Yardeni Research

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Morning Briefing

Thinking About 2025

Check out the accompanying chart collection.

Executive Summary: We're no longer the most bullish strategists on the block. We project a 15% advance in the S&P 500 next year, whereas others see reason to expect 20%. With bullishness abounding, contrarian indicators are flashing red, and we see the potential for a market correction early next year. Today, Eric details YRI's positions on the economic outlook, which is supported by brisk consumer and corporate spending and rising productivity growth; the inflation outlook, which is looking sticky above the Fed's target; what the Fed is likely to do next; and the valuation and fundamentals assumptions that underpin our stock market forecast.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy I: The 2025 Bull Market. Most investment strategists have joined our camp heading into next year. We were among the most bullish forecasters for 2023 and 2024 (*Fig. 1* and *Fig. 2*). Most economists have given up waiting for the "*Godot*" recession to finally show up. We are still bullish, but that is no longer a relatively contrarian position. We project a 15% gain for the S&P 500 next year, but *Barron's* latest cover story, "Why The Stock Market Could Gain Another 20% in 2025," describes an even more optimistic outlook.

As we have pointed out recently, several contrarian indicators are flashing orange, if not red, which could set the stage for a market pullback or correction early next year. We do not anticipate a protracted or deep stock market rout given that we view the economy as not only in good shape but improving.

Until a few months ago, the diehard hard-landers believed that "long and variable lags" from the tightening of monetary policy from March 2022 through August 2024 would slowly but surely weigh on economic growth. Our contention long has been that this notion is misguided because it ignores the Credit Crisis Cycle. Higher interest rates only cause a recession once they break something in the financial system; that rupture causes a credit crisis, which morphs into a credit crunch and then a recession.

That domino effect was interrupted during the latest tightening round because the Federal Reserve/Treasury department/FDIC triumvirate stemmed the mini regional banking crisis in March 2023 by quickly providing a liquidity facility and insuring all depositors of the failed banks. So the economy was able to continue expanding without cuts in the federal funds rate. Now that the Fed has begun easing even before any slowdown in economic growth, it's even more difficult to make the long-and-variable-lags argument.

While there seem to be fewer and fewer bears left these days, a few remain on the prowl. We commend our bearish brethren because they often sniff out nearly everything that could go wrong. We thank them for their thorough work. That allows us to spend more time on what could go right.

We acknowledge the concerns of the bears by assigning a 20% subjective probability to a cauldron of bearish possibilities: a US debt crisis that causes the economy and stock market to stumble, a geopolitical oil shock, a global trade war, or any other problem that pops up. We see much greater reason to be bullish, however, applying a 25% probability to a stock market meltup and a 55% probability to our Roaring 2020s scenario.

Our meltup scenario would likely result from overly loose monetary policy causing the stock market to discount our economic forecasts, laid out below, too quickly. In fact, that may be what the market is undergoing as we speak. Still, we believe the Roaring 2020s can drive the US economy and stock market, not only through the end of the decade but perhaps into the 2030s.

Strategy II: Great Economic Outlook. Let's run through our base-case expectations for economic growth over the year ahead:

(1) *Consumer spending*. We continue to believe the US consumer is in very good shape, not running out of the mythical pandemic excess savings. Strong real wage gains and record nonlabor income (e.g., dividends, proprietorships, interest, and rentals) are fueling spending (*Fig. 3* and *Fig. 4*). Meanwhile, rising asset prices of stocks and homes are allowing Americans to save less and spend more of their income (*Fig. 5*). This is particularly prevalent among Baby Boomers; they hold a record $80 trillion of the $154 trillion in total US household wealth, yet many have no income from wages (*Fig. 6*).

(2) *Corporate spending.* Business formation and innovation are driving hiring and capital spending. Applications for new businesses with a high propensity to have employees on payroll accelerated to 157.7 thousand (sa) in November, nearly matching September 2023's

post-pandemic record (*Fig. 7*).

On an inflation-adjusted basis, companies are spending record amounts on high tech, such as R&D ($665 billion, saar, inflation adjusted), information procession equipment ($533 billion), and software ($770 billion) (*Fig. 8*). High tech now represents half of all nominal capital spending in US nominal GDP (*Fig. 9*). And the NFIB's (National Federation of Independent Business) survey of small business owners showed the percent saying it was a "good time to expand" and they "expected to increase capital spending in the next three months" both surged to multiyear highs in November (*Fig. 10*). Expectations for a lower corporate tax rate and deregulation under Trump 2.0 have boosted business confidence immediately and unleashed the animal spirits.

(3) *Productivity growth*. As we detailed in yesterday's *Morning Briefing*, we are expecting productivity growth to accelerate toward 3.0%-3.5% over the rest of this decade, driving real GDP higher even as a slowdown in labor force growth causes hours worked to increase only marginally (*Fig. 11*). Importantly, productivity driven growth is much less inflationary, as it keeps unit labor costs (ULC) low while tending to boost real wage gains and corporate profit margins.

Corporate outlays on high tech, combined with a labor market short of skilled labor, will help fuel productivity gains.

Strategy III: Sticky Inflation. Since the summer of 2022, we have been disinflationists. Debbie and I said that we expected the core PCED inflation rate to reach 2.0% by the end of 2024. However, we believe the Fed's soon-to-be 100bps of rate cuts may have halted that process. Core services and shelter inflation remain sticky, which could keep the PCED in the 2.5%-3.0% range instead of falling to the Fed's target. The core CPI was 3.3% y/y in November, while the core PCED was 2.8% in October and likely remained there last month (*Fig. 12*). So even a month or two of hotter inflation could see the core PCED a full percentage point above the Fed's target, which could cause the markets to flinch if it convinces investors that the Fed might reverse course and hike interest rates.

Another risk is that goods prices begin to inflate after deflating for several quarters, putting downward pressure on overall inflation. However, we remain broadly optimistic on the inflation outlook, as the productivity growth boom we expect would suppress ULC.

Strategy IV: Fed Pause Ahead. While the Fed has been cutting the federal funds rate (FFR), the Bond Vigilantes have raised long-term Treasury yields by roughly the same amount (*Fig. 13*). The question for the Fed is, why cut the FFR further if bond yields may rise and the economy is doing well?

It seems that many on the Federal Open Market Committee (FOMC) have been asking themselves the same question. Nick Timiraos' latest *WSJ* story details the internal dissent:

"Some needed little convincing to start big. Others were uneasy. Past reductions of a half point coincided with more dramatic financial stress. Bowman, who had been warning of latent risks of more-stubborn inflation, knew when she saw those policy briefing materials that she wouldn't be able to support Powell's proposal. She ended up casting a dissenting vote—the first since 2005 by a Fed governor.

"To avoid multiple dissents and win over colleagues who shared her reservations, Powell convinced them that he could sell the decision in subsequent public remarks as a recalibration made from a position of strength, and not the start of a panicky sprint to lower rates."

We noted the emerging dissent among members of the FOMC in our August 22 *Morning Briefing*. Fed Chair Powell is very likely to signal a pause in further FFR cuts after the widely expected 25bps cut on Wednesday. If inflation rebounds significantly, the Fed's credibility may be impaired. We're rooting for productivity driven disinflation but recognize the risk that tax cuts and deregulations boost demand and therefore the level of interest rates that would contain inflation. Powell said the Fed cannot model the effects of the next administration's fiscal policy this early. But the trillion-dollar annual net interest costs that the Congressional Budget Office forecasts will be an issue unless major changes are enacted (*Fig. 14* and *Fig. 15*).

Commentary from other Fed officials may begin to cite the potential impacts of Trump 2.0 on the inflation outlook very soon.

Strategy V: Bullish Stock Market Forecast. Our base case is for the S&P 500 to rise roughly 15% to 7,000 by the end of next year. We're expecting revenues to grow 5%, profit margins to widen from 12.3% to 13.9%, and earnings per share (EPS) to increase from roughly $240 to $285. We reach our price target by applying a 22 forward P/E to our 2025 forward EPS target of $320 (*Fig. 16* and *Fig. 17*).

Here's more on what we expect the market's internals to look like:

(1) *Valuation*. Of course, a 22 forward P/E is not cheap. However, strip out the Magnificent-7 stocks, and the rest of the S&P 500 is trading at 19.6 times forward earnings (*Fig. 18*). Historically cheap? Not exactly, but below the blowoff-top highs that concern investors.

(2) *Margins*. We're expecting the S&P 493 profit margins to widen as these companies begin to benefit from the high-tech spend and increased productivity growth, which will drive earnings higher (*Fig. 19*). Thus far, only the Mag-7 have widened profit margins materially.

(3) *Sectors*. We continue to recommend overweighting cyclical S&P 500 sectors such as tech-related ones (e.g., Information Technology and Communication Services) as well as Financials and Industrials. Benefitting from high-tech spend and margin expansion, these sectors appear poised to outperform under Trump 2.0 policies.

Strategy VI: Recessions Abroad. Not only do the US economy and stock market look good historically, but they look great compared to those abroad. In short, China is in dire straits, and Europe is a mess. Politically, economically, and financially, the setup is much better domestically. We maintain our "Stay Home" equities strategy, advising overweighting US equities relative to those in the rest of the world, as we have since at least 2010 (*Fig. 20*). It's worked out well thus far.

Here's more:

(1) *China*. Chinese 10-year government bond yields are now below 1.8% (*Fig. 21*). The Chinese government has committed to easy monetary policy and thrown various stimulus measures at its markets, but none have convinced investors that they can boost the economy out of the property rubble (*Fig. 22*).

(2) *Europe*. France's government recently collapsed, replacing the prime minister who serves under President Emmanuel Macron. German Chancellor Olaf Scholz lost a confidence vote yesterday. The French fiscal thrust is getting reined in by the EU, and German business confidence is plummeting (*Fig. 23*).

The euro may fall to parity with the US dollar by year-end (*Fig. 24*). We prefer US and alternative assets (we continue to recommend long dollar and long gold positions) relative to foreign assets.

Strategy VII: Geopolitical Flares. The geopolitical tension over the past two years has failed to elicit much response from oil prices (*Fig. 25*). Energy supply is not only abundant but likely to increase during Trump 2.0, while demand is depressed by weakness in China and Europe. The overthrow of Syria's Assad underscores Russia's waning influence and struggles against Ukraine. It also highlights Israel's success in the Middle East as it weakens Iranian-backed terrorist organizations on the other side of its borders.

We think the Trump administration will seek to end both conflicts quickly, which would likely weigh on oil prices further. The risks associated with hot wars, however, will be replaced by those associated with trade wars given the new administration's trade policies.

The extent to which a trade war could spark further conflagration between the US and other nations, as opposed to successfully encouraging more pro-US policies abroad, remains to be seen, but we are optimistic. The US economy flourished under Trump 1.0, and tariffs did not bring the end of days (or strong inflationary pressures). We expect it to do even better under Trump 2.0.

Calendars

US: Tues: Retail Sales Total, Core, Ex Gas & Autos 0.6%/0.4%/0.4%; Headline Industrial Production 0.2%; Capacity Utilization 77.3; Business Inventories 0.2%; NAHB Housing Market Index 47; Atlanta Fed GDPNow 3.3%; 20-Year Bond Auction; Weekly Crude Oil Inventories. **Wed:** Fed Interest Rate Decision 4.50%; FOMC Economic Projections; Housing Starts & Building Permits 1.35mu/1.43mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Eurozone ZEW Economic Sentiment 11.8; Germany Ifo Business Climate Index Total, Current Assessment & Expectations 85.5/84.0/87.5; Germany ZEW Economic Sentiment 6.4; UK Unemployment Rate 4.6%; UK Claimant Count Change 28.2k; UK Average Earnings Including & Excluding Bonuses 4.5%/5.0%; Canada CPI 0.1%; Elderson. **Wed:** Eurozone Headline & Core CPI -0.3%m/m/2.3%y/y & -0.6%m/m/2.7%y/y; Germany BUB Monthly Report; UK Headline & Core CPI 2.6%/3.6%y/y; UK PPI Input & Output 0.2%/0.2%; UK House Price Index 3.1%y/y; Lane; . (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the December 13 week, forward earnings moved simultaneously higher for all three of these indexes for a fourth straight week, the longest string of weeks since late July; forward earnings had mostly stalled for the SMidCaps since then. LargeCap's forward earnings rose for an 11th week to a record high. (Prior to those 11 weeks, it had fallen for two straight weeks--a first since December 2023, when it fell for three straight weeks.) Notably, LargeCap had snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's forward earnings improved to a 26-month high last week; it's now just 1.3% below its record high in early June 2022. SmallCap's forward earnings rose to a six-week high last week and is now 11.9% below its mid-June 2022 record. Here's how much the three indexes' forward earnings have improved from their recent lows: LargeCap's forward earnings has soared 21.2% from its 54-week low during the week of February 1, 2023; MidCap's is 7.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is just 2.0% above its 72-week low during the March 17, 2023 week. For perspective, these three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.1%, 12.9%), MidCap (-0.5, 13.6), and SmallCap (-12.7, 18.2).

S&P 500/400/600 Valuation (*link*): Valuations were lower w/w for these three indexes during the December 13 week. LargeCap's forward P/E ticked down 0.1pt w/w to 22.1 from a 43-month high of 22.3. It's up 5.2pts from a seven-month low of 17.0 during the October 27, 2023 week and 7.0pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E dropped 0.3pt w/w to 16.7 and is down from a 40-month high of 17.1 during the November 29 week. It's up 4.4pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E fell 0.3pt w/w to 16.7 and is down from a 41-month high of 17.1, also during the November 29 week. It's up 5.9pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 24% discount to LargeCap's P/E compares to 22% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 week. It had been at a

19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 25% discount compares to 23% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 1% discount to MidCap's is among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed was the first regional Fed bank to report on manufacturing activity in its district in December. Coming on the heels of a strong November report—the highest reading since December 2021—this month's report showed that activity held steady. The *headline general business conditions* sank 31 points (to 0.2 from 31.2), well below the consensus forecast of 12.0. It was in contractionary territory for ten of the 11 months—during December 2023 through October of this year. Both the *new orders* (6.1 from 28.0) and *shipments* (9.4 from 32.5) increased, but at a considerably slower pace than in November. *Delivery times* (-7.4 from 3.1) shortened a bit, while *supplier availability* (1.1 from -4.1) was little changed. Meanwhile, *inventories* (10.5 from 1.0) increased at a solid clip. Turning to the *labor market*, conditions showed a small decline in *employment* (-5.8 from 0.9) levels and a slightly shorter average workweek (-3.9 from 6.1). *As for pricing*, both the prices-paid (21.1 from 27.8) and prices-received (4.2 from 12.4) measures moderated, with prices received showing a sharp slowing. *Looking ahead*, firms were fairly optimistic that conditions would improve over the next six months, though not as optimistic as last month, with the index of *future business activity* (24.6 from 33.2) measure falling 8.6 points. Still, 42% of the respondents expect conditions to improve, and only 17% expect them to deteriorate over the period. *Capital spending plans* (11.6 from 13.4) remained modest in December, while employment (13.8 from 23.9) is expected to increase at a slower pace.

Global Economic Indicators

US PMI Flash Estimates (*link*): "Output growth ends 2024 on a 33-month high amid service sector surge" was the headline of the December report. Business activity in the US remained robust this month, with the *C-PMI* (to 56.6 from 54.9) jumping to its highest reading since March 2022 and growth heavily skewed toward the service sector. December's *NM-PMI* (58.5 from 56.1) jumped to a 38-month high, while the *M-PMI* (48.3 from 49.7) showed manufacturing activity continued to contract—with the M-PMI Output Index (46.0 from 47.9) in a tailspin, sinking to a 55-month low. Meanwhile, the survey's *forward-looking sentiment indicators* suggest that "growth could become more balanced in the coming year." Optimism about output over the next 12 months improved in December from the pre-election low in September—climbing to its highest since May 2022. *Confidence in the service sector* climbed to its highest reading in just over two and a half years, and *manufacturing* confidence remained among the highest seen over the past year, though did cool slightly. *Turning to prices*, the December price gauge covering goods and services showed only a marginal increase in prices this month, rising at the slowest rate since prices began rising back in June 2020; that pushed it further below the pre-pandemic long-run average, with the services rate the lowest since May 2020. Manufacturing selling prices held at November's rate in December and are running slightly above its pre-pandemic long-run average.

Eurozone PMI Flash Estimates (*link*): The Eurozone is ending 2024 in contractionary territory as the manufacturing sector continues to decline. Business activity in the Eurozone is moving closer to expansion, as the *Eurozone's C-PMI* (to 49.5 from 48.3) was just short of the breakeven point of 50.0. The NM-PMI (51.4 from 49.5) moved back over 50.0 after having fallen below in November for the first time since the start of this year, while the M-PMI was unchanged at 45.2 in December. Meanwhile, the M-PMI Output (44.5 from 45.1) measure sank to a 12-month low. The two largest Eurozone economies were the main source of weakness once again. *Germany's* C-PMI (to 47.8 from 47.2) continued to contract, though at a slightly slower pace, with the NM-PMI (51.0 from 49.3) moving back above 50.0 to a two-month high. Meanwhile, the M-PMI (42.5 from 43.0) and M-PMI Output (41.7 from 43.1) measures remain deep in contractionary territory. *France* continued to contract, though at a slightly slower pace, with its C-PMI (to 46.7 from 45.9) climbing to a two-month high along with its NM-PMI (48.2 from 46.9). Meanwhile, the M-PMI (41.9 from 43.1) and M-PMI Output (39.6 from 41.1) measures both sank to 55-month lows. *Growth in the rest of the region* continued to post solid gains in output in December, with the rate of expansion reaching a six-month high.

Japan PMI Flash Estimates (*link*): Japan saw its strongest rise in private-sector activity in three months as 2024 draws to an end. December's C-PMI (to 50.8 from 50.1) showed only marginal growth, though the most pronounced since September, as the service sector continued to expand. The NM-PMI (51.4 from 50.5) rose for the second successive month at a stronger rate, led by a rise in new business inflows. The M-PMI (49.5 from 49.0) deteriorated for the sixth straight month, though only marginally; it's not much below the breakeven point of 50.0 now. The *level of optimism* was above average in December, though eased on concerns over labor constraints and rising costs. In line with a stronger rise in *input* costs, *output costs* increased at the steepest rate in eight months.

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