MALVERN CAPITAL MANAGEMENT

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4th Quarter Review and 2025 Market Outlook

January 2025

4th Quarter and Full Year 2024 Review

In 2024, the S&P 500 Index recorded its second straight year with a total return above 20%. We recorded 57 new highs in the S&P 500 Index for the year with a total return of 25.02%. The Dow Jones Industrial Average posted gains of 14.99% and the tech-heavy NASDAQ 100 Index rose 25.88% after rising by over 55% in 2023. Stocks were fueled by strong earnings growth and by the commencement of the Federal Reserve's cutting of the Fed Funds rate plus the anticipation of future interest rate cuts in 2025. For the year, large capitalization growth stocks outperformed large capitalization value stocks by more than double. The "magnificent seven" stocks, all large-cap growth stocks, continued to dominate in 2024 as they had in 2023. We continued a trend we have seen for the past few years of growth stocks out-performing value stocks. Small and mid-capitalization stocks saw double-digit returns in 2024 while developed international stocks posted modest gains of slightly under 4% for the year.

For the 4th quarter of 2024, we did not have any real "Santa Claus" rally to top off the year as we have experienced in recent years. Stocks fell the last four days of the year rather than rallying. The NASDAQ 100 Index posted the best gains of the major indices for the quarter rising by nearly 5%. The S&P 500 rose 2.41% but small and mid-cap stocks were flat. Even though the Federal Reserve began cutting interest rates in 2024, longer-term, market-driven interest rates rose in the quarter acting as a headwind for stocks. Large-value stocks were negative for the quarter. Likewise, rising long-term interest rates negatively affected high-quality bonds. Investment grade bonds (as measured by the Bloomberg Barclays U.S. Aggregate Bond Index) fell over 3.0% in the 4th quarter while lower quality junk bonds were flat.

Indices Performance

Category	Representative Index	4th Qtr 2024	Full Year 2024	Full Year 2023	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	0.93	14.99	16.18	7.56	10.55	11.57
Broad US Large Companies	S&P 500 Index	2.41	25.02	26.29	8.94	14.53	13.10
US Small Cap Companies	Russell 2000 Index	0.33	11.54	16.93	1.24	7.40	7.82
US Mid Cap Companies	Russell Mid Cap Index	0.62	15.34	17.23	3.79	9.92	9.63
Largest 100 NASDAQ Companies	NASDAQ 100 Index	4.93	25.88	55.13	9.71	20.18	18.53
Large "Value" Stocks	Russell 1000 Value Index	-1.98	14.37	11.46	5.63	8.68	8.49
Large "Growth" Stocks	Russell 1000 Growth Index	7.07	33.36	42.68	10.47	18.96	16.78
Large Cap Stocks	Russell 1000 Index	2.75	24.51	26.53	8.41	14.28	12.87
Developed International	MSCI EAFE Index	-8.11	3.82	18.24	1.65	4.73	5.20
Emerging Markets	FTSE All Emerging Markets	-6.50	12.35	8.64	0.33	3.01	4.30
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-3.06	1.25	5.53	-2.41	-0.33	1.35
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	0.17	8.19	13.44	2.92	4.21	5.17
Commodities	Bloomberg Commodity	-0.45	5.38	-7.91	4.05	6.77	1.28
Total US Market (all cap stocks)	Russell 3000 Index	2.63	23.81	25.96	8.01	13.86	12.55
Real Estate Investment Trusts	Wilshire US REIT Index	-5.03	9.11	16.10	-2.47	4.55	5.70
Cash	US T-Bill 90 Day	1.23	5.48	5.11	3.89	2.46	1.73

** 3 year, 5 year and 10 year returns are annualized.*
All periods ending December 31, 2024 except "Full Year 2023."
All returns include the reinvestment of dividends.

Source: Morningstar Direct.

Can the S&P 500 Index post a third straight year with returns over 20%? It has been a long time since we have seen a market correction. Are we due for a correction this year? Will long-term interest rates stop climbing and reverse course? What are we to make of the economy for 2025 and beyond? We look at these issues and others as we formulate our outlook for 2025.

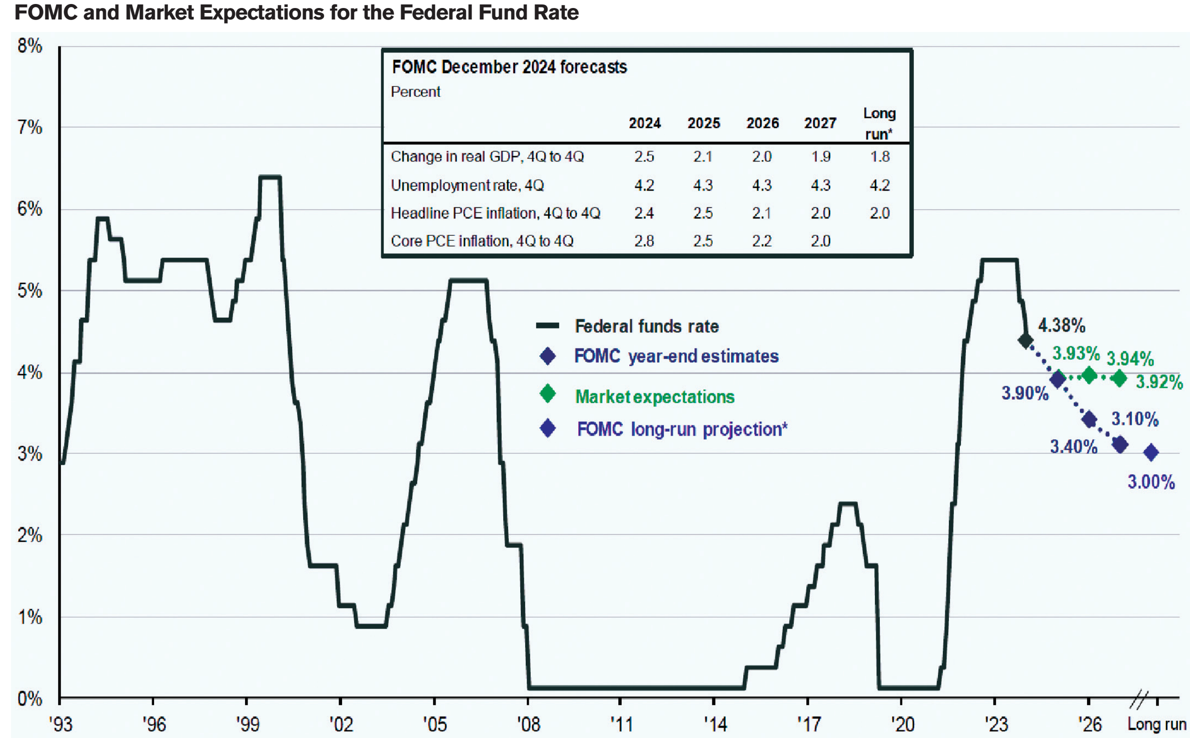
The Federal Reserve and Interest Rates

At the last Federal Open Market Committee (FOMC) meeting of 2024 on December 18th, the Federal Reserve cut the Fed Funds rate by an additional 0.25%, lowering the rate to a range of 4.25% to 4.50%. As such, short-term interest rates fell. However, at the meeting, the Fed said that rather than an expectation of four additional rate cuts in 2025, it sees just two additional Fed Funds rate cuts in the new year. Equity market investors were not happy with the change of policy toward having fewer interest rate cuts in 2025 and stocks promptly sold off with the Dow Jones Industrial Average falling by 1123.68 points and the S&P 500 Index declining by 178.45 points or 2.95% on December 18th. Equity markets endured further declines between the Fed meeting and the end of the year. Likewise, longer-term bonds also sold off resulting in rising interest rates at the long end of the interest rate curve. The 10-year U.S. Treasury Note yield rose from 4.385% (on December 17th) to close the year at 4.573%. Longer-term interest rates are likely rising because the bond market and the Fed are signaling that they believe the economy is sound and they also think that higher inflation may still be a risk.

Fewer interest rate cuts in 2025 than previously expected may stymie equity market returns in 2025. The Fed will remain data-dependent when it assesses the need for a Fed Funds rate cut at future meetings. Inflation data will come under scrutiny at each FOMC meeting. If inflation remains a concern and the economy continues to grow it is less likely that the Fed will be inclined to stray from its projection of two cuts in 2025.

Federal Funds Rate Expectations

FOMC and Market Expectations for the Federal Fund Rate



	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	

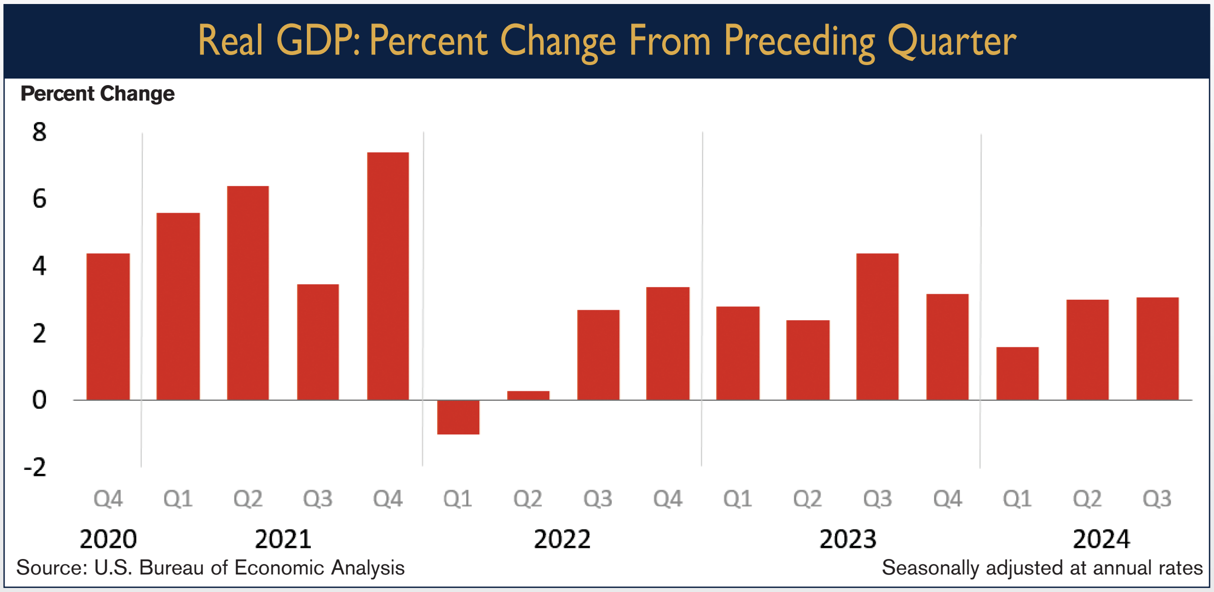
Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.

What does this mean for short and longer-term rates in 2025? We should see further declines in short-term interest rates but continued upward pressure on longer-term interest rates. We project that the 10-year U.S. Treasury Note yield will rise to nearly 5.0% before settling down (some analysts are projecting a 10-year U.S. Treasury Note yield as high as 6.0% in 2025). These higher rates do not bode well for mortgage rates although the housing market remains quite strong and insulated from higher rates.

Inflation and the U.S. Economy

Over the past four years, inflation has ravaged U.S. consumers while the U.S. economy has been quite strong based on various measures. The high inflation rates have been likely caused by the post-pandemic government spending spree, the Federal Reserve's increasing of the money supply through a low to zero Fed Funds rate and its "quantitative easing" programs, higher energy prices, and possibly the lower income tax rates from the 2017 tax reform act. It is often said that "inflation is too much money chasing too few goods." The stimulative effects of the causes of inflation have led to an economy that is quite strong in addition to a "bounce back" from the pandemic-caused recession of 2020.

The real Gross Domestic Product (GDP) for the third quarter of 2024 was 3.1%. In the second quarter of 2024, real GDP grew by a 3.0% rate. Consumer spending, exports, non-residential fixed investment, and Federal Government spending were all contributors to the strong growth in real GDP.



The strong jobs market is a by-product of the strong economy. The Bureau of Labor Statistics has reported healthy monthly job creation since the end of the pandemic. Many of these job gains have been a result of jobs returning online post-pandemic. Less quantifiable is the number of new jobs created by the strong economy versus simply being "bounce-back" jobs.

Despite the strong economy as measured by GDP and job growth, consumer confidence took a hit in December, perhaps making a statement about the future of the economy. The Conference Board's Consumer Confidence Index dropped by 8.1 points to 104.7 in December. The Present Situation Index also dropped by 1.2 points to 140.2. This index reflects consumers' feelings about business and labor market conditions. Lastly, the Expectations Index declined by 12.6 points to 81.1. A reading of 80 generally is a signal of a recession on the horizon.

The Institute for Supply Management Manufacturing Purchasing Managers' Index for November showed a reading of 48.4. Any reading below 50 is considered recessionary. The Institute for Supply Management's Services Purchasing Managers Index for November showed a reading of 52.1, slightly above the recession warning level. The Institute for Supply Management's indices give a good sign as to the health of the economy.

The Conference Board's Leading Economic Index (LEI) jumped by 0.3% to 99.7 in November 2024. However, the LEI for the past six months (May through November) had fallen by 1.6%. It had also fallen by 1.9% in the previous six months from November 2023 through May 2024. Although the Conference Board projects 2024 real GDP to be 2.7%, it expects that GDP growth will slow in 2025 to 2.0%.

The Conference Board's Coincident Economic Index increased by 0.1% in November and has increased by 0.6% for the past six months (May through November). The Conference Board's Lagging Economic Index rose by 0.3% in November. For the past six months, the Index was a negative 0.4%.

Despite mixed economic data, we continue to forecast no recession over the next 12 months. However, given the fragileness of the U.S. consumer brought on by inflation, we believe that it is very important that Congress and the White House extend the 2017 tax cuts. The 2017 tax cuts are slated to expire at the end of 2025 which would result in an effective tax increase on nearly every taxpayer.

The U.S. is Likely to Impose Tariffs

Tariffs are a tax imposed by one country on another country's exported goods. It is widely discussed that Donald Trump plans to implement a 10% tariff on goods imported to the U.S. and a 60% tariff on goods imported from China in his second term in office. In retaliation, other countries may impose a tariff of some sort on goods being exported from the United States. Trump implemented many tariffs in his first term in office and President Biden maintained most of those Trump-era tariffs when his administration took office.

Can tariffs be harmful to an economy? Tariffs are intended to level the playing field between domestic producers of goods and their foreign competitors. Most countries impose some tariffs. Tariffs can have negative impacts on an economy. In theory, they make prices for goods more expensive. If, for example, the U.S. produces steel at $1000 per ton, but China can produce it at $500 per ton, China can sell it to the U.S. at a much lower price than a U.S. producer would sell it. To make the U.S. producer competitive, the U.S. can impose a tariff to make the price of both the U.S. producer and Chinese producer similar and therefore more competitive. However, the consumer ends up paying a higher steel price. If steel is highly "elastic" (an economic term meaning that the higher the price the less of a good is sold), less steel will be sold.

China may have a "comparative advantage" in producing steel and many other products. A comparative advantage is where one country can produce a good or service at a lower cost than another country can, which suggests that free trade is a more optimal economic process than a country trying to produce all goods and services to meet its own demand. Thus, a system of tariffs may not be the most beneficial economic choice for the global economy.

What are the implications for the markets should the U.S. impose new tariffs? "Elastic" products will be produced less in the economy which ultimately affects the sales of many companies which ends up impacting corporate earnings. "Inelastic" goods and services (inelastic are goods and services where price has little or no impact on quantities sold) should not see an adverse impact on sales and may improve sales as more goods and services are produced and sold domestically which may positively impact sales and earnings of those domestic companies. In other words, some companies' stock prices will benefit while others will be hurt by the imposition of tariffs.

Corporate Earnings

The analysts at S&P Global estimate the trailing 12-month earnings ending December 31, 2024, of the S&P 500 Index at $233.28 per share. Its 12-month forward projection for earnings is $271.25 per share (earnings ending December 31, 2025). This represents earnings growth of 16.3% over the next 12 months. Furthermore, companies are becoming much more efficient in generating earnings from sales with net operating margins of 11.80% (as of September 30, 2024). The average operating margin for S&P 500 companies since the first quarter of 1993 is 8.46%. 11.80% represents significant efficiency in generating earnings from a dollar of sales by U.S. companies. Operating margins improved by 5.83% from the 3rd quarter of 2023 to the 3rd quarter of 2024.

As of the quarter ending September 2024, S&P 500 companies have generated sales of $501.35 versus $468.52 representing growth in sales over 12 months of 7.01% per share. Shareholders saw a return in the form of dividends at a rate of 1.27% or $74.83 per share cash.

The incoming Trump administration would like to cut corporate income tax rates from 21% to 15%. If Trump is successful at cutting corporate income tax rates, this will have a significant impact on corporate earnings and the estimate for earnings growth going forward. When Trump came into office in 2017, he was able to reduce the corporate income tax rate from 35% to 21%. The 35% tax rate was among the highest corporate tax rates in the world. Corporate tax rates are much more competitive globally now.

S&P 500 Tax Rates

	QUATERLY	12-MONTH
Avg fr 1993	**29.41%**	**30.29%**
Jun-24	20.51%	18.22%
Mar-24	20.15%	17.72%
Dec-23	13.97%	17.74%
Sep-23	17.70%	19.35%
Jun-23	18.81%	19.82%
Mar-23	20.20%	20.15%
Dec-22	20.90%	19.66%
Sep-22	19.50%	18.46%
Jun-22	20.05%	17.83%
Mar-22	18.35%	17.54%
Dec-21	16.33%	17.56%
Sep-21	16.97%	17.62%
Jun-21	18.65%	17.80%

Source: S&P Global, December 31, 2024.

Market Valuations

Based on various valuation measures, the S&P 500 Index appears to be over-valued at present. With a December 31, 2024 estimated earnings of $233.28 per share on the S&P 500 Index, the trailing price-to-earnings (P/E) ratio is 25.21 times. The 30-year average P/E ratio is 20.05 times (average of the last 30 quarter-end P/E ratios). With a December 31, 2025 estimate of $271.25 per share, the 12-month forward P/E ratio is 21.68 times. The 30-year average P/E ratio according to JP Morgan is 16.86 times. Given the historical averages for both trailing and forward P/E ratios, the market seems a little stretched.

Other measures also confirm the valuation extremes. The Cyclically Adjusted Price Earnings ratio (CAPE ratio) which considers inflation, is also showing signs of over-valuation. The CAPE ratio is currently at 37.04 times versus a 30-year average of 28.02 times. The current price-to-book ratio (P/B ratio) is 4.47 versus a 30-year average of 3.19 times.

Another measure of interest is the Fed Model. This model considers long-term interest rates in relation to the market's value. The model says that when the earnings yield on stocks is lower than the 10-year U.S. Treasury Note yield, stocks are over-valued. If the earnings yield is higher than the 10-year U.S. Treasury Note yield, stocks are undervalued. At present, with an earnings yield on stocks of 3.97% and a yield on the 10-Year U.S. Treasury Note of 4.573% on December 31, 2024, stocks would be considered expensive. The thought here is that if investors can obtain a higher yield on bonds than on stocks, they will seek that "safer" vehicle to invest their money.

As far as our equity market outlook goes for 2025, we still believe stocks will generate positive returns given the expected growth in earnings, the likely cut in the corporate income tax rate at some point, anticipated further Fed Funds rate cuts by the Fed, and the still relatively low longer-term interest rates. Price-earnings multiples may contract a little in 2025. We believe that a year from now, the market will justify a lower P/E ratio than the current trailing P/E ratio of 25.21 times, perhaps as much as 8% lower. This suggests a trailing P/E ratio of 23.20 times. If we apply that multiple toward the estimated earnings of $271.25 per share, we get a price appreciation of 7% for the S&P 500 Index or a price of 6293.00. In addition, we add an expected dividend yield of 1.3% giving us a total return of 8.3% from the Index in 2025. We expect a choppy, yet positive year for stocks.

The Possibility of a Market Correction Increases

A market "correction" is defined as a decline in the indices of at least 10% but less than 20%. A decline of 20% or greater is defined as a "bear" market. The last two years have seen S&P 500 Index returns over 20% each year. However, we believe that we will see a market correction in early 2025. The correction may have already started at the end of 2024 with the post-Federal Reserve meeting statement regarding its change to interest rate policy for 2025.

With our earlier discussion of the over-valuation in the market, we expect that the market will adjust the rather high P/E ratio and other expensive valuation measures. Interest rates have a bearing on the value of the market with lower rates translating into higher stock prices. The Fed's adjustment of the number of interest rate cuts in 2025 will adversely affect earlier expectations for stock prices. In addition, long-term interest rates have risen which also impact stock prices. Lastly, it is also a fact that we have not seen any significant decline in the market for some time now. On average the market will experience a correction every 12 months.

Given our outlook for a brief market correction, we tend to construct our portfolios with a reduced "downside capture" percentage. The downside capture ratio translates into the percentage of negative return a portfolio will endure in a down market. If the ratio is 100, then the portfolio will decline exactly with the benchmark index in a down market. A percentage below 100 would indicate that a portfolio will decline by less than the market in a down market. Likewise, a percentage above 100 means that a portfolio will decline by more than the market in a down market. We try to design our client portfolios to have a downside capture percentage below 100. A lower downside capture percentage is expected to help smooth out the volatility of a portfolio's returns over a full market cycle.

Conclusion

We have experienced back-to-back years of total returns for the S&P 500 Index and the NASDAQ Index in excess of 20%. A change in monetary policy by the Federal Reserve contributed to the strong gains for equities. But a further alteration to monetary policy may act as a headwind for stocks as the Fed has lowered its expectations for interest rate cuts in 2025 from four to two cuts.

The U.S. economy has been very strong in recent years but the effects of uncontrollable inflation have overshadowed that strength. Much of the strength in the economy may also be attributable to a "bounce back" from the economy's shutting down during the pandemic. Some economic indicators are weakening but GDP growth and job growth are positive. Tariffs are likely to be implemented with the new administration's taking of office. Tariffs may have no impact on the demand for "price inelastic" goods but will likely impact "price elastic" goods. Will tariffs themselves be inflationary? We shall see.

Corporate earnings continue to grow and will likely be positively impacted by even lower corporate income tax rates if the Trump administration gets its way. Companies are becoming more efficient at translating sales into profits. Nonetheless, the market is expensive. We still see a positive total return in 2025 of 8.3% with an S&P 500 Index price target of 6293.00. However, we expect a volatile year. A market correction is likely early in 2025. It is important to construct portfolios that absorb less of the decline than the market endures to provide the possibility to do well over a full market cycle. Trying to get in or out of the market or time the market is very difficult and nearly impossible to do consistently.

As such, we are here to listen, counsel, and provide direction to all our clients.

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