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December 23, 2024

DJIA: 42906.95
SPX: 5974.07
NASDAQ: 19764.89

The Outlook for 2025

A Year of Promise and Potential Turbulence

This will be our last publication in 2024, but we will be back to our normal writing schedule in early 2025. In the interim, we wish you and yours a wonderful holiday season and a New Year filled with joy, profits, good health, good friends, and good times!

2024 is ending on an uneasy note for many of America's political allies. French President Emmanuel Macron suffered a major setback in June's 2024 Parliament elections, and he immediately called for snap legislative elections. But the end result was a French National Assembly with three roughly equal, unmanageable, and incompatible factions. Macron appointed two prime ministers in the following four month period, in hopes of passing a budget that would rein in France's growing fiscal deficit. But to date, this effort has been unsuccessful, and his future is uncertain. In Germany, Chancellor Olaf Scholz, who won the 2021 election as Angela Merkel 2.0, lost a vote of confidence in December due in large part to a stagnating economy and disputes over the budget. Voters will go to the polls again on February 23, 2025 in hopes of finding a new coalition. (Friedrich Merz, a conservative, is expected to be chancellor after February's election.)

The UK has had a succession of Conservative Prime Ministers since the pandemic (Boris Johnson, Liz Truss, and Rishi Sunak), but in July the Tories were dumped from leadership, dwindling from 372 to 121 seats in Parliament. Britain's Conservative Party is now led by Kemi Badenoch, the first black leader of a British political party, and the new hope for the Tories. Badenoch is a right-wing politician who has railed against identity politics, transgender rights, and state spending; and her selection as leader creates a striking contrast with Keir Starmer, the leader of the Labor Party and Britain's current "serious and straightlaced" prime minister. Closer to home, Canada's Prime Minister, Justin Trudeau, faces huge opposition after the recent resignations of both his finance and deputy prime ministers. More than 50 Liberal MPs are calling for Trudeau's resignation and the New Democratic Party leader Jagmeet Singh, who has been helping keep Trudeau in office, said he would present a formal motion of no-confidence when the House of Commons chamber returns from a winter break in January. In sum, many of our allies are facing political upheaval and most of the issues dividing citizens in Europe and Canada are the same as those seen in this country: inflation, immigration, rising deficits, the Ukraine/Russia war, and a growing conflict in the Middle East. Voters are looking for change and the trend is toward more conservative right-wing politicians. This shift was also seen earlier in Italy, the eurozone's third largest economy, when far-right leader Giorgia Meloni became Prime Minister in 2022.

And political change appears to be everywhere. On December 8, 2024, President Bashar al-Assad of Syria fled to Russia after six decades of his family's autocratic rule. His sudden overthrow at the hands of a revolt backed partially by Turkey and with roots in jihadist Sunni Islam, could mark a major turning point in the Middle East. It was an obvious blow to both Russia and Iran who backed Bashar al-Assad. According to Reuters, Senior US diplomats met with Syria's de-facto new ruler Ahmed al-Sharaa last week and after having what was described as a "good" and "very productive" meeting with him about Syria's political transition the US removed an existing bounty on his head. This shift in power holds great promise for positive change in the Middle East.

Here at home, voters were also looking for change, and the re-election of President Donald J. Trump, who won not only a majority in both the House and the Senate but a majority of all voters, was greeted with both jubilation and trepidation, domestically and abroad. Trump, the disruptor, has cobbled together a Cabinet full of potential disruptors who promise to bring transparency and common sense change to the federal government. However, change will not be easy to achieve in Washington DC or be pleasant for everyone, so we would expect some pushback. The creation of the Department of Government Efficiency (DOGE), led by Elon Musk and Vivek Ramaswamy, is a unique experiment, and in our view, the effort to bring efficiency to government may be Elon Musk's greatest challenge to date. Still, the most encouraging result of the November presidential election is that there is a renewed focus on growing jobs in America, removing government regulations that hinder corporate growth, and controlling budget deficits. Still, all of these will require profound change and is what could make next year a time of promise and potential turbulence.

Investors greeted the election results with a surge of optimism and the Dow Jones Industrial Average and the S&P 500 index soared 7.5% and 5.7%, respectively, in the month of November. But after setting fresh record highs in the first half of December, the S&P Composite index fell 2.9% on December 18th, just shy of its biggest one-day decline of the year. The catalyst for this shift was the Federal Reserve indicating that there would be fewer rate cuts in 2025 than expected. The reaction to the Fed's new forecast was an unfortunate sign that speculation, coupled with the expectation of easier money, was a significant driver of stock prices in 2024. This risk adjustment to the Fed's statement could continue in the near term; and unfortunately, breadth data has deteriorated in recent trading sessions, which could inspire even more selling. But in the longer term, an unwinding of speculative activity is a favorable development.

Forecasts

<u>Our assumptions for 2025 include GDP growth of 3.2% YOY, a 15% increase in SPX earnings, a maximum of two fed funds rate cuts, Treasury bill yields falling to 4.1%, Treasury bond yields stable at 4.3%, and inflation remaining sticky at 2.75%. This combination results in our valuation model generating a predicted PE of 17.3 times and an SPX target of 5372 based on our 2026 earnings estimate. In short, the stock market is 40% overvalued by this benchmark. However, we must point out that at the end of 2021, 2022, and 2023 the market was also 30% or more overvalued by this benchmark, yet the market continued to climb higher</u>. Liquidity and momentum have been overriding valuation in recent years and stock prices have been boosted by stocks benefiting or expected to benefit from the adoption of artificial intelligence. Household liquidity still remains favorable and offsetting the risk in valuation are the fact that the US economy remains the global engine of growth, US is the home of many, or most of the companies benefiting from the future of artificial intelligence, and global liquidity remains high due to the sizeable global monetary and fiscal stimulus seen in the post-Covid era.

History Making?

Nevertheless, the narrowness of the marketplace is a concern. According to MSCI, if one uses the iShares MSCI ACWI ETF (ACWI.O - $118.85) as a proxy for global equity weightings by country, the US was nearly 62% of the fund in September 2024. Apple Inc. (AAPL - $255.27) was the largest stock in the ETF in September, representing 4.3% of the portfolio, which is more than any country weight, other than the US or Japan at 5.1%. The UK ranks third in country weighting at 3.6% and China has a 2.6% weight on a purchasing power parity basis. In short, the global equity market has been skewed toward the US and within the US market the six largest stocks in the S&P 500 make up roughly 30% of the index. In comparison, in March 2009, the top six stocks represented about 15% of the S&P 500. Many believe that this boom in artificial intelligence (AI) is still in its infancy; however, the leader in the AI boom, Nvidia Corp. (NVDA - $139.67), took a tumble after being added to the Dow Jones Industrial Average on November 8, 2024. This is not a surprise since most stocks retreat after being added to a major index due to pre-buying, but overall, after being added to the DJIA, history suggests many stocks underperform expectations. This will be a risk to monitor in 2025.

It is likely that 2024 will close with double-digit annual gains in all three popular indices for the second year in a row and this is a fairly rare occurrence. All three indices had three consecutive double-digit annual gains in: 1943-1945, 1949-1951, and 1995-1999 and each of these occurrences was followed by a significant bear market. The most memorable advance was seen in 1995-1999 (five years of double-digit gains), and it was followed by a major bear market and substantial annual losses for three consecutive years. Double-digit gains for two years in a row have been more common: 1954-1955, 1975-1976, 1982-1983, 1988-1989, 2009-2010, and 2016-2017. Each of these occurrences was followed by a weak annual performance with negative or negligible annual gains in the subsequent year. See page 8. Two years of double-digit gains does not tell us if 2025 will be an up year or a down year, but it does suggest that 2025 could be an important and pivotal year. Double-digit gains in 2025 would, in our view, confirm that the market is in the throes of a stock market bubble. The alternative would be a subpar performance in the equity market next year during which PE multiples fall and earnings catch up with prices. This would be preferable in the longer run. Either way, we see 2025 as a turning point for equity investors.

Hurdles

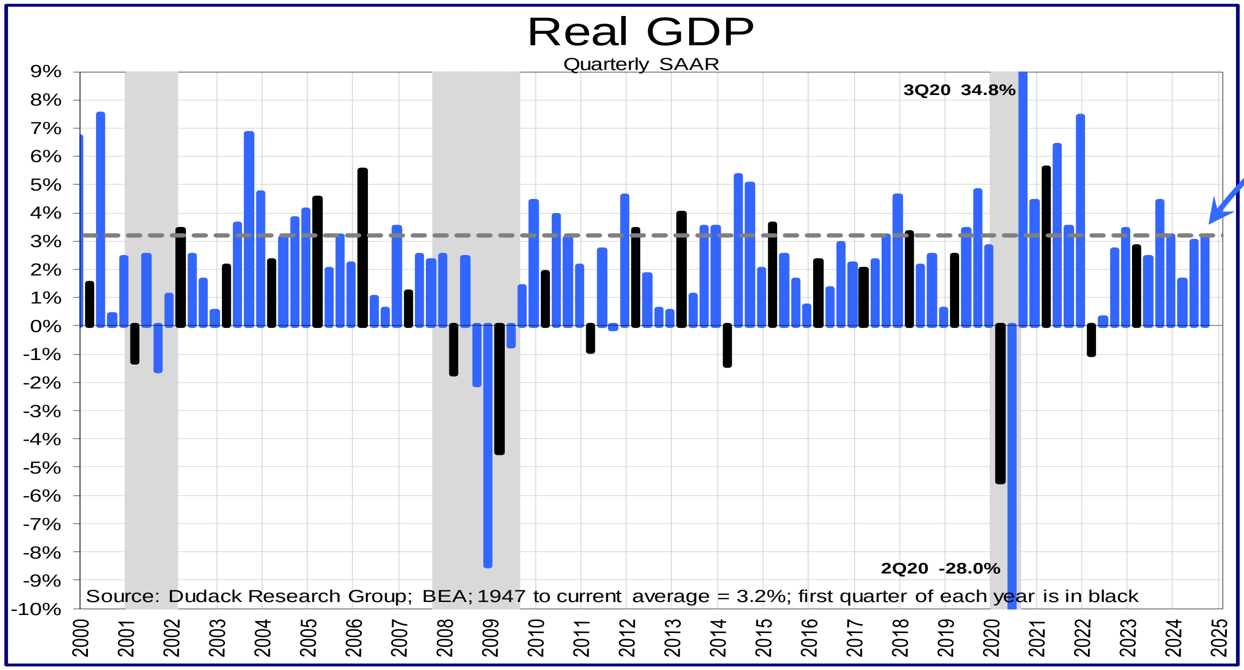
Along with valuation, the hurdles for 2025 include economic weakness in Europe and China, potential weakness in the US housing market, a deterioration in the job market, and the fact that the strong GDP seen in 2024 was artificially boosted by a surge in government spending.

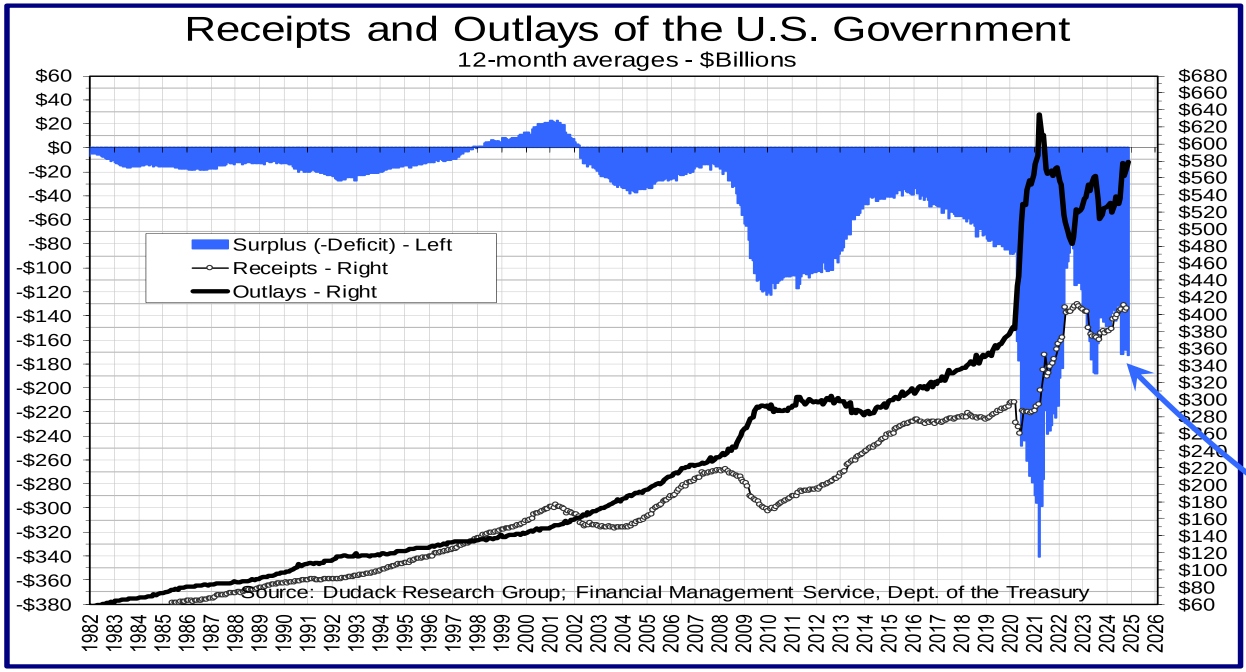
In the twelve months ended in November, deficit spending increased to 7.1% on nominal GDP, which is an unusually high level, particularly during an economic expansion and it is an unsustainable pace. Debt as a percentage of GDP currently stands at 124% and interest on the debt is expected to rise to 13.3% of total federal expenditures this year, exceeding total expenditures on national defense. This massive federal debt issue is the biggest risk to the bond market in a generation and it will be a major impediment in 2025. It behooves equity investors to monitor the bond market in 2025, since it is often the precursor to stock market declines.

Conclusion

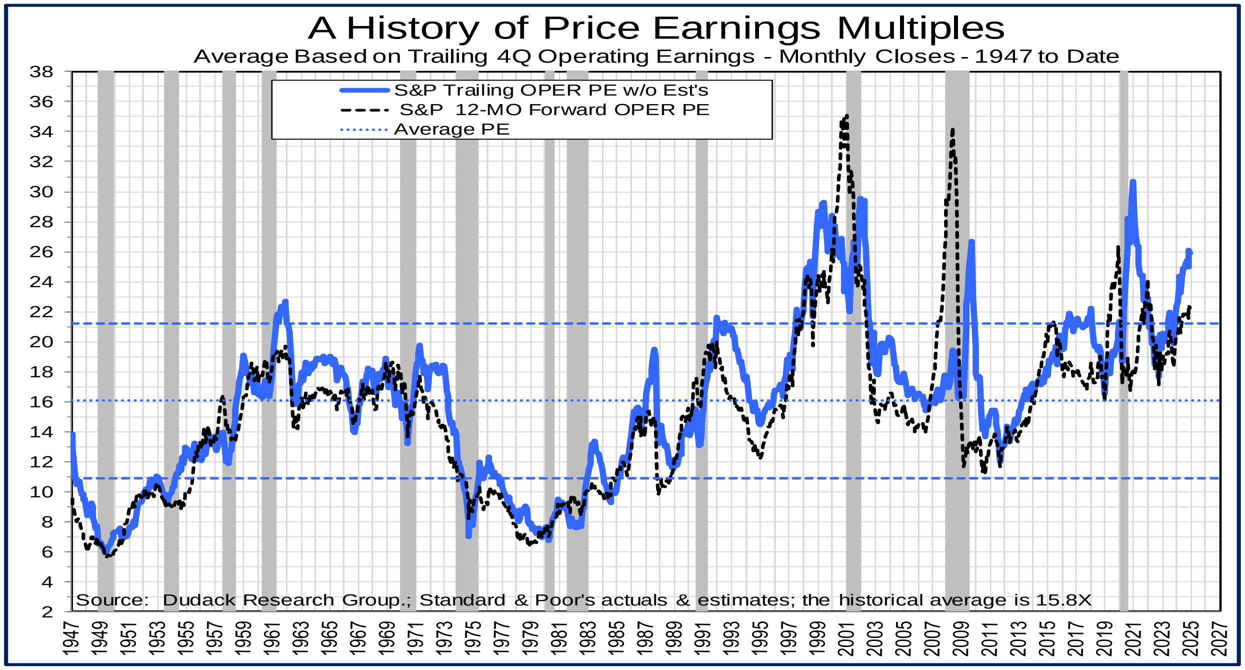
Overall, we believe economic activity should be relatively healthy in 2025 due in large part to the support given to the energy sector which will help to lower energy prices. This in turn lowers expenses for the household sector and improves margins in the corporate sector -- a combination that potentially increases both consumption and corporate earnings. The incoming business-friendly administration is also expected to improve the growth path for the small business sector which is the source of over 45% of all jobs in America. Prior to his inauguration, President-elect Trump has already proven that he can get foreign companies to invest in the US, and that too, increases jobs which improves household income. Overall, we expect top line revenue growth next year will lead to at least a 15% increase in S&P earnings and this should support further gains in the equity market. However, much of this was priced in during the November rally, and we would not be surprised if stock prices were flat to lower in the first quarter of 2025.

ECONOMICS: GDP GREW 3.0% AND 3.1% IN 2Q AND 3Q 2024 BUT WAS BOOSTED BY ROBUST FISCAL (DEFICIT) SPENDING

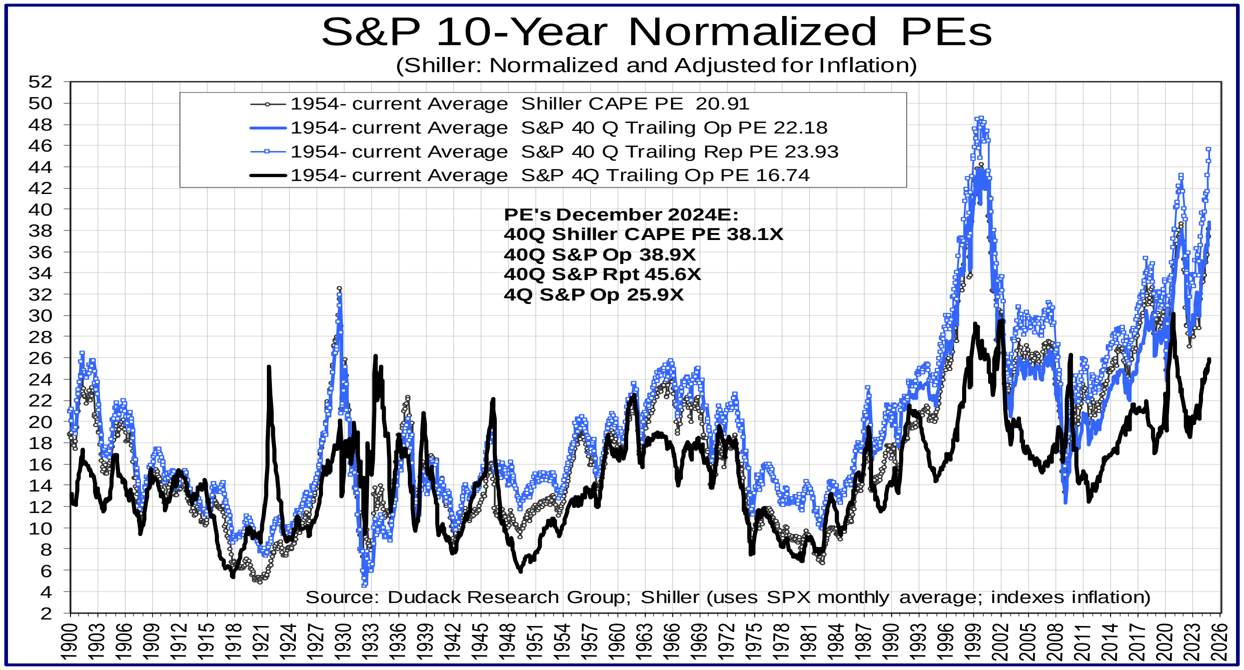




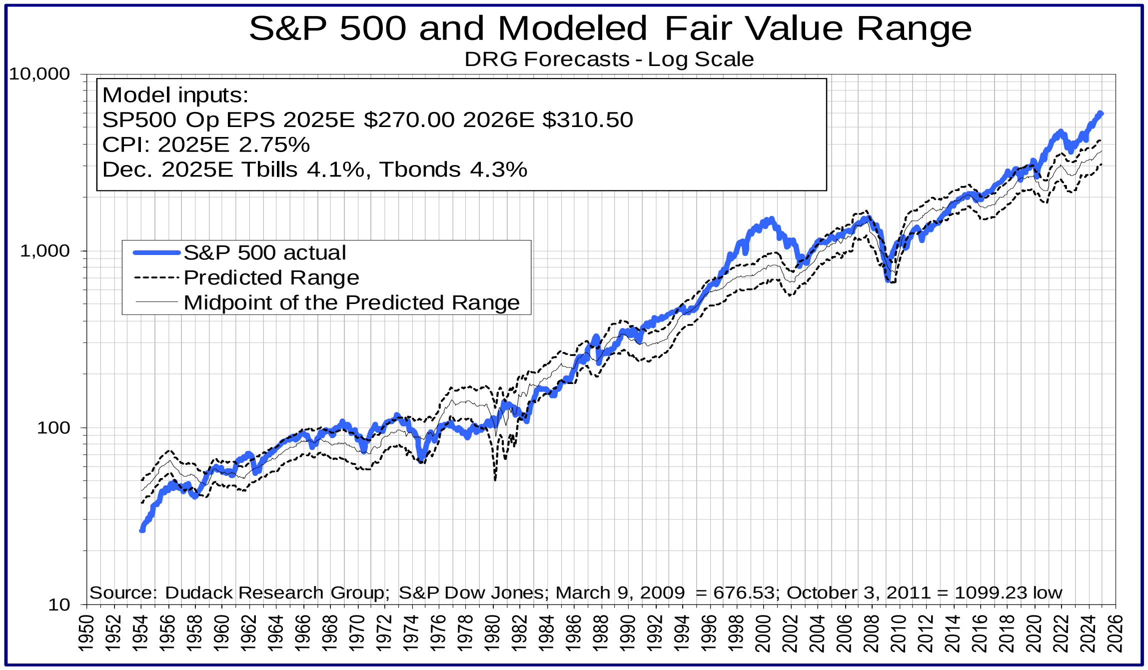
VALUATION: FUNDAMENTAL METRICS SHOW THAT THE EQUITY MARKET IS RICHLY VALUED BUT NOT YET AT "BUBBLE" VALUATIONS



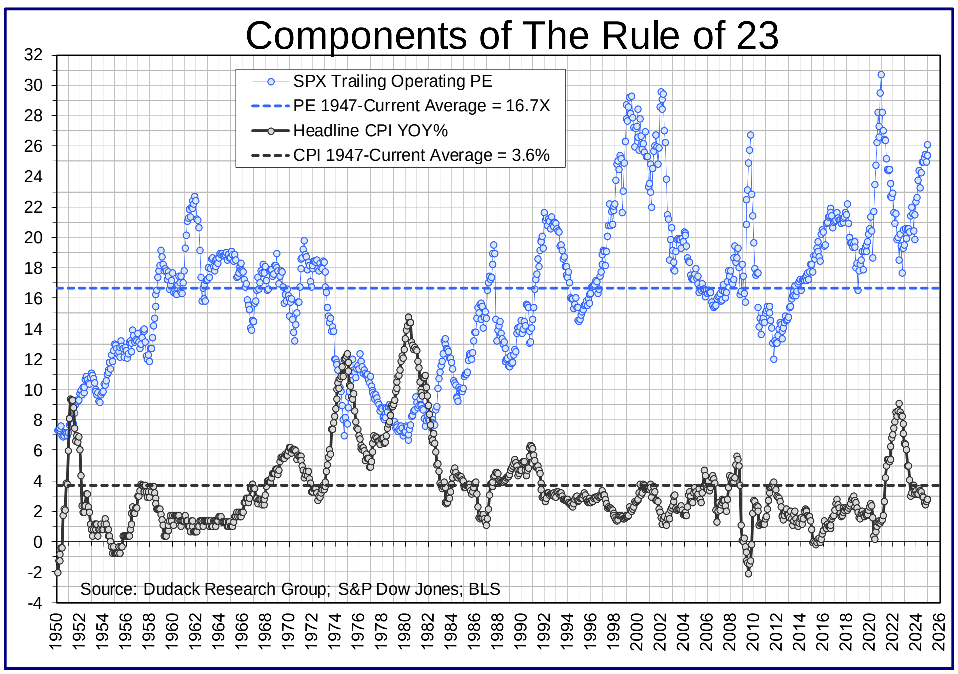
In past bubbles, the trailing S&P operating earnings multiple has reached 30 times!

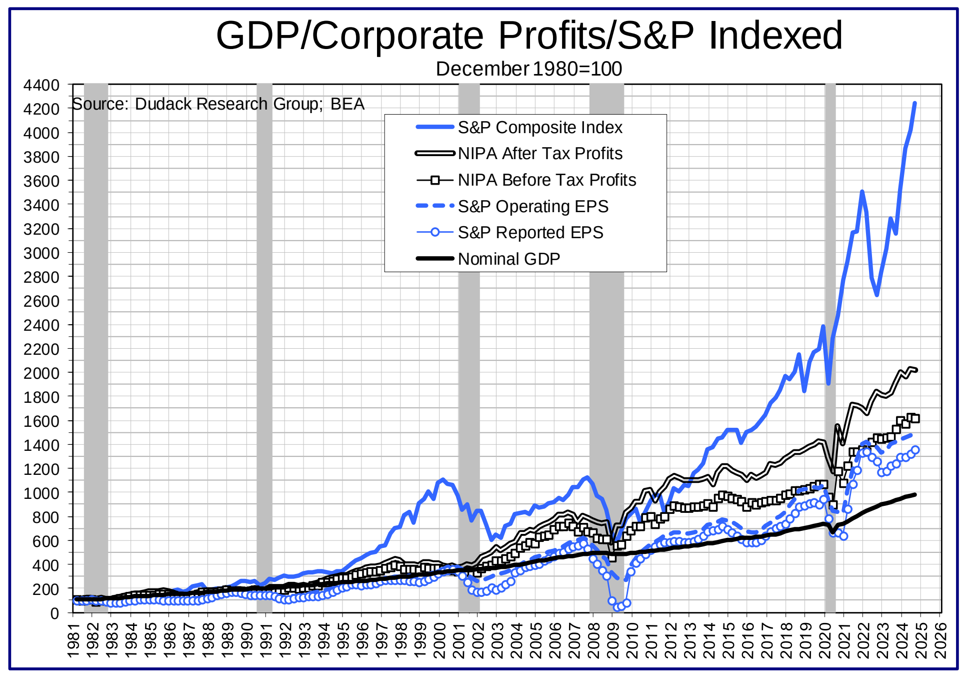


VALUATION: THE SPX IS NOW TRADING NEARLY 40% ABOVE OUR MODEL'S 2024 FAIR VALUE RANGE! (AGAIN!)

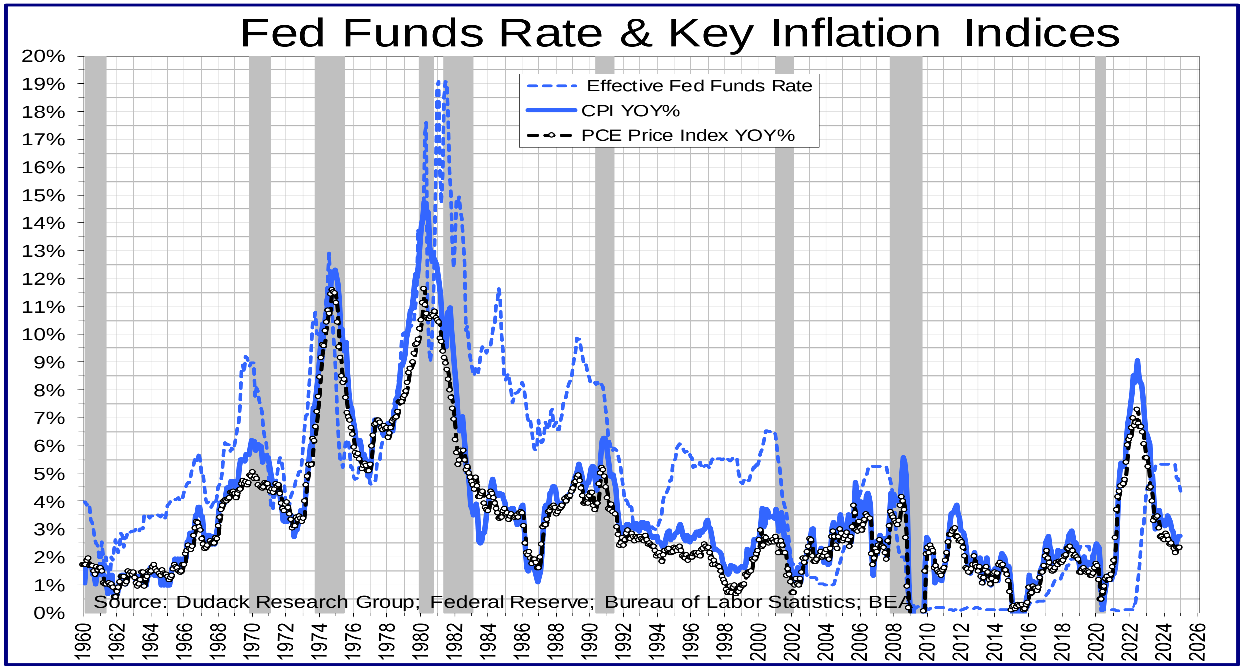


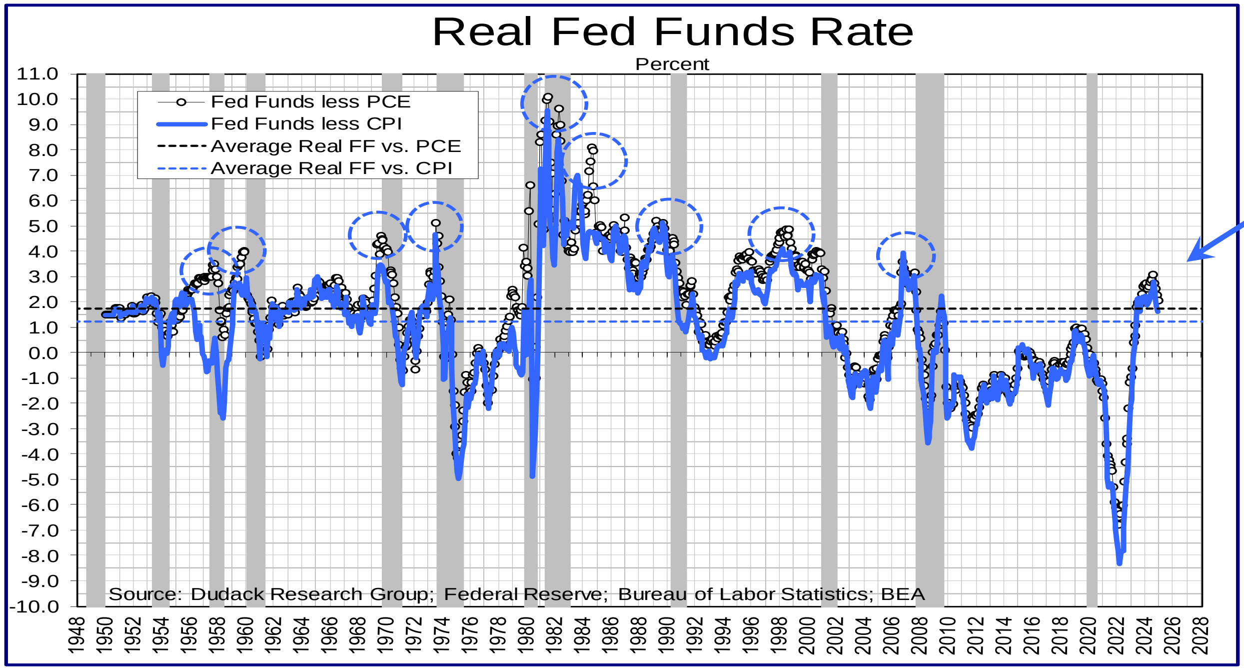
Our model incorporates our assumptions for 2025 which include GDP growth of 3.2% YOY, a 15% increase in SPX earnings, a maximum of two, or three, fed funds rate cuts, Treasury bill yields falling to 4.1%, Treasury bond yields stable at 4.3%, and inflation moderating, but still high at 2.75%. This combination gives us a predicted PE of 17.3 times and an SPX target of 5372 based on our 2026 earnings estimate.





MONETARY POLICY: THE FED WAS LATE TO ADDRESS INFLATION BUT REAL RATES HAVE BEEN ABOVE AVERAGE FOR TWO YEARS





Annual Performance

	DJIA	SP500	NASQ		DJIA	SP500	NASQ		DJIA	SP500	NASQ
1901	-8.7%	---------	---------	1943	13.8%	19.4%	---------	1985	27.7%	26.3%	31.4%
1902	-0.4%	---------	---------	1944	12.1%	13.8%	---------	1986	22.6%	14.6%	7.4%
1903	-23.6%	---------	---------	1945	26.6%	30.7%	---------	1987	2.3%	2.0%	-5.3%
1904	41.7%	---------	---------	1946	-8.1%	-11.9%	---------	1988	11.8%	12.4%	15.4%
1905	38.2%	---------	---------	1947	2.2%	0.0%	---------	1989	27.0%	27.3%	19.3%
1906	-1.9%	---------	---------	1948	-2.1%	-0.7%	---------	1990	-4.3%	-6.6%	-17.8%
1907	-37.7%	---------	---------	1949	12.9%	10.3%	---------	1991	20.3%	26.3%	56.8%
1908	46.6%	---------	---------	1950	17.6%	21.8%	---------	1992	4.2%	4.5%	15.5%
1909	15.0%	---------	---------	1951	14.4%	16.5%	---------	1993	13.7%	7.1%	14.7%
1910	-17.9%	---------	---------	1952	8.4%	11.8%	---------	1994	2.1%	-1.5%	-3.2%
1911	0.4%	---------	---------	1953	-3.8%	-6.6%	---------	1995	33.5%	34.1%	39.9%
1912	7.6%	---------	---------	1954	44.0%	45.0%	---------	1996	26.0%	20.3%	22.4%
1913	-10.3%	---------	---------	1955	20.8%	26.4%	---------	1997	22.6%	31.0%	21.5%
1914	-30.7%	---------	---------	1956	2.3%	2.6%	---------	1998	16.1%	26.7%	40.1%
1915	81.7%	---------	---------	1957	-12.8%	-14.3%	---------	1999	25.2%	19.5%	85.6%
1916	-4.2%	---------	---------	1958	34.0%	38.1%	---------	2000	-6.2%	-10.1%	-39.3%
1917	-21.7%	---------	---------	1959	16.4%	8.5%	---------	2001	-7.1%	-13.0%	-21.1%
1918	10.5%	---------	---------	1960	-9.3%	-3.0%	---------	2002	-16.8%	-23.4%	-31.5%
1919	30.5%	---------	---------	1961	18.7%	23.1%	---------	2003	25.3%	26.4%	50.0%
1920	-32.9%	---------	---------	1962	-10.8%	-11.8%	---------	2004	3.1%	9.0%	8.6%
1921	12.7%	---------	---------	1963	17.0%	18.9%	---------	2005	-0.6%	3.0%	1.4%
1922	21.7%	---------	---------	1964	14.6%	13.0%	---------	2006	16.3%	13.6%	9.5%
1923	-3.3%	---------	---------	1965	10.9%	9.1%	---------	2007	6.4%	3.5%	9.8%
1924	26.2%	---------	---------	1966	-18.9%	-13.1%	---------	2008	-33.8%	-38.5%	-40.5%
1925	30.0%	---------	---------	1967	15.2%	20.1%	---------	2009	18.8%	23.5%	43.9%
1926	0.3%	---------	---------	1968	4.3%	7.7%	---------	2010	11.0%	12.8%	16.9%
1927	28.8%	---------	---------	1969	-15.2%	-11.4%	-0.8%	2011	5.5%	0.0%	-1.8%
1928	48.2%	---------	---------	1970	4.8%	0.1%	-13.7%	2012	7.3%	13.4%	15.9%
1929	-17.2%	---------	---------	1971	6.1%	10.8%	27.7%	2013	26.5%	29.6%	38.3%
1930	-33.8%	---------	---------	1972	14.6%	15.6%	17.2%	2014	7.5%	11.4%	13.4%
1931	-52.7%	---------	---------	1973	-16.6%	-17.4%	-31.1%	2015	-2.2%	-0.7%	5.7%
1932	-23.1%	-15.1%	---------	1974	-27.6%	-29.7%	-35.1%	2016	13.4%	9.5%	7.5%
1933	66.7%	46.6%	---------	1975	38.3%	31.5%	29.8%	2017	25.1%	19.4%	28.2%
1934	4.1%	-5.9%	---------	1976	17.9%	19.1%	26.1%	2018	-5.6%	-6.2%	-3.9%
1935	38.5%	41.4%	---------	1977	-17.3%	-11.5%	7.3%	2019	22.3%	28.9%	35.2%
1936	24.8%	27.9%	---------	1978	-3.1%	1.1%	12.3%	2020	7.2%	16.3%	43.6%
1937	-32.8%	-38.6%	---------	1979	4.2%	12.3%	28.1%	2021	18.7%	26.9%	21.4%
1938	28.1%	25.2%	---------	1980	14.9%	25.8%	33.9%	2022	-8.8%	-19.4%	-33.1%
1939	-2.9%	-5.5%	---------	1981	-9.2%	-9.7%	-3.2%	2023	13.7%	24.2%	43.4%
1940	-12.7%	-15.3%	---------	1982	19.6%	14.8%	18.7%	2024	13.8%	25.2%	31.7%
1941	-15.4%	-17.9%	---------	1983	20.3%	17.3%	19.9%	2025			
1942	7.6%	12.4%	---------	1984	-3.7%	1.4%	-11.2%	2026			

Source: Dudack Research Group; Refinitiv; Blue = 2 or 3 consecutive years of double digit gains

This table highlights each time one of the popular equity indices has had two double-digit annual gains in a row (light blue) or three double-digit annual gains in a row (dark blue). Both are relatively rare.

All three indices have had three double-digit gains in: 1943-1945, 1949-1951, and 1995-1999. Each of these occurrences was followed by a significant bear market. The most dramatic advance seen in 1995-1999 (five years of double-digit gains), was followed by substantial annual losses for three consecutive years.

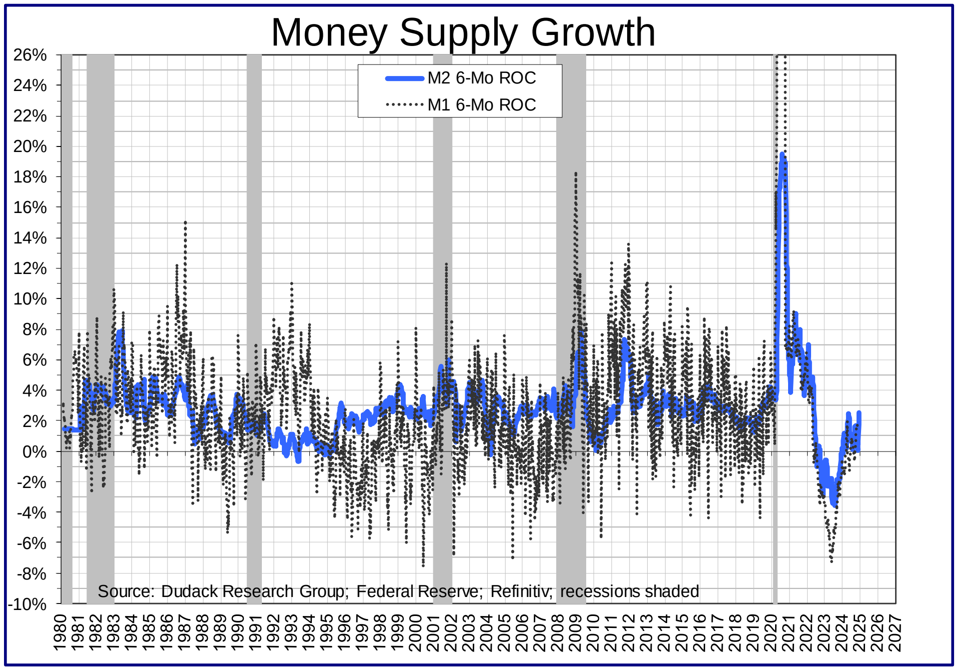
There have also been times when all three indices have had two double-digit gains in a row: 1954-1955, 1975-1976, 1982-1983, 1988-1989, 2009-2010, and 2016-2017. Each of these occurrences was followed by a weak market with negative or negligible annual gains in the averages in the subsequent year.

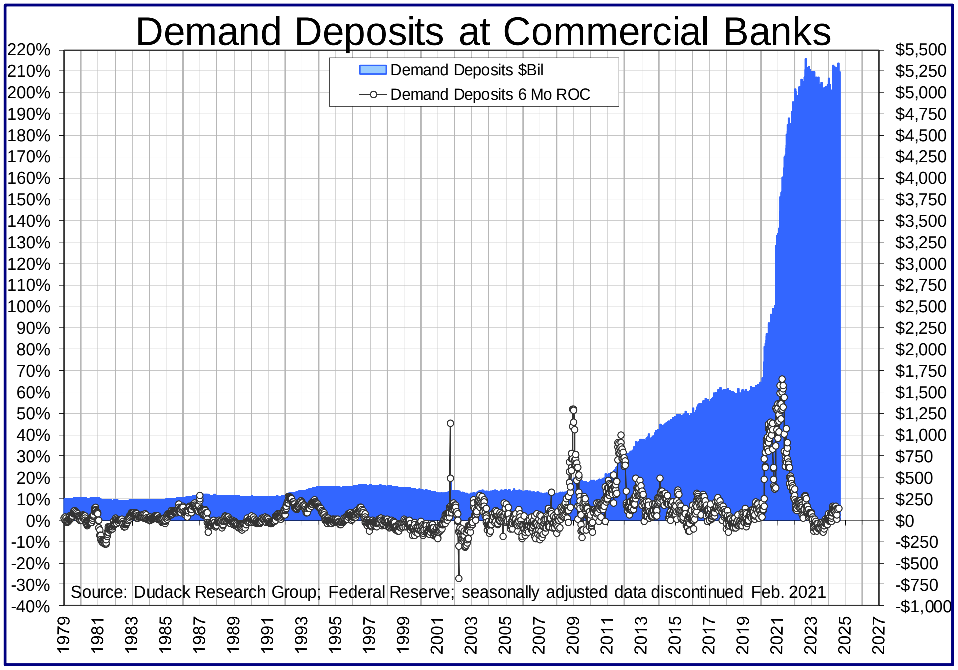
This analysis does not tell us if 2025 will be an up year or a down year, but it does suggest that 2025 could be an important pivotal year. Double-digit gains in 2025 would, in our view, confirm that the market is in the throes of a bubble.

The alternative would be a subpar performance in the equity market in 2025 during which PE multiples fall and earnings catch up with prices.

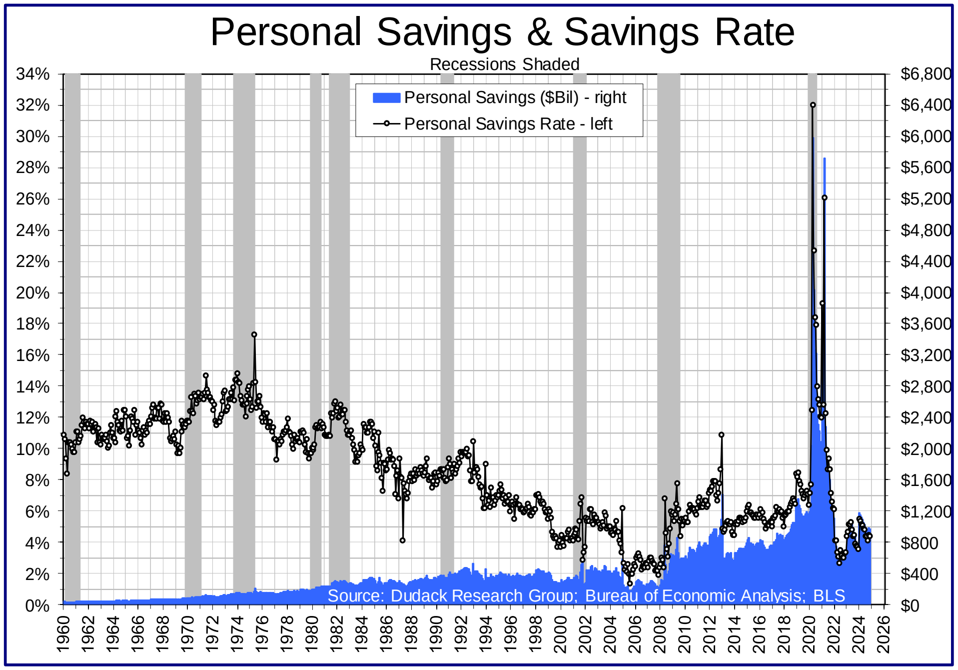
Either way, we see 2025 as a turning point for equity investors.

THE FED'S EASING IN 2024 TRANSLATED INTO HEALTHY LEVELS OF MONEY SUPPLY, DEMAND DEPOSITS, AND PERSONAL SAVINGS

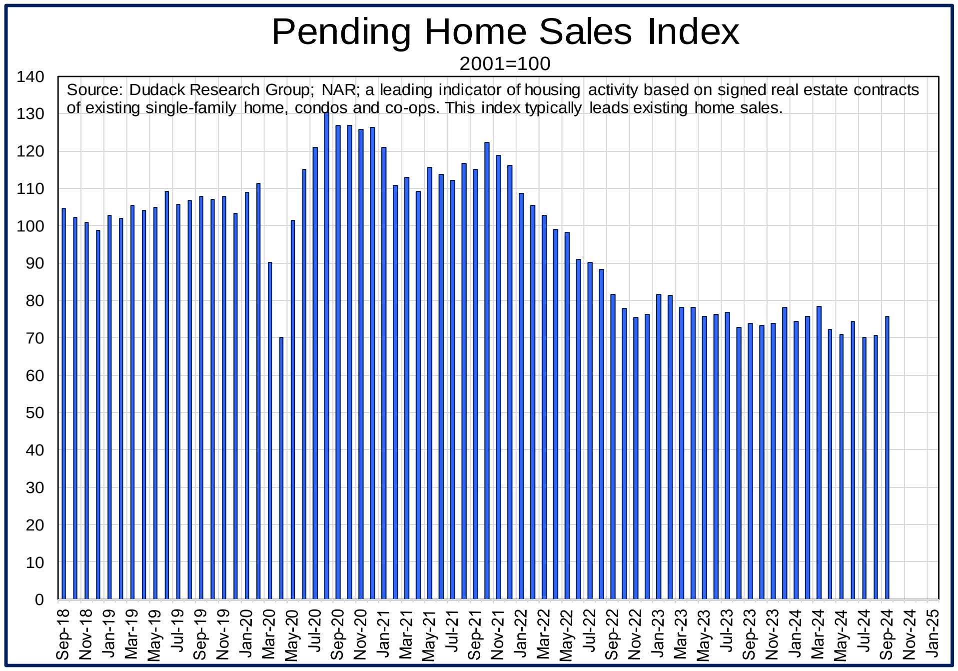


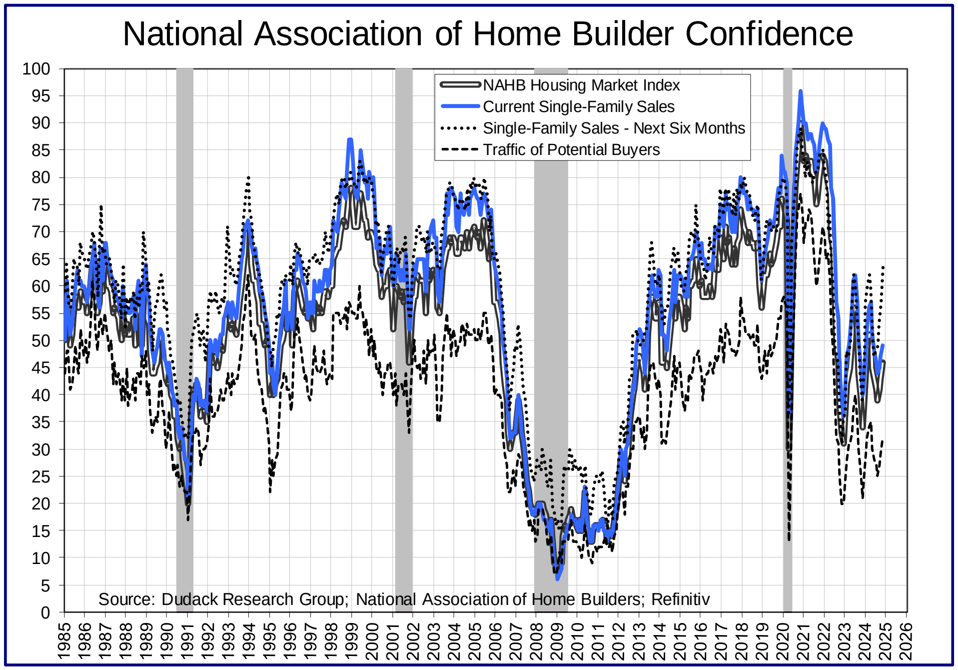


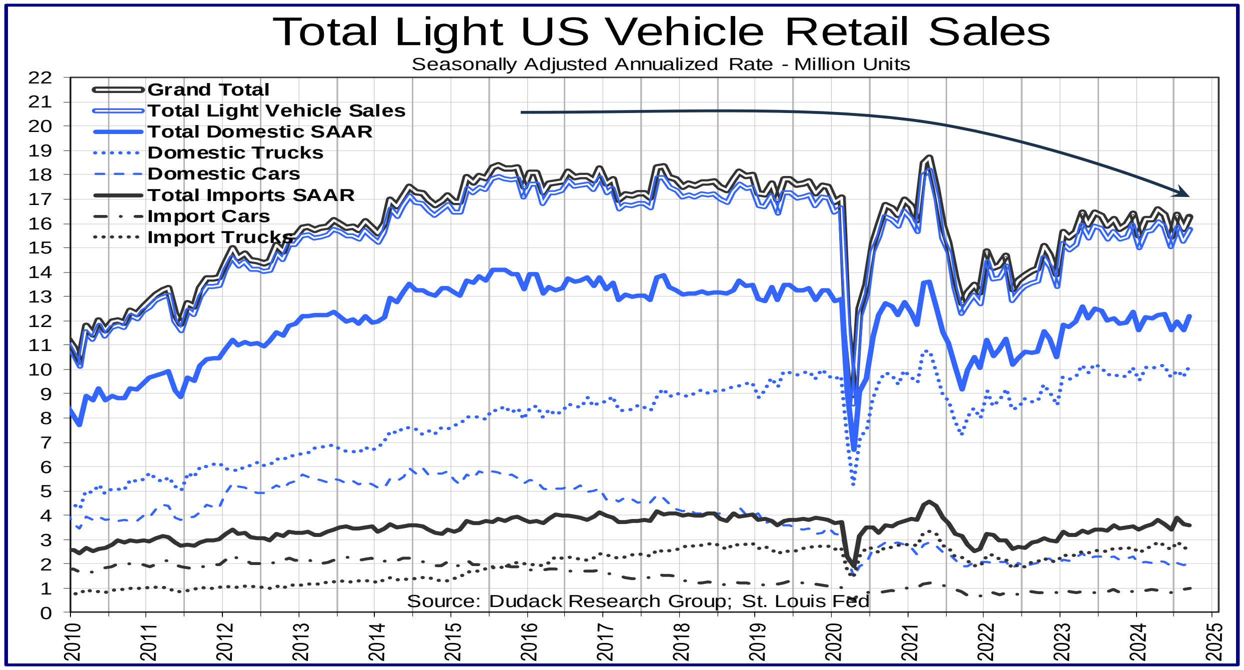
Household liquidity remains healthy, and this supports both consumption and the stock market.



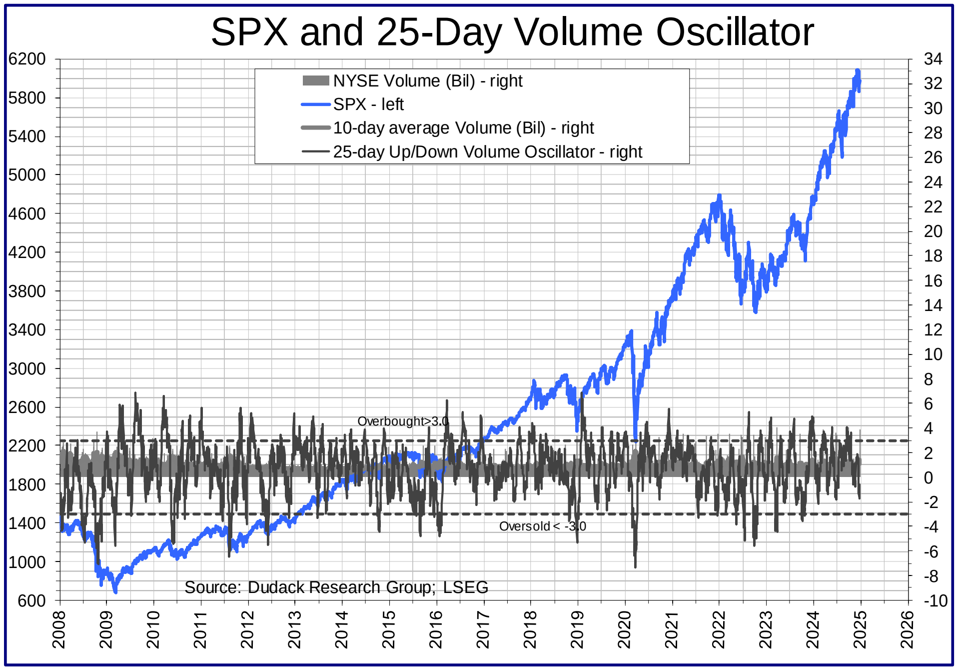
ECONOMY: HOUSING AND AUTOS ARE CORE TO ECONOMIC ACTIVITY AND BOTH HAVE BEEN DECELERATING SINCE MID-2021

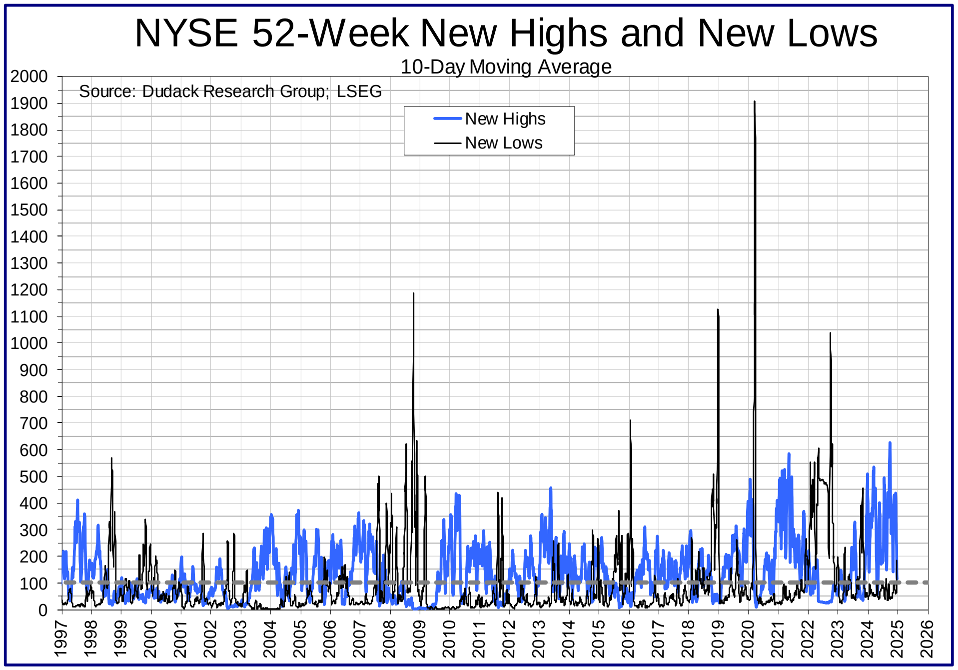


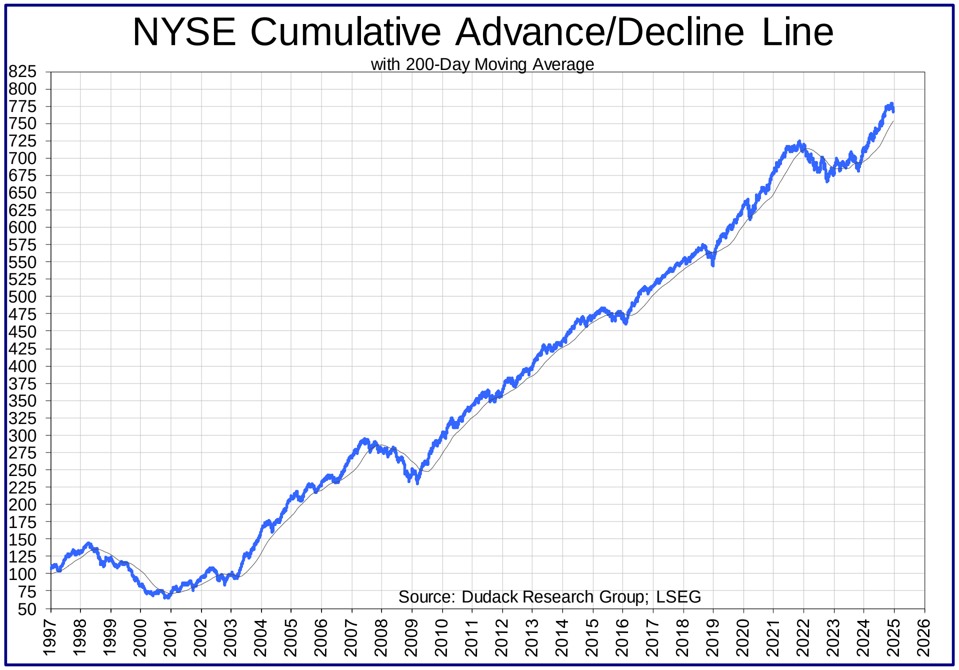


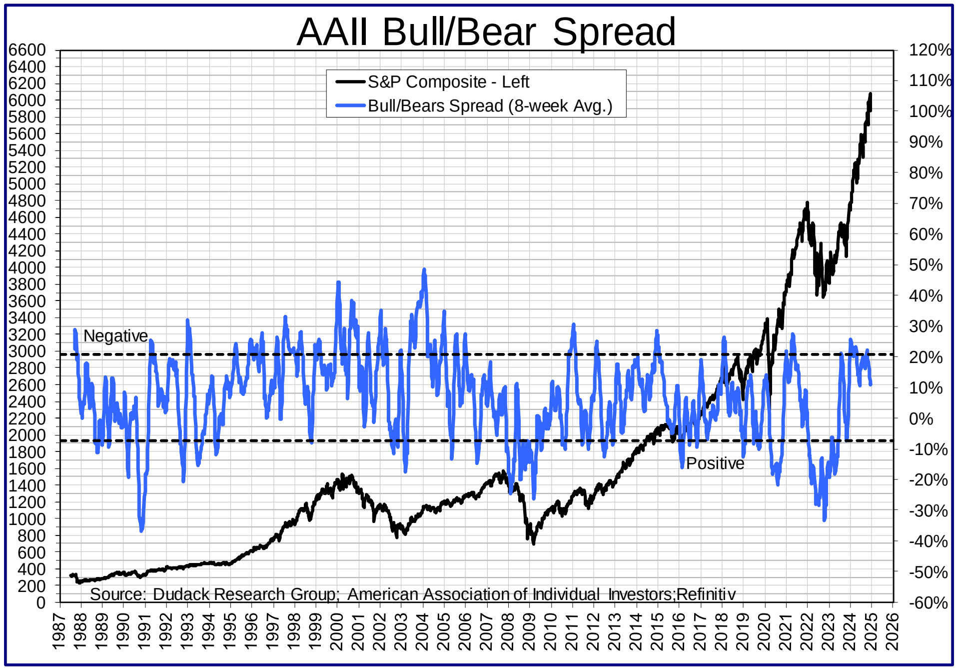


TECHNICAL: BREADTH DATA DETERIORATED IN THE SECOND HALF OF DECEMBER SHOWING INTERNAL MARKET WEAKNESS

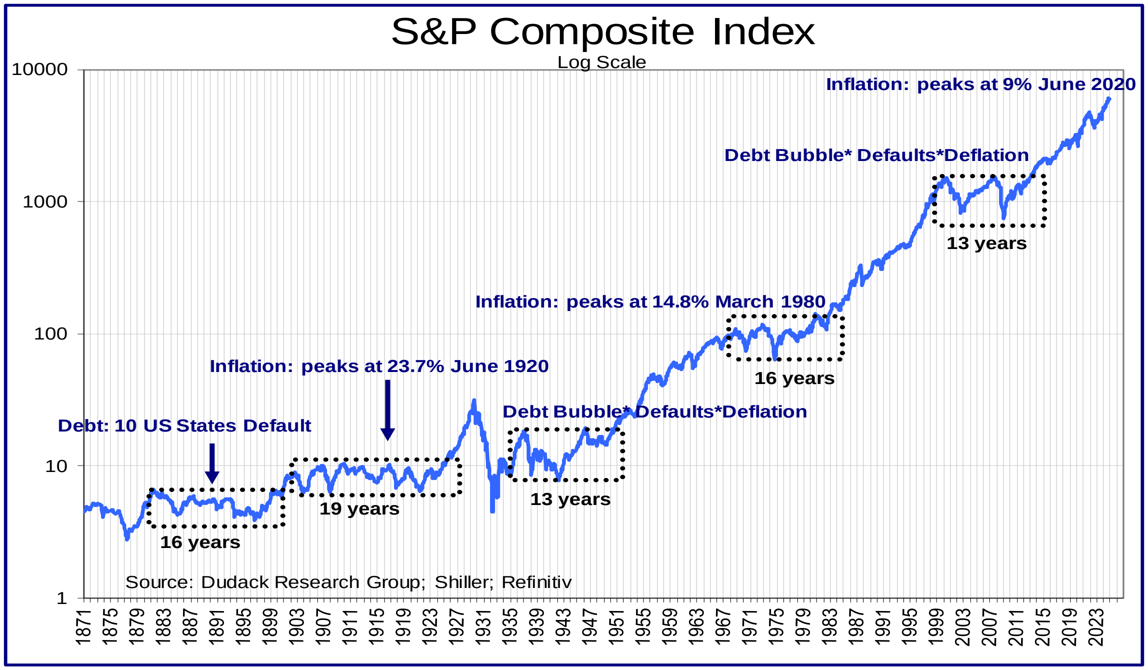


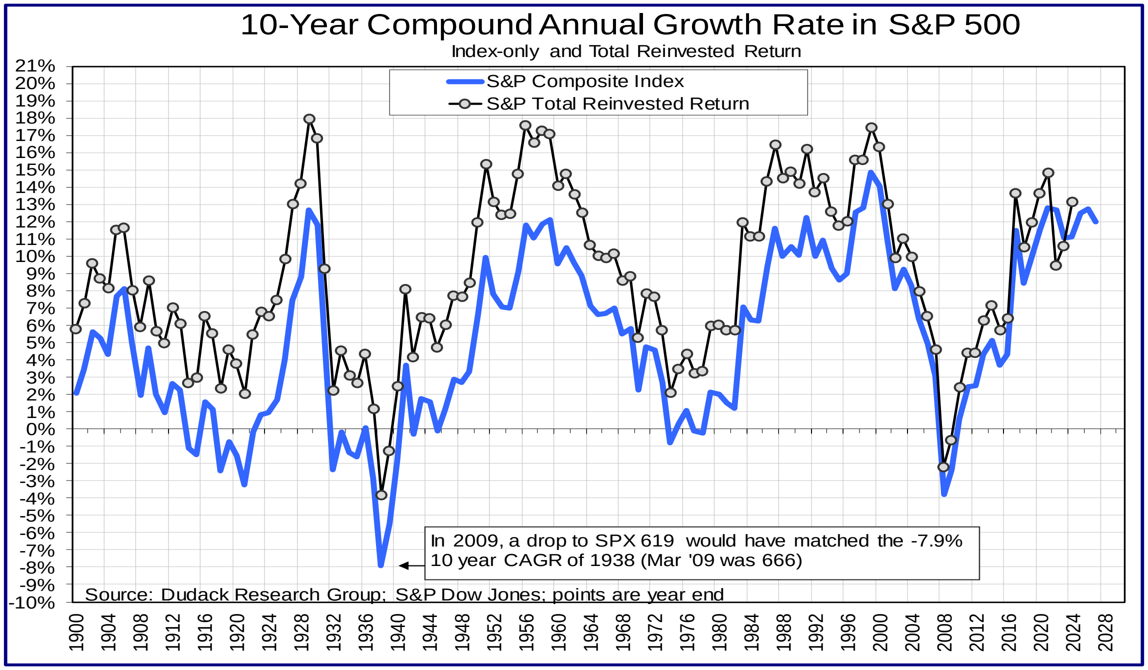






THE SECULAR TREND HAS BEEN QUESTIONABLE SINCE THE COMPOUND GROWTH RATE HIT 13% IN DECEMBER 2021





How high can a bull market cycle go?

Historically, a breakout from a major flat trend (2014) will initiate a bullish cycle with a life span of 8 to 16 years. This implies a major peak in equities could occur between 2022 and 2030 and history suggests the catalyst for the end of the cycle is apt to be high inflation.

These bull cycles rarely end before the SPX index has generated a compound annual growth rate (CAGR) of at least 12% to 15% and a SPX total reinvested return compound annual rate (CAGR) of 15% to 17%.

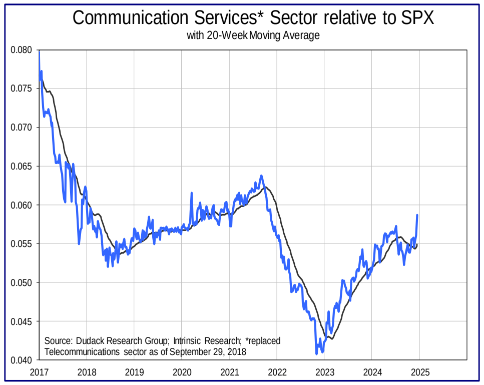
However, the SPX's 10-year compound annual growth rate reached 13% as of December 21, 2021, a level predicting at best, a flat to down year for 2022. This proved to be omniscient. But the current question is will 2025 carry this SPX up to the 15% level seen at the top of a bubble?

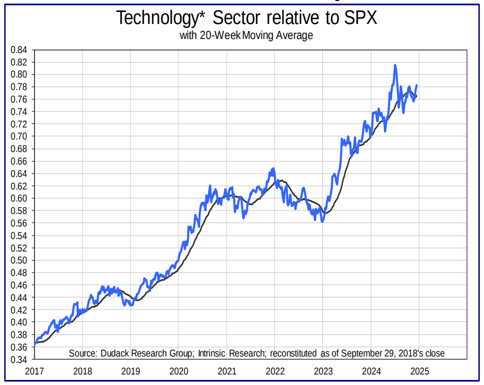
DRG Recommended Sector Weights

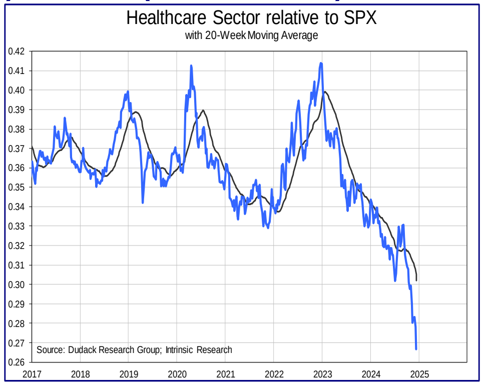
Overweight	Neutral	Underweight
Communication Services	Healthcare	REITS
Technology	Staples	Materials
Consumer Discretionary	Utilities	Energy
Financials	Industrials	

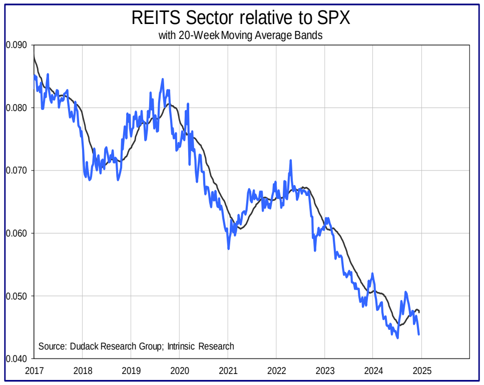
11/19/2024: Upgraded Consumer Discretionary from N to O; Downgraded Healthcare from O to N. 9/10/2024: Upgraded Utilities from U to N; Downgraded Energy from N to U.

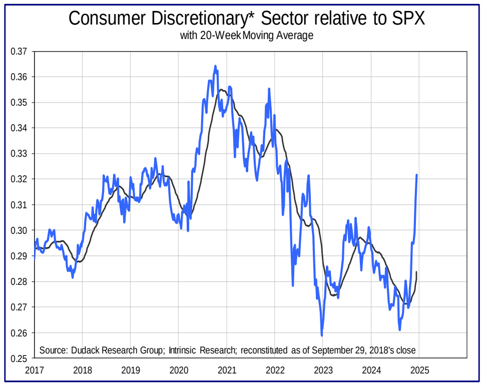
Relative Performance Charts – Trend displays relative over (trending up) or under (trending down) performance to SP500 - weekly closing prices

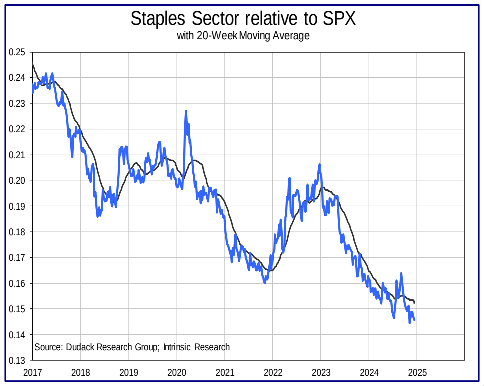


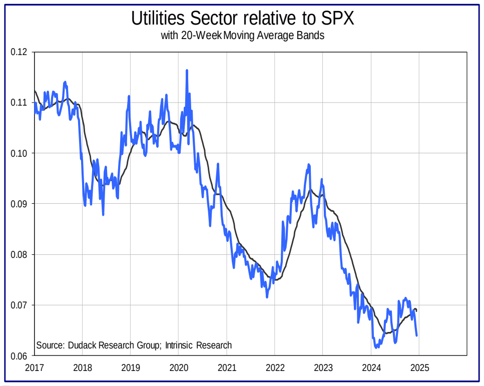


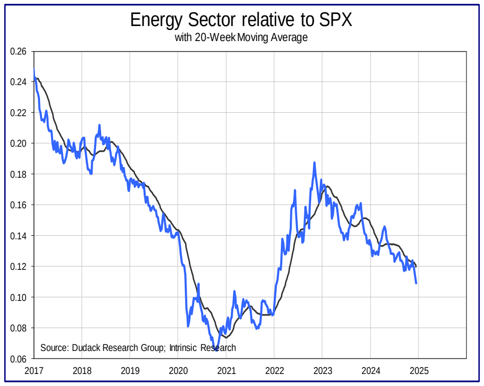


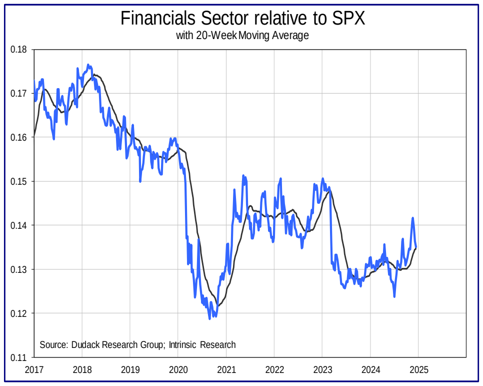


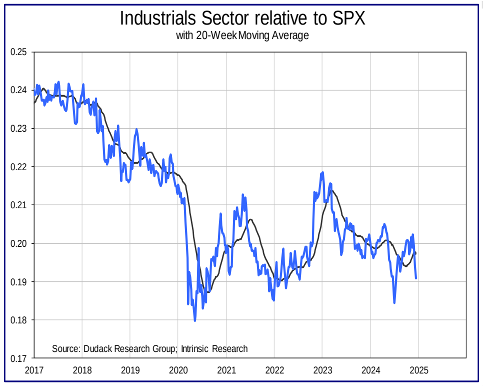








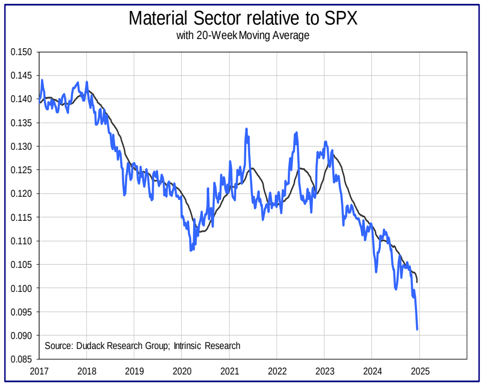




2024 Performance - Ranked

SP500 Sector	% Change
S&P COMMUNICATIONS SERVICES	41.9%
S&P INFORMATION TECH	39.2%
S&P CONSUMER DISCRETIONARY	32.5%
S&P FINANCIAL	28.8%
S&P 500	25.2%
S&P UTILITIES	20.2%
S&P INDUSTRIALS	16.9%
S&P CONSUMER STAPLES	12.9%
S&P HEALTH CARE	1.8%
S&P REITS	1.6%
S&P ENERGY	0.4%
S&P MATERIALS	-0.7%

Source: Dudack Research Group; Refinitiv; Monday closes



DRG Asset Allocation and Forecasts

	Benchmark	DRG %	Recommendation
Equities	60%	60%	Neutral
Treasury Bonds	30%	30%	Neutral
Cash	10%	10%	Neutral
	100%	100%	

Source: Dudack Research Group; 11/26/2024: moved 5% cash to equities

Source: Dudack Research Group; S&P Dow Jones; IBES LSEG Consensus estimates

	S&P 500 Price	S&P Dow Jones Reported EPS**	S&P Dow Jones Operating EPS**	DRG Operating EPS Forecast	DRG EPS YOY %	LSEG IBES Consensus Bottom-Up $ EPS**	LSEG IBES Consensus Bottom-Up EPS YOY%	S&P Op PE Ratio	S&P Divd Yield	GDP Annual Rate	GDP Profits post-tax w/ IVA & CC	YOY %
2008	903.25	$14.88	$49.51	$49.51	-40.0%	$65.47	-23.1%	18.2X	2.5%	0.1%	$1,029.90	-9.8%
2009	1115.10	$50.97	$56.86	$56.86	14.8%	$60.80	-7.1%	19.6X	2.6%	-2.6%	$1,182.90	14.9%
2010	1257.64	$77.35	$83.77	$83.77	47.3%	$85.28	40.3%	15.0X	1.9%	2.7%	$1,456.50	23.1%
2011	1257.60	$86.95	$96.44	$96.44	15.1%	$97.82	14.7%	13.0X	2.0%	1.6%	$1,529.00	5.0%
2012	1426.19	$86.51	$96.82	$96.82	0.4%	$103.80	6.1%	14.7X	2.1%	2.3%	$1,662.80	8.8%
2013	1848.36	$100.20	$107.30	$107.30	10.8%	$109.68	5.7%	17.2X	2.0%	2.1%	$1,648.10	-0.9%
2014	2127.83	$102.31	$113.02	$113.01	5.3%	$118.78	8.3%	18.8X	2.2%	2.5%	$1,713.10	3.9%
2015	2043.94	$86.53	$100.45	$100.45	-11.1%	$117.46	-1.1%	20.3X	2.1%	2.9%	$1,664.20	-2.9%
2016	2238.83	$94.55	$106.26	$106.26	5.8%	$118.10	0.5%	21.1X	1.9%	1.8%	$1,661.50	-0.2%
2017	2673.61	$109.88	$124.51	$124.51	17.2%	$132.00	11.8%	21.5X	1.8%	2.5%	$1,816.60	9.3%
2018	2506.85	$132.39	$151.60	$151.60	21.8%	$161.93	22.7%	16.5X	1.9%	3.0%	$2,023.40	11.4%
2019	3230.78	$94.55	$157.12	$157.12	3.6%	$162.93	0.6%	20.6X	1.8%	2.5%	$2,065.60	2.1%
2020	3756.07	$109.88	$122.38	$122.38	-22.1%	$139.72	-14.2%	30.7X	1.6%	-2.2%	$1,968.10	-4.7%
2021	4766.18	$132.39	$208.17	$208.17	70.1%	$208.12	49.0%	22.9X	1.3%	5.8%	$2,382.80	21.1%
2022	3839.50	$139.47	$196.95	$196.95	-5.4%	$218.09	4.8%	19.5X	1.7%	1.9%	$2,478.80	4.0%
2023	4769.83	$94.14	$213.53	$213.53	8.4%	$221.36	1.5%	22.3X	1.5%	2.5%	$3,101.80	4.0%
2024E	~~~~~	$197.87	$233.62	$233.66	9.4%	$243.64	10.1%	25.6X	1.4%	NA	NA	NA
2025E	~~~~~	$172.75	$272.42	$270.00	15.6%	$275.07	12.9%	21.9X	NA	NA	NA	NA
2026E	~~~~~	$192.43	NA	$310.50	15.0%	$310.15	12.8%	NA	NA	NA	NA	NA

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