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January 2025 Market Commentary

Since the Great Recession in 2008, the US economic recovery has been nothing short of remarkable, and fortunately this has been reflected in the stock market. In the last 15 years, as measured by the S&P500 Index, aggregate corporate earnings have increased at an annual rate of 9.7%, and the stock market has returned 13.9%.

In 2020 the global pandemic briefly but momentously interrupted the economic recovery, and its disruption of the supply chain for products caused inflation to spike to 9% in 2022. In response, the Federal Reserve tightened monetary policy, raising its short-term policy rate (Fed funds) from 0.25% to 5.50% over 16 months beginning in March 2022. This historically aggressive monetary policy convinced most if not all Wall Street strategists to forecast a recession and a decline in corporate earnings and stock prices. This scared investors and the stock market declined 25% in the first nine months of 2022. Fortunately Wall Street was wrong, and there was no recession. In focusing on monetary policy, Wall Street failed to consider fiscal policy!   During the pandemic years (2020 and 2021), the federal deficit soared to $3 trillion annually, and then averaged $1.6 trillion for the next three years. This federal spending offset the impact of Fed tightening.

Corporate earnings were stable in 2023 and in 2024 are expected to finish up 10% for the year. The stock market increased 26% in 2023 and another 25% this year. Estimates are for another 13% in earnings growth this year, so the market is currently valued at 22 times forward earnings, relatively expensive by historical standards. Earnings are supported by record profit margin forecasts for 2025.

In addition to earnings growth, the other key variable in the valuation of the market is the level of interest rates, which is dictated by inflation. The Fed measures inflation by the personal consumption expenditure index excluding food and energy, known as the core PCE. This measure has declined from a peak of 5.6% in September 2022 to 2.8%, prompting the Fed to reduce its Fed funds rate from 5.25% to 4.25%, even though inflation is above the Fed's target (2%). Part of the problem is the cost of housing (like apartment rents) because new rental leases take time to adjust. Unfortunately, the bond market is not cooperating with the Fed, as the yield on the 10YR Treasury (not controlled by the Fed) has increased since last September from 3.60% to 4.60%. Bond investors are concerned about the aforesaid federal deficit spending, which is stimulating growth, as well as the new administration's policies, such as tariffs, income tax cuts, and deportation of illegal immigrants. Hopefully tariffs will be used to encourage reshoring of manufacturing in the US-Mexico-Canada trade corridor and to reduce the income tax rate on domestic manufacturers. However, an estimated 80% of illegal immigrants are working, and a significant number of deportations would drive up wages, especially in agriculture and construction, which would be inflationary.

Since the pandemic the total federal debt has soared from $23 trillion to $36 trillion, and the interest cost has soared to over $1 trillion annually, as much as defense. Most of this interest is paid to citizens, businesses, and pensions and mutual funds as a form of savings. Of the $36 trillion in federal debt, $7 trillion is interagency (owed by one agency to another), and another $4 trillion is held by the Federal Reserve (who returns its interest earned to the Treasury). Publicly traded debt is "only" $25 trillion, which compares to GDP of $29 trillion, and total national assets of $221 trillion (corporate, small business, and households). Because of America's productivity and wealth, the bond market considers the federal debt to be more of a political problem than an economic one. Unfortunately, Congress will probably continue its deficit spending until the bond market resists the rising supply of Treasuries at auction.

Some strategists have pointed out the similarities between the current hype surrounding Artificial Intelligence (AI) and the dot.com bubble in the late 1990s. The advent of the internet changed the world, but that didn't stop Wall Street from inflating a stock bubble that burst and caused a recession in 2000! In 1999 Big Tech was trading at 50 times earnings; this compares to 40 times now for the so-called Magnificent 7 (Alphabet, Apple, Amazon, Meta, Microsoft, Nvidia, and Tesla). This year the Mag 7 are expected to grow earnings at 21%, compared to 11% for the equal weighted S&P500 trading at a more reasonable 17 times. During periods of policy uncertainty, such as today, investors prefer the dominance of the Mag 7, which now comprise a record 32% of the S&P500. As the contours of economic policy take shape, investors can be expected to broaden their holdings to include relatively less expensive quality growth stocks. Rapid build-out of AI infrastructure does create business risk for Mag 7, that is, delays in implementation or disappointing returns on investment, either by providers or early adopters of the new technology.

Our strategy remains the same as it always has. We look to buy and hold stocks with good growth potential at reasonable prices. This has worked in market environments similar to where we are today, and we believe it will continue to work well.