November provided excellent returns for US stocks but many headwinds for international stocks. The S&P 500, Dow Jones Industrial Average, and Nasdaq rose 5.9 percent, 7.7 percent and 6.3 percent respectively. As a rule, smaller outperformed larger and domestic outperformed international – in our opinion, this pattern was predictable considering the Republican Federal election sweep on November 3rd. The Russell Mid-Cap gained 8.2 percent for the month, and the Russell 2000 (small caps) gained 9.4 percent. Conversely international markets declined on the back of a stronger post-election dollar and the threat of tariffs. The MSCI EAFE declined 0.5 percent and the MSCI Emerging Markets declined 3.3 percent.

The bond market rallied a little after it's rough October, having priced in perhaps a bit too much growth and inflation given the narrow majority in the House of Representatives which will likely stifle the passage of legislation. The Barclays Aggregate bond index rose 1.1 percent for the month and municipal bonds had ones of their best months of the year gaining 1.7 percent as measured by the Barclays US Municipal Bond index.

In December, we like to review our January predictions – and we made four of them. 1) We thought other investments would outperform the Magnificent Seven for the year. 2) We thought contrarianism and diversification would pay dividends and diversified portfolios would do reasonably well in 2024, despite a series of challenges. 3) We thought the Fed's 2 percent target inflation rate would likely no longer be a cap on the inflation rate, but instead a floor. 4) We thought Investors would spend most of the year worried election results would dramatically impact markets, but in the end they wouldn't.

As we write this on December the 7th, three of the four predictions appear to have been accurate. We were certainly wrong/early on our Magnificent 7 call – those stocks performed exceptionally well the first half of the year and much better than the average stock for the full year – though they have not provided much return in the latter half of the year. That said, every S&P 500 sector save healthcare is up double digits for 2024; healthcare still gained about 9.7 percent through December 7th. Our belief that markets would be much broader in 2024 than they had been in 2023 did prove correct. While the Magnificent 7 may not have faltered, the "Wee 493" had an excellent year.

Diversified portfolios did again provide good returns so far in 2024 – the absolute level of return depending on risk and allocation of course. But both stocks and bonds provided positive returns for the year as we expected. We thought bond returns might have been a little higher and stock returns maybe a tad lower, but overall, our prediction proved true.

For the full year, inflation is likely to be on the order of 2.5 percent to 2.6 percent, but we won't have final CPI data for December until mid-January. Nevertheless, expectations for a quick retreat below the 2 percent threshold held by many economists last January did not come to fruition.

Despite the Republican election sweep, their advantage in the House of Representatives remains incredibly tight. While Republicans will certainly pass some legislation with their narrow majority, Morgan Stanley thinks with regard to the markets "the majority of the fiscal policy we expect is an extension of expiring provisions in the Tax Cut and Jobs Act (TCJA).“ Another way to say that would be: tax policy will likely stay the same as it is now so we do not expect much in the way of new fiscal stimulus. It’s not surprising then that markets neither exploded nor imploded as the election wrapped up. There were some election winners and losers of course, but you’d be hard pressed to make the case the election produced much drama in the stock or bond market.

As we head into the Holidays, we do have a sense of optimism about 2025. It is certainly true that stocks are not inexpensive by historical standards, but earnings growth has been robust and continues to be well distributed. We believe inflation will remain sticky and rates may not fall as much as bond investors looking for quick returns would prefer. Morgan Stanley thinks the Fed will pause rate cuts by the second quarter of 2025. That said, the pause in cuts and sticky inflation will likely be predicated on stronger global growth – not a terrible environment for equities. Morgan Stanley research anticipates 13% earnings growth in 2025. Bond investors may be in once again for a single-digit kind of year.

Seth Carpenter, Morgan Stanley’s Chief Global Economist, summed up the reasons for stock optimism and mild bond expectations succinctly in this month’s On the Markets.

GROWTH. We see another couple years of near-3% per year global growth.

INFLATION. We believe global disinflation will slow and be dispersed, as inflation in major developed market economies continues to stabilize after the COVID surge.

MONETARY POLICY. We see monetary policy becoming more complicated, consistent with our expectation for the Federal Reserve to continue cutting until its May meeting, when price gains from tariffs and residual seasonality push up inflation and force a pause.

Setting aside our cautious optimism about the average stock’s earnings growth in in 2025, we are getting quite concerned about the average investor’s risk appetite. To be clear, it’s not just the recent string of positive returns or even the slightly-above-average forward price-to-earnings ratio of the average stock. Market returns, while certainly good post-Covid and post-2022 inflation crisis, are not historically unprecedented. There have been many periods that provided longer strings of good index returns with higher average PEs. On the other hand, as contrarians, we always remember to be fearful when risk appetite is increasing. According to data from Bank of America cited by Richard Bernstein advisors this past month, in the aggregate, investors may now hold more equity risk (equity portfolio weighting times the relative volatility of the equities they actually hold) than at any other time since the technology bubble of the late 90s. Perhaps this explains Warren Buffet’s decision to liquidate 705 million Apple shares in 2024, about 70 percent of Berkshire’s holdings. As the Oracle of Omaha often reminds his followers, ”When others are greedy, be fearful. When others are fearful, be greedy.“

We have already begun making changes to discretionary accounts to tilt toward value and away from growth, add mid and small cap exposure, and further diversify fixed income holdings in the wake of the election results. We will of course provide our 2024 full year recap and 2025 predictions in our January note. In the meantime, we wish you and yours the happiest of holiday seasons.

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Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, local tax-exemption typically applies if securities are issued within one's city of residence. The tax exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Diversification does not guarantee a profit or protect against loss in a declining financial market.

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