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Monthly Market Commentary
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Closing out 2024, we are grateful for a remarkable market year. The challenge looking into 2025 will be whether the performance can be replicated especially because market levels look borderline frothy in my view, and by many measures, the stock market is expensive. When markets have risen this much, I feel that it's difficult to sustain the same trajectory and we may have to navigate more risks. In response to this, I plan to highlight how I've adjusted strategies to manage potential risks and volatility.

Commentary Summary

1. Both 2023 and 2024 were blockbuster years and the S&P 500 is quite high, in my view. The markets have set a high bar that may be difficult to meet, which I believe raises the possibility of future volatility.
2. While I'm an optimist, its difficult to ignore rising risks, namely headlines, geopolitical, tariffs and inflation, and Federal Reserve interest rate path that is growing murkier.
3. I feel that markets currently reflect the optimism and forward-looking optimism that has developed over the past two years. I highlight a few potential paths to consider in 2025.
4. I have already started rebalancing by capturing profits made in stocks over the past two years and reinvesting in bonds. Stocks look relatively expensive, but bonds may be attractively priced especially after three years of sell-offs. Either way, the goal is an increased focus on risk and volatility management.

Stretched valuations imply high expectations and a difficult hurdle to maintain.

Based on traditional valuation metrics, the markets are expensive. The S&P ended the year up +23% as of 12/31/2024, the S&P 500 was priced at 5,881.[1] The Trailing 12 Month Earnings Per Share (EPS) was $239.[2] Dividing price by EPS yields a Price to Earnings ratio of 24.6x. Considering that the 30-year average Price to Earnings ratio is 19x, market valuations are fetching a 29% premium over historical averages.

US equities have delivered an average annualized return of 12.8% per year over the past five years which has significantly outpaced most other global markets.[2] Replicating this could be difficult because I feel like markets are priced to perfection: assets with the strongest fundamentals are now the most expensive, and I'm concerned that expectations are so high that even "good" news may not be good enough. This could trigger an air pocket or sell-off. While it's true that some analysists believe that current valuations have merit, their stance is that we can't compare the current to the past. It's true that companies are more efficient (profit margins have nearly doubled), higher quality (less debt to EBITDA), and have better management and controls.[3] I believe it's also true that the influence of tech and AI capabilities of companies across the spectrum has enabled a more dynamic, faster responding, and more efficient business climate. I think its best to focus less on the debate over market valuations and instead acknowledge that markets have been terrific, and it may make sense to be mindful of risk and volatility.

Risks to the Markets and Economy May be Rising

By multiple measures the US economy is currently the largest, most diverse, and has the greatest depth compared to any economy in the world. At the same, time, I do see potential headwinds.

- Rising Headline Risk
  The incoming presidential administration is generating headlines that may impact the markets and the economy. Examples of this include recent cabinet appointments, the congressional debt ceiling, the spat with Canadian Prime Minister Trudeau, the Panama Canal, and Greenland. We try to stay politically

neutral yet the President's words have the power to move markets, implying that we may have to navigation rising headline risk as we parse the difference between comments and policy.

- Potential tariffs are a tax and could contribute to inflation, in my view.
  President Trump will likely raise tariffs significantly not only on China but also on Canada, Mexico, and Europe. It is likely that the cost of tariffs will be passed from companies directly to consumers in the form of higher prices. This is essentially a tax and could contribute directly inflation and hinder growth. Lower and middle class Americans will likely feel the brunt of tariffs and it could lead to a slowdown in spending and a decline in household resilience (checking and savings may drop, borrowing may rise). If tariffs trigger inflation, at best the Fed stops cutting rates, and at worst they increase rates, which could be like 2022 all over again.

- Geopolitical risks are increasing in intensity and frequency.
  America enjoys an enviable position of not having any geopolitical conflict within her borders. In my view, Americans observe these conflicts from a distance. I believe this is why the US markets and US business have not been adversely impacted. It is difficult to ignore the multi-state conflicts in the Middle East, the Russia/Ukraine war, China's saber-rattling in Taiwan, and Russian covert terrorism attacks on people and infrastructure in the European Union. If any one of these conflicts were to escalate it could generate headline risk and be a distraction for markets.

- A declining interest rate environment is not a foregone conclusion.
  Quoting Fed Chairman Powell in his December 4 conference, "*there is little urgency to lower rates quickly, given the uncertainty in inflation outlook, and a solid economic outlook*". Recent data suggests that the lingering presence of inflation is leading the Fed to slow the pace of rate cuts. The consensus seems to be that initial rate cuts were small victories that helped boost stocks, bonds, business sentiment, and the economy, but the future interest rate trend is more uncertain. If inflation doesn't slow as quickly as the Fed would like, if immigration policies experience a significant shift, or if tariffs result in an increase in prices, then the Fed's job could get more difficult.
  Finally, President Trump has expressed a desire to have more influence over the Federal Reserve and interest rate policy. This is challenging to navigate because President Trump's policies are often different or more muted that what he verbalizes. We will know more with time.

My thoughts for 2025

My chief concern is that markets have increased so much that all the potentially good news is priced into stocks, and any bad news or surprises could cause a pull-back. Stated differently, I believe that the bar to more gains in 2025 is already set very high.

- In my view, the S&P 500 increased by 24% in 2023 because of optimism around friendly market events (end of Fed rate hikes, and economic soft landing), AI profits, improving profit margins, and positive resolution to geopolitical tensions.
- In 2024, I believe the stock market did well because of declining interest rates, improved liquidity (more lending), high productivity, improved labor supply, a resilient consumer, resilient economy, improved earnings growth, and stable-to-increasing profits.
- Looking into 2025, I feel that many of the drivers of 2023 and 2024 are in place. I see three potential paths forward:
  1) Productivity boosts from AI, technology, and a stable labor market continue to drive the markets higher.
  2) Lower rates, expanding market breadth, and broadening growth might for a recalibration of momentum away from tech/growth and into under-valued parts of the market that haven't enjoyed the same run-up. This includes industrials, materials, mid-cap, and small-cap.
  3) The aforementioned sources of risk combined with high market levels imply a heightened sense of vulnerably to a sell-off.

I believe that incremental gains may be more difficult to achieve, and clients may want to acknowledge the possibility of stronger headwinds.

Strategic Rebalancing

Fed rate hikes have historically caused a recession. At this time, it appears that not only has a recession been averted but the markets and economy are cruising along nicely. Stocks have enjoyed significant growth, but I feel there is a point of tension because expensive markets may now be relying more on momentum and less on fundamentals. I also have concerns that some clients are getting risk amnesia: multiple years of good markets may be leading to complacency and a rising acceptance of unnecessary risk. Combined, this seems like a compelling case to rebalance by trimming profits in stocks and reinvesting in bonds and alternatives. I have already done so in IRAs where rebalancing has no tax impact and will target taxable accounts on a case-by-case basis (because of capital gains). The goal is to help re-align client accounts back to strategic targets, hopefully protect profits earned over the past 24 months, and position better to manage any potential sell-offs. The good news is that if I'm trimming profits from expensive stocks, I'm buying bonds that have sold off for nearly 3 straight years and therefore may be more reasonably priced.

I feel this approach presents a win-win situation. If potential market risks don't materialize, 2025 could continue to do well because the Trump Administration's pro-growth, less regulations policies are realized, inflation remains under control, earnings and profits are maintained, and we benefit from future earnings and productivity potential from Artificial Intelligence. The more the markets rise, the more frequently I would expect to rebalance. If potential market risks do materialize, accounts will have been rebalanced as reasonably as possible with the goal of protecting profits and bonds/alternatives should act as ballast in managing volatility. Finally, a market sell-off could create buying opportunities that rebalanced accounts could be better positioned to capitalize on.

Regardless of the outcome, I always believe that forecasting is a generally futile exercise, timing the markets is difficult if not impossible, and the best client outcomes are from having a plan, sticking to a plan, and never making investment decisions based on emotion.

Questions & comments are welcome,
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Sources & Disclosures:
[1] Factset, S&P 500 Market Weighted Index, as of market close 12/31/2204.
[2] Vanguard Institutional Research, December 2024.
[3] From report produced by the Economics Group of Wells Fargo Bank, N.A..
The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.
US Treasury bonds are guaranteed by the full faith and credit of the U.S. Government for the timely payment of interest and principal if held to maturity. The opinions expressed in this report are those of the authors and are not necessarily those of Wells Fargo Advisors or its affiliates.
Alternative investments, such as hedge funds, funds of hedge funds, managed futures, private capital, real assets and real estate funds, are not appropriate for all investors. They are speculative, highly illiquid, and are designed for long-term investment, and not as trading vehicle. These funds carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. The high expenses associated with alternative investments must be offset by trading profits and other income which may not be realized. Unlike mutual funds, alternative investments are not subject to some of the regulations designed to protect investors and are not required to provide the same level of disclosure as would be received from a mutual fund. They trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences for the fund and the investor. An investment in these funds involve the risks inherent in an investment in securities and can include losses associated with speculative investment practices, including hedging and leveraging through derivatives, such as futures, options, swaps, short selling, investments in non-U.S. securities, “junk” bonds and illiquid investments. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. At times, a fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all. Other risks can include those associated with potential lack of diversification, restrictions on transferring interests, no available secondary market, complex tax structures, delays in tax reporting, valuation of securities and pricing. An investment in a fund of funds carries additional risks including asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investor should review the private placement memorandum, subscription agreement and other related offering materials for complete information regarding terms, including all applicable fees, as well as the specific risks associated with a fund before investing.