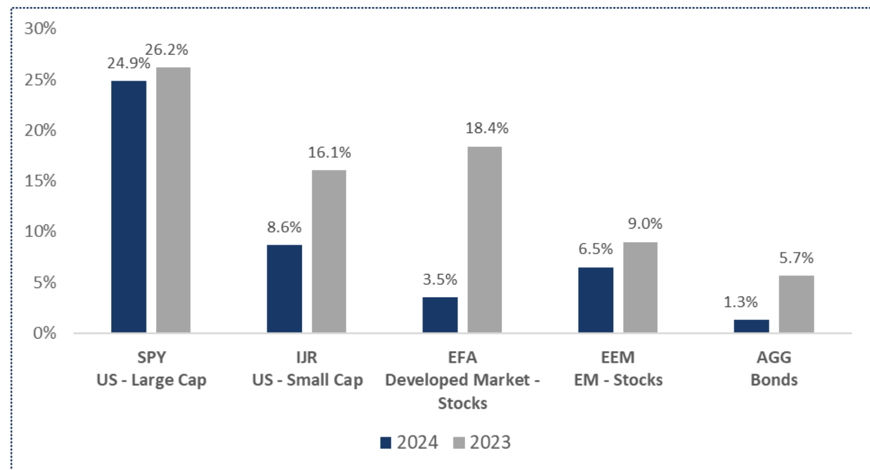
Navigating 2025

"If everybody is thinking alike, then somebody isn't thinking." **– George S. Patton**

Markets finished the 4th quarter with more upside and the S&P 500 gained 25% on the year. Along the way, there were 57 record closes as inflation continued its descent, the Fed started lowering rates, and AI lifted the big tech stocks to lofty levels. These are the best performing back-to-back years for the stock market since 1998

The Dow (DJIA) returned 16% and the Nasdaq increased by 25%. Although the major indices performed quite well, the returns were extremely concentrated. The Magnificent Seven (large technology stocks) accounted for more than 53% of the S&P 500's total return and Nvidia alone made up 21% of the return.



The aggregate bond index ended the year positive, but returns were just over 1%. Through mid-September, bonds were up over 5%. However, as the Fed started lowering short-term rates, long-term rates moved substantially higher, wiping out much of the bond returns for the year.

Diversifying Strategies had another strong year led by Private Credit, which had double-digit returns. Real Estate transactions increased and there are green shoots emerging as investors become more comfortable with higher rates. Below we provide a brief recap of 2024 and our views as we move into 2025 and beyond.

2024 Recap

In our 2023 Outlook, we looked at the history books as they related to years in which the S&P 500 had gained over 15%. Historically, the following year was positive over 70% of the time and up over 15% about 1/3 of the time. In addition, election years have historically been good years for the market and the Fed was set to lower interest rates. In the end, 2024 delivered both big returns and low volatility as the largest drawdown on the year was just 8%. Although the Fed did not deliver the number or magnitude of cuts expected by the market, the expectation of the cuts kept markets climbing. There was an inflation scare early in the year, but the trend continued lower through the balance of the year with the exception of housing and insurance costs. The combination of inflation being conquered and an economy that wasn't too hot allowed for the first-rate cuts in September and they continued into December, when the Fed said it is now on pause.

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Earnings also continued to deliver and should end the year up around 9%. Most of the increase in earnings can be attributed to rising profit margins, which continue to be near historic highs. The bigger story for stocks is the multiple that investors were willing to pay, which increased to 21.5x (P/E) at year end and was the single biggest contributor to stock returns. Investor optimism, by many measures, is at an extreme and could prove a headwind as we enter 2025.

Perhaps the biggest surprise of 2025 was the massive rise in the 10-year Treasury note, just as the Fed started cutting rates in September (see chart). By year end, the fed funds rate was reduced by 1%, while the longer-term rates increased by 1%. As a result of these moves in rates, most yields on short-term savings/CDs have declined, while mortgage rates have risen to 7%. This is a double whammy for many consumers.

Despite the headwind in rates, the market shrugged it off as the odds of a Trump election turned into a reality. The extension of the 2017 tax cuts, deregulation and the prospects of a more efficient government have moved front and center. As mentioned above, investor and consumer sentiment are near records and stocks feel fully priced here. So where do we go as we head into 2025?

2025 Outlook

"There is no substitute for facts" – **Harry S. Truman**

Stock Outlook

Since 1950, there have been eight times in which the S&P 500 has appreciated over 20% in back-to-back years. The following year was positive 75% of the time with returns averaging about 12%. The two down years experienced single-digit declines and not catastrophic losses. The mid to late 90s experienced 5 straight 20%+ years, which was quite impressive until the bubble burst in 2000. There are certainly some similarities as the internet was one of the driving factors back then and AI is leading the markets today. We believe 2025 will be driven by investor sentiment, policy and most importantly earnings.

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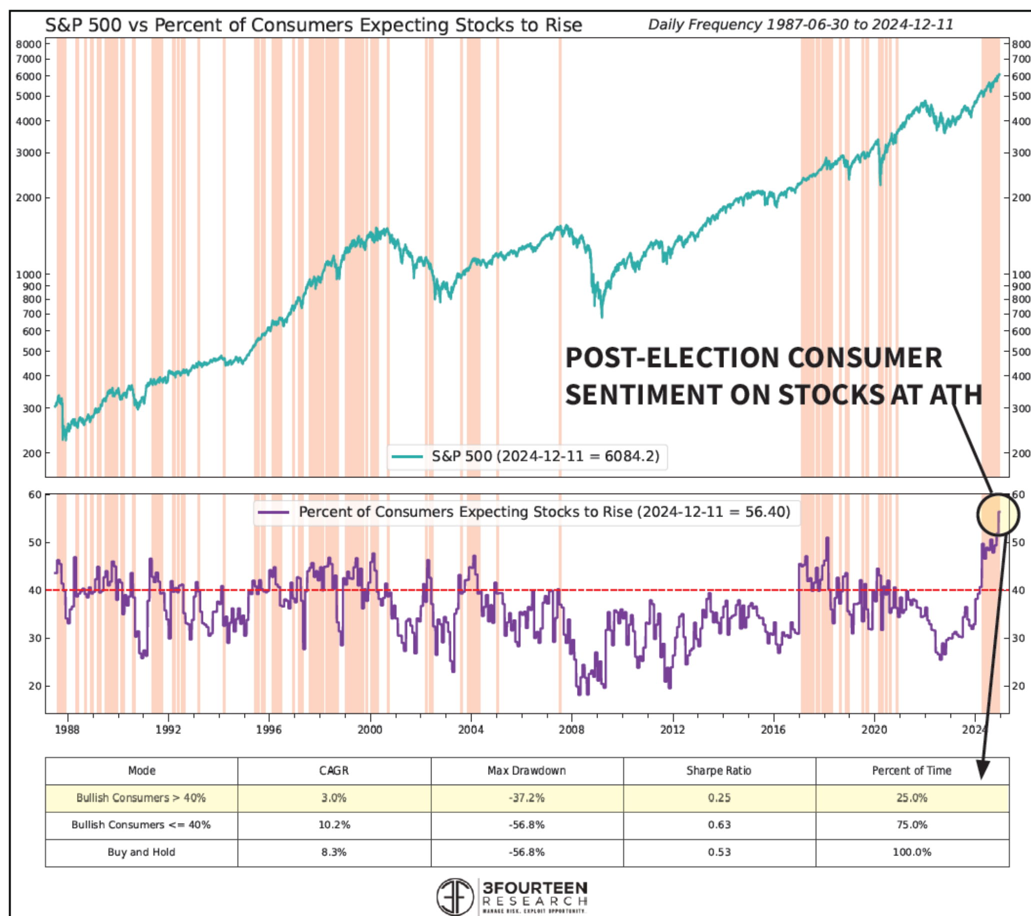
Investor sentiment tends to be a great contrarian indicator. When sentiment is at extreme pessimism, forward returns are typically the highest. Vice versa, when investor sentiment is at extreme optimism, markets tend to disappoint. Famed investor Howard Marks likened this phenomenon to a pendulum which swings from euphoria to depression and from overvalued to undervalued. Most importantly, it swings between extreme risk taking and extreme aversion to taking any risk. Cycles tend to be constant over time, but the drivers are usually different. As we see from the chart below, investor optimism as measured by consumers expecting the market to rise this year, just reached an all-time high. Historically, readings this high have produced low returns for stocks. There are many indicators similar to this one and they were all flashing warning signs at year end. We hope this time is different.

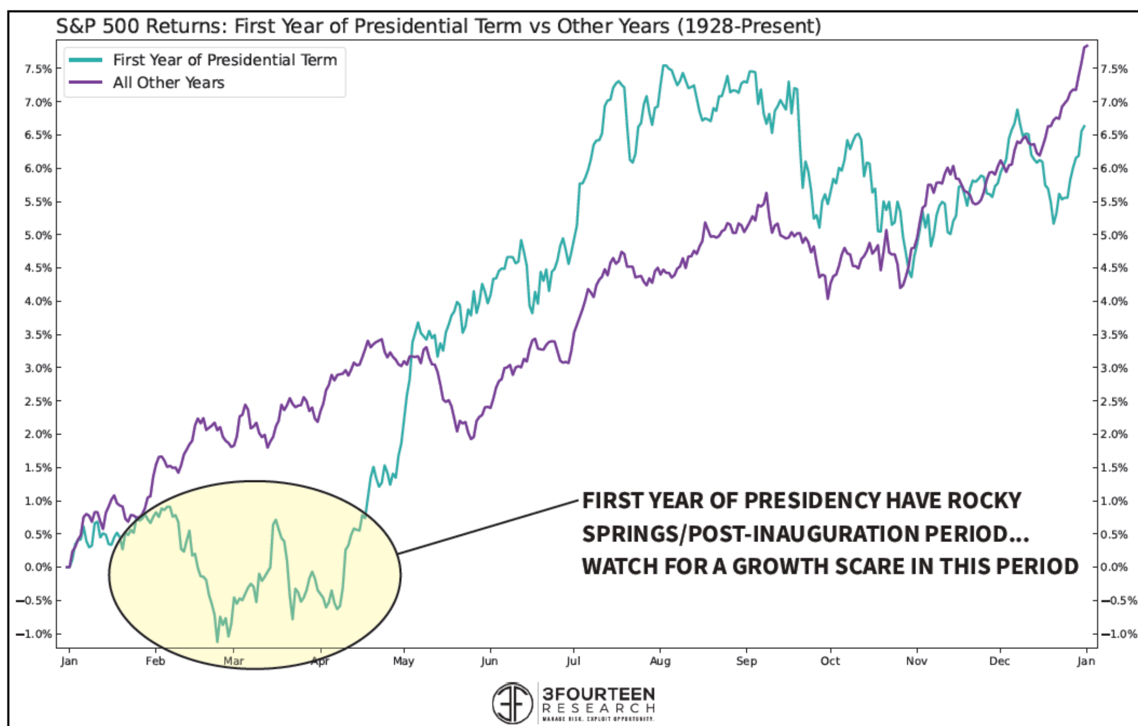


Mode	CAGR	Max Drawdown	Sharpe Ratio	Percent of Time
Bullish Consumers > 40%	3.0%	-37.2%	0.25	25.0%
Bullish Consumers <= 40%	10.2%	-56.8%	0.63	75.0%
Buy and Hold	8.3%	-56.8%	0.53	100.0%

Much of the reason for the market performance since the election relates to the optimism around investor friendly policies. Tax policy will probably be the first initiative as the tax cuts from 2017 are set to expire at the end of the year. There is hope that the cuts are not only made permanent, but that there are deeper tax cuts as well. One proposal is for a 15% corporate tax rate, which would be a tail wind for most S&P 500 companies. Over the past couple of years, we have discussed the out-of-control deficit and government budgets. There is hope with the formation of DOGE (Department of Government Efficiencies) that the government may finally get its financial house in order. DOGE is not a new idea, during World War II Senator Truman led a bipartisan senate committee to clean up fraud and abuse in the government. He used

CBS radio as a platform to communicate and asked the public to submit letters of waste and abuse. In the end, the program saved the government $10-$15 billion, which adjusted for inflation would be around $800 billion in today's dollars. Today's communication platform will be X (formerly Twitter) and our spiraling government debt could use some relief.

In addition, there is also hope for decreased regulation as it relates to the banks and decreased red tape in simply getting things done. Historically markets have performed well in the first year of the presidential cycle (chart below). However, there is typically a letdown in the market over the first several months. Perhaps this is the path for 2025 as the extreme optimism is worked off and maybe it won't be so easy to implement the desired agenda.



Earnings will be in focus over the balance of January and throughout the year. As we discussed earlier, much of the 2024 returns can be attributed to the expansion in the multiple that investors were willing to pay for stocks, which is in expectation of earnings growing by 14% this year and 13% in 2026, after growing by just 9% in 2024. With a market somewhat priced for perfection, earnings misses, or negative guidance, could lead to increased volatility this year. There are many variables that will impact earnings, but we believe the most important are increased inflation, tariff wars, and higher for longer interest rates. We believe inflation will continue to decline, but at a slower pace. Housing and insurance costs should get some relief as we move through the year. The tariffs are a complete unknown. The best we can hope for is that this is rhetoric and negotiation. The worst outcome is an all-out trade war, which benefits no one. As the Fed continues to balance its mandate of lower inflation and solid employment, rates could stagnate at current levels. With an economy that is in very good shape, there simply may be no reason to continue lowering rates. We don't believe that higher rates are necessarily harmful for large companies, but for their small cap

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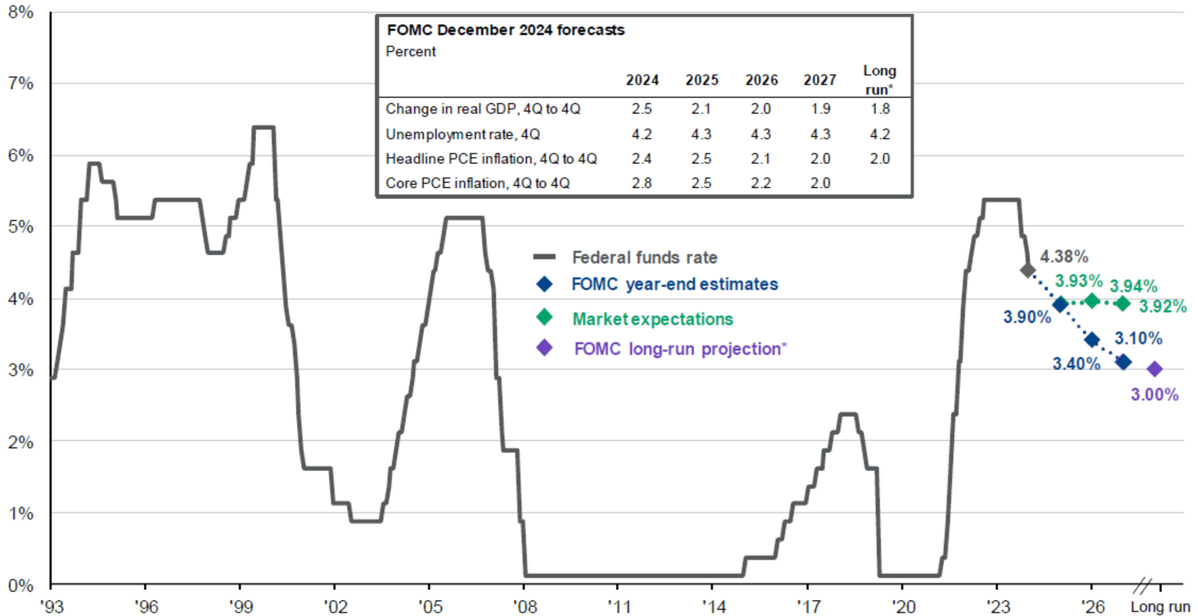
counterparts, this would be a big challenge as they typically have much higher leverage with shorter maturities.

Fixed Income Outlook

The fixed income markets remain in good shape, despite the lackluster performance from 2024. Corporate and High Yield spreads remain historically low. These spreads are a measure of the anticipated risk in the bond markets. Corporate bonds look solid, and investors should expect yields in the range of 5-6%. Of course, the direction of overall rates will have a positive or negative effect on the total return on these bonds and it is difficult to know where rates will be at the end of 2025. It does some like there is limited risk at this point as the 10 year is near 4.75% as we write this letter.

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



FOMC December 2024 forecasts

Percent

	2024	2025	2026	2027	Long run*
Change in real GDP, 4Q to 4Q	2.5	2.1	2.0	1.9	1.8
Unemployment rate, 4Q	4.2	4.3	4.3	4.3	4.2
Headline PCE inflation, 4Q to 4Q	2.4	2.5	2.1	2.0	2.0
Core PCE inflation, 4Q to 4Q	2.8	2.5	2.2	2.0	

Floating rate bonds have been very good performers over the past several years and should continue to provide diversification and a high level of income. The overall movement of rates will have little impact on floating rate returns, so this continues to be one of our favorite areas in the fixed income markets.

The fed funds rate should continue lower this year with The Fed indicating a decline of approximately 1%, while overall market expectations are more conservative and indicate only 0.50% of cuts. Regardless, the trend is down, and this will continue to push rates on savings, money markets and CDs lower. Therefore, we see this as a pretty good time to allocate back to traditional fixed income versus the short-term instruments.

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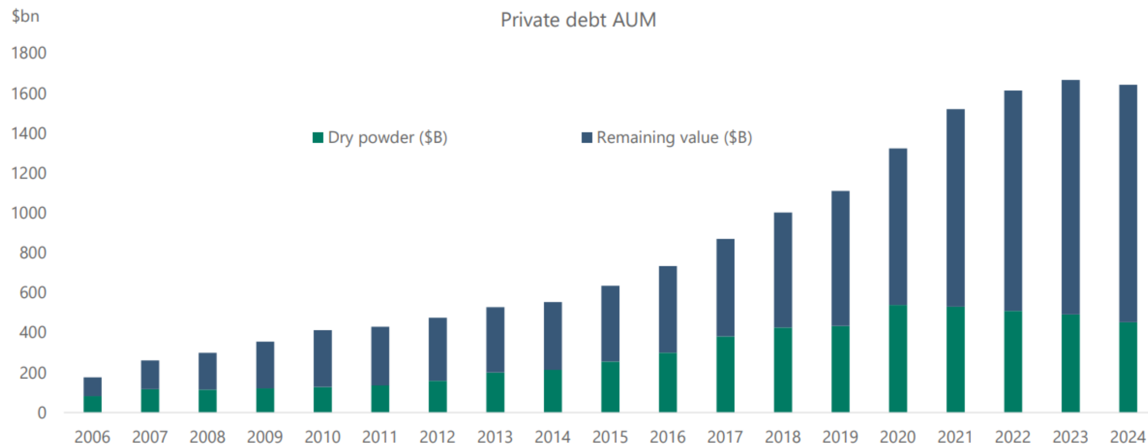
Private Markets Outlook

As a reminder, we use private markets as a diversifier to both stocks and bonds as well as a source of returns. The two main ways that we invest in private markets are through real estate and private credit. We are starting to see some green shoots in commercial real estate after a two year down cycle. Transaction volumes have increased across sectors as investors have become more comfortable with the idea of higher interest rates moving forward. We believe 2025 should be positive for most sectors, but our focus continues to be on affordable housing, industrial and data centers. The chart below shows the current picture for housing in the US and the cost of ownership continues to be cost prohibitive for many potential homebuyers creating a pool of longer-term renters. New multifamily development has declined substantially over the past two years and will result in a lower supply of new apartments coming on the market, which in turn should push rents higher and be a tail wind for multi-family.

Industrial assets also look attractive, and we see two primary catalysts for continued growth. Reshoring will continue under the new regime and new manufacturing will create increasing demand for logistics. The second catalyst relates to e-commerce, which will continue to grow. Today, e-commerce represents less than 25% of all retail sales in the US and this suggests a very long runway of growth for home delivery.

The hottest real estate asset going into 2025 is the development of data centers. As the AI boom continues, it is a race amongst the giant technology companies to build out their data centers and enhance their computing power. Hundreds of billions of dollars were already forecasted to be invested this year and last week Microsoft announced it would spend another $80 billion. Blackstone's data center arm, QTS, currently has $100 billion in its development pipeline. Based on estimates from CBRE, it is estimated that facilities under construction today will need almost 5,000 megawatts of power. Again, this is just what is under construction and 5,000 megawatts is the power needed for 1-3 million homes.

Private Credit has had back-to-back double digit return years. The outlook for 2025 looks to be more of the same. Traditional bank financing continues to be tight, and the private markets have been more than willing to pick up the slack. The chart below shows that the total size of the private debt market today is approximately $1.5 trillion. Although the asset class has seen a lot of growth, it represents just 6.6% of all US debt outstanding. In addition, $400 billion of the $1.5 trillion is in cash (dry powder), which should provide both a cushion to existing deals and opportunities for future deals.



The biggest risk to Private Credit lies in the ultimate number of defaults. Today, defaults are extremely low and with recession expectations back to normal levels, we don't anticipate a sudden increase. We have been investing in this space for over 15 years and believe that manager selection and due diligence are essential. Most managers tout the same protections, but under the hood, we have found the risk profile to be very different. Having a top tier manager who is focused on principal protection first and yield second has been the key to long term success.

Resources

What We Are Reading:

On Bubble Watch: Howard Marks most recent memo discusses the commonalities of bubbles.
Howard Marks Memo

Glass Still Half Full: KKR's annual outlook is always a good read and written by fellow Richmond-er, Henry McVey: Outlook for 2025

AI Eats the World: Benedict Evans every year produces a widely read presentation exploring macro and strategic trends in the tech industry. For 2025, he dives into Artificial Intelligence: Future of AI

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Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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