Let Your Winners Ride

CFRA Macro Research

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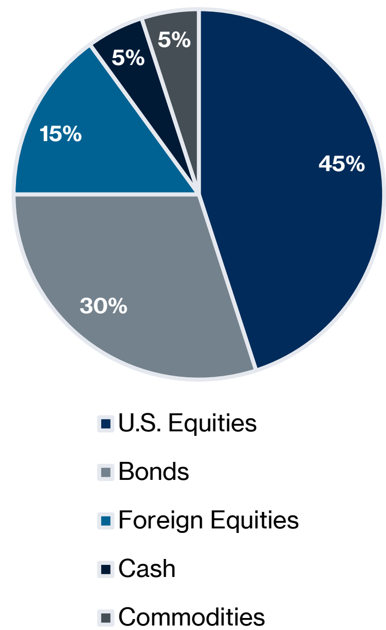
Key Takeaways

- Global economic growth should remain solid in 2025, with the U.S. economy continuing to outpace other advanced countries. This macro environment should continue to support growing global asset allocations into U.S. equities, in our view. Within U.S. equities, we have overweight sector recommendations for Information Technology, Communication Services, and Financials.
- While there are key macro tail risks we are monitoring, including stretched valuations, historically low equity risk premiums, and potential protectionist trade policy changes, the broader U.S. market trend remains bullish into 2025, supported by earnings growth and technical indicators.
- Our clients will often use our macro market outlook to help with asset allocation. For portfolio construction, clients can then leverage our sector ratings to add/lower exposure. CFRA has rated the Information Technology sector Overweight since December 7, 2021; Communication Services since March 28, 2023; and Financials since January 16, 2024. We continue to see these as the most attractive sectors as we enter 2025.

Figure 1: Recommended Moderate Risk Allocation



Fundamental Context

Global Economic Growth

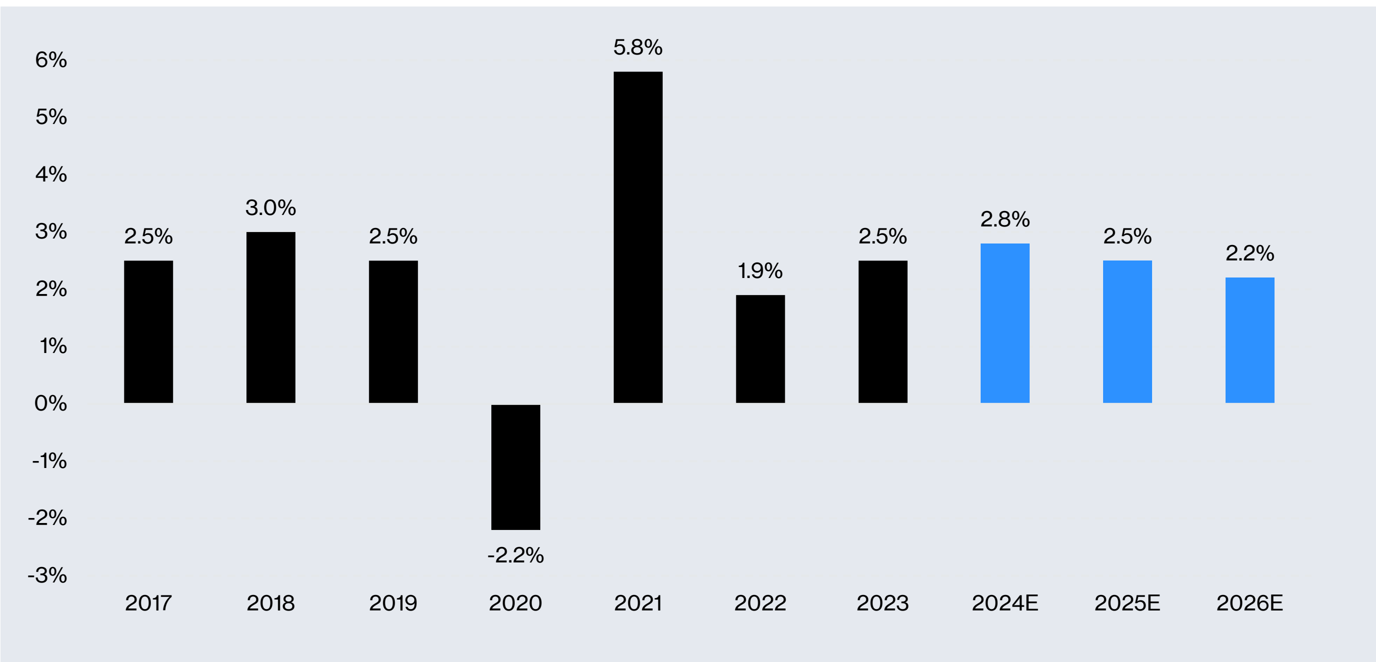
The global economy is expected to grow moderately in 2025, reflecting a mix of resilience in advanced economies and challenges in emerging markets. The International Monetary Fund (IMF) projects global GDP growth of 3.3% for 2025, which is in line with 2024. The U.S., the largest global economy, should outperform other advanced economies. Central banks are broadly easing monetary policy, which should provide support for 2025 growth. However, their ability to strike a balance between reducing inflation and maintaining economic momentum will remain a key challenge. Emerging markets, particularly in Asia and Sub-Saharan Africa, are forecasted to grow faster than advanced economies, with support from structural reforms and investments. However, the overall growth in emerging markets will be constrained by China's underperformance. China's economy faces headwinds from weak domestic demand, a challenging real estate market, and subdued export growth. Global growth in 2025 will depend on how central banks and governments navigate the path between inflation control and economic stimulus. Risks include potential financial market volatility, persistent geopolitical tensions, and renewed supply chain disruptions. On the upside, faster-than-expected disinflation could allow for more aggressive monetary easing, potentially boosting consumption and investment worldwide. Overall, we have a global economic backdrop that should support equities over the next year, with U.S. equities particularly well positioned.

U.S. Economic Trends

The U.S. economy has remained solid in the face of higher interest rates and persistent inflation. Our base case for real U.S. GDP growth in 2025 and 2026 remains a healthy 2.0-2.5%. Growth will be driven by consumer spending, steady business investments, and government expenditures. However, the pace may be tempered by higher interest rates, which could suppress housing activity and borrowing. The labor market is expected to remain supportive, though wage growth may stabilize as businesses adapt to labor shortages through automation and efficiency gains.

After years of elevated inflation, the Federal Reserve's tightening measures are expected to bring inflation closer to its 2% target sometime in 2025, barring unintended cost pressure shocks from new immigration and trade policies. While inflationary pressures from energy and food costs could persist, improved supply chains and demand stabilization have eased pressure on prices. The Fed will likely maintain elevated interest rates to ensure inflation remains under control, but we still expect four 25 basis point cuts in 2025, which will bring the federal funds rate more in line with a neutral rate. Consumer spending, the key driver of U.S. economic activity, is expected to grow moderately, supported by low unemployment. However, higher interest rates and tighter credit conditions could constrain spending on big-ticket items, such as homes and vehicles. Consumer confidence will depend heavily on inflation trends and broader economic stability.

Figure 2: Annual U.S. Real GDP Growth 2017-2026e



Source: U.S. Bureau of Economic Analysis (BEA); Projections from Action Economics.

Valuations are Rich

After a 60% increase in two years, U.S. stocks are trading at high multiples relative to recent history, highlighting a potential disconnect between stock prices and underlying economic and corporate fundamentals. This elevated valuation paradigm reflects optimism about future earnings growth, particularly in sectors like technology and communication services, in our view. Much of the market's valuation premium is concentrated in a handful of mega-cap tech companies, which have supportive growth expectations. Thus, while the overall market appears frothy, growth expectations should continue to support equity prices.

Figure 3: S&P 500 Index and Sector Valuation Multiples

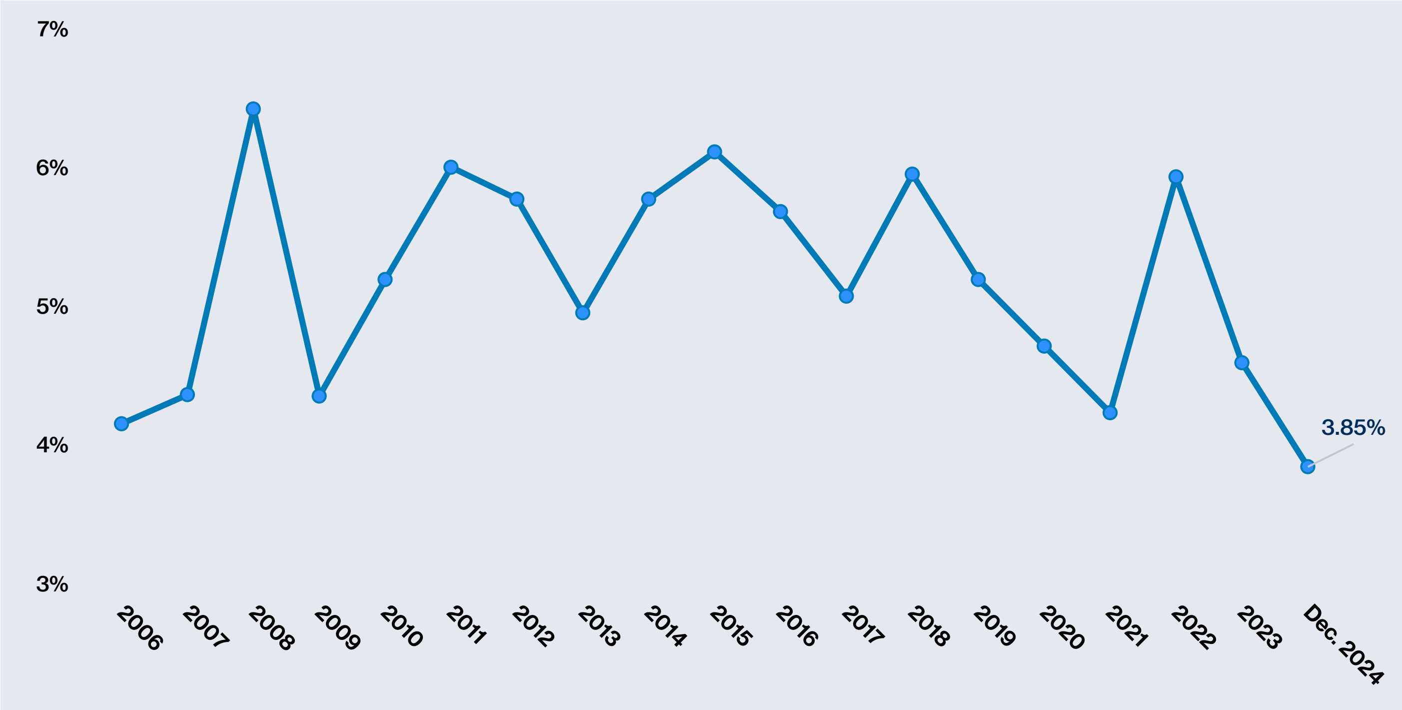
	NTM P/E			Price to Sales			TEV/NTM EBITDA		
S&P 500 Sector	**Now**	**10Y Avg.**	**Prem/(Disc)**	**Now**	**10Y Avg.**	**Prem/(Disc)**	**Now**	**10Y Avg.**	**Prem/(Disc)**
Comm. Services	20.4	16.8	21	4.3	2.6	64	12.2	9.2	34
Cons. Disc.	31.1	24.9	25	3.1	2.0	55	17.7	14.1	26
Consumer Staples	22.0	20.2	9	1.6	1.5	5	15.3	13.9	10
Energy	14.6	23.4	(38)	1.3	1.3	2	6.8	7.4	(8)
Financials	17.5	13.9	26	3.6	2.5	41	NM	NM	NM
Health Care	17.6	16.7	5	1.6	1.8	(11)	13.9	12.5	11
Industrials	23.4	19.2	22	2.6	1.9	36	15.8	12.7	24
Info. Technology	30.8	22.0	40	9.5	5.5	73	22.4	15.2	47
Materials	20.4	17.7	15	2.2	1.9	17	11.1	10.1	10
Real Estate	39.0	42.6	(8)	6.9	6.9	(1)	12.0	11.1	8
Utilities	18.1	18.1	(0)	2.7	2.3	18	19.7	19.7	(0)
S&P 500	**23.2**	**19.0**	**22**	**3.3**	**2.4**	**38**	**15.5**	**11.9**	**31**

Source: S&P Capital IQ as of December 14, 2024.

The S&P 500 Index is currently trading at a next-12-month (NTM) P/E of 23.2x, a 22% premium to its 10-year average, with most of this premium driven by large caps. Similarly, revenue and FCF-like valuation metrics are trading at over 30% premiums to their 10-year averages. Not surprisingly, from a sector standpoint, the Information Technology sector is trading at the most extreme premium to its average at 40%, again chiefly driven by large caps. Nevertheless, eight of the 11 major sectors are trading at a premium to their historical averages, so we are dealing with a broad-based, overvalued market relative to the recent past.

In addition, the equity risk premium recently ticked to a new 20-year low at 3.85%, suggesting very little risk priced into valuations. Equity risk premiums indicate the price of risk embedded in equity valuations, or the return investors require to be in equities versus risk-free assets, like treasuries. Historically, periods of low equity risk premium are followed by higher risk premiums as risk gets repriced. We believe equity risk premiums will remain historically low in 2025, supported by solid earnings growth, so we don't see a valuation paradigm shift anytime soon. Therefore, while there are reasons to be cautious based on a low equity risk premium, market exuberance can last for some time and continue to drive valuations much higher in a growth environment.

Figure 4: Implied Equity Risk Premiums



Source: Dr. Aswath Damodaran, Stern NYU.

Earnings Growth Appears Supportive

U.S. Corporate earnings trends remain very healthy. Third quarter earnings came in much better than expected. S&P Capital IQ consensus estimates point to a Q3 2024 year-over-year rise of 7.0%, up from the September 30 estimate of 3.6%. Eight of 11 sectors have seen upward revisions to Q3 estimates, led by Communication Services, Consumer Staples, and Financials. The S&P 500 is projected to post an 8.5% EPS rise in 2024, followed by a very strong 13.3% increase in 2025. This corporate earnings backdrop is very supportive of solid economic growth and should continue to support stretched valuations. Nevertheless, it will be important that these high growth earnings expectations remain anchored to support stretched valuations.

Technical Indicators Bullish

On November 25, many of CFRA's proprietary technical core indicators reached levels not seen in months, confirming the health and staying power of the bull market, according to Lowry Research, a CFRA business. While some of Lowry's indicators of market health have weakened in recent weeks, these short-term trends appear to be closely tied to the digestion of gains in smaller-cap stocks, rather than the persistent weakness among small-cap issues that typically accompanies the formation of major market tops. In this context, investors are likely best served by viewing any near-term pullbacks that could occur as buying opportunities.

Sector Outlooks

The foundation of our fundamental research starts with top-down economic analysis and market strategy. CFRA's top-down and company-specific fundamental analysis is a highly collaborative process, which leverages all of our research capabilities, including forensic accounting research and diagnostic scores, Lowry Research's technical power rankings, as well as regulatory and legal risk views on the sectors from our Washington Analysis policy research team. CFRA conducts a formal and highly collaborative sector outlook process with all analysts globally. So far for 2024, our overweight recommendations have outperformed all other sectors.

Figure 5: CFRA Sector Scorecard

	2024 YTD Total Return	Sector Rating	STARS Cap-weighted Average
Communication Services	**39.2%**	Overweight	3.9
Information Technology	**38.2%**	Overweight	4.1
Financials	**33.1%**	Overweight	3.8
Consumer Discretionary	**31.3%**	Marketweight	3.6
Utilities	**25.3%**	Underweight	3.4
Industrials	**23.0%**	Marketweight	3.3
Consumer Staples	**17.4%**	Underweight	3.4
Real Estate	**8.7%**	Marketweight	3.4
Energy	**7.8%**	Underweight	3.4
Materials	**7.3%**	Underweight	3.5
Healthcare	**5.9%**	Marketweight	3.5

Source: S&P Capital IQ. As of December 6, 2024.

CFRA's sector and industry outlooks as well as individual equity STARS ratings are dependent on each other. As mentioned above, sector outlooks go through a highly collaborative process. A key factor in our ability to provide actionable investment ratings with the potential for outperformance is making sure our macro environment and sector outlooks are aligned with our STARS ratings and vice versa. For example, in determining sector recommendations, CFRA looks at our market-cap weighted STARS ratings in each sector. In the table above, the Information Technology, Communication Services, and Financial sectors have the highest market capitalization weighted STARS, indicating a greater proportion of buy-rated equities in these sectors as ranked by our fundamental equity research team.

Based on the current macro backdrop, we continue to see these sectors as best positioned as we enter 2025 and remind investors to let your winners ride. Following market up years, which 2024 is clearly shaping up to be, history suggests that investors stick with the leading sectors. Since 1991, the S&P 500 gained 8.5% and rose in price 71% of the time, while the prior year's top 3 sectors rose 11.2% and gained in price 83% of the time, outperforming the S&P 500 Index 75% of the time. Despite the potential for economic shocks from broad-based tariffs, U.S. economic exceptionalism should continue in the near term, driven by a remarkably resilient consumer, a decent job market, and expansionary fiscal and regulatory policies.

To learn more about CFRA's most recent views on sectors, stocks, and other fundamental equity topics, visit https://www.cfraresearch.com/fundamental-equity-research/.

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