

Here we are in 2025 with two strong years of market performance behind us. A common question I've been getting is, "Are we due for a bad year in the market since we've had two good years in a row?" It's a great question that I'm sure is on most people's mind so let's explore that a little bit. Back-to-back years of 20%+ return in the S&P 500 is rare. It's only happened 8 times since the end of World War 2. Of those 8 times, 6 saw positive returns in year 3, with an average return of 12.5%. That's a win rate of 75% with an average return higher than the long-term average. While past performance is no guarantee of future results, it's still encouraging. When the stock market is doing well, it tends to continue to do well. Which raises the question, "why is the stock market doing so well?"

The main driver of U.S. stocks over the long run, is and always will be, corporate earnings. This is one of the reasons I mention quarterly earnings so often in my market updates. From 2020 to 2024, the US stock market was up roughly 99% and earnings accounted for about 60% of that (dividends accounted for 15% and multiple growth accounted for about 24%). The primary reason stocks have continued to do so well is that forward measures of earnings have been growing for years now. In January of 2023 we (consensus) thought the S&P 500 would do \$225 per share in earnings looking at the following 12 months. In January of 2024, we thought it would be \$243 per share and now at the end of 2024 we are expecting \$270/share. It's that simple. If earnings are growing the market is likely to grow with it.

The next question is, "Why are earnings growing?" Well, our economy is benefiting from many tailwinds including strong consumer spending (we have a massive generation, the millennials, entering their prime spending years), rock solid corporate balance sheets, a housing market that has remained stable even with demand waning, government spending, and technological advancements including AI and weight loss drugs.

As a result of multiple years of gains, valuations have become somewhat expensive. Do higher valuations predict down markets? The short answer is no. Valuations historically have been a terrible timing tool so there is not much we can do with the information other than to acknowledge it. If you always sold when valuations were high, your long-term performance would be terrible.

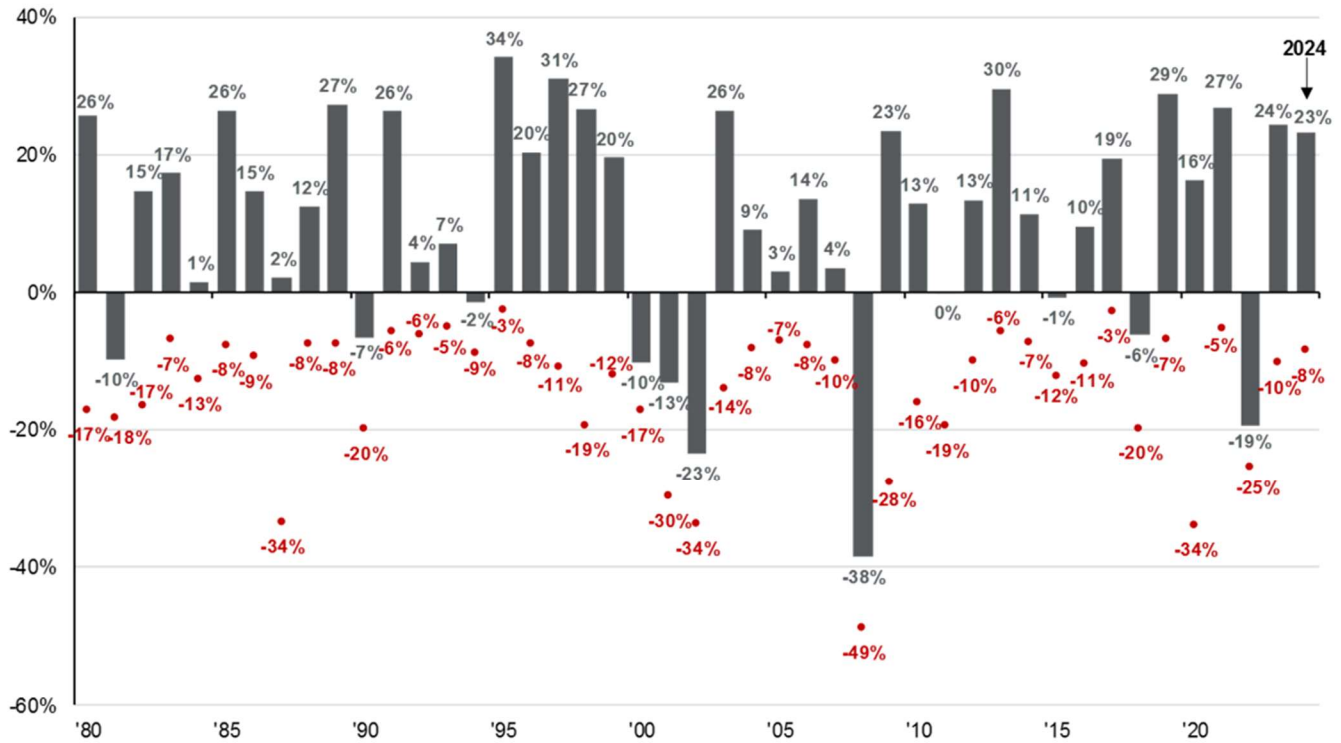
The big change looking forward to 2025 is the new administration. All eyes are on the potential impact of tariffs, immigration reform, and tax code changes. It's too early to draw any conclusions because we don't know what will actually get passed vs. what is being proposed. However, what is likely to derail the market won't be any of these policies and unfortunately likely won't be predictable either. This is because risk, TRUE RISK, is something that none of us can foresee. Think about the three biggest risks we saw in the past 24 years: COVID, The Global Financial Crisis, and 9/11. No one saw any of those coming. This is why we build durable, diversified portfolios with the anticipation we will see unpredictable bear markets.

While we are cautiously optimistic about the market for 2025 that doesn't mean we would be surprised by a short-term correction. The S&P 500 typically has a 10% correction every 14 months, and we've been blessed with limited volatility in 2024. Therefore, we wouldn't be shocked to see some volatility as we head into 2025. What do we do in anticipation of this potential +/- 10% correction? Quite frankly, nothing. Short-term market corrections are too difficult to predict and time. You have to make two perfect decisions. Getting out at the right time, and then getting back in at the right time. No one in the history of the market has been able to do that consistently and we've seen that attempting to time the market generally results in worse long-term returns than riding out the inevitable ups and downs. The following chart is a perfect illustration to this point. Even in up years it is common for the market to have a correction intra-year.

The chart below from JPMorgan goes back to 1980 showing calendar year returns (grey bar) and intra-year declines (red dot). You can see that in every positive year the market still experienced a short-term decline.

S&P intra-year declines vs. calendar year returns

Despite average intra-year drops of 14.1%, annual returns were positive in 34 of 45 years



FIXED INCOME MARKETS:

We've seen rates trend back up as the Fed's "dot plot" estimates just two rate cuts in 2025. This is lower than the market's expectations of four rate cuts. I believe too much emphasis is being put on the Fed's actions and the speed at which they will cut rates. Keep in mind the Fed typically cuts rates to stimulate a slowing economy. The economy, at the moment, does not need stimulated as the GDP rate has been bouncing around 2.5 - 3.5%. We do expect the Fed to trim rates as the rate of inflation is still significantly below the current Federal Funds Rate, but we don't want aggressive rate cuts as that typically means the economy isn't in good shape. Our prediction is that the Fed will continue to cut rates likely in the range of 2 - 4 times in 2025, which will continue to bolster fixed income returns. With our taxable bond funds paying somewhere around 4% we wouldn't be surprised to get the coupon plus an extra percent or two of price appreciation over the next few years making an expected rate of return in the 4 - 6% range.

- Tyler O. Vallano, CFP®

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