Quarterly Insights

The Magnificent Seven Rides Again

By Aaron Huey, CFA

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amazon.com

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Alphabet

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Meta

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Microsoft

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NVIDIA

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The "Magnificent Seven" stocks had another terrific year in 2024 with a year-to-date return of 53.7% through November 30, 2024. The S&P 500 index was up 28.1%. Nvidia alone contributed 5.5% of the S&P 500 index return. A single stock accounted for nearly 20% of the market's gain! As a group, the seven stocks contributed 12.1% of the return.[1] The surge in these stocks has many investors asking: "Am I missing out?"

While having some exposure to these stocks can benefit investors, an evidence-driven investing strategy would not recommend putting all your eggs in this basket. History suggests reasons why:

Chasing the strong returns of the largest stocks has not been a winning strategy. The fund manager Dimensional conducted an analysis[2] of stock returns of companies before and after they became one of the 10 largest in the U.S. stock market. The research team calculated the average five-year returns in excess of the market before and after joining the top 10. The returns prior to joining the top 10 were excellent, outperforming the market by 20%. However, the returns in the five years after joining the top 10 were lackluster, underperforming the market by -0.9%. While not terrible, the average outcome suggests that the strong returns realized in stocks that become the largest are not likely to persist in the following period.

Shunning small stocks in favor of very large stocks may also lead to missing out. In a recent Eye on The Market report[3] from J.P. Morgan, the authors reviewed the historical performance and characteristics of small company stocks. The authors observed that "From 1930-2010, there were six extended periods of small cap outperformance as it dominated large cap over that entire period." Additionally, they found that small stocks are trading at about a 25% lower price relative to their earnings than large stocks. A similar valuation discount was observed during "Tech Bubble" around the year 2000. Small stocks subsequently outperformed large stocks over the next several years after that period.

The evidence suggests investors are better off owning a broadly diversified portfolio that includes both large and small stocks. This increases diversification and avoids overconcentrating risk in one area of the market. Diversification is always working for you, but sometimes the result is underperformance to hot stocks or popular indexes. The fear of missing out (FOMO) on spectacular returns is natural for most investors. However, staying focused on your portfolio performance relative to your personal goals can help you avoid jumping into an investment at just the wrong time.

1 Returns data from Morningstar.

2 Dimensional Fund Advisors. "Think Twice about Chasing the Biggest Stocks." February 20, 2024.

3 J.P. Morgan. "Eye on the Market: The Lion in Winter." July 23, 2024

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The Top Investing Questions for 2025

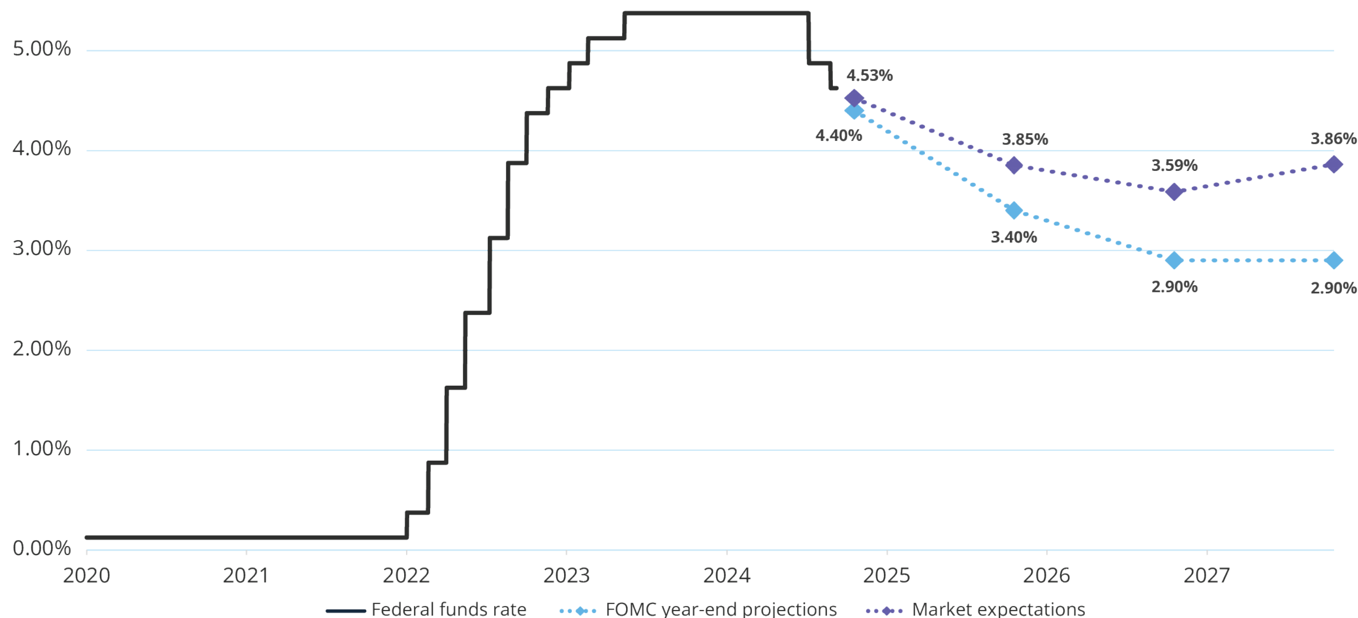
By Corey Hendershot, CFA

As we turn the page on 2024, a new chapter begins filled with new opportunities as well as obstacles we must face in our lives and investment portfolios. With the backdrop of a new administration entering the White House and the Republican sweep of Congress, 2025 is shaping up to be a year of significant change. Let's look at the top investing questions for the year ahead and the potential implications for your portfolio.

1. How low will rates go?

The Federal Reserve began easing rates in September with a half-point cut followed by a quarter-point cut in November, lowering the federal funds target range from 5.25%-5.50% at its recent peak, to 4.50%-4.75%. The question remains — how much lower will the Fed go in 2025? The Federal Open Market Committee (FOMC) released projections in September, with the most hawkish committee member expecting only two more quarter-point rate cuts to occur in 2025, while the most dovish members expect to lower rates by 1.75% by year-end. As of the time of writing, futures markets are projecting two more quarter-point cuts in 2025. However, as the Fed would suggest, the outlook for the path of rates remains uncertain. As new economic data comes in, the Fed adjusts accordingly and given the impending policy changes under the Trump administration, it's difficult for anyone to predict exactly what will end up happening.

Federal Funds Rate Projections



2. How will the Trump administration's policies affect the economy?

While the presidential election results are still fresh and the new administration's policy objectives still need to be ironed out, a few major policy points discussed throughout the election campaign may provide some insight. However, it's important to keep in mind that the political landscape is continuously changing, and there will likely be adjustments to the policies that the Trump administration ultimately rolls out.

- **Tax cuts:** Key provisions from the 2017 Tax Cuts and Jobs Act (TCJA) are set to expire at the end of 2025. The new administration will likely extend the TCJA, and it is also possible that they will push for a lower corporate tax rate for domestic production. Over the short run, these tax cuts could stimulate the economy and boost GDP growth. Longer term, they would lead to a larger federal deficit without an equal or greater offset.
- **Higher tariffs:** Putting aside any potential geopolitical ramifications, the proposed 10% tariff on all imports and 60% tariff on Chinese goods may result in higher inflation and interest rates.
- **Reduction in immigration:** Heavily reducing immigration could lead to decreases in the growth of the labor force and subsequently lower economic growth. Additionally, wages could increase, leading to higher inflation.
- **Corporate deregulation:** The specifics on the deregulation policies the new administration plans to implement are murky at best. However, in general, corporate deregulation could lead to increases in capital investment and hirings.

3. Will the U.S. stock market continue its impressive climb?

The five-year return for the S&P 500 was 15.8% through the end of November 2024. The average five-year return since 1926 has been 10.3%. Excluding the year 2022, we've seen double-digit returns over the past five calendar years.

Many investors are feeling euphoric with this increase in wealth. The American Association of Individual Investors conducts a regular survey of members to see if they are bullish, neutral, or bearish. The most recent survey indicates that their members are bullish with an average reading during 2024 of 44.5%. Since 1987 the average reading has been higher in only three years: 2000 (49.4%), 2003 (48.4%), and 2004 (49.0%). For additional context, the average since 1987 is 37.7% and the low was observed in 2022 with an average of 24.7%.

While returns have been excellent and investors are optimistic, downside risks remain. The Goldman Sachs Global Strategy Paper No. 71 made headlines in the fall with the forecast that the S&P 500 will deliver a return of only 3% during the next 10 years. This forecast was primarily informed by two structural forces:

- **Current valuations for the S&P 500 are high.** The price relative to a dollar of earnings is near its all-time high since 1930. Starting valuations are far from a perfect predictor of performance, but they currently point to muted returns going forward.
- **Market concentration is at a high level.** The authors point out that concentration matters for long-term returns. Their analyses showed that it is extremely difficult for a company to maintain high levels of sales growth and profit margins over long periods, and the same goes for a highly concentrated index. According to the report, "As sales growth and profitability for the largest stocks in an index decelerate, earnings growth and therefore returns for the overall index will also decelerate."

Although we do not recommend that investors make any major changes to their portfolios based on these observations, this is an excellent time to conduct a portfolio review. It may be appropriate to update your financial plan to see if there is an opportunity to realize gains in U.S. stocks and redeploy into international stocks with more attractive valuations or lower risk fixed income assets.

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2025 Tax Planning Considerations

As we begin tax planning for the year, the key questions relate to the future of the 2017 Tax Cuts and Jobs Act (TCJA). This legislation introduced significant changes, with many provisions set to expire at the end of 2025. With the presidential election year behind us, we have some insight into how the new administration may manage tax policy, as well as what aspects of the TCJA may be extended, modified, or left to expire. Of course, nothing is certain, and there are still many unknowns about future tax policy developments.

Consider how tax policy could evolve under the new administration. To pass legislation, Republicans will need bipartisan support as Democrats will retain enough Senate votes to filibuster legislation. However, fiscal policy bills using reconciliation will likely be the way to fast-track legislation with a simple majority vote, as has been the case in the recent past. This method could be used to extend current tax brackets, the qualified business income (QBI) deduction, and the estate tax lifetime exemption. Even so, there is still plenty of uncertainty about what will happen with some of the key provisions in the TCJA, particularly the $10,000 cap on itemized deductions for state and local taxes (SALT). While many congressional leaders support extending or raising the cap, others have suggested allowing the cap to expire at the end of 2025.

Prepare for the sunset of the TCJA provisions.

Individual tax rates: There is a possibility that the top individual tax rate of 37% will revert to the pre-TCJA level of 39.6% at the end of 2025. When it comes to deferring income and speeding up deductions, it's important to think carefully about how this strategy lines up with other provisions, especially those that might expire or stick around after 2025.

Standard deduction: The TCJA nearly doubled the standard deduction. If no action is taken, the standard deduction will revert to pre-TCJA inflation adjusted amounts. Many taxpayers may see their tax bill go up if they do not have sufficient mortgage interest and charitable donations that would allow them to itemize and make up the shortfall. Non-itemizers may want to focus their attention on above-the-line deductions available to everyone, such as deductible IRA contributions (subject to income limitations), student loan interest, and self-employed retirement contributions, among others. Those still working likely need to focus on pre-tax and tax-free benefits offered by employers such as 401(k), Flexible Spending Accounts (FSAs), and Health Savings Accounts (HSAs).

Estate planning: The lifetime gift exemption for 2024 is $13.61 million per individual, or $27.22 million for a married couple. These exemptions are expected to be cut in half if the TCJA is not extended. While there are discussions about making these large exemptions permanent (or eliminating the estate tax altogether), careful consideration should be given to making annual exclusion and lifetime gifts now to use up this historically high exemption. After all, we do not know what will happen in the future. If you have not reviewed your estate plan for a while, this is the perfect time to dust off the plan and make updates with a qualified estate planner.

Corporate and business planning: The current corporate tax rate of 21% is permanent, which means it will not change if the TCJA is allowed to sunset. But no tax law is truly permanent because Congress can and does frequently change tax policy. It seems likely that corporate tax rates will remain low for the near future and may come down to as low as 15% for domestic manufacturers under the new administration.

It is important to remember that each taxpayer's circumstances are different. Contact your wealth or tax advisor to develop an appropriate plan tailored to your individual situation.

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