Private Client Letter

by John E. Chapman

Previewing Clearwater Capital's Outlook 2025

In 2024, the S&P 500 experienced a remarkable rise of over 23% and delivered a total return of 25%. This was a year punctuated by 57 record highs, marking it as the fifth most prolific year for records since 1957, all without a single correction reaching 10%. Central to this impressive performance were the "Magnificent Seven," a group of influential stocks that fueled roughly half of the gains. Their leadership was propelled by investments and optimism surrounding artificial intelligence, which bolstered large-cap and growth stocks.

Growth stocks outpaced value stocks in 2024 with the Russell 1000 Growth Index posting a return of 33.4% for the year versus its Value counterpart, which managed a 14.4% gain. The strength in mega-cap stocks left small caps lagging well behind. The Russell 2000 Index, comprised of smaller companies, returned 14.4%, as these stocks grappled with relative earnings weakness and sensitivity to interest rates.

In the global arena, the United States outperformed both developed international and emerging market equities which returned approximately 4% and 8%, respectively (MSCI EAFE and MSCI EM indexes). These markets were hindered by inferior economic and earnings growth alongside a robust U.S. dollar, which appreciated by over 7% during the year.

The short and shallow recession that we believed was more likely than not to occur in 2024 never materialized. Still, neither did the double-digit earnings growth that was expected at the beginning of the year. Only about a third of the stock market gains in 2024 can be attributed to earnings growth, leaving two-thirds of the rally to be explained by multiple expansions. In other words, stock prices rose mostly on optimism and investors' willingness to push valuations higher and higher.

As 2025 gets underway, the global economy is at a crucial juncture, characterized by significant economic policy changes and lingering challenges. Geopolitical tensions remain elevated around the world, while trade and immigration policies in the U.S. are expected to shift meaningfully over Trump's second term in office. This year is sure to test investors in ways we have not seen since the beginning of the pandemic in 2020.

Our general view is that the global economy will experience moderate growth through the coming year. While advanced economies will see a stabilization in growth rates, we anticipate emerging markets, particularly in Asia, to drive global expansion. We believe economic activity in the U.S. will slow as the post-COVID effects of excess pandemic savings and large government spending programs continue to fade.

Inflation rates, which spiked significantly during the early 2020s, should further stabilize in 2025, however the Fed's targeted inflation rate of 2% may prove to be elusive. Core CPI appears to be stuck in the 3.3% range and the Fed is likely to maintain a cautious approach to monetary policy, balancing between supporting growth and curbing persistent inflationary pressures.

Our base case for investors in 2025 is to expect more modest returns than were experienced over the past two years. With valuations near all-time highs, we see an uptick in volatility sometime in early 2025 and a stock market correction cannot be ruled out. Historically, 10% corrections occur on average about once a year, and we have not seen one in three years. The coming year could prove much more difficult as compared to 2023 and 2024, however, opportunities will emerge.

Should a market correction materialize, we believe it would represent an opportunity to increase equity exposure, and we would favor high-quality value stocks over expensive growth stocks.

As I mentioned in my post-election Private Client Letter:

"Overall, I believe the net effect of the policies Trump has proposed will have a positive impact on the growth prospects for the economy – much like they did in his first presidency. Accordingly, corporate profitability should be heading higher in the coming years and the investment environment appears to be favorable.

This said, I believe expectations are running high and the equity market is currently overvalued. Most of Trump's proposals will take time to implement and many will be modified through negotiations and the political process. Apart from his policies, certain economic and geopolitical risks remain in place and have the power to be very disruptive in the near term."

Less regulation, lower taxes, and increased M&A activity are among the positives that will eventually act as tailwinds for a rising stock market. Elevated valuations, slowing economic growth, and sticky inflation will likely prove to be headwinds to rising equity prices over the near term.

Our full Outlook 2025 report will explore all our expectations for the coming year and will be published early next month. As always, thank you for your continued confidence in our abilities to help you navigate the many challenges associated with growing and protecting your wealth.

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