



A Franklin Templeton Company

U.S. Equity Outlook: Guarded Optimism Amid Elevated Bullishness

6 December 2024

Key Takeaways

- ▶ We expect 2025 to be a more modest but positive year for equities (compared to the current one) given ample liquidity, healthy corporate profits and animal spirits that have been buoyed by expectations of a pro-growth, deregulatory agenda.
- ▶ Our focus is on evaluating the sustainability of current fundamentals and monitoring risks that could impact this favourable backdrop. The biggest risks we see are elevated levels of bullishness in the short term and overly aggressive expectations for lower rates over the longer term.
- ▶ While mega cap stocks that have most benefited from the generative AI investment cycle could tread water near term, we expect diversified portfolios that include small and mid-capitalisation companies, as well as more cyclical companies, to benefit from continued growth across the economy.

Stocks Have Delivered Historically Strong Performance

The S&P 500 Index's advance of 28% year to date through November is the second-strongest 11-month start to a calendar year since 1997 and one of the best of all time. With a trailing 12-month return of 34% — the 95th percentile of one-year rolling returns since 1989 — it's hard to describe this run as anything but spectacular.

With Donald Trump expected to bring lower taxes and a lighter regulatory touch to his second presidential term, the stock market projects a rise in productivity and an unleashing of capital investment over the next several years. In our view, the initial impacts of Trump's victory are likely to be directionally consistent with 2016, favouring value, small capitalisation and cyclical stocks, albeit to a lesser degree given a more mature economic backdrop and current lofty valuations. Market internals, meaning the participation of different sectors, styles and market capitalisations in contributing to overall returns, affirm a stock market whose gains are broad based and indicative of a healthy investing environment.

Liquidity, the primary driver of bull and bear markets in our opinion, continues to be plentiful with credit spreads near all-time lows (Exhibit 1), capital markets funding wide open (corporate high yield issuance was +44% year to date through October) and the yield curve positively sloped for the first time in two years. Therefore, with animal spirits vibrant and expectations elevated, our focus is on examining the sustainability of current fundamentals and monitoring risks, both long and short term, which could impact this favourable backdrop.

Exhibit 1: Liquidity Has Rarely Been So Plentiful



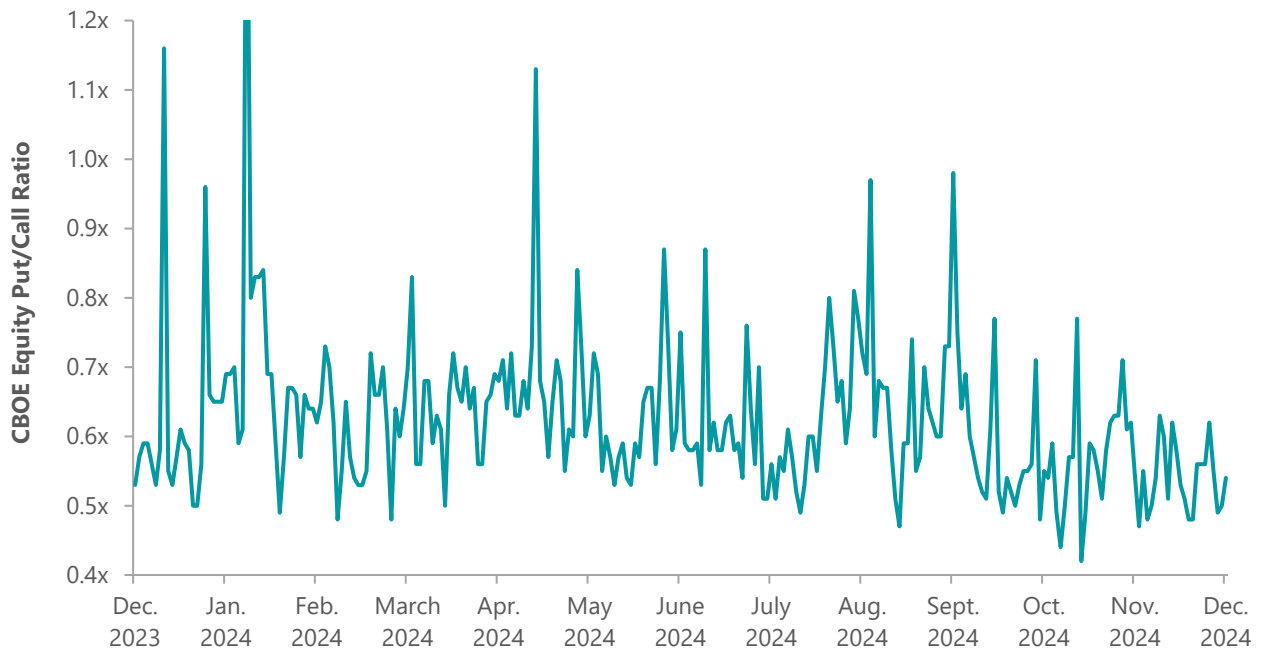
As of 30 September 2024. Source: ClearBridge Investments, Bloomberg Finance.

Perhaps the strongest driver of equity returns over the last 12 months has been the resiliency of corporate earnings defying almost all expectations, including ours, for slower growth. Bottom-up earnings estimates are projected to grow 14.6% in 2025, and while it is typical to see some softening as the year progresses, we expect solid economic growth driven by continued fiscal spending, productivity gains, stable employment trends and wage gains. We feel that potential policy changes being floated by the Trump administration are at least partially reflected in market valuations and combine pluses and minuses that will be better understood in time. That said, we are expecting a reduced regulatory regime that will unlock investments and drive a merger and acquisition upcycle, which would be positive for capital markets.

In terms of longer-term risks, our primary concern is that investor expectations for lower interest rates are too aggressive and could function as a gating factor on higher stock market returns. We believe that real interest rates going forward are more likely to be in line with longer-term historical levels, not those following the financial crisis era to which many equity investors are anchored, especially considering the likelihood for higher fiscal spending and refunding levels. While equity markets have been willing to absorb higher discount rates to date, the gradual acceptance of a “back to the future” rate regime, as well as the uncertainty of future government policy actions, will likely play a greater role in determining equity returns in 2025 than this past year.

Shorter term, we worry that near-term expectations have become too complacent, or said more plainly, too bullish. Most surveys, including the Investors Intelligence Bull/Bear Ratio, Citi’s Panic-Euphoria model, as well as current put/call ratios, show elevated levels of bullishness; historically, these have been contrary indicators and preceded below-average near-term returns. However, it should be noted that high market sentiment, like high market valuations, does not itself guarantee market weakness, but rather creates the antecedent conditions that make a market vulnerable to correction. Geopolitical issues, poor policy decisions, unexpected earnings and/or interest rate movements can all provide the unpredictable spark.

Exhibit 2: Put/Call Ratios Suggest Increasing Investor Complacency



Note: The ratio for 10 January 2024 has been excluded from the chart.

Data as of 6 December 2024. Sources: Chicago Board Options Exchange, Macrobond.

Finally, while we agree that the impact of generative AI will create game-changing technologies and opportunities for investors over the next decade, we feel that this cohort of companies, made up of market leaders for which earnings expectations are sky high, could face some volatility. As these companies are digesting recent gains, lofty expectations are likely to meet the reality of normal non-linear adoption rates, changing business models, anticipated bottlenecks and unknown returns on investment. Fortunately, over the last three to six months, investors have broadened their interests to include other subsectors of the S&P 500, contributing to further gains.

Our expectation is that 2025 will be a more modest but positive year given ample liquidity, healthy corporate profits and animal spirits that have been buoyed by expectations of a pro-growth, deregulatory agenda. Longer-term fundamentals remain solid, and we continue to expect diversified portfolios, including small and mid cap companies, as well as more cyclical companies, to benefit from further growth across the economy. However, we do expect more potential volatility throughout the year given already-stretched investor optimism amid a variety of indeterminate risks, which could prove to be a buying opportunity for long-term investors.

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