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US stock markets marched higher during the 4th quarter, powering higher by double-digit returns for the second straight year. Following the best two back-to-back years since 1997-1998, the S&P 500 is priced optimistically for a "goldilocks" economy with the belief that rich forward valuations will hold while earnings growth accelerates. The Federal Reserve continued the rate-cut cycle that it began in September by cutting rates by 50 basis points (i.e., ½%) total in the 4th quarter, with one 25bps cut in November and another 25bps cut in December. Despite the rate cuts, interest rates on longer-term government bonds shot higher by the end of the year.

The most popular benchmarks for US stocks all closed the year out with positive performances. The S&P 500 and Dow Jones Industrial Average indexes posted gains of +2.4% and +0.9% during the 4th quarter, allowing them to finish the year +25.0% and +15.0%, respectively. It was the Nasdaq Composite index yet again, led by the market's largest technology companies, which finished with the largest gains. The Nasdaq returned +29.6% for the full year after tacking on +6.4% during the final three months of the year[i].

Headlines make it look like it was another banner year broadly for domestic stocks. A fuller story, however, is told under the surface. Because of the extreme concentration of market capitalization that has been developing, as we've discussed in these letters over the past year or so, a select handful of stocks – mostly megacap technology companies known as the "Magnificent 7" – dominated trading and almost single-handily pushed the S&P 500 and Nasdaq Composite indexes to record highs. Such dominance by just a few stocks is a sign of poor market health and is a cause for concern. As market analyst, Carter Worth, points out: *"The Russell 3000 Index, representing approximately 98% of the investible US equity market, was +22.15% in 2024, yet the median performance of the index's constituents was +3.82%. This is sobering. Fully 1,331 stocks in the Russell 3000 (45.7% of the index) were DOWN on the year, while 1,581 stocks (54.3%) of the index were UP on the year. That's even more sobering.[ii]"*

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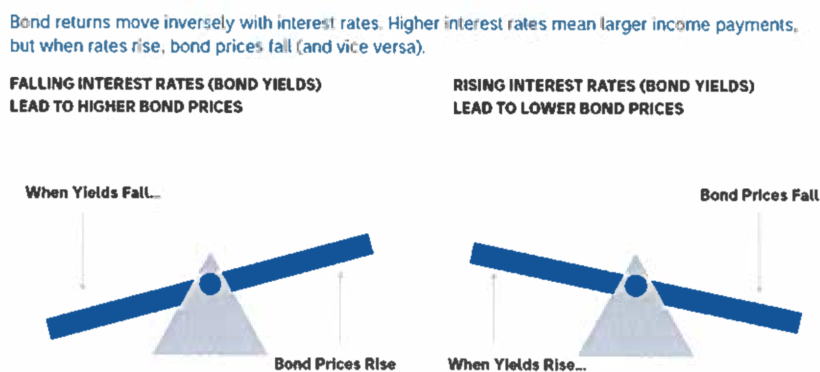
Overseas stocks had a much tougher time during the 4th quarter, as a stronger US dollar factored in to be a major headwind. Developed-economy stocks (as measured by the MSCI EAFE index) and the still-developing-economy stocks (as measured by the MSCI Emerging Markets Index) each lost about -8% during the quarter. These indexes finished the year with much more muted returns, relative to domestic stocks at least, of +3.8% and +7.5%, respectively. The dispersion between US and overseas stocks has rarely, if ever, been this wide for this long[iii].

The Bloomberg US Aggregate index, the benchmark for taxable bonds, posted a loss during the quarter of -3.1%. This loss was largely a result of interest rates moving up – the opposite of the Federal Reserve's rate cut intentions. The bond index finished the full year 2024 with a small gain of +1.3% with the yield on the closely-followed US Treasury 10-year bond finishing at 4.57% – near the highest levels of the year[iv]. The simple chart below serves as good reminder of the relationship between interest rates and bond prices.



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office
Note: Bond prices may also be influenced by other factors such as credit quality, default, and reinvestment.

Outside of the traditional stock and bond asset classes, the broad Bloomberg Commodity index was nearly flat again during the 4th quarter leaving it with a YTD gain of +5.4%[v]. Oil finished the year at $71.72/bbl, ending at essentially the same price as the beginning of the year. Gold bullion, one of our team's favorite asset classes due to a multitude of factors, appreciated over +27% in 2024, the most in 14 years. Although this outperformed most major asset classes, it still seems to be the Rodney Dangerfield of the investment world – "No Respect!"

Based on the most reliable gauges of historical market valuation, our team continues to believe that we are in the midst of the one of the greatest speculative bubbles in US history. The stock market is overvalued relative to even previous peaks, with almost all metrics (more than just one!) in the 97-99% of historical extremes. Stocks could stay overvalued or become even more overvalued over the near term, but the probability of low, or shall we dare say even poor, returns over the next few years almost seems inescapable at this point.

	Latest	Month ago	Beginning of year	Percentile since		
				2000*	1970*	1950*
P/E ratio (LTM)	28.32	29.21	25.09	82%	89%	92%
P/E ratio (NTM)	23.66	24.41	21.68	99%		
CAPE ratio	37.35	38.03	32.37	98%	95%	96%
Dividend yield	1.24%	1.22%	1.47%	99%	97%	98%
P/Sales ratio	3.09	3.14	2.59	99%	100%	100%
P/Book ratio	5.21	5.29	4.43	100%	100%	100%
Q ratio	2.34	2.38	1.95	99%	100%	100%
Buffett ratio (Market cap/GDP)	2.02	2.07	1.73	97%	99%	99%
Average household equity allocation	51.8%	51.8%	48.3%	99%	100%	100%
S&P 500/M2 money supply ratio	0.28	0.28	0.23	100%	96%	

* 100% most bearish Source: Hulbert Ratings

Source: Hulbert Ratings

In addition to overvaluation, market sentiment appears to be excessive. *Barron's* magazine had a cover story titled: "Stocks Could Gain Another 20% in 2025. Embrace the Bubble." Meanwhile, CNBC ran a story, "Jim Cramer explains why you should look toward more cult stocks in 2025." The speculative mania has not been contained to just the largest tech stocks and index funds, but has spilled over to gambling-like vehicles such as cryptocurriences. Since the election, a brand new crypto coin called Fartcoin (not misspelled, and one of the 16,000 or so cryptocurrencies, or electronic gambling tokens, as we like to call them) soared over +2,000% to more than $1 billion in "value" while Dogecoin, initially created as a joke, grew to be "worth" $46 billion[vi], making it more valuable than entire companies like Ford Motor Co, General Mills, and Delta Airlines.

But is this a bubble? As Howard Marks of Oaktree Capital recently wrote, a bubble is "more of a state of mind than a quantitative calculation." He outlines his definition of a bubble as being characterized by not only a rapid rise in stock prices, but highly irrational exuberance, outright adoration of the investment and a belief that they can't miss, and a fear of missing out ("FOMO")[vii]. Lastly, these factors are usually accompanied by a widespread belief that "there's no price too high." When you can't image any flaws in the argument and are terrified that your office colleague/golf buddy/brother-in-law will own the investment in question and you won't, its hard to conclude there's a price at which you shouldn't buy.

"The greed itch begins when you see stocks move that you don't own. Then friends of yours have a stock that has doubled; or if you have one that has doubled, they have one that has tripled. This is what produces market tops. Obviously no one rationally would want to buy at the top, and yet enough people do to produce a top. It is really quite amazing how time horizons and money goals can change when there are stocks around that are going up 100% in six months. Finally it all turns into a marvelous carmagnole that is great fun if you leave the party early.[viii]"

– Adam Smith, The Money Game, 1967

(Side note: If you're like us, you may not have recalled seeing the word "carmagnole" before. Apparently it was a song and dance during the French Revolution.")

With stock market valuations sky-high and low probable returns to follow, our team continues to focus on optimal means to manage those mounting risks. As investors think what the next few years might look like, they may think "making plus-or-minus-2% wouldn't be the worst thing in the world." That would certainly be true if stocks were to sit still while underlying valuations caught up to prices. But another possibility is that a significant drawdown occurs and is compressed into a year or two, similar to the big declines we saw in stock prices in 2000-02. In such a scenrio, the impact to an investment portfolio may not be benign. The new year is a great time to reassess your financial goals, to be brutally honest with yourself around your comfort level with investment risk, and to evaluate how this all aligns with your long-term financial goals.

Our team stands ready to help and assist in any way that we can. We thank you for the opportunity to be of service. We are always available to help address any questions or concerns that you may have. Please do not hesitate to reach out to us at any time.

Happy New Year,

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i All domestic equity index returns courtesy of Morgan Stanley Capital Markets Research
ii "Recalibrating Our Crystal Ball" by John Hathaway of Sprott Investment Management, January 8, 2025
iii All international equity index returns courtesy of Morgan Stanley Capital Markets Research
iv All fixed income index returns courtesy of Morgan Stanley Capital Markets Research
v Commodity index returns courtesy of Morgan Stanley Capital Markets Research
vi "Running on Empty?" by Fred Hickey of The High-Tech Strategist, January 1, 2025
vii "On Bubble Watch" by Howard Markets of Oaktree Capital, January 2025
viii "Ring Out, Wild Bells" by John Hussman of Hussman Investment Trust, December 2024

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A basis point is defined as one hundredth of one percent (1%), used chiefly in expressing differences of interest rates.

An investment cannot be made directly in a market index. For index and indicator definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-defnitions

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