Market Newsletter Fourth Quarter 2024

EXECUTIVE SUMMARY

- In the fourth quarter, large stocks continued to gain while smaller stocks, foreign stocks and bonds were unprofitable.

- In 2024, stocks and bonds were profitable, although large US stocks were the most profitable helped by the 'Magnificent 7'. Despite rate cuts by the Federal Reserve, bonds had lackluster performance as long-term interest rates rose.

- Stocks could continue to rise, helped by momentum and earnings growth. Historically gains at this stage come along with volatility spikes and periodic drawdowns, which is why discipline is called for.

- According to FactSet, earnings of companies in the S&P 500 are expected to grow by 14% in 2025 and 13% in 2026. Although this is possible it will not be easy to achieve.

- A portfolio of the best ideas of successful investors does not perform well as many asset management firms have found out.

Table 1: Market indices

(Returns include dividends reinvested)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	2.41%	25.02%	25.02%	8.94%	14.53%
S&P Mid Cap 400	0.34%	13.93%	13.93%	4.87%	10.34%
S&P Small Cap 600	-0.58%	9.33%	9.33%	3.99%	10.21%
MSCI Emerging Markets	-7.84%	8.05%	8.05%	-1.48%	2.10%
MSCI EAFE	-8.06%	4.35%	4.35%	2.17%	5.24%
Vanguard Total Bond Market Index	-3.07%	1.11%	1.11%	-2.53%	-0.43%
Investment Grade Credit	-2.84%	2.76%	2.76%	-1.98%	0.48%
Non-Investment Grade Credit	0.16%	8.20%	8.20%	2.91%	4.04%
Bloomberg Commodity Index	-0.45%	5.48%	5.48%	4.05%	6.77%
Dollar Index	7.64%	7.05%	7.05%	4.28%	2.39%
10 Yr. Rate	4.57% 12/31/2024	3.87% 12/31/2023	3.87% 12/31/2023	1.51% 12/31/2021	1.92% 12/31/2019

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Vanguard Life Strategy (Asset Allocation) Funds

	Quarter to date	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
Income (20% stocks)	-2.04%	4.66%	4.66%	-0.46%	1.87%
Conservative Growth (40% stocks)	-1.86%	7.54%	7.54%	0.93%	3.99%
Moderate Growth (60% stocks)	-1.74%	10.31%	10.31%	2.29%	6.00%
Growth (80% stocks)	-1.56%	13.18%	13.18%	3.61%	7.99%

Source: Vanguard

Table 3: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 01/06/2025			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	227,000	Positive	The employment situation bounced back from the effect of strikes and hurricanes. Unemployment rate at 4.2% has been inching up since the low set in early 2023. Average hourly earnings have risen by 4% in the last 12 months.
Weekly Claims for Unemployment Insurance	211,000	Positive	Claims for unemployment insurance are at a historically low level. The 4 week average was 223,250.
ISM Manufacturing Index (over 50 indicates growth)	49.3	Positive	Manufacturing is still contracting but at a slower rate than before, as the ISM index rose to a 9 month high and is almost 50. Production and new orders rebounded, but outlook remains uncertain with the risk of Tariffs under the new administration.

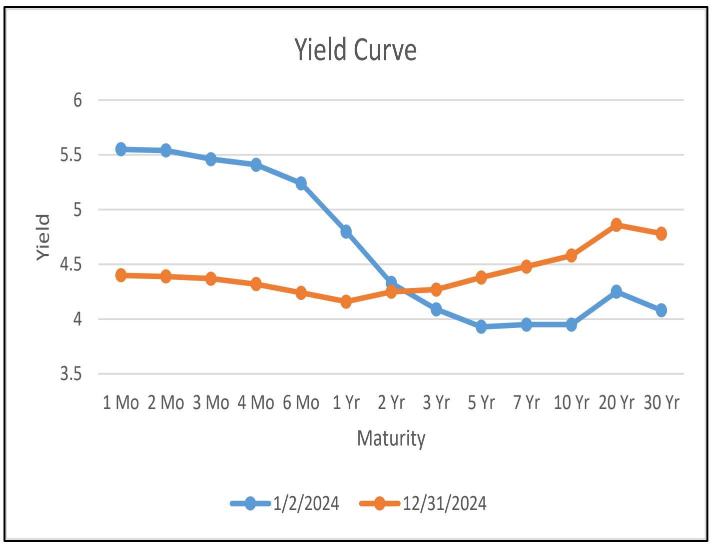
	Latest Release	Recent Trend	Notes
ISM Non Manufacturing Index (Over 50 indicates growth)	52.1	Positive	After some weakness in the summer the services sector is growing (Index >50). Other recent data such as the S&P PMI index also show improvement in the services sector.
Consumer Prices (Month over month change)	0.3%	Negative	Monthly inflation was the highest in seven months. As expected, the last mile to curtail inflation seems to be challenging. Yearly consumer inflation was 2.7% as compared to the recent low of 2.4% set in October.
Producer Prices (Month over month change)	0.4%	Negative	Like Consumer prices, monthly Producer prices rose the most in 7 months. Excluding food and energy, prices rose 0.2% in November. Year over year PPI was 3%, the largest increase since February 2023.
Retail Sales (Month over month change)	0.7%	Positive	Consumer purchase of motor vehicles and online products led to a strong retail sales in line with the strong underlying momentum in the economy. In another positive note, October number was revised up.
Consumer Confidence (Conference Board)	104.7	Negative	Consumer confidence unexpectedly fell in December weighed by political concerns. The pop in confidence after elections, could not be sustained as consumers worried about the impact of tariffs on the economy and the stock market.
Durable Goods Orders (Month over month change)	-1.1	Negative	Headline durable goods orders slumped in November because of a drop in aircraft sales. Non-defense capital goods excluding aircrafts, a proxy for business spending, rose 0.7%.
Industrial Production (Month over month change)	-0.1%	Negative	US Industrial production fell for three consecutive months due to weaker utility and mining output. Manufacturing, which is over 75% of industrial production, also struggled, hobbled by limited capital spending and high borrowing costs.
Capacity Utilization	76.8%	Positive	Capacity utilization has remained more or less close to its long term average.
Housing Starts	1.289 Million	Negative	New home construction fell to the lowest level since July as a drop in multifamily projects reversed a rebound in starts of single-family houses in hurricane affected South.
Home Prices (Case-Shiller Home Price Index- Year over Year)	4.20%	Positive	Home prices are continuing to rise nationally as the index rose for the 21st consecutive month to a new all-time high. The rate of increase in home prices are continuing to fall, however.
GDP (Real, Annualized)	3.1%	Positive	Third quarter 2024 GDP growth rate was revised upwards to 3.1%.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Stocks had mixed performances in the fourth quarter with large stocks posting a positive return, helped by companies in the technology and financial industries, but smaller stocks and international stocks posting negative returns. Smaller stocks rose significantly after the elections in the hopes that lower interest rates and deregulation could help smaller companies, but the rally faded as the year ended, with the realization that inflation and interest rates may not drop as quickly as expected. Bond prices fell as interest rates rose in the fourth quarter (Interest rates and bond prices are inversely related).

Despite the Federal Reserve (Fed) cutting interest rates from a two-decade high, bonds had another lackluster year in 2024. While this may seem surprising as rate cuts should have lifted bond prices, the relationship between a portfolio of bonds and interest rates is nuanced. The Fed cut short term rates through the Fed Funds rate, but a strong economy and expectation for a slower than expected pace of rate cuts led long term interest rates to rise (Fig 1) in 2024 for the fourth consecutive year, the longest stretch since 1981. As a result, long term bonds were one of the worst performing asset classes in 2024, hurting bond portfolios.

Fig 1: Long term rates rose even as the Fed cut rates



Source: US Treasury Department, Sarsi

Fig 2: Performance of styles in 2024 (%)

	Value	Blend	Growth
Large	14.69	23.99	27.75
Mid	12.28	13.47	20.33
Small	9.67	9.68	12.98

Source: Morningstar, Sarsi

Despite a late year fizzle, the S&P 500 returned over 20% for the second consecutive year, something it has not done since 1998. This could make achieving further gains difficult especially as stocks are not cheap at these levels, however, the underlying momentum and breadth of the stock rally augurs well for further gains as historically, stocks don't stumble when the trailing returns are as strong as they have been in recent months. As we discussed in our 1Q 2024 letter, stocks tend to do well after hitting all-time highs. However, historically such gains come along with volatility spikes and periodic drawdowns, which is why discipline is called for.

In 2024, growth outperformed value (Stocks that are cheap in relation to their earnings), and large stocks outperformed smaller stocks as seen in Fig 2. Stocks of stable, dividend paying companies underperformed significantly- a portfolio of high dividend stocks in the S&P 500 (SPDR® Portfolio S&P 500® High Dividend ETF) returned almost 10% less than the S&P 500 index. Among sectors, Communication services (Which includes of stocks such as Meta Platforms, Alphabet and Netflix) and Financial Services were two of the top performers while Materials and Healthcare were two of the worst performers as seen in Fig 3. The 'Magnificent Seven' i.e. Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla accounted for 55% of the S&P 500's performance last year. Excluding these seven stocks, the other 493 stocks returned only 10% (Fig 4)

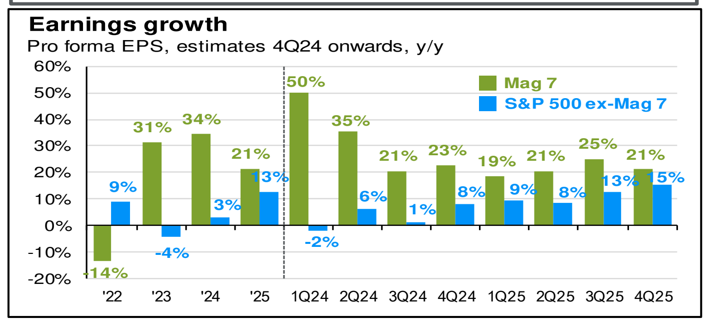
Fig 3. Performance of sectors in 2024 (%)

Materials	0.14
Health Care	2.47
Real Estate	5.07
Energy	5.52
Consumer Staples	12.19
Industrials	17.31
Technology	21.63
Utilities	23.28
Consmer Discretionary	26.51
Financial Services	30.55
Communication Services	34.7

Source: *State Street ETFs, Sarsi*

Fig 4: Magnificent 7, returns and earnings vs rest of S&P 500

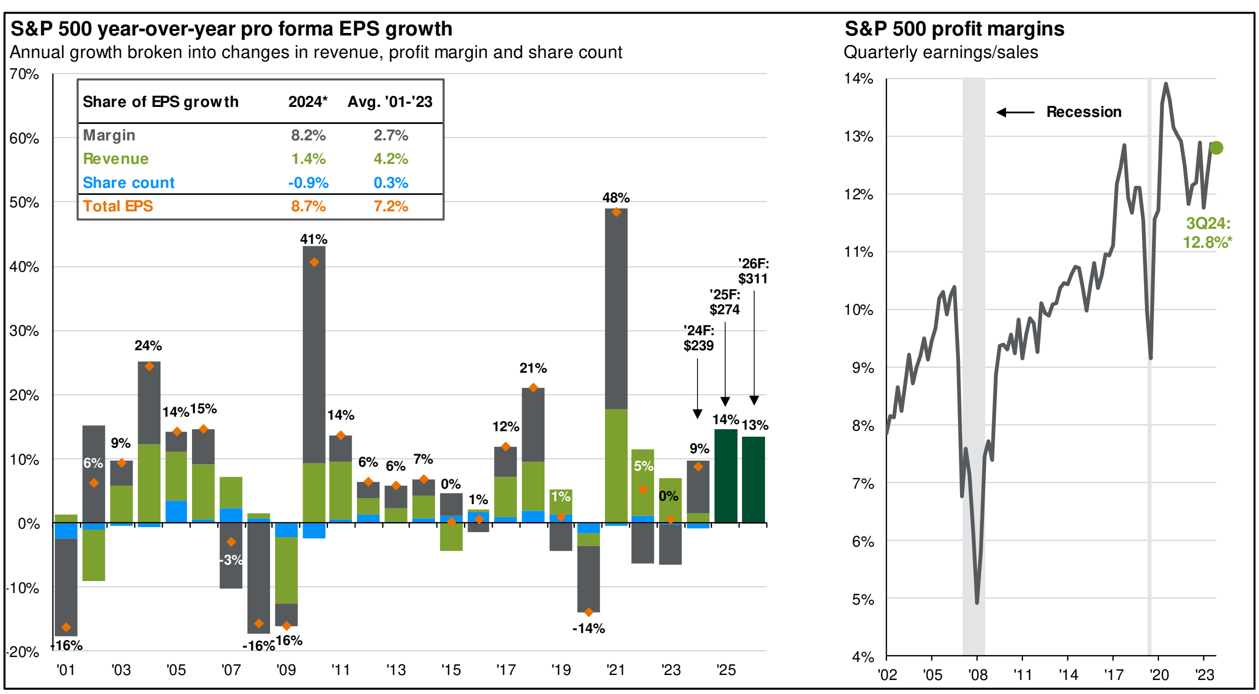
Returns	'21	'22	'23	'24
S&P 500	27%	-19%	24%	23%
S&P 500 ex-Mag 7	17%	-8%	8%	10%
Magnificent 7	40%	-40%	76%	48%
*Share of returns***	*33%*	*56%*	*63%*	*55%*



Source: JP Morgan

Under the surface, corporate earnings continued to grow across sectors, and analysts have confidence that the bull market will continue to broaden in its third year. Among the 16 large Wall Street firms tracked by Opening Bell Daily, the average forecast sees the S&P 500 climbing 14.03 percent in 2025. Corporate earnings are expected to support this optimistic forecast. According to FactSet, earnings of companies in the S&P 500 are expected to grow by 14% in 2025 and 13% in 2026. These numbers are higher than the 9% earnings growth in 2024, most of which came from margin improvement. (See Fig 5). With near peak margins and elevated interest rates, it will be harder to achieve these earnings growth numbers but stocks other than the Magnificent 7 are expected to contribute to growth in earnings (Fig 4).

Fig 5: Margin improvement was a significant contributor to earnings growth in 2024.



Source: JP Morgan

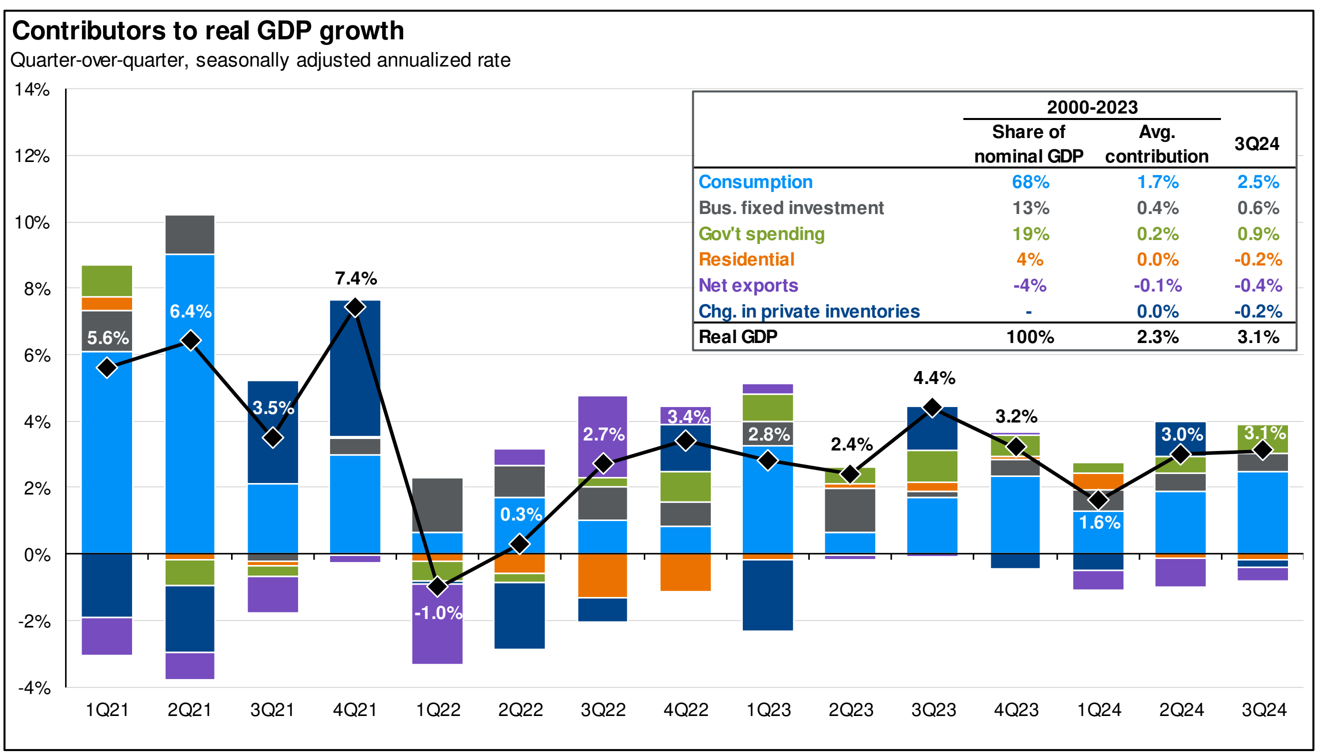
Some of the biggest losses in the fourth quarter came in stock markets outside the US, especially after the elections, as investors feared tariffs and trade uncertainties could hurt economies outside the US. Developed markets around the world gave back most of the year's gains in the fourth quarter and the MSCI EAFE ended the year up just 4.35%. The Chinese stock market, a major part of the emerging market indices, rose sharply in late September and early October when officials there announced a stimulus package to counter economic slowdown, focusing on liquidity improvements, boosting the property market, and stabilizing financial markets. But the rally was short lived, and most of the gains were lost by the end of the year, as markets adopted a wait-and-see approach.

Diversified portfolios had decent returns in 2024 but underperformed the broader index- as seen in Table 2, a moderate growth portfolio run by Vanguard with about 60% in stocks returned 10.31%.

The Fed cut interest rates by 0.25% at its November and December meetings but surprised markets in December with a major change to its projections for 2025. Its most recent projections show just two more 0.25% cuts are expected in 2025, down from four in its projections in the third quarter. Fed members have signaled that with inflation staying sticky, they are in no hurry to cut interest rates quickly or deeply.

Relatively high interest rates have had the intended effect of slowing down the economy. (Table 3) The employment situation, manufacturing and industrial production have tempered down. However, consumers are still in great shape because wages have grown faster than inflation, and retail sales have been strong. As seen in Fig 5 consumption has been supporting economic growth, accounting for 2.5% out of the 3.1% GDP growth in the third quarter. Based on a model developed by the Federal Reserve of Atlanta, the US economy is expected to have grown by 2.4% in the fourth quarter, slower than the third but still healthy.

Fig 5: Consumption has been and continues to be a significant contributor to economic growth.



Source: JP Morgan

Should you invest in the best ideas of successful investors?

Journalists have a difficult job of coming up with topics to write about, especially now when articles are released throughout the day. One popular topic is writing about the stock purchases and sales of successful investors. Unfortunately, since these investors do not speak freely to the press the articles are based on whatever crumbs of information the journalists can glean from publicly available sources, such as regulatory filings. Shaping your investment strategy based on these articles is not a good idea. There is a significant lag between the time the investor acts and the time when it is publicly known and the actual reason for the specific action is never known in the larger context of portfolio management. For example, an investor could sell stocks and increase cash in the portfolio leading journalists to conclude that the investor is being defensive, while the real reason for this action could be that the investor is preparing for a large redemption or is planning for a large future purchase.

Even if you were able to get the best ideas of successful investors without a lag, it would not help you. Several asset management firms** have tried these ‘best ideas’ funds without any success. The reason these best ideas funds fail is that investors spend most of their time on their best ideas which leads to overconfidence and the tendency to stick to their ideas even when facts change. As discussed in our letter 2Q2023, highly profitable companies don’t grow forever. It is difficult to identify which stocks will perform the best before the fact and it is not profitable to invest in those stocks after the fact. Your best bet for capturing the returns of the winners and managing the losses of the losers is to create a resilient, diversified portfolio.

**For example, The Capital Group, a large asset management firm, created funds using the highest conviction ideas of their portfolio managers. These funds did not generate good returns. See *Why investors' best ideas can sometimes be their worst*