificial intelligence (AI) can be compared to the aforementioned internet revolution. These factors, coupled with the typical historical market trajectory during post-election years shown in the chart above, could indicate another positive year for the stock market in 2025.

*Large Cap: S&P 500 Index; Small Cap: Russell 2000 Index; Int'l Developed: MSCI EAFE Index; Int'l Emerging: MSCI Emerging Markets Index; US Inv-Grade Bonds: Bloomberg Aggregate Index; Int'l Bonds: Bloomberg Global Aggregate ex-USD Index; High Yield: Bloomberg US Corporate High Yield Index; Cash: BofA Merrill Lynch 3-Month US Treasury Index; Real Estate: FTSE EPRA/NAREIT Developed Index; Commodities: Bloomberg Commodity Index; Alternatives: Wilshire Liquid Alternatives Index

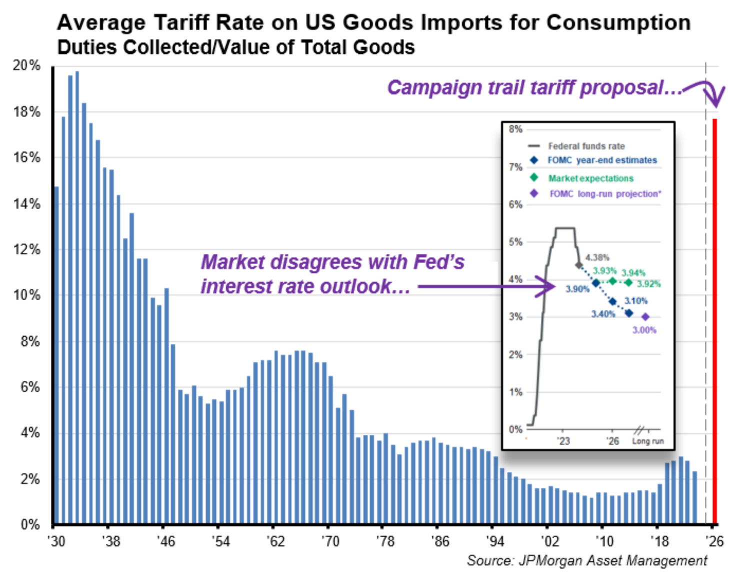
Bonds: Higher Yields = Higher Returns?

The chart at right examines the relationship between bond yields and subsequent 5-year annualized returns in various historical eras. I5-years is a positive correlation between the two. For example, in the 1980's one could buy bonds yielding 17% and garner a 20% annualized return over the ensuing 5-year period. In the 2010's bonds were yielding 3% and experienced between 2% and 4% annualized returns in the five years following. Obviously, the beginning yield has a marked influence on total return. That said, at approximately 4.9% the current yield on the bond market is both above the money market yield and suggests an approximate 5% return over the next five years. In other words, bonds are looking more attractive than cash at this time, particularly if the Fed continues to cut interest rates.



The Economy & The New Administration

The economy enters 2025 in a strong position. Real GDP growth is close to 3%, the labor market is near full employment with 48 consecutive months of job growth, productivity is above its pre-pandemic trend which has driven corporate earnings and fostered 20 consecutive months of wage growth surpassing inflation, inflation itself has declined from over 9% to under 3%, and credit conditions have eased. All else equal, 2025 should see a continuance of this strength, barring some shock to the system or significant policy shifts. As it relates to the latter, one example that could reignite inflation is sweeping tariffs on imported goods.



The chart at right reflects the Tax Foundation's estimate of the impact of the tariff policy proposed on the campaign trail: 20% on all imports and 60% on Chinese imports. This would return rates to levels not seen since the 1930's, would likely cause a retaliatory trade war, and almost certainly reignite inflation. This, in turn, could cause the Fed to discontinue their rate cutting action. Indeed, as the inset chart shows above, though the Fed expects its key rate to decline to 3% in the coming years, the market believes the Fed may be finished cutting and expects the rate will remain around 3.9%. Market rate expectations will likely remain in a holding pattern until additional clarity is attained on tariff, immigration, tax, and regulatory policy.

The Future: 2025 & Beyond

Research suggests 2025 has the potential to be another positive year in both the stock and bond markets. In terms of the economy we can go "back to the future" by looking at the first Trump term to deduce what may happen over the next four years. Tax cuts and regulatory reform could be stimulative but sweeping tariffs and mass deportations could reignite inflation. All things considered and noting historically rich valuations on US stocks at this time, we expect returns to be slightly lower in the coming years as reflected on the table at right. As always, we will monitor developments and, for our actively-managed clients, proactively make tactical adjustments as warranted.

Long-Term Target Total Return Estimates	All Fixed Income	Conservative	Moderately Conservative	Balanced	Moderately Aggressive	Aggressive	All Equity
2024 Estimates	5.0%	6.0%	6.5%	7.0%	7.5%	8.0%	8.0%
2025 Estimates	4.75%	5.5%	6.0%	6.5%	7.0%	7.5%	7.5%
Return Ranges	-4% to +13%	-4% to +15%	-8% to +20%	-14% to +27%	-20% to +34%	-24% to +39%	-28% to +43%

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