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The Magic 8 Ball

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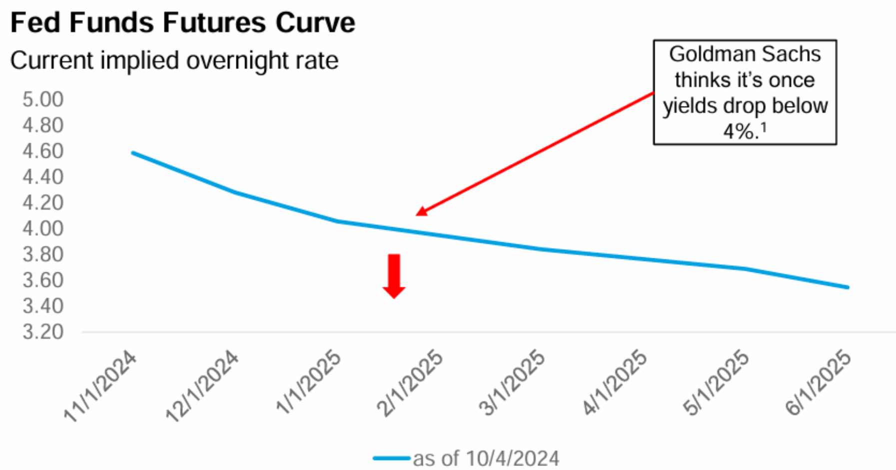
It's the time of the year that outlooks are published, and a New Year offers a clean slate for the educated analysis. However, it would be productive to look to history to help gauge where we could see things end up. Starting here could give us some context on the heels of 2 historically great years for the S&P 500. Will the good run continue? Will the market take a pause? Could we see excess triggering more than a correction? While not exactly a magic 8 Ball, could we find ourselves as John Maynard Keynes' observed: "The markets can remain irrational longer than you can remain solvent?" Or will it be a case where the market is amid what Sir John Templeton observed: "Bull markets are born on pessimism, grown on skepticism and die of euphoria?" We'll dive into all of that in this quarter's note.

2024 built on 2023's gains making 2 straight years of the S&P 500 providing 20%+ Gains. But how common are 2 consecutive years of 20% gains or more. When we look back over the prior 4 decades (See the chart below), it happened once in the 80's, but saw year 3 as a rather negative year. In the 90's, the 1st 5 years showed slow, but consistent gains, and then it went on a tear where we saw 5 years of 20%+ gains. Yet, it ended with the DotCom bust. For the next 2 decades, we didn't get to see consecutive 20%+ gains again.

While we had the S&P driven by securities, in what came to be called the Magnificent Seven in 2023, we did see the market start to broaden out a little in 2024. In 2024 we saw strong returns from tech as well as other sectors and securities. It is this broadening out that we need to see continue to help set up a healthy base for any move forward. So, will we see market irrationality or more skepticism growing the market? Morgan Stanley's Andrew Slimmon and Team (Chart Below) sees that chance coming this year. And that leads us to believe more of the Sir John Templeton Camp.

When does the cash exit the swollen money market funds?



Historically, lower yields alone do not drive assets out of money markets.

But lower yields + a healthy economy + FOMO does.[2]

1. From Goldman Sachs Tactical Flow of Funds, August 2024.
2. Dave Kostin. Goldman Sachs, October 11, 2024.

Source: Bloomberg.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** The views, opinions, and forecasts are those of the presenter and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole and may not be reflected in all the strategies and products that the Firm offers.

That doesn't mean that it will be smooth. In our earlier charts of the S&P, you can also see periods of consolidation. Given the strength of the past 2 years, a little profit taking wouldn't be surprising. Yet for the potential of 2025, the big items worth watching are both inflation and the 10 Year Treasury Yields. A surprising jump in either could get the market's attention, and potentially not in a good way. While the 10 Year seemed to react, earlier in 2024, to the employment picture, it changed and started to react toward the CPI data as CPI took a pause, on the way to the Fed's target and inflation started to regain the Fed's attention (See Chart Below). Inflation, while lower, could be the biggest risk to Treasury yields as well as the market.

The market has the potential to build on the gains of the past two years, but we will look towards market breadth and continued improvement in inflation for a gauge of how strong and durable we could see the market perform in 2025. We won't use a Magic 8 Ball, but for those opportunities, we will be looking towards history as our guide. We will also be looking at Financials, Industrials and Quality for potential opportunities to help build on the past two years of equity gains in 2025. We will do this while watching Inflation, Employment and Treasury Yields for any potential headwinds.

That's all for this quarter's note, but please let us know if you have any questions or concerns.

We are here to help!