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Thoughts on 2025 Market Outlook

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Navigating Optimism Around Market Risks

As we turn the calendar to 2025, we have a number of risks that could jeopardize the current bull market including,

- Potential Fed mistake of holding restrictive rates for too long
- Geopolitical tensions remain high with conflicts in Ukraine and the Middle East and another trade war coming with Trump 2.0
- Possibility of inflation reigniting with Trump's plans to cut taxes, implement tariffs, reduce immigration and deport millions of workers

Even with these risks in mind, I remain optimistic for my 2025 market outlook, but I do expect market volatility to increase next year. We all know Trump is unorthodox and is always willing to shake up the status quo. Sometimes Trump's bold statements during his first term caused large swings in market volatility. Expect volatility to increase during Trump 2.0.

Economic Outlook

On the bright side, the consumer and labor markets remain very healthy, the Fed is cutting interest rates, S&P 500 net profit margins are approximately 12% (above the 5-year average of 11.5%), and the 4th quarter marked the 6th consecutive quarter of large cap's earnings growth. Analysts expect the S&P 500 to grow earnings by 14.8% in 2025, which is above the trailing 10-year average earnings growth rate of 8.0%. Earnings are also expected to broaden across multiple sectors. The Mag 7 stocks are projected to grow earnings by 21% in 2025 while the "other 493" are expected to grow earnings by 13%, which would be a substantial improvement of the 4% earnings growth in 2024 for that group of stocks.

Inflation remains stubborn, but the disinflationary trend is slowly moving in the right direction as evidenced by the CPI last month. The November consumer price index highlights the strength of the US consumer as the price pressures were mostly in discretionary items, including motor vehicles, lodging away from home like hotels, and airfares. Housing also continues to be the most stubborn component as shelter accounted for 40% of the monthly CPI increase. However, it has declined notably. The shelter index increased 4.7% over the last year, which represented the smallest 12-month increase since February 2022. Inflation for rent and owners' equivalent rent saw their smallest one-month increases since July 2021 and April 2021, respectively. Pre-COVID, housing inflation typically ran hotter than general inflation (3.3% inflation rate between 2015 – 2019) and Powell has acknowledged in past Fed meetings that it may take years for housing inflation to return to normal due to the nation's housing shortage.

Housing typically contributes 15 – 18% of the US GDP, so a restart in this sector could provide strong tailwinds to the overall economy. However, we should not be holding our breath for a strong rebound in that sector as mortgage rates remain over 7%. Other headwinds facing home builders may include labor shortages and high building material costs. Labor shortages would likely get worse if President-elect Trump implements mass deportations since foreign-born workers who are not citizens comprise about 18% of the construction work force. Also, the cost of some building materials could rise if Trump imposes widespread tariffs.

There are growing concerns about the possible heavy usage of tariffs. I do think investors are in a “wait and see” mindset knowing that Trump sometimes negotiates in public, but many of those statements never result in policy changes. While Trump has issued several tariff threats, it’s worth remembering that under Trump’s first term, 25% was the upper limit to the Section 301 tariffs that were imposed on Chinese exports. Even if higher tariffs are put in place, it would most likely not happen until the 2nd half of 2025.

Trump considers the stock market performance as an important part of his scorecard. Trump regularly started his speeches as President in his first term with the question “How’s your 401K doing” when the markets were riding high, so he clearly does not want to create any policies that threaten the current bull market. Trump also knows that the Red Sweep happened as voters were fed up with inflation. 68% of US voters taking part in election exit polls rated the US economy as ‘poor’ or ‘not so good,’ while 75% said that inflation has caused hardship in their family over the last year. It’s fascinating to hear 68% of voters thought the US economy as “poor” or “not so good” when the stock market hit 57 new highs in 2024, the unemployment rate is near historic lows, and consumer net worth is up nearly 50% since 2019. If inflation reignites in the next two years, that could have major impacts on mid-term elections in 2026. The quickest way to turn this unified government into a divided government in two years is to create policies that reignite inflation or push the US economy into a recession.

It’s also worth noting that during Trump’s first term the S&P 500 returned 14.1% annually, which was the best performance under any President expect for Bill Clinton. The stock market is impacted by many different factors besides who is in the White House, but Presidents do have some influence with their economic policies. During his first term, Trump came into office with the S&P 500 P/E at 17, which is obviously not the situation now with the S&P 500 P/E ratio over 22.

Investment Outlook

Investors should remain diversified, but I would advocate for some slight tilts towards certain areas of the market.

- I still believe investors should slightly overweight US equities as these companies have a superior fundamental outlook, but I still advocate for some international equity exposure as the valuation discount of international vs the US is near record lows. While the valuation of the S&P 500 is frothy with a forward PE ratio of over 22, we know it’s top heavy. The top 10 stocks’ PE ratio is 30.5 while the “other 490” PE is a much more reasonable 18.8.
- Financial stocks should benefit from a deregulated environment under Trump and with interest rates expected to fall, we will most likely M&A activity pick up in 2025.
- I continue to really like Healthcare due to the high potential of weight loss drugs and the increasing need for healthcare services with aging demographics of developed markets. Some analysts have estimated that the weight-loss drug industry will be worth $80 - $140 billion annually by 2030 with an estimated 40 million Americans likely using these drugs. Healthcare is projected to have the second highest sector earnings growth in 2025 (20.5%).
- Small cap stocks are very interest rate sensitive, so the Fed cutting rates should help this asset class as should their attractive valuations and earnings projections for 2025. Trump’s victory can bring more support to mid/small cap stocks as his proposed policies should benefit domestic companies. Typically, 90% of mid/small cap revenues are domestic based (as opposed to 60% for US large cap stocks), so this asset class will be more insulated if Trump reengages in similar trade wars from his first term.

- I also like Industrials and Materials which are expected to have the 3rd and 4th, respectively, highest earnings growth rate in 2025. As a result of the global pandemic, protectionist policies and geopolitical tensions, we are slightly backpedaling from globalization, and that movement should continue under Trump's 2nd term. The trend of more companies bringing back manufacturing to the US may generate strong tailwinds for both the industrial and materials sectors. Recent legislation has incentivized companies to build domestic factories supporting semiconductors, clean energy, and EV manufacturing. Additionally, companies are committing sizable capital expenditures on warehouses, distributions centers, and data centers to support these business lines. The number of US data centers is projected to increase by 50% by 2026.
- While I advocate for diversification, investors should continue to have allocations to the Mega Techs. I believe we are still in the early innings of the AI revolution and Technology is projected to have the highest earnings growth rate next year. When risks in the markets elevate, investors typically transition to stocks with high Quality ratings with strong balance sheets and cash flows. The Mega Tech stocks have served as this high Quality / defensive investor strategy, and I believe that will remain the case in 2025.