THE SERIOUS INVESTOR: WINTER 2025

Welcome to the winter edition of LVW's *The Serious Investor.*

As we begin 2025, we reflect on the key market drivers that shaped 2024 and examine our outlook for the year ahead. Several significant themes emerged throughout the year that continue to influence market dynamics and shape our investment perspective.

As 2024 progressed, interest rates were a key indicator of market sentiment, falling as anticipation of rate cuts increased, and rising as the market digested the potential for tariffs and other policy changes that may come with the new administration.

When rates rose during the first and fourth quarters, U.S. large-cap stocks (S&P 500) outperformed both small-cap stocks (Russell 2000) and international stocks (MSCI All Country World ex-U.S.). Conversely, when rates declined in the third quarter, small-cap stocks and international equities showed stronger relative performance. Looking ahead, we expect rates to remain elevated in 2025, a scenario that typically favors U.S. large-cap stocks with their tilt toward tech-driven growth profiles.

Dollar strength emerged as another significant factor, particularly in the fourth quarter when the U.S. dollar surged 8% against developed market currencies and 7% against emerging markets.[1] This continued a decade-long trend in which dollar appreciation has coincided with U.S. equity outperformance—the S&P 500 has delivered compound annual returns of 13.4% compared to 5.2% for international stocks.[2] While long-term concerns about federal debt levels and budget deficits exist, in the near term the dollar's structural strength remains intact. Higher U.S. yields will likely support dollar strength through 2025, providing continued support for U.S. equities relative to international markets.

The "Magnificent Seven" mega-cap tech stocks—Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla—were instrumental in driving S&P 500 performance throughout 2024. Without these market leaders, S&P 500 gains would have been just 6.3% in 2024, compared to the index's actual return of 23.3%. These companies now represent 33% of the S&P 500, up from 28% in 2024 and 20% in 2023.[3] Their influence will remain crucial in determining whether U.S. large-cap stocks can maintain their leadership position in 2025.

With the crosswinds impacting U.S. fixed-income rates, we continue to favor multi-strategy investments where security selection and portfolio positioning can help mitigate equity market risk along with less interest rate sensitivity than traditional fixed income. Nonetheless, fixed-income markets have become marginally more attractive heading into 2025. Rising medium- to long-term yields across the bond market in late 2024 have improved prospective returns compared to a year ago. Our fixed-income preferences emphasize quality over credit risk given tight spreads, shorter duration to manage rate sensitivity, and municipal bonds over taxable bonds in taxable portfolios.

Valuation: Mega-cap stocks continue to dominate

The S&P 500's valuation remains above historical averages, reaching levels comparable to the dot-com era and post-COVID period. Elevated benchmark valuations are largely due to the influence of the Magnificent Seven stocks. At the end of the year, the price-to-earnings (P/E) ratio for the S&P 500 was 21.5x; however, if the 10 largest companies are eliminated, the P/E ratio drops to a more reasonable 18.2x.[4]

Growth: A diverging world

Earnings growth for the S&P 500 is projected to broaden in 2025. During 2024, the index's growth excluding the Magnificent Seven was approximately 3% and is projected to increase to 13% during 2025.[5] The U.S. consumer provides stability as GDP continues to exceed historical trends. Globally, most major regions are expecting earnings to soften as we move into 2025.[6]

Liquidity: Interest rates remain elevated, and crosswinds abound

The Federal Reserve cut rates again in December; however, markets were focused more on the prospects for future cuts. With inflation slightly above targeted levels and softening in the labor markets, the potential for tariffs and additional tax cuts increases uncertainty with respect to the path of forward monetary policy.

Positioning and market outlook

As we enter 2025, we believe global markets are firmly in a mid-cycle environment with no imminent recession risk. Our analysis suggests:

- U.S. large-cap stocks are positioned to maintain their leadership, driven by resilient economic growth and strong but decelerating earnings growth. Their secular growth story remains compelling, particularly as global investors seek safety amid high interest rates and dollar strength.
- Small-cap stocks may deliver solid returns but will likely lag their larger counterparts absent meaningful interest rate declines that would encourage broader risk-taking.
- International equities face continued headwinds from dollar strength, potentially leading to underperformance when measured in U.S. dollar terms.
- Fixed income offers enhanced opportunities for portfolio stability and income generation, driven by higher starting real yields.

Barring any exogenous shocks or material increase in recession risk, we expect 2025's market dynamics to largely mirror those of 2023 and 2024: U.S. large caps leading, small caps taking second place and international equities lagging when measured in dollar terms.

We appreciate your continued trust and confidence in LVW Advisors.

[1, 2, 3] DataTrek Research, Factset.
[4, 5, 6] JPMorgan Asset Management.

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