Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Fourth Quarter, 2024

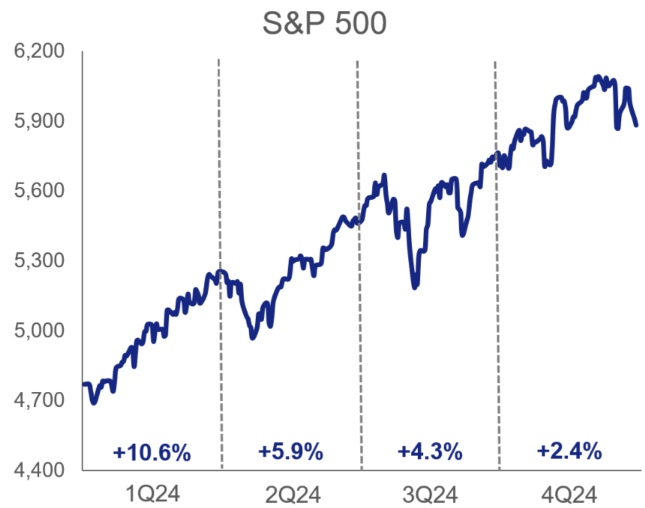
WHERE TO FROM HERE?

Priming the pumps. With more than 40% of the world's population going to the polls in 2024, it seemed like a reasonable bet that incumbents around the globe would do "whatever it takes" to keep the economy rolling. For its part, the Biden administration did not disappoint—whether it was the Treasury General Account (TGA), the Strategic Petroleum Reserve (SPR), or student loan forgiveness, the US economy was primed for growth.

A bullish backdrop. Estimates now suggest that year-over-year, real GDP grew at 2.8% in 2024, inflation fell to 2.9%, and S&P 500 operating earnings rose 9%. Combine those metrics with what is essentially full employment and it is not surprising that the S&P posted its best back-to-back yearly performance since 1998. While the 10-year Treasury yield rose ~50 basis points during 2024, for most of the year it stayed well below the 4.5% level that has spelled trouble for risk assets since the start of the current bull market. Add in a Fed easing cycle and the prospect of a new President-elect perceived as more pro-business than his predecessor, and it isn't surprising that stock valuation multiples expanded as well.

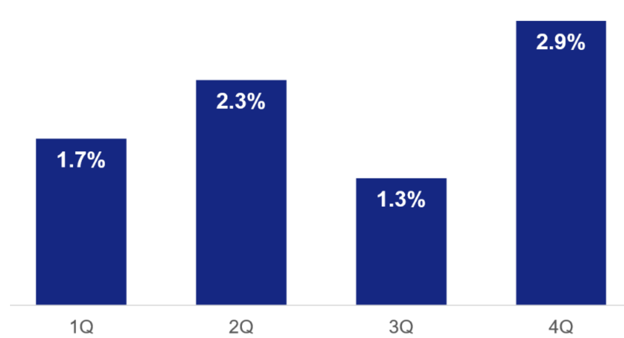
Government efficiency. Whether the bull market can continue and at what pace will, in our estimation, depend on whether the hype surrounding the new administration is justified. At least conceptually, the new advisory commission DOGE (Department of Government Efficiency), may be a chance to stop fiscal bleeding that, if left unchecked, could lead to higher risk-free interest rates regardless of the rate of inflation. Progress on this front may not be met with enthusiasm in Washington, however—a city President Kennedy described as possessing "Southern efficiency and Northern charm."

Great expectations. By our lights, the chances of a recession in 2025 are low given the strength in corporate profits, strong labor markets, and tight credit spreads. Still, with the S&P 500 trading at almost 22x forward earnings, the VIX at 17, and Bitcoin at $96,000, it is safe to assume that expectations for risk assets remain high. With the largest 10 stocks in the S&P 500 comprising nearly 39% of the index, a good portion of outperformance for active portfolio managers this year will be driven by how long the A.I. trade continues to outperform. There are times, of course, when great companies can be bad stocks. We are betting on the A.I. trade to continue, but our head is on a swivel as the story of this new technology unfolds.

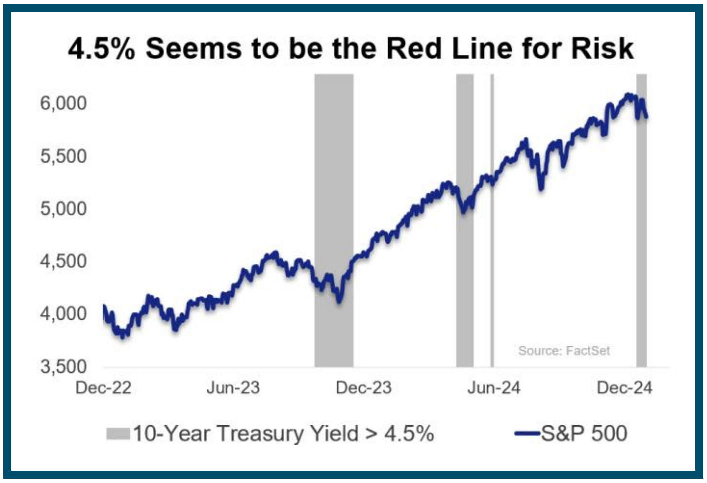


Asset Class	Representative Benchmark	Q4 Return
US Large Cap	S&P 500	2.4%
US Small Cap	Russell 2000	0.3%
International	MSCI AC World ex-USA (USD)	-7.5%
Commodities	Bloomberg Commodity	-0.5%
Gold	LBMA Gold PM ($/oz)	-0.8%
Municipal Bonds	Bloomberg Municipal Bond	-1.2%
Taxable Bonds	Bloomberg US Aggregate	-3.1%
Cash	Bloomberg 3-Month T-Bill	1.2%

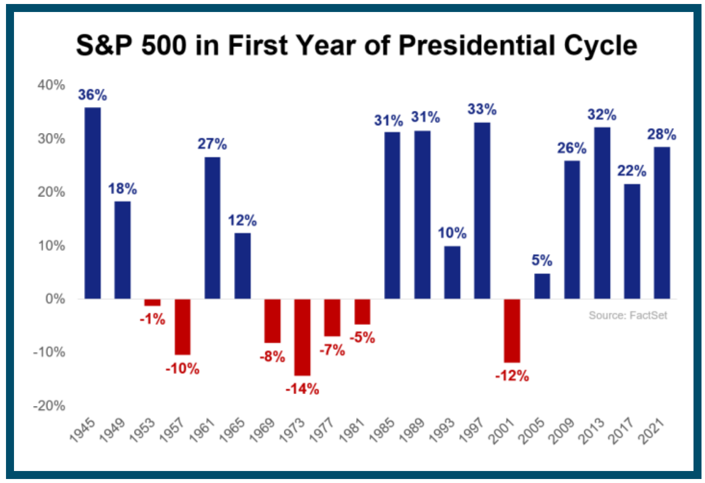
S&P 500 Average Quarterly Return (since 1928)



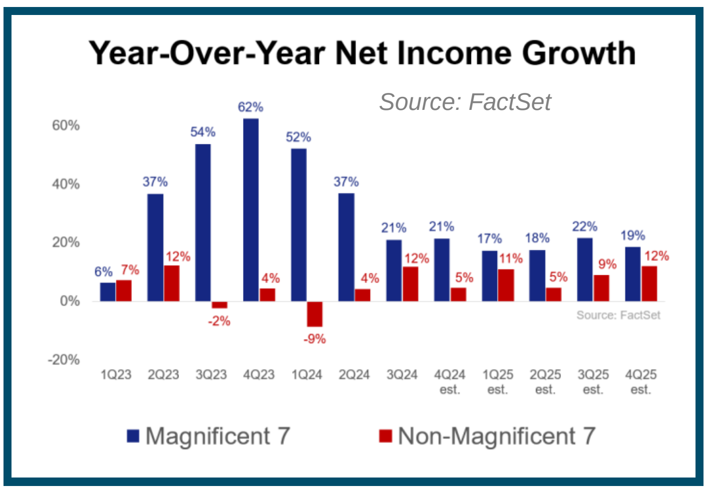
All of the data shown above is from FactSet



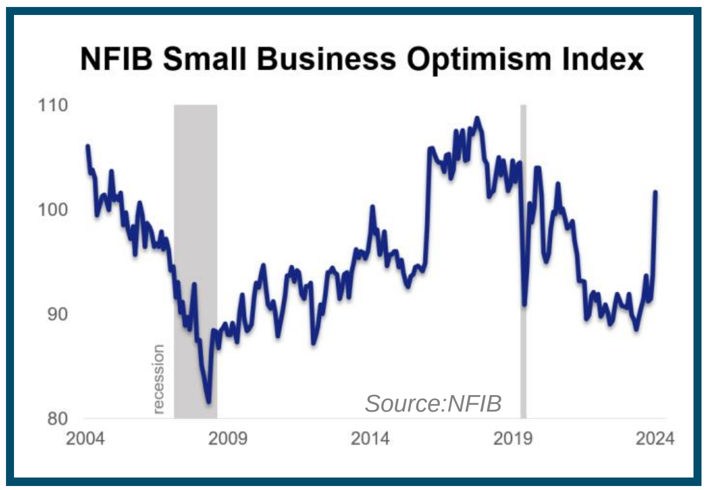
In 2024, our market forecast generally consisted of being risk-on with long-term interest rates below 4.5% and growing more cautious approaching 4.5%. And indeed, a majority of the big selloffs since Oct. 2022 have come alongside a sharp rise in long-term rates. With the S&P 500 trading at 26-27x trailing earnings, it would be difficult to describe the market as cheap. And while there are reasons that the S&P 500 is trading rich vs. history, higher long-term rates loom large and cast doubt on the supposition that it should. Higher interest costs raise the specter of Treasury yields rising on spiking issuance alone.



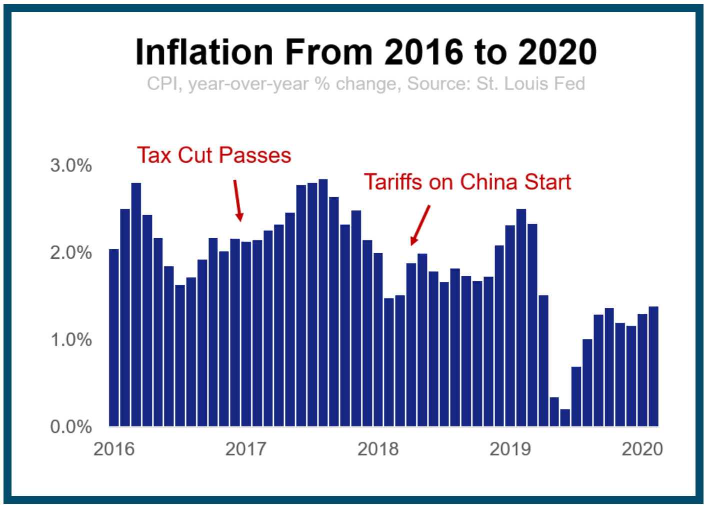
Despite all the turmoil across the globe in 2024, the S&P 500 rose 25%. Stocks flinched in the final two weeks of the year, but were up 1.7% post-election, higher than the 1.4% average since 1936. The first year of a president's term is also often good for markets (the caveat is if there is a recession, e.g., 2001, 1981). The fall of the Berlin Wall ushered in a golden era of US fiscal policy in which politicians could cut taxes and grow spending with limited impact on the debt servicing cost of the US. This allowed new presidents to do big fiscal policy after winning, often catalyzing stocks toward stellar gains. However, higher debt servicing costs will limit the ability to do this.



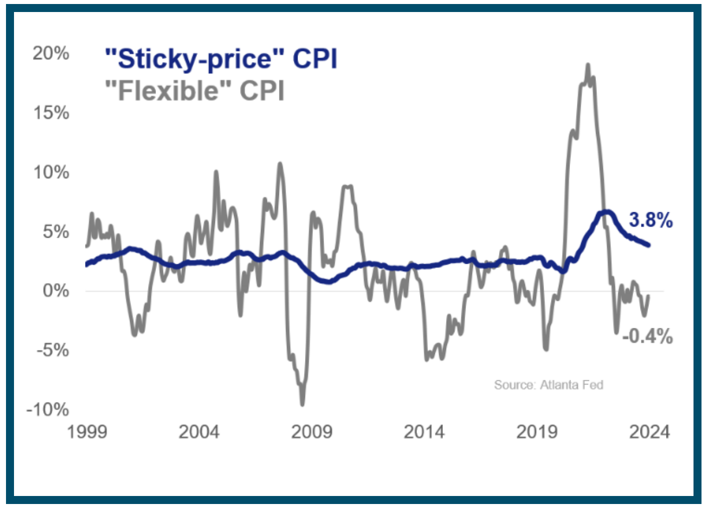
For 2025, analysts expect the S&P 500 to report an earnings growth rate of 15%. And while non-Magnificent 7 companies are expected to report earnings growth of 13% for 2025 (up from 2024), it remains clear that the largest, most liquid companies are carrying overall growth expectations for the index. We continue to harbor skepticism for the Street's expectation for the rate of revenue growth, but it appears to be directionally correct. By our lights, it will be difficult for the consumer to replicate its strong positive year-over-year trend (as we anniversary recent growth in wages and savings). Ditto Big Tech (though growth rates remain strong in AI/services). Strategas estimates a more modest 9% growth rate for S&P 500 EPS in 2025.



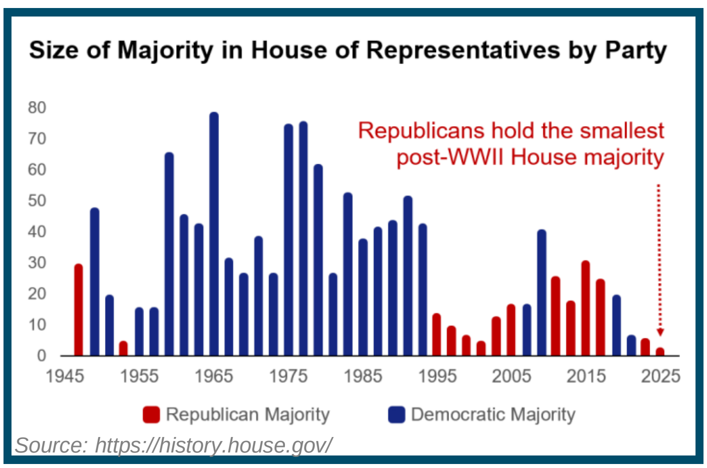
In December, the NFIB Small Business Optimism index saw its largest month-over-month jump in 30 years. This is primarily a function of the certainty that stemmed from the election result as well as the anticipation of more favorable tax and regulatory policy from the federal government. With the outlook for equities generally positive against the current pro-growth backdrop, we chose to add to Small Caps in our global asset allocation portfolios in December. Post-election performance has proved welcome for this long-dormant "also ran" asset class. Expected economic growth and 1Q25 liquidity surge should continue to bolster Small Caps. We are also overweight U.S. Large Cap Value and U.S. Mid Cap Value.



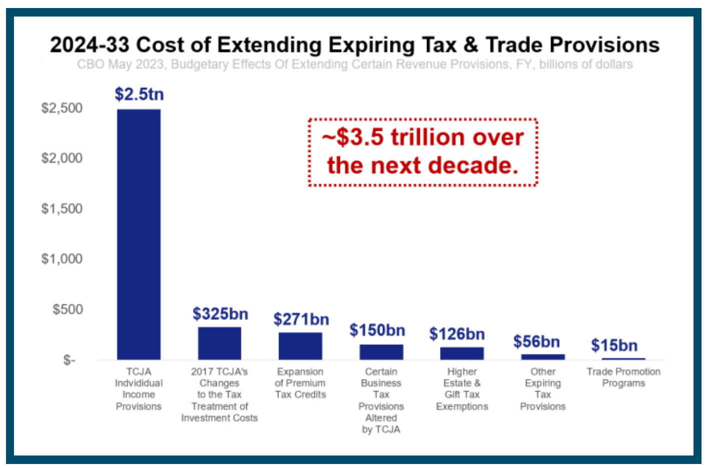
In 2018 the Fed decided that the combination of tax cuts, immigration restrictions, and tariffs were inflationary and decided to keep rates high. CPI decelerated from 2.9% to 1.5% while the Fed's elevated rates spooked markets into a late-year selloff. The Fed was forced to course correct as a result (the "Powell Put"). At its Dec. 2024 press conference, the Fed seemed to be making a similar judgment with the new administration. But tariffs on China alone are not likely to move the macro outlook. Without a global tariff, the risk of tariffs' effect on inflation is overestimated in our view.



U.S. CPI is still well above the Fed's target of 2%, and moreover, most of the slowing in recent months has been in the "flexible" components (volatile prices that change more frequently). On the other hand, sticky prices (rents, education, medical care and other prices that are slower to adjust to economic conditions) have remained stubbornly above pre-Covid trend. Critically, this measure contains a component of inflation expectations that is useful when forecasting future inflation. Stubbornly high sticky prices give the Fed less room to maneuver. We forecast just two 25 bp rate cuts in 2025.



Republicans swept the November 2024 election (taking the White House and both chambers of Congress), but with the slimmest House majority in the post-WWII era. House Speaker Mike Johnson managed to retain his position by a single vote on the first day of the 119th Congress, but Johnson's narrow victory and the recent near-miss on a government shutdown provide a preview for how challenging it can be to corral a hyper-narrow majority. Given President-elect Trump's sizable day-one legislative agenda, this dynamic will be worth monitoring closely (especially as the debt ceiling clock ticks).



One of the highest priority pieces of Trump's agenda is to fully extend the Tax Cuts and Jobs Act and pass new tax measures by April 15. However, with Congress narrowly divided and deep divisions in the Republican Caucus, it will take time to move a tax bill. The US fiscal situation only adds to the complications. Net interest costs are at their highest percent of overall tax revenue in decades, leaving hard choices to be made around tax bill pay-fors (i.e., where will spending cuts come from?). Investors should for now be focused on the changes that President-elect Trump can do by executive action: immigration, trade, LNG exports, financial deregulation, and education reform.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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