Equity Insight
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Monthly Equity Market Topics

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In brief

- A promising 2025 for equity markets — or not?
- US economy fundamentally strong
- Valuation risks loom large
- Trump 2.0 will bring uncertainty
- How much will Mag 7 monetize generative AI?

The US economy's strength provides reason for optimism, but elevated valuations and policy uncertainties necessitate a balanced and disciplined approach. Investors should focus on companies with realistic growth prospects, strong fundamentals and a demonstrated ability to navigate evolving economic and geopolitical conditions. As 2025 unfolds, the interplay between macroeconomic stability, technological innovation and policy decisions will shape the trajectory of equity markets and business performance alike.

A Promising 2025 for Equities or a Call for Caution?

The US economy enters 2025 with strong macroeconomic momentum, raising critical questions for investors and business leaders. Can this translate into another strong year for equity returns? While recent history has shown robust performance — two consecutive years of 20%+ gains in the S&P 500 Index — historical data suggest that such streaks are exceedingly rare. Since 1927, three consecutive years of 20%+ returns have only occurred during exceptional periods, such as the 1990s bull market and the Roaring Twenties. Could 2025 mark a new chapter, powered by AI and economic resilience?

Macroeconomic Strength Providing a Solid Foundation for Economy

The US economy is fundamentally sound, with steady growth expected. Key factors shaping this optimism include the following:

- **Real GDP Growth:** Projections place GDP growth in the mid-2% range, reflecting strong economic fundamentals.
- **Earnings Growth:** Analysts forecast a 14.5% increase in corporate earnings on the back of continued margin expansion, driven by deregulation, extending and potential new tax cuts, stable energy prices and falling input costs.

- **Consumer Spending and Industrial Recovery:** Consumer spending remains robust, bolstered by real wage growth and low unemployment. Meanwhile, manufacturing PMIs, although still negative, show signs of recovery.
- **Inflationary Stability:** Inflation remains well contained in the mid-2% range, and short-term rates are trending lower, creating a supportive environment for equities.
- **Supportive Technicals:** Confidence and sentiment are high, driving flows into equities while equity supply remains constrained. The US Federal Reserve cutting rates during strong earnings growth should further support markets.

Valuation Risks Looming Large

Despite a promising economic backdrop, elevated valuations pose risks for equity markets.

- **High Multiples Across Metrics:** The S&P 500 is trading at near-historic valuation levels, with price-to-earnings ratios (both current and forward) reflecting significant optimism about future profitability. This is true for a number of other metrics, *e.g.*, price to sales, book to price or EV to sales.
- **Potential for De-Rating:** Rising 10-year Treasury yields, which we believe are more relevant for equity markets than the federal funds rate, are now above 4.5% and could apply downward pressure on equity valuations. Historically, multiples tend to contract in response to rising rates or heightened economic uncertainty. Sustained higher 10-year yields are likely to be a drag for equity returns, and the “un-inversion” of the 2s-10s curve might be a harbinger of an economy slowing faster than we think.
- **Earnings Sensitivity:** Elevated expectations heighten the risk of sharp revaluations for companies that fail to meet earnings targets.

Policy and Geopolitical Uncertainty

The incoming administration introduces a new layer of unpredictability that could shape market outcomes.

- **Pro-growth Initiatives:** Proposed tax cuts, deregulation and lower energy prices could extend economic tailwinds.
- **Potential Headwinds:** Tariffs, trade tensions and stricter immigration policies may increase costs and dampen economic growth.
- **Geopolitical Risks:** Trade disputes, particularly with China, could disrupt supply chains and impact revenues for US companies with significant international exposure.
- **Idiosyncratic Risks:** RFK Jr.’s impact on health care and Trump’s on Fed independence
- **Fiscal Policy:** Continued loose fiscal policies have the potential to keep bond yields elevated. While most commentators see limited success for the Department of Government Efficiency in cutting government spending, investors should not underestimate the positive impact that running large deficits with a strong economy and low unemployment has had on corporate profitability over the past few years.

Markets are constantly trying to price the future based on what we know today, and all of the above is well known and understood. Nearly half (42%) of last year's 25% return came from multiples expanding, reflecting upbeat expectations for US earnings and profitability. We think investors should brace for heightened market volatility as these policies take shape and geopolitical developments unfold.

All in all, it should be a relatively decent year for US equities, but expecting 20% returns may be a bridge too far as multiple expansion wanes, having priced in the good macro news.

Ability of the Magnificent Seven to Monetize Generative AI

The performance of size and value and the overall performance of the S&P 500 will likely be determined by what the Mag 7 does. While we expect earnings to broaden out over 2025 and provide many more opportunities for investors (only 30% of stocks outperformed the S&P 500 over 2024), a key driver of returns will be the growth in generative AI revenues and whether the expectations priced into the Mag 7 are met or exceeded.

These seven companies represent 34% of the S&P 500 index and a whopping 56% of the Russell 1000® Growth Index and are central to the generative AI revolution, with their ability to capitalize on this technology poised to shape broader market trends. Understanding AI adoption and how this plays out is essential when taking a view on the Mag 7.

- **Valuation Premiums Reflect High Expectations:** The Mag 7 trades at 41.5x historical earnings, far above the 24x average for the rest of the market.[1] While this reflects AI's transformative potential, which we agree with, what is needed in terms of profitability could lead to revaluations. There are also questions about scalability and diminishing returns on the newer models, such as ChatGPT 5.
- **Massive AI Investments:** Hyperscalers are projected to spend over $200 billion on AI-related infrastructure and R&D in 2025. This capex will likely hit profitability in subsequent years, and we believe investors will become increasingly focused on the return these investments are making.
- **Compute:** What level of computing power and data center capacity is required to meet these needs? Inference, or running an already trained model, demands far less computing than training, as do smaller models designed for specific applications compared with the LLMs we read about.
- **Market Concentration Risks:** With these companies holding such a large influence over indices, we believe that their performance will have outsized impacts on overall market dynamics. Also, while they are different kinds of businesses at heart, AI is a common thread powering their incremental growth and outlook, and the other six are Nvidia's largest customers by far.

The ability of these companies to deliver returns on their AI investments will be critical, especially as competition intensifies and operational costs for advanced models grow.

Investors are likely to be increasingly sensitive to the return that companies are earning on their AI spend, and changes in these views have ramifications for investors' outcomes on size, value and overall performance given the influence of these stocks across US and global indices.

Endnote

[1] Bloomberg US Magnificent 7 Index & Bloomberg US Ex Magnificent 7 Index.

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