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Doll's Deliberations®

Weekly Investment Commentary

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Key takeaways

Equities fell again last week (S&P 500 -1.91%). Small stocks (Russell 2000) are down more than 10%. Treasurys were weaker, with the 10-year yield the highest in over a year. The push higher in yields put pressure on some mega cap tech stocks, given concerns around elevated valuations. Positive sectors included energy (+0.90%) and healthcare (+0.52%); worst sectors were real estate (-4.09%) and technology (-3.10%).

Equity markets (Index total return %)	Last week	Year-to-date
DJIA	-1.83	-1.38
S&P 500	-1.91	-0.89
NASDAQ	-2.34	-0.76
Russell 1000	-0.40	0.74
Russell 1000 Growth	-2.20	-0.79
Russell 1000 Value	-1.54	-0.77
Russell 2000	-1.30	0.40

S&P equity sectors (Index total return %)	Last week	Year-to-date
Communication services	-0.57	0.86
Consumer discretionary	-2.33	-1.23
Consumer staples	-1.90	-2.20
Energy	0.90	2.86
Financials	-2.61	-2.04
Heathcare	0.52	1.55
Industrials	-1.01	-0.28
Information technology	-3.10	-1.71
Materials	0.14	-0.93
Real estate	-4.09	-3.70
Utilities	-1.90	-0.10

1. The December payroll report recorded 256,000 new jobs, 100,000 higher than the consensus. This adds credibility to those arguing for the Fed to pause, putting Treasurys under more selling pressure.
2. By contrast, the JOLTS report showed that the gap between quits and layoffs (a leading indicator of labor market demand) ticked down, indicating the labor market has cooled.
3. With Friday's employment report, it is the 48th consecutive positive payroll print, making it the second longest in the 85-year history of the series (only exceeded by the pre-Covid expansion).
4. The consensus for this week's CPI is core +0.2% and headline +0.3% (again closer to 3% annually than the Fed goal of 2%).
5. U.S. real GDP looks to have grown at roughly +3% q/q annualized for three consecutive quarters, making 2024 a good year. But trend U.S. trend growth is likely closer to 2% than 3%. So, 2025 should see a slowdown. Signs of a slowing economy include a rise in jobless claims, increasing layoffs, and hiring freezes, and a drop in mortgage applications.
6. It was only a few weeks ago that expectations of 100+ basis points (bps) of Fed cuts this year was likely. The futures curve is now suggesting just 30 bps. If the Fed is done cutting rates and the economy is showing signs of slowing, that would likely mean equity market difficulties.
7. Bond yields have been rising due to sticky inflation reports, the likely Trump agenda, and the massive government financing needed.
8. Over the last three months, the broad real-trade-weighted dollar has appreciated 21% at an annual rate. A stronger USD tends to weigh on corporate earnings, especially multi-national earnings. The sectors with the largest foreign revenue exposure are technology and materials.
9. President-elect Trump and House Speaker Johnson expressed a preference for one reconciliation package, combining tax with immigration, energy, defense, spending cuts, and possibly the debt ceiling. This bill will take several months to craft, with passage uncertain.
10. Elon Musk conceded that cutting government spending by half of his initial goal ($2 trillion) would be an "epic outcome" to attain. (See Prediction 10 in "10 Predictions for 2025" white paper on crossmarkglobal.com.)

Fewer tailwinds/more headwinds

International equity markets (Index total return %)	Last week	Year-to-date
MSCI ACWI	-0.18	0.53
MSCI ACWI EX U.S.	0.29	0.14
MSCI EAFE	0.73	0.43
MSCI EM	-0.62	-0.76

Fixed income markets (Index total return %)	Last week	Year-to-date
Bloomberg U.S. Aggregate Bond	-0.34	-0.47
Bloomberg U.S. Corp High Yield	0.01	0.32
Bloomberg U.S. Gov/Credit	-0.36	-0.48
Bloomberg U.S. T-Bill 1-3 Month	0.04	0.09

Alternatives (Index total return %)	Last week	Year-to-date
Real estate (FTSE NAREIT)	-1.95	-1.51
Commodities (DJ)	4.15	3.90
Global listed private equity (Red Rocks)	-0.61	0.27
Currencies (DB Currency Future Harvest)	0.01	0.05

Rising inflation and interest rates that led to fears of a hard landing through much of 2022 and 2023 have long dissipated. The combination of falling interest rates and continued economic growth has, at least in the past, been associated with strong equity returns.

Despite the favorable backdrop, the set-up for equities as we enter 2025 is complicated by three main factors. First, the speed of the recent rises in stock prices has reflected much of the good news that we are expecting on growth. Second, high valuations are likely to limit forward returns. Third, unusually high market concentration increases portfolio risks: Concentration has increased by geography (the U.S. has been increasingly dominant) and by sector (technology has generated the bulk of equity returns).

The powerful rally in equity prices in recent months leaves equities "priced for perfection." The surge in stock prices in the past two years (24% in 2023 and 23% in 2024) has been in the 93rd percentile over equivalent periods in the past century. Stocks are increasingly vulnerable to a correction driven either by further rises in bond yields and/or disappointments on growth in economic data or earnings. Stocks in the U.S. show valuation near all-time highs even if we exclude the largest technology companies.

There is considerable uncertainty regarding a range of important macro issues, especially on the trade and political fronts, as well as ongoing high geopolitical tensions. Additional uncertainty begins on January 20 with the return of Trump and his threat of immediate new tariffs.

A simple comparison of the most cyclical versus the most defensive parts of the market illustrates that much of the strength in equities in recent months has reflected higher growth expectations where optimism on deregulation and tax cuts have also played a role. This leaves equities vulnerable to any growth disappointments. The extraordinary ramp-up in capex spending that mega cap technology companies are making is reducing free cash flow and the scale of future profit growth.

This all makes the case for diversification more powerful. This can be achieved in various ways: First, through selective geographical diversification; second, through a broadening of sector exposures; and third, via more focus on alpha than beta.

Conclusion

Lower returns in the year ahead seem inevitable, especially given already rich equity valuations and prospects for higher bond yields. Inflation will prove stickier and higher than central banks and markets are forecasting. That implies that central banks will cut rates by less than markets are discounting, with some possibility that the Fed could be forced to hike interest rates by the end of this year. The crosscurrents of ongoing economic expansion and higher bond yields signal that equity markets will be choppy in 2025. Rising earnings will provide underlying support, but expensive U.S. stocks are especially vulnerable to a further increase in U.S. Treasury yields. While we expect Trump to emphasize growth over disruption, his expected daily social media commentary will inevitably create periodic capital market volatility. Geopolitics is also a wildcard, with the prospect of a halt to the Ukraine and Middle East wars potential positives, while tensions between China and U.S. are at risk of intensifying.

Source: Bloomberg as of Jan. 10, 2025

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