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Private Client Letter

by John E. Chapman

What a Year This Has Been

Recession fears have eased significantly since the summer, driving renewed investor confidence and a surging stock market.

The S&P 500 gained 5.7% in November as the Index delivered its best monthly return in a year and ninth winning month out of 11. With the national elections now concluded, stocks benefited from steady economic and earnings growth and the anticipation for pro-growth policies emerging from Trump's second term in office. Small cap stocks did particularly well in November as the Russell 2000 rallied 10.8% on anticipation of tax cuts and trade policy that favors domestic producers.

Remarkably, U.S. equities are poised to deliver back-to-back 20%-plus years for the first time since the 1990s. Prior to that tech boom period, the S&P 500 last produced consecutive years with 20% gains in 1954 and 1955.

Cautious investors who subscribe to the philosophy that they win by not losing often prepare for the worst while hoping to be pleasantly surprised when things that could go wrong don't. The past 18 months have been quite a run where seemingly everything that could go wrong has gone right.

While I have long believed that a short and shallow recession was more likely than not, it now appears that the Fed may have engineered a rare "soft landing" wherein their tighter financial conditions brought inflation down without stalling the economy. There were concerns over the economy late in the summer and into early fall, however economic data has stabilized and even started to improve - so much so that the Fed is starting to dial back the pace of anticipated rate cuts.

My view of the economy and the equity markets has certainly become more constructive going into 2025. While conditions look more promising on balance, it's important to be aware of potential risks and shifts. Rising interest rates and strength in the U.S. dollar are important developments to keep an eye on.

- Higher interest rates (i.e. borrowing costs) discourage spending by consumers and businesses alike. They also make saving more attractive than spending, slowing economic activity. Slower consumer spending, reduced business investment, and tighter financial conditions collectively dampen GDP growth. Small businesses are particularly sensitive to tighter credit markets. Should rates rise quickly, small businesses would likely dial back expansion activity potentially leading to layoffs and rising unemployment.

- A stronger dollar makes U.S. goods and services more expensive for foreign buyers, potentially reducing demand for exports. This can hurt U.S. manufacturers and exporters, leading to slower growth in sectors dependent on international trade. In turn, this can reduce overall corporate earnings. With current valuations running high, any downward pressure on earnings could trigger an increase in market volatility.

These trends are far from bearish, however I bring them up simply because they are no longer bullish, and in the market that's been thinking only about what can go right, it's always good to provide some balance.

As President Trump continues to shape his cabinet, we'll get a better idea of which policies he campaigned on will become priorities and which may not. What we do know is that taxes and regulation are likely to be lower and interest rates and tariffs have the potential to be higher. Still, the U.S. economy is dynamic and complex. While presidential policies can have some impact on financial markets, they are only pieces of a very big puzzle.

Even as investor economic expectations are rising for 2025 and beyond, it is important to note that historically high equity valuations don't require an economic downturn to experience a pullback.

The S&P 500's 12-month forward price-to-earnings (P/E) ratio compared to its trailing P/E ratio has potentially advanced ahead of fundamentals. Another red flag comes from the widely followed Shiller CAPE ratio, which reveals that current market levels rival historical peaks seen during past bubbles. The CAPE ratio also indicates U.S. stocks are significantly more expensive than their European counterparts, which traditionally trade at similar valuation levels.

Valuations are almost never a reliable predictor of market returns over a one-to-three-year horizon, but they are powerful predictors of long-term returns. In other words, "expensive" equity markets can become even more expensive in the short to intermediate time horizons. However, high valuations could eventually prove to be a limiting factor to longer-term returns.

While I have become more bullish on the continued growth of the U.S. economy, the bullish case will require rising productivity growth, positive effects of a wave of disruptive innovations, smaller government, lower taxes, and less regulation. At this moment, positive trends in these important factors appear to be materializing.

We wish you and your family a joyous and happy holiday season. As always, thank you for your continued confidence. Please reach out should you have any questions or concerns.

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