A review of recent economic and financial market developments, and what our team expects going forward.

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Key Takeaways:

- Strong economic data is allowing the Fed to take a gradual approach to additional rate cuts. Monitoring incoming data will be important to determine if the Fed will be able to continue taking a gradual approach.
- As U.S. large cap valuations are higher than their longer-run averages, continue to focus on diversification into other areas of the market such as small cap and international stocks.
- Given current yields on bonds, 2025 will continue to provide a favorable environment for bond investors.

In December 1996, Federal Reserve Chair Alan Greenspan warned the stock market might be experiencing "irrational exuberance," suggesting stock prices could be unsustainably high. At that time, the S&P 500 had impressive returns in 1995 and 1996. However, despite his warning, the S&P 500 continued to perform well throughout the decade. Greenspan's concerns were validated when the bubble burst in 2000 and the term "irrational exuberance" has since become associated with speculative stock market bubbles.

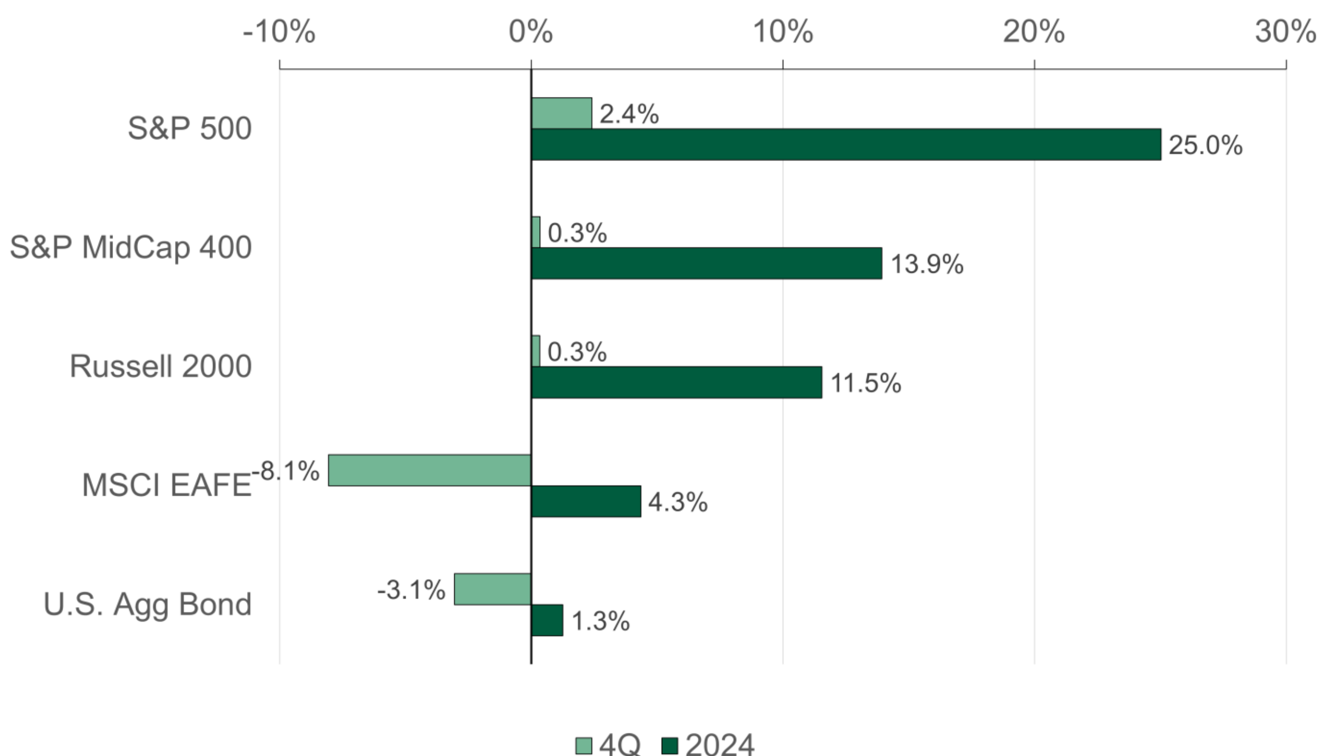
Our investment team sees some parallels to this halcyon period but is not currently worried about a repeat of history. The S&P 500 has had two consecutive years of 20%+ returns, a rarity since the late 1990s. While this rally has been driven by the largest stocks, particularly in the technology sector, it has been supported by robust earnings growth and strong fundamentals from these companies. As 2024 progressed, the rally expanded to include other sectors due to the resilient U.S. economic growth and election uncertainty in the rearview mirror. As seasoned investors, we understand predicting market tops is nearly impossible and the reasons for market corrections are only clear in hindsight. Our role is to identify risk and optimally position client portfolios with the information available to us.

Today, we believe the risks are more balanced between stocks and bonds. The S&P 500's forward price-to-earnings ratio is well above the 20-year average, prompting us to lower the high end of our long-term stock return projections. However, the U.S. economy remains strong despite challenges like national debt and geopolitical uncertainty. Corporate earnings are projected to be healthy next year, and AI is likely to provide a positive backdrop. Bond yields are attractive compared to recent history but have declined from their peak. Credit spreads, or the difference in the yield of two bonds with the same maturity, could widen if the economy falters, adding risk.

Ringing in the New Year…and the Register

And as the world rang in the new year, the S&P 500 rang the cash register. This is the fourth year out of the last six where the S&P 500 has seen returns over 20%. Smaller cap stocks also had a strong year, but did not quite keep up with their larger-cap peers. International stocks took a step back in the fourth quarter with emerging market stocks ending the year up 8.1% while developed stocks returned 4.3%. Bonds also took a step back in the quarter as interest rates backed up prior to the election causing bond prices to fall but still managed to squeeze out a 1.3% gain on the year.

Figure 1



Source: FactSet data and analytics

We continued to get mostly favorable economic data points though the last quarter of the year. The consumer's appetite to spend is strong. In the third quarter, personal consumption expenditures (PCE) increased by a seasonally adjusted annual rate (SAAR) of 3.7% over the prior quarter with goods increasing by 5.6% and services increasing by 2.8%. This trend of consumer spending continued into the fourth quarter with retail sales in October and November moving higher and better than economists had expected.

This, in large part, is due to the labor market's continued strength. Non-farm payrolls continued to move higher. Over the past three months (September through November as we will get December's figure in January), jobs increased by 518,000, the unemployment rate finished the year at 4.2%, and job openings to unemployed workers has come down but jobs remain plentiful at over 7.7 million at the end of October. Initial jobless claims, as well, remain at low levels with the 4-week moving average ending the year at 226,500.

Heading into 2025

While it seems like a broken record at this point, inflation will continue to be a close watchpoint. The Federal Open Market Committee's (FOMC) final meeting of the year brought about another 0.25% cut to the federal funds interest rate target taking the range down to 4.25-4.50%. While the cut was widely expected, their outlook was not. The Summary of Economic Projections (SEP) moved anticipated rate cuts in 2025 down to two, from four previously, due to stickier inflation than anticipated. The PCE price index ended the year at an annual 2.4% for the month of November while Core PCE ended at 2.8%. The Federal Reserve members see both PCE and Core PCE ending next year at 2.5% (higher than the previously expected 2.1% and 2.2% respectively).

The Fed is still in the position of needing to balance keeping the economy on stable footing while continuing to bring inflation back down. As Fed Chair Powell stated in the press conference after the meeting, if the economy and labor market remain in a solid position, they can continue to be careful and take a more gradual approach in bringing their target ranges down. Along with inflation, data such as consumer spending, consumer sentiment, jobless claims, and payrolls among others will need to be tracked closely for clues as to where the Fed will ultimately take rates and where the economy is headed.

We recommend a neutral position between stocks and bonds in multi-asset portfolios. This allows us to balance the risks prevalent today and is our preferred strategy as we head into a new year.

Rising Valuations in the S&P 500

As the S&P 500 showed continued strength throughout 2024, we look ahead to 2025 and beyond with more managed expectations around the prospects for equity returns going forward, particularly in U.S. large cap stocks. As valuation for the S&P 500, as measured by price-to-earnings (PE) ratio, has moved higher in recent years, it now trades close to 22x which is nearly 2 standard deviations from its 20-year average of about 16x (Figure 2). This means that of all daily observed PE ratios over the last 20 years, the S&P 500 has traded above this measure less than 5% of the time, demonstrating that valuations are on the higher end of their recent historical average.

Figure 2

S&P 500 Fwd PE Ratio - NTM

Source: FactSet Financial Data & Analytics *As of:12/31/2024*

We do observe attractive valuations outside of U.S. large cap stocks but do not see signs of a major catalyst that would result in significant outperformance from small and mid-cap stocks while sharing similar views on international stocks. We see a balanced mix of opportunities and risks within all the major asset classes, and as a result we continue to have a neutral view between market capitalizations for U.S stocks and for exposure between domestic vs international stocks.

Looking Outside of U.S. Large Cap

When the results of the election became known, we saw small cap stocks rally significantly for a few days after the election, likely from market expectations of a more relaxed regulatory environment paired with a potentially more aggressive foreign trade policy. Small caps derive more earnings domestically and may have more domestic based supply chains which minimize the impact potential tariffs may have on them relative to large cap peers. Additionally smaller companies with less resources for compliance needs would benefit from reduced regulatory hurdles. This rally, however, quickly reversed as we saw longer-term interest rates begin to rise, which will be discussed in more detail below. Higher borrowing costs are generally harder to absorb for small and mid-size companies compared to their large cap peers.

International stocks cooled off during the 4th quarter as we saw the dollar strengthen significantly off its lows from the previous quarter. A stronger dollar reduces returns from international investment outside of the U.S. for U.S. dollar-based investors, as returns earned in other currencies need to get translated back to U.S. dollars at the higher exchange rate. We see a strong correlation between the 10-year treasury yield and the U.S. Dollar movement, particularly over the last 5 years, which we believe contributes to the strength of the dollar among other factors (Figure 3). We continue to see attractive valuations overseas but acknowledge the dollar strength may continue to be a headwind for U.S. investors investing internationally. We also remain overall cautious on emerging markets where we maintain a preference towards developed markets relative to emerging markets.

Figure 3

While valuation is not a direct predictor of future returns, we do observe a relationship where more elevated valuation levels, like those we are seeing in the S&P 500, result in lower 5-year returns looking forward. For these reasons, we have lowered our forecasted average annual returns expectation for the next 5-10 years from 5-9% for stocks to a narrower range of 5-8%. While maintaining realistic expectations about what returns may be on a go-forward basis, that does not derail our approach to investing in the equity markets and we will continue to look for attractive opportunities going forward.

How Low Can the Fed Go?

Treasury rates fluctuated during the year as the Federal Reserve shifted towards a more accommodative stance. Despite the Federal Reserve's actions, bond yields have risen. The 10-year Treasury yield rose from its yearly low in mid-September, following the first Federal Reserve rate cut, and ended December at 4.57%. This is still below the year-to-date high of 4.70% set in April. The rise during the quarter is attributed to factors such as investors pricing in fewer future Fed rate cuts, ongoing inflation concerns, positive economic data, and worries about the U.S. fiscal situation, including elevated levels of debt and deficits.

We believe the longer Treasury rates will remain elevated and short rates are likely to fall due to Fed easing. Credit spreads, which measure the yield difference between bonds of the same maturity but different credit quality, suggest the market is not overly concerned about the economic outlook. We think bond investors are not being adequately compensated for taking on credit risk, so we prefer higher quality fixed income investments.

How Bonds Work for You

The variability of bond returns in the last few years has many of our clients asking about the benefits of owning bonds in a multi-asset portfolio. Bonds are a unique asset class as they pay coupon income, but their price can also fluctuate based on interest rate movements. When market interest rates rise, new bonds are issued with higher rates, making existing bonds with lower rates less attractive. As a result, the prices of existing bonds fall to adjust their yield to match the new market rates. The opposite occurs when market interest rates fall. Longer maturity bonds will have greater fluctuations in price than short term bonds but can provide a stable and predictable income stream over a longer period.

There is an adage that says a bad day in the stock market is like a bad year in the bond market. It means the losses you might experience on a single bad day of stock trading could be equivalent to the losses you might see in bonds over an entire year. Historically, bonds have had lower volatility compared to stocks due to several key factors. These include regular income payments and a set maturity date which provides a clear timeline for when investors will receive their principal back. Bonds tend to be less sensitive to economic conditions due to bondholders being paid before stockholders in the event of a bankruptcy.

Standard deviation is used to measure volatility for financial assets because it quantifies the extent to which returns deviate from their average. Over the last 20 years, the standard deviation of returns for the Bloomberg Aggregate Bond Index was 4.2% compared to 15.0% for the S&P 500. Clients in multi-asset portfolios can reduce the volatility of their returns by increasing their investment in bonds.

In addition to lower variability of returns, bond returns tend to have a low correlation to other asset classes. Over the last 20 years, the correlation coefficient between the Bloomberg U.S. Aggregate Bond Index and the S&P 500 was 0.24. The correlation with the FTSE 3-Month Treasury Bill Index, used as a proxy for cash, was 0.07. When assets have low or negative correlations, their price movements are not closely linked. This means that when one asset's value decreases, the other might not be affected or could even increase, balancing out the portfolio's performance.

Bonds with higher coupon income payments are better equipped to handle increases in interest rates than low coupon bonds. However, low coupon bonds may be trading at a discounted price to par value. When a bond trades at a discount, its total return can be equivalent to current market yields due to the combined effect of its coupon payments and the capital gain realized when the bond matures at its face value. Often, investors confuse a bond's coupon income with the yield which considers the total return an investor could receive holding a bond to maturity. Yield to maturity considers the bond's current market price, par value, coupon interest rate, and time to maturity. It is expressed as an annual rate and reflects the present value of all future cash flows from the bond, including both interest payments and the repayment of principal. It is a comprehensive measure that reflects the bond's overall return. As of year-end, the average yield to maturity on the Bloomberg Aggregate Bond Index was 4.91%.

We believe 2025 will provide a favorable backdrop for bond investors given the current level of bond yields. Our research shows long-term total returns in fixed income are highly correlated to the investor's starting yield to worst (Figure 4). Yield to worst represents the lowest possible yield that an investor can receive on a bond without the issuer defaulting. This metric is particularly relevant for bonds with provisions that allow the issuer to repay the bond before its maturity date, such as callable bonds. This would suggest bonds are priced to earn a total return near 5% with one third the volatility of the S&P 500. We recommend bond investments align with the investor's financial goals and time aligning the bond fund's duration with their investment horizon.

Figure 4

Fixed Income Yields & Forward Returns

1970s 1980s 1990s 2000s 2010s Current Starting Yield

4.91%

5 -year Subsequent Returns (Annualized)

24.00% 19.00% 14.00% 9.00% 4.00% -1.00%

1.00% 3.00% 5.00% 7.00% 9.00% 11.00% 13.00% 15.00%

Starting Yield

Source: FactSet Financial Data and Analytics *As of December 31, 2024*

The Bottom Line

As we anticipate the new year, we are met with an uncertain future as navigating both bull and bear markets provides challenges. We always recommend relying on a trusted financial advisor to navigate the ups and downs of investor sentiment. Currently, we believe a balanced approach between stocks and bonds allows us to mitigate prevalent risks and remain ready to capitalize on opportunities as we move through 2025.

Figure 5

Asset Class	Next 5 to 10 years*	Long-term Average
Stocks	5%-8%	10.4%
Bonds	4%-6%	4.8%
Cash Equivalents	1%-4%	3.3%
Balanced Portfolio (50% Stocks/ 50% Bonds)	4%-7%	8.2%

*Forecasted average annual returns of COUNTRY Trust Bank Wealth Management

Source: Morningstar and COUNTRY Trust Bank® - See Definitions and Important Information below

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Diversification, asset allocation and rebalancing do not assure a profit or guarantee against loss. All market indexes are unmanaged, and returns do not include fees and expenses associated with investing in securities. It is not possible to invest directly in an index.

Definitions and Important Information

Figures 1-4: Chart data comes from FactSet data and analytics

Figure 4: Chart data reflects statistics of the Bloomberg US Aggregate Bond index. *2010s are from January 2010 to Dec 2019. Starting Yield reflects month-end yield to worst (YTW). Returns are 60 months of forward total returns which are geometrically linked and annualized. Past performance is not indicative of comparable future results.

Figure 5: The long-term average return data comes from Morningstar and is based upon compound average annual returns for the period from 1926 through December 31, 2024. Stocks are represented by the Ibbotson® Large Company Stock Index, which is comprised of the S&P 500® Composite Index from 1957 to present, and the S&P 90® Index from 1926 to 1956. Bonds are represented by the Ibbotson® U.S. Intermediate-Term Government Bond Index. Cash Equivalents are represented by the 30-day U.S. Treasury bill. The "Balanced Portfolio" is representative of an investment of 50% stocks and 50% bonds rebalanced annually. Forecasted stock returns include small capitalization and international equities. Forecasted bond returns include investment grade corporate bonds. These returns are for illustrative purposes and not indicative of actual portfolio performance. It is not possible to invest directly in an index.

Stocks of small-capitalization companies involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies, and they may be expected to do so in the future.

International investing involves risks not typically associated with domestic investing, including risks of adverse currency fluctuations, potential political and economic instability, different accounting standards, limited liquidity, and volatile prices.

Fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss.

Yield to maturity represents the total rate of return an investor can expect from a bond if they hold it until maturity and reinvest all interest payments at the same rate. It's expressed as an annual percentage.

The S&P 500® Index is an unmanaged index consisting of 500 large-cap U.S. stocks. The index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities.

The S&P Midcap 400 is a stock market index published by Standard & Poor's (S&P). It measures the performance of 400 mid-sized companies in the United States, providing a benchmark for this segment of the market. These companies typically have market capitalizations ranging from about $2 billion to $10 billion.

The MSCI EAFE Index measures international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Bloomberg Aggregate Bond Index, often referred to as "the Agg," is a broad-based benchmark that measures the performance of the U.S. investment-grade bond market. It includes a wide range of fixed-income securities.

The Nikkei 225 index is a price-weighted equity index, which consists of 225 stocks in the 1st section of the Tokyo Stock Exchange.

Non-farm payrolls are collected by the U.S. Bureau of Labor Statistics (BLS) monthly through the establishment survey which provides information on employment, hours, and earnings of employees on non-farm payrolls.

The CBOE Volatility Index (VIX), often referred to as the "fear index," is a real-time market index that represents the market's expectations for volatility over the coming 30 days.

GDP or Gross Domestic Product is the monetary value of all goods and services produced during a specified period. The figure is used as a barometer of an economy's health including its size and growth rate. In the U.S., quarterly GDP figures are typically "annualized" meaning the quarterly growth is compounded for four quarters.

The price-to-earnings ratio is a valuation ratio which compares a company's current share price with its earnings per share (EPS). EPS is usually from the last four quarters (trailing P/E), but sometimes it can be derived from the estimates of earnings expected in the next four quarters (projected or forward P/E). The ratio is also sometimes known as "price multiple" or "earnings multiple."

The yield curve plots the interest rates of similar-quality bonds against their maturities. The most common yield curve plots the yields of U.S. Treasury securities for various maturities. An inverted yield curve occurs when short-term rates are higher than long-term rates.

Credit spreads measure the difference in yields between bonds with the same maturity but different credit quality.

The Personal Consumption Expenditures (PCE) economic indicator measures consumer spending on goods and services in the United States. It is compiled and reported by the Bureau of Economic Analysis (BEA) and includes expenditures on both durable and non-durable goods as well as services.

The federal funds rate is the interest rate at which depository institutions (like banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis. This rate is a key tool of U.S. monetary policy, set by the Federal Open Market Committee (FOMC) of the Federal Reserve. Changes in the federal funds rate can influence various economic factors, including inflation, employment, and the rates on consumer loans and mortgages.

Initial Jobless Claims: An initial claim is a claim filed by an unemployed individual after a separation from an employer. The claimant requests a determination of basic eligibility for the UI program. When an initial claim is filed with a state, certain programmatic activities take place and these result in activity counts including the count of initial claims. The count of U.S. initial claims for unemployment insurance is a leading economic indicator because it is an indication of emerging labor market conditions in the country. However, these are weekly administrative data which are difficult to seasonally adjust, making the series subject to some volatility.