2024 marked another year of political division and economic uncertainty, but financial market calm and strength. U.S. stocks wrapped up another strong year, with the benchmark S&P 500 Index returning 25%. This performance follows on the heels of a solid 2023, and marks the 6th year in the last 8 in which large cap U.S. stocks have returned at least 18%. As you may have guessed, large cap U.S. equities were once again the place to be in 2024, extending a winning streak of historic proportions over other asset classes. In fact, over the decade ending 2024, the S&P 500 (U.S. large caps) has returned 13.1% annually, while the Russell 2000 (U.S. small caps) returned 7.8%, MSCI Europe (European Stocks) returned 5.6%, MSCI Emerging Markets (Emerging Markets Stocks) returned 4.0% and the Bloomberg U.S. Aggregate Bond Index (Fixed Income) returned 1.4%. U.S. exceptionalism has been driven primarily by strong earnings growth over the past decade, as the technology sector delivered new innovations to the world and powerful COVID-19 era fiscal stimulus supported consumption and investment that continues even to this day. The remaining outperformance is explained by expanding valuations, with the relative premium of U.S. large cap stocks now hitting historically large margins versus other equity markets.

The drivers of the equity gains of 2024 were excitement over artificial intelligence, an unexpectedly robust economy, and a surprise red sweep in the recent U.S. elections. Artificial intelligence remained at the top of minds of investors throughout the year, as continued progress in the emerging technology has driven benefits in many areas of the economy. Most famously, semiconductor companies have been the clearest beneficiaries, with Nvidia riding their advanced AI chips to become the most valuable company in the world for a point during 2024. Aside from the technology sector, the AI boom has led to a reinvigoration for many “old economy” companies that will be needed to build out and power new AI datacenters, such as industrial companies, utility companies, and energy companies. Many companies in these sectors are reporting and projecting their highest growth rates in at least 2 decades out of the AI buildout. Next, the surprisingly robust economy has also led to companies reporting continued earnings growth, something that felt unlikely this time 2 years ago. Rewinding to October 2022, equity markets had fallen 25% from their peak, with the near consensus of economists and Wall Street strategists concluding that a recession would be coming in 2023 or 2024. Not only has that recession not arrived, but the economy has continued to show impressive GDP growth through both years. Finally, a “red wave” in the recent U.S. elections led to a stunning rally in equity markets that has since moderated. The excitement around potential regulatory relief, tax cuts, and a pro-business agenda sent stocks of all kinds soaring in November, most notably in speculative areas such as cryptocurrencies and small cap biotech. Given all of the trends noted above, the backdrop for the economy appears to remain favorable.

However, it may be a time for prudence. Sentiment around U.S. equities has reached a fever pitch, with retail flows and confidence reaching levels last seen in 2021. Valuations have grown faster than earnings in 2024, leading to an increasingly expensive equity market, one in which the largest 10 components of the S&P 500 index now trade around 50x trailing earnings, one of the most expensive measures in history. The euphoria of the election has also started to wane, with controversial staffing decisions, rising long

term interest rates, and uncertainty created by President elect Trump's negotiating style all leading to increased volatility. The creation of a new agency, the Department of Government Efficiency, led by Elon Musk and Vivek Ramaswamy has weighed on companies with revenue tied to Federal expenditures, and the elevation of Robert F. Kennedy Jr to lead Health and Human Services led to a dramatic decline in the shares of some health care and food companies. The prospect of higher deficits, inflation, and growth under a Trump administration also has led to a steady rise in long term interest rates, weighing recently on interest rate sensitive areas of the market including real estate and autos. The long awaited interest rate cutting cycle that started in September may end up being short lived if one is to believe the bond market. Finally, the sometimes unpredictable style of President elect Trump may increase volatility as the market assesses the ever changing priorities of his new Administration.

With the U.S. economy and companies the envy of the world after a long period of outperformance, and investors feeling jubilant, how much longer can U.S. large cap stocks maintain their dominance over every other asset class? Many Wall Street firms are starting to suggest that the remarkable run may be coming to an end soon. This fall, the Goldman Sachs equity research team released a paper suggesting that the S&P 500 will deliver a total return of 3% annualized over the coming decade, with a range of 1-7% compared to the 13% over the last decade. Their analysis is driven by high starting valuations, high concentration of the stock market, potential for economic contractions, and elevated interest rates. Analysis from other firms such as JPMorgan, Vanguard Group, and Morningstar reach similar conclusions: the historic valuation discount of small cap stocks and international stocks, as well as the yields offered by the bond market after 3 years of rising rates across the yield curve, will offer equal, if not better, expected returns over the next decade. While this may sound sacriledge to the current generation of investors, long periods of U.S. large cap underperformance happened not that long ago. In the decade from 2000 to 2010, the MSCI Emerging Markets Index (Emerging Markets Stocks) returned 16.1% annually, the Russell 2000 (U.S. small caps) returned 6.3%, the Bloomberg US Aggregate Bond Index (Fixed Income) returned 5.8%, MSCI Europe (European Stocks) returned 3.8%, and the S&P 500 returned 1.4%. While we are not making any bold predictions ourselves, and consider U.S. large caps to be the finest companies in the world and the continued bedrock of any sound investment program, we do think opportunities are arising in other geographies and asset classes.

As always, through the aforementioned economic and financial market volatility, we have not strayed from "staying the course" with our core portfolio of high quality equities and investment grade fixed income, knowing that patient investors with a long-term focus will come out ahead. These principles continued to pay off in 2024, and will be as important as ever in navigating changing power in Washington over the coming years.

Please do not hesitate to contact any of us in the office if you desire to discuss investment strategy or your own individual circumstances. All of us here at Graybill Wealth Management wish you a very Happy New Year and a healthy and happy 2025!