ambwealth

Wealth Advisory Market Update

January 7, 2025

ambwealth

Market Update

Equities:

Following the best monthly (November) performance of the year, the annual Santa Claus rally failed to materialize, with the market—as measured by the S&P 500—declining by over 2% in December. Despite this pullback, 2025 marked another strong year, with the S&P 500 achieving consecutive annual returns exceeding 20% for the first time since the 1990s. However, the past two years have been characterized by a highly concentrated market, driven by a handful of companies, resulting in the most concentrated equity market since 1929.

Market breadth continued to deteriorate in December, extending a trend seen throughout the year. There were 14 days during which more stocks in the S&P 500 declined than advanced, tying 1978 for the longest streak of this nature in a century. Market valuations remain elevated and disconnected from fundamentals based on several metrics. For example, the price-to-book ratio stands at 5.3x, approaching the 5.5x peak seen during the dot-com bubble, far above the historical average of 2.9x. Given these stretched valuations, we continue to seek companies trading at a discount relative to intrinsic value. While market concentration has been a key driver of performance, it also presents opportunities in non-tech sectors, where many stocks appear undervalued.

Looking ahead to 2025, S&P 500 earnings guidance has weakened following disappointing fourth-quarter earnings calls. Of the companies issuing guidance, 67% have been negative—10% above the five-year average and 5% above the ten-year average. Additionally, leveraged investing has surged, with inflows into leveraged ETFs exceeding last year's by nearly $20 billion. Retail investors now hold a higher equity allocation than ever before, while fund manager cash levels have dropped to historic lows. This widespread bullish sentiment evokes the cautionary adage: "If everyone is bullish, who is left to buy?" Such dynamics often signal market tops.

Economic Indicators and Monetary Policy:

In December, the Federal Open Market Committee (FOMC) reduced the federal funds rate by 25 basis points, marking a cumulative 100-basis-point reduction since September. The market focused on the Fed's Summary of Economic Projections (SEP) for future policy insights. The latest SEP was more hawkish, with members now forecasting only two rate cuts in 2025, down from four in previous projections. Inflation is expected to end 2025 at 2.8%, 20 basis points higher than earlier estimates, while the unemployment rate forecast improved slightly to 4.3%.

During his post-meeting press conference, Fed Chairman Jerome Powell noted that the decision to cut rates was closely debated, emphasizing confidence in the current economic trajectory. Powell asserted that the labor market had sufficiently cooled and inflation, measured on a 12-month basis, was stable. He expressed confidence in achieving the 2% inflation target.

Our perspective remains skeptical of the rationale for rate cuts. If economic growth is solid, the labor market stable, and inflation flat, maintaining higher rates would seem prudent. Cutting rates under such conditions risks reigniting inflation. Evidence of economic fragility includes the persistent gap between private and total payrolls, negative for 19 consecutive months—a sign of labor market weakness. Consumer data also raises concerns: credit card defaults reached $46 billion in the first nine months of the year, the highest since 2010, representing a 50% annual increase. According to Moody's, the savings rate for the bottom third of earners is 0%, and subprime auto loan defaults exceed Great Financial Crisis levels. These indicators point to a financially strained consumer. In our view, massive fiscal deficit spending—approximately $1 trillion every 90 days—has artificially delayed a recession.

Strategy:

We remain vigilant, closely monitoring economic data and policy changes under the new administration while adhering to our disciplined, fundamentals-driven approach. We prioritize equities in sectors well-positioned for the current environment, focusing on companies with market leadership, robust balance sheets, and resilient demand for their products or services.

Interest rates have shifted significantly since the Fed began rate reductions, with the 10-year yield rising 90 basis points. This upward move in long-term yields reflects fiscal spending pressures, while short-term rates follow the federal funds rate downward. Credit spreads remain unusually tight despite weakening economic data. We favor high-quality bonds and view the current environment as an opportune moment to secure attractive yields in intermediate maturities, anticipating further rate declines in the coming years.

As we navigate this complex landscape, we value the opportunity to partner with you in pursuing your financial objectives.

Matthew J. Roach, CFA®
Chief Investment Strategist

Mike Servetas
Assistant Portfolio Manager