Investment Environment & Outlook

January 2025

Volume 12, Issue 1

TRUST SERVICES | INVESTMENT MANAGEMENT | FAMILY OFFICE | ESTATE SETTLEMENT

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Market & Economic Environment

The traditional "Santa Clause" rally did not materialize in December as investor concerns over trade policy, tariffs and the future path of Monetary Policy weighed on sentiment. Even so, 2024 marked another strong year as the S&P returned +23.3% after gaining +24.2% during 2023. Coupled with the S&P's loss of (-19.4%) in 2022, the three-year compounded return is +9.4%, which is slightly higher than the long run average returns of the markets. Sustained economic growth, consumer spending, solid household balance sheets, and lower interest rates set the stage for an investment environment filled with opportunities.

GROWTH VS. VALUE

Large-cap growth companies dominated the S&P's performance while value stocks, characterized by lower P/E ratios and higher dividend yields, underperformed. This extends a trend that has persisted in recent years. Investors are paying a premium for growth with the Russell 1000 Growth Index trading at 28.9x earnings and the Russell 1000 Value Index at 16.2x earnings. In 2025, portfolios with a mix of growth and value should serve investors well.

"MAGNIFICENT 7"

Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla continue to rapidly drive global technological innovation. Their influence on the financial markets is significant. They represent 32% of the S&P 500 index, which can distort market movements. The "Magnificent 7" collectively surged +62% in 2024. Given elevated valuations, the ability of these companies to maintain earnings momentum will directly shape market returns.

ECONOMY

Against the backdrop of a resilient economy, investors' willingness to pay premium valuations signals their expectations of continued corporate earnings growth. Given the uncertainty surrounding tariffs and other trade policies, could investors be blissfully ignorant of a potential earnings slowdown? Even with tailwinds at the back of the economy, current valuation levels leave less margin for error if earnings disappointments materialize.

BULL MARKETS

Since 1947, the S&P produced 11 bull market runs. History shows the third year of a bull market is typically weaker, with the first year averaging a gain of +46.9%, the second year +10.9%, and the third year +4.8%. After two years of solid returns, will history repeat itself? With the S&P trading at a premium, investors should remain aware of the potential risks that the markets can swiftly present.

CONSUMER CONFIDENCE:

Consumer confidence reflects how people feel about the economy and their own financial situations. December's confidence measures unexpectedly fell and slipped to their lowest levels since September. Policy uncertainty from the incoming Administration appeared to weigh heavily on the minds of consumers. Less optimistic consumers could pullback their spending which would dampen overall economic growth. Consumer confidence will determine the trajectory of the economy and influence policy decisions in the year ahead.

RETAIL SALES

Economic data remains mixed. Even as confidence levels slipped, consumer resilience endured. Robust retail sales drove economic growth during the 3rd quarter to 3.1%. Heading into the important holiday spending season, November retail sales also exceeded expectations. With the economy on solid footing and election uncertainty in the rearview mirror, the stage was set for a strong holiday season of spending that could extend economic growth.

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Fixed Income Observations

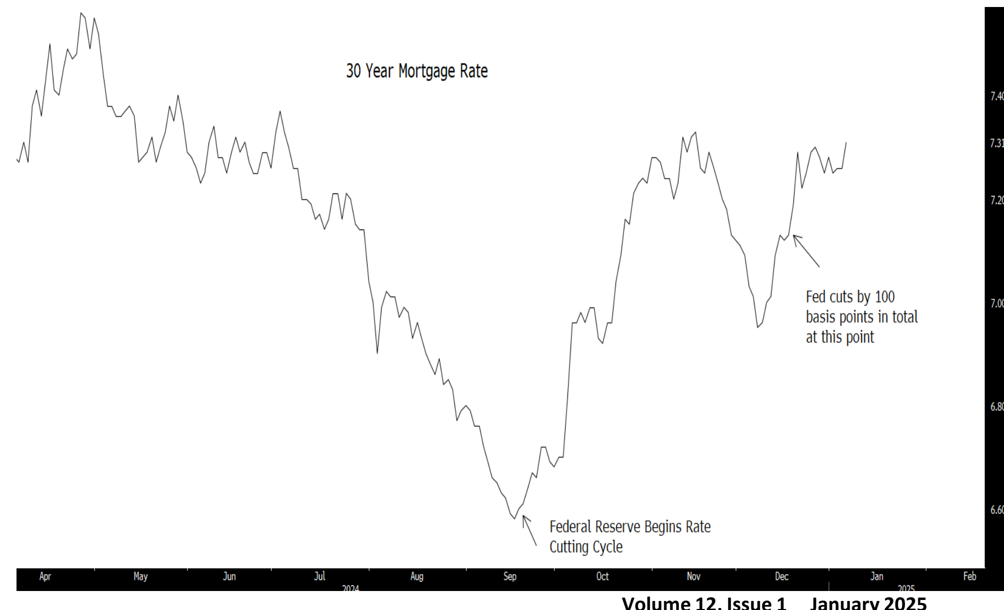
Interest rates remain a focal point heading into 2025 due to their influence on the economy, investor sentiment and the broader markets. Federal Reserve policy makers will continue to lower interest rates this year, but at a slower rate than originally anticipated. With a January pause likely, the March FOMC meeting will likely be the next opportunity to lower rates. This will give policy makers more time to collect and assess economic and inflation data to confirm that a “soft landing” scenario remains the highest probability outcome.

Consumers and bond investor's view interest rates from very different perspectives. Consumers are hyper focused on what the Federal Reserve is doing during hiking and cutting cycles as they try to determine the impact on their saving accounts or borrowing costs. Many consumers were waiting for the Federal Reserve policy makers to begin their much-anticipated cutting cycle before making large purchases such as housing and autos more affordable. What unfolded across the rates markets even after several Federal Reserve rate reductions (100 basis points), surprised many would be borrowers. Longer term Treasury bonds, which underpin the pricing of auto loans and mortgages, have risen sharply. The

Federal Reserve does not control the yield curve beyond ultra-short maturity Treasury bonds. Forces such as growth, inflation, geopolitical uncertainty, and term premiums play a more important role in determining yield levels for longer dated Treasury bonds. With the start of a new Presidential Administration, investors will be very focused on how policy will impact credit markets. On the eve of the 47th President's inauguration, bond yields have continued to march higher.

Macro Observations

- The chart on the right illustrates how 30-year mortgage rates trended higher even in the face of 100 bps of interest rate cuts. Current rates remain above 7%. This perspective serves as a good reminder that the longer-end of the yield curve is not controlled by Federal Reserve Monetary Policy.
- As we manage fixed income portfolios, we continually watching for changing market environments and focus on long-term investing. Today, due to uncertainty on the inflation front, we favor the belly of the yield term structure, which in our view, offers the best risk/reward opportunities.
- With the 10-year Treasury yielding over 4.7%, the opportunity set involves locking in high yields across both risk-free bonds and investment grade bonds.



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