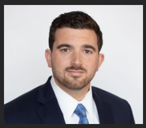
Market Perspectives After a Nervous Start to 2025



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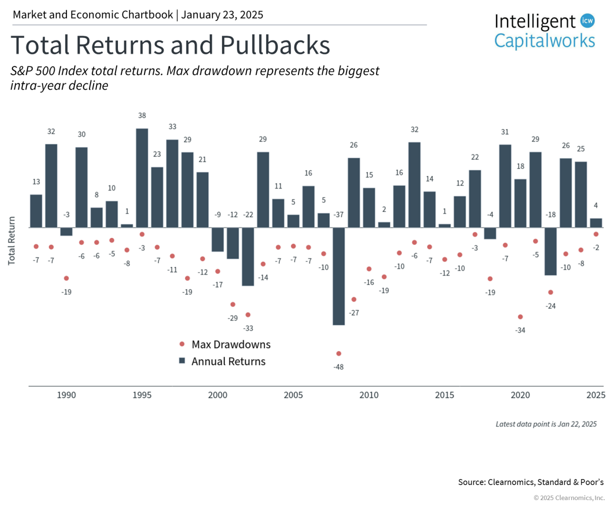
The stock market has struggled in recent weeks as concerns have grown around interest rates, market valuations, the direction of the economy, and more. Since the market peak on December 6 last year, the S&P 500 has pulled back 4.3% while the 10-year Treasury yield has climbed from 4.15% to 4.76%.

This market decline reflects a natural adjustment as investors digest new economic data. The recent jobs report for December was stronger than expected, which means the economy may need less support from the Fed in the form of lower interest rates. At the moment, the market believes the Fed will cut rates just once in 2025, and that this may be the final cut of the cycle. However, these expectations can shift quickly, as they did throughout 2024.

Market volatility is normal and expected after two strong years

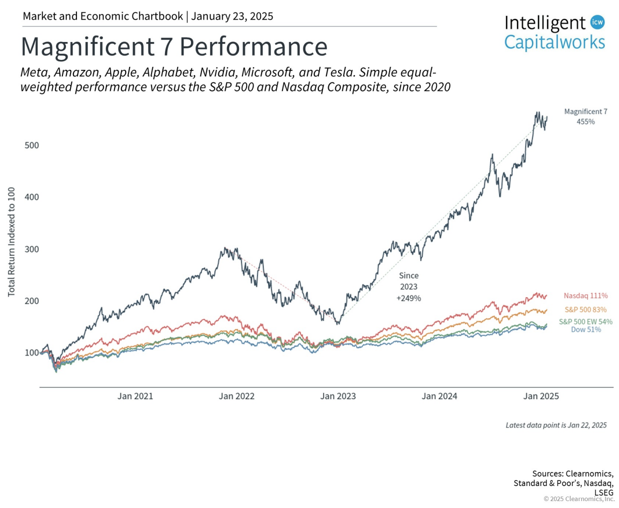


This is where setting the right expectations is necessary. While market declines can be unsettling, it's important to remember that there have only been a handful of trading days this year and a lot can happen in the coming months. Markets also began last year with a brief pullback that then gave way to a long rally. While the past is no guarantee of the future, long-term investors should not overreact to a few days of market uncertainty. If anything, this beginning-of-year volatility may present opportunities to review and rebalance portfolios according to long-term financial goals.

It's important to keep in mind that markets have been relatively calm over the past two years as major indices have climbed to new record highs. As the accompanying chart shows, last year's largest decline for the S&P 500 was only 8%, which is low by historical standards.

History shows that almost every year experiences several market pullbacks. Markets tend to recover quickly from these short-term declines, so trying to time them often backfires. This is why, for investors with longer time horizons, it's often better to simply stay invested. Investors who stayed in the market over the past several years, despite the pandemic, inflation, Fed rate hikes, geopolitical conflicts, and other issues, have come out ahead.

The Magnificent 7 have propelled U.S. stocks to new heights



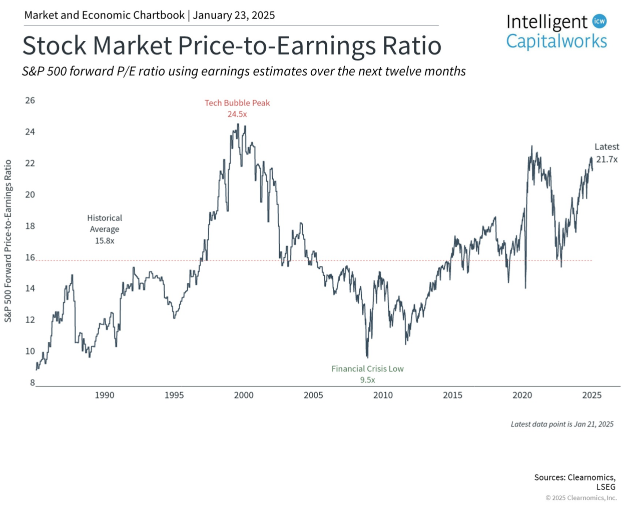
Another concern among investors is whether the rally in technology and artificial intelligence stocks is sustainable. Investors often focus on the so-called "Magnificent 7" – seven technology stocks that have benefited from trends in AI. They have been at the heart of the broad market's strong performance: as a group, these stocks have soared 250% since the beginning of 2023, and nearly 500% since 2020.

Despite the Magnificent 7's rally and the ongoing importance of AI, investors should maintain a broader perspective. In 2022, during a period of rising rates and economic stress, technology and growth stocks were the hardest hit. This is because the value of these stocks depends greatly on expected earnings and cash flows far into the future. So, when interest rates go up, the value of these future cash flows can decline, leading to a setback in stock prices.

Another risk for investors is that, because the S&P 500 is weighted by the size of companies, stocks like Nvidia that outperform can become overweighted in investment portfolios. Investors may find that they are less diversified than they would like, or that their portfolios are far more sensitive to the movements of just a few stocks.

This is not a statement of whether the Magnificent 7 will or won’t continue to perform well. Instead, it’s a reminder that investing is not about making a few concentrated bets; it’s about constructing an appropriate portfolio that is aligned with long-term financial goals, ideally with the guidance of a trusted advisor.

Valuations are historically high



Perhaps the most significant difference investors face this year is that stock market valuations are well above average. As the accompanying chart shows, the price-to-earnings ratio for the S&P 500 is 21.5x, near its highest level in recent years and not far from the all-time peak of 24.5x during the dot-com bubble. In fact, some investors wonder if there is a market bubble today, or at least one in AI stocks.

A high price-to-earnings ratio means that investors are paying more for every dollar of earnings than in the past. This means that future returns may be lower, or equivalently, that markets have gotten ahead of future returns. The key question is whether the underlying economic and market fundamentals are healthy, or if the market rally is built on a house of cards as it was in 2000 or 2008. Today, the economy is still growing steadily, the job market is strong, and the companies with the most enthusiasm have robust earnings.

When valuations are high, the solution is not to avoid stocks altogether. Instead, it’s to stay balanced across different parts of the market that can outperform at different times. These might include sectors beyond Information Technology and Communication Services, and also investment styles such as value, small caps, or other uncorrelated opportunities. The key is to hold a portfolio that is appropriate for your specific financial goals.

The bottom line? While the stock market has struggled in recent weeks, investors should not overreact. Instead, it’s important to maintain a balanced portfolio that can withstand short-term uncertainty, while supporting long-term financial goals.

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