Traub Capital Management
Outlook, Q1, 2025
January 3, 2025

Overview

The S&P 500 finished in 2024 at a level of 5,882, up from 4,769 at the close of 2023. This is a gain of 23% or 25% including dividends. The magnitude of the rise surprised virtually everyone. We expected a "low double-digit gain", so we too were pleasantly surprised. However, the low double-digit gain we expected was higher than the vast majority of forecasts you saw from the major Wall Street firms.

With bonds, we expected lower yields on the short end of the yield curve and higher yields on the longer end, which is precisely what happened. The overnight rate fell from 5.3% to 4.3%, while the rate on the 10-year treasury obligation rose from 3.9% to 4.6%. Our position of generally short-term bonds, floating rate bonds and significant money market fund holdings worked well in this environment.

Our forecast for 2024 rested on a strong domestic economy with inflation declining, but stabilizing well above the Fed target of 2%. For 2025, we will continue to see a strong domestic economy. We also expect inflation to decline slightly, with the overall levels stabilizing a bit under 3% and well above the Fed target of 2%. For the stock market, we expect equity returns to remain healthy. For bonds, we also expect the longer end of the yield curve to remain stable, while the short end declines a half point or so.

US Economic Picture

Well back into 2021, we were projecting growth in the domestic economy and no recession. In 2021, we were unique in this view. We continue to hold that the domestic US economy is in good shape and that there is no recession projected for 2025. The difference now is that after four years of most everyone's continuous cry for recession, our "no recession" view has become the mainstream view for 2025.

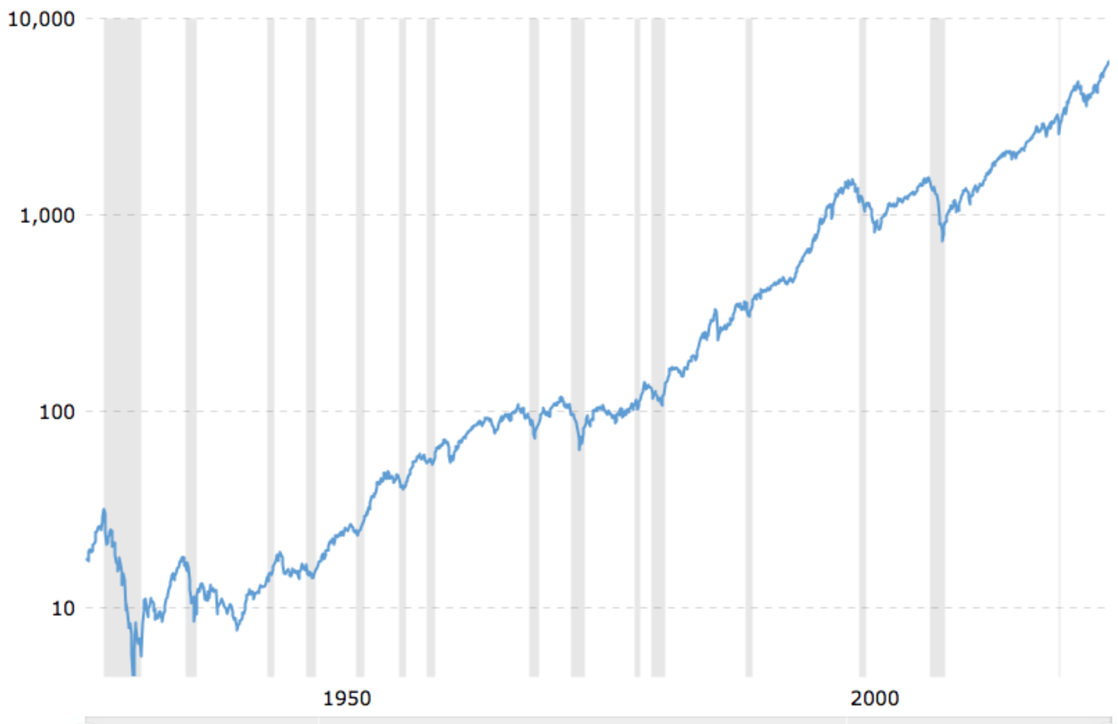
The driving force for continued growth in the domestic US economy remains the very low levels of unemployment coupled with the continuously increasing size of the labor force. At the same time, wages are increasing at a rate generally exceeding inflation. This combination means that people will have money and when people have money, they will spend it. We expect to see growth in real US GDP (after subtracting out the impact of inflation) of almost 3% in 2025 and another 2+% in 2026. This growth will couple with annual productivity improvements of over 1.25% in both years. Unemployment will stick around 4 1/2%, which is basically a full employment economy.

No recession in 2025, nor in 2026 will mean, with the exception of the short impact from the COVID pandemic, that the US will not have seen a recession since 2008 – a span of what will have been eighteen years. This eighteen-year period will match the period from 1982 to 2000 that was also marked with only one brief recessionary period. In that same 1982 to 2000 period, the S&P 500 went from a value of 100 to a value of 1,500 for an annual return over the eighteen-year period of 17.2% including dividends, and a total return of 2,000%, including dividends. A corresponding gain for the current 18 year period would see the S&P 500 going from its low of 750 in March 2009 to a value of

13,000 by the end of 2026 or a bit over twice its current level. We don't see anything close to a value of the S&P of 13,000 by the end of 2026, but the cumulative rise we have seen in the last decade is hardly unprecedented. Bull markets do not end because they are "too high".

Bear Markets and Recessions

Below is a long-term look at the S&P 500 index from MacroTrends. It shows recessionary periods and the value of the S&P 500 going back to 1928. To show the impact of change in the lower values of the S&P 500, the graph uses a logarithmic scale on the "Y" axis. Recessionary periods are shown as gray vertical bars.



What is immediately clear from this graph is the correlation of recessions to down market periods (bear markets). Almost every bear market is associated with a recession, either just before or during the market downturn. There are a few periods where the market turns down and no recession develops, but these periods are typically short.

We do not see a recession on the horizon in 2025, nor in 2026. As such, we are assigning a very low probability to a bear market decline in 2025 where the S&P 500 index declines by more than 20%.

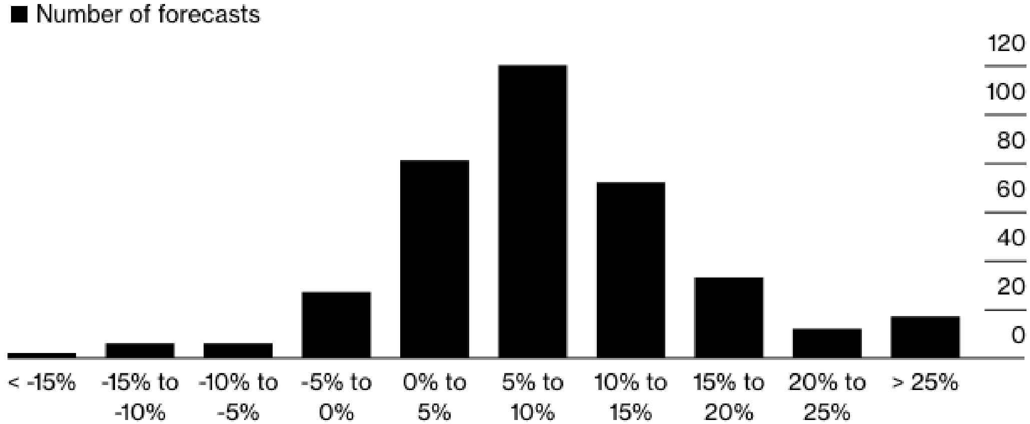
Assessing What Will Not Happen

In looking out to see what will likely happen in the future, it is often very helpful to look at what is likely to not happen. Above, we show that the probability for a bear market is very low. So let's look at the next thing that has a low probability.

The charts below are taken from Bloomberg. They show the frequency chart for Wall Street forecasts compared to actual results.

Strategists Tend to Herd with Year-Ahead Market Forecasts

Counts of brokerage forecasts by annual S&P 500 Index returns, 2000-2024



Source: Bloomberg
Note: Forecasts for price change in S&P 500 Index made one year in advance, for forecast years 2000 through 2024

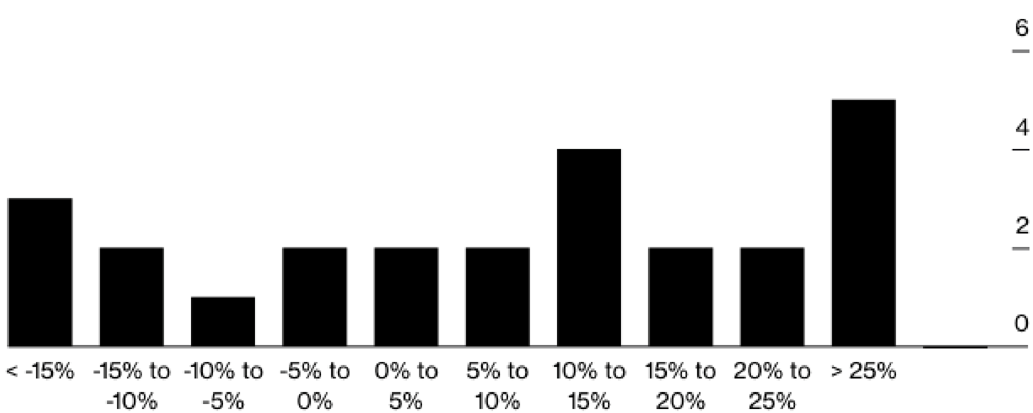
This first graph shows the frequency of forecasts by major Wall Street firms for the last 24 years. You can see that the most frequent forecast is for a gain of 5 to 10% in the equity markets when looking out one year. Zero to 5% is the next most frequent forecast followed by 10 to 15%. The current consensus forecast is for a 9.1% increase.

We don't want to disparage the well-intended forecasts made by major firms, but you can see that they do tend to collect right in the middle, which roughly matches the long-term gain of the equity markets of 10.7% for the last 30 years. Forecasting a 5 to 10% gain is also a very comfortable place to be, since most all the other firms are in the same place.

However, being part of the herd does not mean an accurate forecast. Below, also from Bloomberg, is a chart of the market actual returns over the same twenty-four years.

Market Returns' Actual Distribution Far Different From That of Forecasts

Counts of annual S&P 500 Index returns, 2000-2024



Source: Bloomberg
Note: Returns are price change only. 2024 returns are through 12/17/24, annualized through end of year

You can see that the actual returns bear basically no relation to the forecasts. In fact, we hold that, in all probability, the most widely forecasted outcome will not happen. This is because the most widely forecasted outcome is what people expect and that outcome is already reflected in prices today. Consequently, we place a very low probability on a market return of five to ten percent.

Having ruled out a bear market, or a market return of 5 to 10% leaves us looking at a small negative return or a gain of greater than 10%. We further narrow down the probabilities below.

Earnings

Earnings are the primary driver of stock prices and earnings of the S&P 500 companies should see another year of very good increases. We are expecting that 2025 earnings will be up a bit over 10% compared to 2024. By the end of 2025, the market will be looking at projected 2026 earnings which should be up another 9% up from 2025. It follows that with earnings up, stock prices should also be up.

The Price/Earnings ratio of the S&P 500 is 21.7 based on our expected 2025 earnings of $271. This P/E ratio is higher than the long-term average, but it is not excessive. An earnings increase of 10% would point to an increase in the S&P 500 value of a corresponding 10% without any change in the P/E ratio. That said, P/E ratio is a very poor indicator of stock market performance twelve months out as P/E ratios can change pretty dramatically. Generally in periods of solid growth in earnings, the market tends to extrapolate those gains. That extrapolation translates into higher P/E ratios. This happens before market euphoria sets in and things come back down to a longer-term trend. As discussed above, confidence in the economy is not euphoric in our view. There is no evidence of euphoria either in the financial headlines, nor in the numerical measures of confidence.

Presidential Cycle

As we all know, Donald Trump will become President in January. We have again seen his style on display calling for very big changes on most everything from tariffs, to illegal aliens, to the takeover of the Panama Canal, to the purchase of Greenland from Denmark, to taxes, to name a few. All these pronouncements add to uncertainty. Markets do not like uncertainty. Republicans do have nominal, but very narrow, control of both houses of Congress, but the party is not unified. There is no mandate and no guarantee of passage of legislation. People will begin to see that while the presidential agenda may be sweeping, policies that actually get implemented will not upend society and uncertainty will wane. Waning uncertainty, coupled with a strong inherited economy points to higher market returns.

Confidence

Bull markets rise on increasing optimism and end on excessive euphoria. It is hard to conclude that today's markets are euphoric. US consumer confidence tumbled over 8 points in December as measured by the Conference Board. The indicator dropped to 104.7 in December from 113 in November and is now in line with its long-term average of 100. Nothing points to high economic optimism, much less to euphoria.

In particular, our last Economic Outlook placed a small probability of a very large run-up in stock prices in the final quarter of 2024 which would have followed had euphoria become the dominant market sentiment. The fact that in Q4, the S&P 500 was up barely 2% pretty much rules out the idea of market euphoria. With 2024 closing the year with confidence at just moderate levels indicates to us that the market is continuing to climb the Wall of Worry.

The Fed, Inflation and Interest Rates

In the past four years, there is not a day that has gone by without there being a headline story in the financial press about the Federal Reserve (Fed). As we have said here many times, the control that the Fed exercises over the economy is nowhere near what it did when the US was basically a manufacturing economy. Such will continue to be the case going forward. Fortunately, we have seen that the Fed seems willing to set the Federal Funds rate near the long-term average while watching the economic data. Basically, they are no longer doing any harm. Further lowering of the Federal Funds rate will not have much impact from here – either on the general economy, nor on inflation. The economic conditions in the US will be determined by continued expansion in the labor force, improved wages and improved productivity.

By controlling the Federal Funds rate to control inflation, the Fed is fighting the wrong war. Milton Friedman connected inflation to the money supply, not to the Federal Funds rate. Below is a graph of the change in the Consumer Price Index in red and the change in the money supply in blue.

Inflation goes up generally about a year after the money supply increases. Inflation also goes down generally about a year after the money supply decreases. The correlation is pretty clear. In particular, note the dramatic increase in the money supply in 2020 and in 2021. What followed was the large spike in inflation seen in 2022 and 2023. Since August 2023, however, the supply of money has been increasing again and it is that increase in the money supply that is causing the persistent inflation we are seeing. The increase in the money supply is not consistent with a level of inflation of 2% and we are not going to see inflation get to the 2% level in 2025 in spite of whatever moves the Fed is likely to make in the interest rate on Federal Funds.

Can Three Strong Years in a Row Happen?

Ruling out the things that are unlikely and assessing the probabilities of things that are likely leads us to conclude that we should see a low double-digit gain in the overall equity markets again in 2025. We do believe that these gains will be principally enjoyed by US domestic stocks as the US economy is in much better shape than any other developed country.

If you read any other forecasts, you will see that the above is not the popular conclusion and you will see all sorts of reasons that basically boil down to the assessment that the markets are too high. As we have seen, markets are not made by history, but rather on anticipation of the future. Corporate earnings do not slow down because they were "too high" last year and neither does the market. A three-year span of double-digit gains in the US equity markets is far from unprecedented and we believe it will happen again in 2025.

As always, we sincerely thank you for your continuing relationship with Traub Capital and your continued faith in the stewardship of your investment portfolio and we look forward to continuing to work with you in the upcoming years.