

## Market outlook as of January 2025

*“The only thing that makes life possible is permanent, intolerable uncertainty; not knowing what comes next.”*

**Ursula K. Le Guin (1929 -2018) American author, best known for her works of speculative fiction.**

### Overview

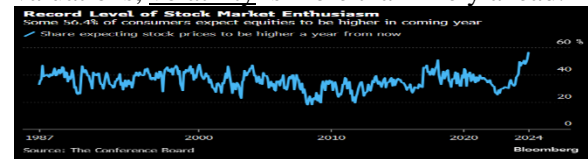
2024 was another banner year for the stock market, driven by several factors: The US economy grew by approximately 2.9%, supported by resilient consumer spending, Federal fiscal stimulus by way of excess spending, the Federal Reserve interest rate cuts and the prospect of artificial intelligence propelling efficiency and corporate profitability. Despite fewer likely rate cuts going forward, we see a positive outlook for US stocks, driven by a combination of lower borrowing costs, robust US merger and acquisition activity, a broadening of US earnings growth, additional AI momentum, and the possibility of increased capital market activity(M&A) under a second Trump administration. By the end of 2025, most pundits expect the S&P 500 to reach 6,600, about a 10% gain from here.

Overall, it's hard to be bearish for 2025 as the economy is strong (USA unemployment currently stands at a low 4.2%), with steady growth, a slowing rate of inflation, and the Fed is in a strong position to react to any new risks that arise. Financial markets and fiscal conservatives in Congress unwillingness to accept larger deficits may limit further spending due to inflationary concerns which would be a good thing. The proposed Trump administration aims to cut regulation and encourage M&A (mergers and acquisitions), which should increase productivity across industries. We think the US is in a stronger position than other major economies heading into the new year, and we anticipate that

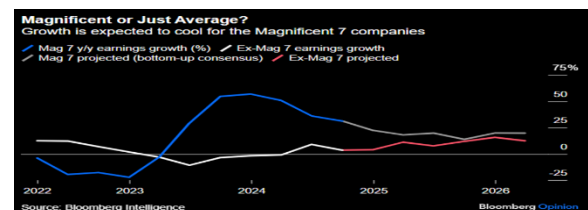
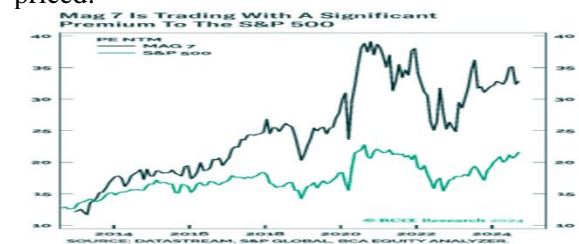
the US dollar will stay strong despite the potential for volatility.

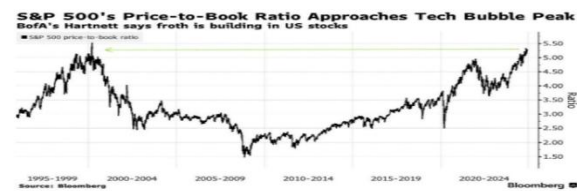
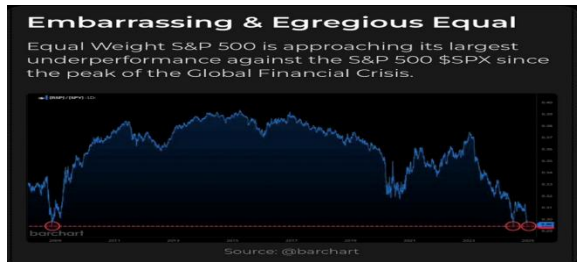
**The key risks we see going forward are excessive optimism, extended valuations and the concentration in the market around the magnificent 7 coupled with the potential for inflation to reignite:** Though there are signs of a tech bubble like the one that occurred in the late 1990s, the market may experience sharp corrections (drop of around 10%) if sentiment changes or outside variables cause volatility.

**Market sentiment and concentration.** After equity markets reached all-time highs, there is a feeling of optimism, but given the high valuations, volatility is more than likely ahead.



The market has been remarkably concentrated around the so-called magnificent seven stocks that now trade at relatively high valuations, while the rest of the market looks far more reasonably priced.





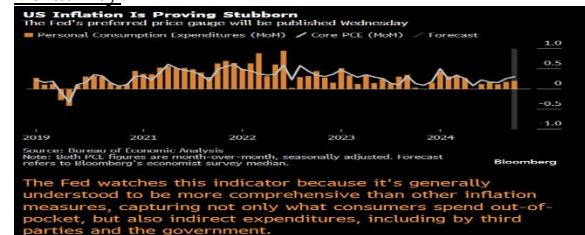
*We would not be surprised to see a market correction:* Policy uncertainty is higher than usual, in part because there are so many dynamics to deal with. The policies of the Trump administration require careful balancing. Deregulation and tax reforms should boost economic growth. An inflationary shock could be brought on by tariffs and immigration restrictions may even cause the Fed to consider raising interest rates as the economy deteriorates.

There is a high possibility for a misstep by either the Federal Reserve with regard to interest rates and inflation, and the Trump administration overdoing tariffs or spending. Historically 10% corrections happen on average almost once a year, while we have not seen one in three years. Equities have had two great years with stretched valuation levels, a 10% decline should not be a surprise, and could even be a good thing to bring back rationality especially to areas where traders are overly optimistic while ignoring the risks of overvaluation.

**Inflationary Concerns:** One area we are watching closely is the potential for *inflation to reignite* and long-term bond yields which we view as the canary in the coal mine. The election made it abundantly evident that American voters disapproved of the inflation during the Biden administration. The outlook for inflation will limit the extent to which tariffs and immigration controls can be implemented.

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Given the sizeable budget deficit, it appears likely that the incoming administration will advocate for tax cuts; however, there are risks associated with further fiscal stimulus. The prospect of increased government debt and deficits may not be well received by bond markets, which could lead to more widespread market and economic volatility.



Current inflation is running closer to 3% rather than the Fed's target of 2%. The risk is that inflation could be further stoked due to higher tariffs and tight labor markets due to deportations. Recent large union wage settlements are inflationary and have also been troubling. Bond markets are also backing up, a sure sign that inflation expectations going forward are a concern. (see chart below)



The U.S. market is susceptible to *unfavorable surprises due to elevated sentiment and equity valuations* and could face difficulties if the dollar continues to strengthen which makes US exports more expensive. The earnings yield advantage that stocks have had over bonds since 2002 has been diminished as the 20-year U.S. Treasury yields are approaching 5%.

We favor the remaining 493 stocks in the S&P 500 and mid-cap US stocks as a current portfolio diversification strategy away from the concentration in the S&P 500 index. With 76% of mid-cap revenues coming from the US compared to 59% for large caps, profit from the robust US

economy and are largely protected from tariff exposure and could even be beneficiaries. Furthermore, mid-cap stocks are predicted to have attractive valuations and strong earnings growth of about 13% in 2025, trading at almost the biggest discount to large-cap stocks over the previous 20 years.

Gold was a standout performer for 2024, returning 27.8%, boosted by heavy central bank buying, geopolitical concerns, and a decline in the opportunity cost of holding the zero-yielding asset as US rates fell. Overall, and notwithstanding fewer likely interest rate cuts, we see a favorable backdrop ahead driven by a mixture of lower borrowing costs, resilient US activity, a broadening of US earnings growth, further AI monetization, and the potential for greater capital market activity under a second Trump administration. We anticipate taking advantage of expected volatility using any near-term turbulence to add to underinvested areas that offer much better value and an improved risk-reward ratio. For this reason, we think it's critical to invest over the long term and strike a balance between capital growth, income and capital preservation.