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One of the most difficult things to do in sports is to be a repeat champion. Likewise, it is unusual for market leaders to repeat, although that is exactly what happened in 2024. Large cap growth stocks returned 37% for the year, after a return of over 30% in 2023. During these two years, that is the highest returning market cap and style return, and more than twice the gain of its value counterpart both years. All in all, it was a good year for equities, although the returns came from a relatively small number of mega cap growth stocks. While the cap weighted S&P 500 posted a gain of 25% for the year, the average stock did not fair nearly as well, as the Dow Jones Industrial Average returned 15%, the S&P 500 Equal Weight Index returned 12.8%, and Russell 2000 small cap index gained just 11.4%.

The fourth quarter of 2024 brought positive total returns of 2.4% for the S&P 500, but only four of its 11 sectors posted gains quarter-over-quarter. Over the same time frame, the Russell 2000 Index, the small-cap benchmark, gained 0.3%, while the Bloomberg US Aggregate Index, a broad measure of the US bond market, decreased by 3.1%. The yield on the 10-year US Treasury note closed the fourth quarter at 4.57%, while the yield on 3-month Treasury bills was 4.31%. This rise in yields came despite the fact the Federal Reserve cut the federal funds rate by 50-bp total, with one 250bp cut in November and another 25-bp cut in December. Labor market resilience, sticky inflation, and the potentially reinflationary policies of the incoming Presidential administration have turned the Fed increasingly hawkish. Payrolls surprised to the upside in November, but the overall unemployment rate rose slightly to 4.2%, in the same general range as the last few months.

With the current economic backdrop, the Global Investment Committee (GIC) is market-weight equities and market-weight fixed income. In equities, the GIC recommends large-cap value and mid-cap growth, as they may be the biggest beneficiaries of the incoming administration's focus on deregulation and tax cuts. The GIC shifted to underweight for international developed and moved to overweight for emerging market equities. The GIC maintains neutral positioning in fixed income assets and does not recommend taking relative duration risk as it believes current US Treasury yields are close to "fair value." They advocate that investors rely on higher-quality sectors for income and as a potential offset against the downside surprise of a slower growth trajectory.

On the labor market front, the November payroll report came in stronger than expected, with 227,000 jobs added in the month vs. economists' consensus of 220,000, stalling the cooling labor market narrative. Inflation data was mixed throughout fourth quarter 2024, rising slightly to 2.7% in November, dampening the likelihood of aggressive Federal Reserve rate cuts in 2025. The Fed continues to weigh its dual mandate of keeping inflation low and maintaining strength in the job market while being sure to not overheat the economy by cutting rates too rapidly. MS & Co.'s Economics team believes that there will now be only two 25-bp cuts in 2025, one in March and one in June.

In the end, 2024 was another year dominated by narrow breadth, with the majority of the returns coming from a small number of mega cap growth stocks. As illustrated in the accompanying chart, the Mag 7 is likely to mean revert in 2025.

While repeat sports champions are uncommon, three-peat champs are even more uncommon, especially in recent history, with the last time happening more than 20 years ago when Los Angeles won the NBA title for the third straight year. This year, Kansas City will be attempting to three-peat as Super Bowl champs. I believe the odds are against them winning again, just as US large cap growth stocks may fail to lead the market in 2025. Overall, with the equity risk premium at the lowest levels since 2002, we believe volatility will be back this year, and market gain may be muted compared to the past few years. Stay tuned in to find out!

As always, please reach out to anyone on our team if you have any questions, and we hope 2025 is a safe, healthy, and prosperous year for you and your family!

Best Regards,

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Sources:

Morgan Stanley Q4 2024 client market commentary letter
Morgan Stanley Wealthbook Slides, December 2024

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For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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