January 6, 2025

Morning Briefing

Risks & Reward In 2025

Check out the accompanying chart collection.

Executive Summary: The January Barometer and January Effect have been interesting statistical regularities that may not have much investment usefulness. It's better to stay in the stock market whatever the month brings than to try and execute exits and entrances based on the calendar. Over time, the market has a bullish bias, which is why we do too. … Today, Dr Ed lists what could go right for the stock market this year—including better-than-expected earnings, technological advances, and a strong economy buoyed by consumer spending—and what could go wrong. On that list, inspired by the worries of more bearish prognosticators, are the known unknown economic effects of Trump 2.0 policies and how the bond market may respond to them. … Dr Ed reviews "Blitz" (+).

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Strategy I: January Barometer & Effect. As goes January, so goes the year? That's the premise of the January Barometer. It has a track record of being right more often than it has been wrong. During 42 of the 59 years from 1965 through 2024, January's monthly percent change has been in the same direction as the yearly percent change (*Fig. 1*). Both time periods had positive signs in front of the numbers during 29 of those years and negative signs during 11 of those years.

There is also the January Effect, which suggests that the month tends to be a good one for stocks because investors often sell their securities at a loss during December to offset their capital gains for the year and lower their tax bills, only to buy back those stocks in January.

Put the two January phenomena together, and the result is that Januarys tend to be up months for the stock market. Indeed, the month has been the fourth best month of the year, with an average m/m gain of 1.2% from 1928 through 2024 (*Fig. 2*).

But wait a minute: Only three of the 12 months have averaged negative returns since 1928.

That’s because the stock market tends to rise over time. So most months, including January, have been up on average simply because stock prices have an upward bias over time! Doesn't that imply that it is better simply to stay invested for the long run than to trade these two January statistical regularities, which don't always pan out?

Furthermore, doesn’t the fact of a January Effect imply a negative December Effect from tax selling? December is known for its Santa Claus rallies! December has been up 1.3% on average since 1928, making it the third best performing month of the year. There are 12 months in the year, and the stock market has been up during 49 of the 60 years since 1965.

Strategy II: What Could Go Right. We are biased by the stock market’s bullish bias. We tend to be permabulls because bear markets are infrequent and are usually relatively short compared to bull markets, which tend to last for some time. Since January 1978, the S&P 500 is up 66.6-fold (*Fig. 3*). In that entire 47-year period, there were just six bear markets that lasted only a bit more than one year on average. Bear markets tend to be caused by recessions. There have been only six of them since 1978, lasting just 14 months on average (*Fig. 4*). (See our *Stock Market Historical Tables: Bull & Bear Markets*.)

As we’ve previously noted, we regularly follow the growlings of the permabears as an efficient way to assess what could go wrong for the economy and the stock market. Very rarely do we find that they’ve missed all the things that could go wrong, while we frequently find that they’ve mostly ignored an assessment of what could go right. (See our December 23, 2024 *QuickTakes* titled “*Permabulls Versus Permabears*.”

The S&P 500 peaked at a record high of 6090.27 on December 6. It ended 2024 at 5881.63. The index ended the first week of the new year at 5942.47, just below its 50-day moving average (*Fig. 5*). The Nasdaq peaked last year at a record 20,173.89 on December 16 and bounced off its 50-day moving average last week to close at 19,621.7 (*Fig. 6*).

On balance, we expect that the next few weeks could be choppy for the stock market before the S&P 500 and Nasdaq resume climbing to new record highs during the spring.

Here is a list of what could go right in early 2025, followed by a review of what could go wrong:

(1) *Q4's earnings reporting season* over the next few weeks might be better than expected. They usually are when the economy is expanding. The analysts' consensus estimate for Q4 earnings growth is 8.2% (*Fig. 7*). There were typical upside earnings surprises during the

previous three earnings seasons. There should be another during the Q4 earnings season. Leading the way should be banks, semiconductors, cloud computing, retailers, and restaurants.

(2) *CES 2025* is this week. The Consumer Electronics Show, or “CES” for short, kicks off Monday evening and runs through Friday, January 10. This highly anticipated industry tradeshow features the biggest tech players from across the globe showcasing their latest consumer technology with daily product launches, keynotes, activations, and demos. It will undoubtedly be all about AI. Indeed, Nvidia founder and CEO Jensen Huang will deliver a keynote address Monday at 6:30 p.m. Nvidia produces the GPU chips that power AI.

Nvidia’s stock price is up 12.1% from a recent low of $128.91on December 18 to $144.47 on Friday partly on expectations that Huang’s comments will be bullish. They should be. Last Friday, January 3, Microsoft announced plans to spend $80 billion this fiscal year building out data centers, underscoring the intense capital requirements of artificial intelligence. That’s up from $50 billion last year. On Friday, the S&P 500 rose 1.3%, led by a 4.5% jump in Nvidia, on the news from Microsoft.

Much of the spending on data centers by cloud infrastructure providers goes toward high-powered chips from companies including Nvidia Corp. and infrastructure providers such as Dell Technologies Inc. The massive AI-enabled server farms require lots of power, which prompted Microsoft to strike a deal to reopen a reactor at the Three Mile Island nuclear power plant in Pennsylvania, the site of a notorious partial meltdown in 1979. Amazon and Google also have signed nuclear power agreements.

(3) *GDP*. Q4's GDP will be reported on January 30. Along the way, the Atlanta Fed's *GDPNow* tracking model is likely to show a growth rate running around 2.5%-3.0% (saar). The January 3 GDPNow estimate was revised down to 2.4% from 2.6% following the release of December’s national manufacturing purchasing managers index (M-PMI). But real consumer spending is still tracking at a solid 3.0%. The weakness was in capital spending on equipment, down 5.3%. However, intellectual property, which includes software, remains strong at 5.2%.

The M-PMI data for December showed that the overall index rose to 49.3 last month from 48.4 in November. So it remained below 50.0 for the ninth straight month and 25 of the past 26 months (*Fig. 8*). However, both new orders (52.5) and production (50.3) rose above this level. Employment fell (from 48.1 to 45.3). We think this might show that productivity is increasing in manufacturing.

(4) *Consumers.* Despite the weakness in manufacturing employment, initial unemployment claims remained low at 211,000 during the December 27 week, and continuing unemployment fell by 66,000 to 1.844 million during the previous week (*Fig. 9*). Just as encouraging is that the jobs-plentiful series in the consumer confidence index survey rose to 37.0% during December from a recent low of 31.3% during September (*Fig. 10*).

Consumers are still spending. The Redbook retail sales series shows a solid increase of 5.5% y/y through the week of December 27, 2024 (*Fig. 11*). It has a good correlation with the comparable growth rate for monthly retail sales excluding food services. Consumers also responded to auto dealer discounts. The seasonally adjusted annualized rate for total new-vehicle sales rose to an estimated 17.2 million units in December, up from 16.6 million in November (*Fig. 12*).

On the other hand, construction spending may be starting to lose its mojo. It has been moving sideways at a record high for the past eight months through November, reflecting a similar development in the construction of manufacturing structures, which has been soaring for the past couple of years (*Fig. 13* and *Fig. 14*).

Strategy III: What Could Go Wrong. The outlooks for the economy and earnings in the new year are good, but valuation multiples are stretched. They must be discounting expectations that the current economic expansion will last for quite a while, which we think is a realistic possibility given our Roaring 2020s base-case scenario.

If we compare the current secular bull market in the S&P 500 since 2010 to the one that started early in the 1980s, we find that the former is closely tracking the latter (*Fig. 15*). This suggests that the stock market has plenty of upside over the rest of this decade, as it had during the second half of the 1990s—if it continues to closely track the previous one. The only problem is that valuations are much higher this time around: The S&P 500's forward P/E at the end of 2024 was 21.6, well above around 13.0 in 1994 (*Fig. 16*). The Buffett Ratio is currently around 3.0, well above around 2.0 at the peak of the 1999 tech-led bubble that was followed by the tech wreck in the early 2000s (*Fig. 17*).

Again, with a little help from the permabears, here is a list of what could go wrong in early 2025, casting doubt on the outlook for a long expansion and causing valuation multiples to shrink:

(1) *Trump 2.0 has too many known unknowns currently.* The stock market is anticipating that the incoming administration's new policies will probably be bullish on balance. We

agree with that assessment, but it may take some time to know that. There will be lots of new policy initiatives introduced and perhaps implemented by executive orders once President Donald Trump is inaugurated on January 20.

It's hard to know how they'll collectively affect the economy and whether they might produce negative unintended consequences. Higher US tariffs could boost inflation and could trigger retaliatory measures by trading partners. Mass deportation of illegal immigrants could disrupt some industries' labor pools and put upward pressure on wages. Extending income-tax-rate cuts for consumers should bolster economic activity but could be inflationary. Deregulation and a lower corporate tax rate should also be stimulative and might fuel disinflation. Trump's energy policies are also likely to be disinflationary.

The most widely unanticipated scenario is that Trump 2.0 will cause stagflation. That would be a bearish scenario for stocks, for sure. We include it in our bucket of bearish risks to which we assign a 20% subjective probability.

(2) *Interest rates might move higher*. Perhaps the greatest known unknown is how the Fed and the bond market will respond to Trump 2.0. In his December 18 *press conference*, Fed Chair Jerome Powell said that the Fed doesn't know what policies Trump 2.0 will include or how much they will impact the economy and financial markets. He also suggested that the Fed might pause lowering the federal funds rate partly because of this uncertainty.

Meanwhile, the Bond Vigilantes have been challenging the Fed's three-monkeys cluelessness about the economy, inflation, and Trump 2.0. Since the FOMC started cutting the federal funds rate on September 18—lowering it by a total of 100bps through December 18—the 10-year bond yield has risen by as much (*Fig. 18*). The Bond Vigilantes are protesting that the Fed is stimulating an economy that doesn't need to be stimulated, that inflation remains above the Fed's 2.0% target, and that Trump 2.0 might both revive inflationary pressures and boost the federal deficit.

The risk for stocks is that the Bond Vigilantes will be right, sending the yield back to 5%, which was last year's high. In this scenario, the Fed might be forced to raise the federal funds rate, reviving fears of a recession. Valuation multiples would surely melt down quickly in that case. Again, we put this scenario in the 20% risk bucket.

Movie. Blitz (+) (*link*) stars Saoirse Ronan as a mother of a young boy who is evacuated to the British countryside when the Germans bombed London during World War II. He jumps off the train, determined to return home. Along the way he dodges several harrowing perils

attributable to the blitz. There are plenty of scenes that recreate the devastation caused by the bombardment. But the story line and the acting aren't compelling.

Calendars

US: Mon: S&P Global C-PMI & NM-PMI 56.6/58.5; Factory Orders -0.3%; Auto Sales 16.5mu; Cook. **Tues:** JOLTS Job Openings 7.65m; ISM NM-PMI 53.5; Trade Balance -$77.5b; Weekly Crude Oil Inventories; Barkin. (FXStreet estimates)

Global: Mon: Eurozone, Germany & France C-PMIs 49.5/47.8/46.7; Eurozone, Germany & France NM-PMIs 51.4/51.0/48.2; UK C-PMI & NM-PMI 50.5/51.4; Germany CPI 0.4%m/m, 2.4%y/y. **Tues:** Eurozone Headline & Core Flash CPI 2.4%/2.7%y/y; France CPI 0.3%m/m/1.5%y/y; Italy CPI 0.3%m/m/1.5%y/y; Italy Unemployment Rate 6.0%. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* dipped to 3.01 during the final week of 2024, the lowest since mid-November. *Bullish sentiment* fell to 54.1% that week from 62.9% during the first week of December—which was the most bulls since late July, when the report noted seven consecutive weeks with bulls over 60%, ending at 64.2%. *Bearish sentiment* has increased over the same period from 16.1% to 18.0%, while the correction count increased from 21.0% to 27.9%. In the *AAII Sentiment Survey* (as of January 2), bullish sentiment about the short-term outlook for stocks fell, while neutral sentiment rose and pessimism was unchanged. *Bullish sentiment* sank 2.4ppts to 35.4%, falling below its historical average of 37.5% for the first time in five weeks, and was the lowest since April 25, 2024 (32.1%). Meanwhile, *neutral sentiment* climbed 2.3ppts to 30.4%, below its historical average of 31.5% for the 25th time in 26 weeks. *Bearish sentiment* was unchanged at 34.2%, above its historical average of 31.0% for the sixth time in seven months.

Global Stock Markets (US$ Performance) (*link*): The US MSCI index soared 23.4% in 2024, ending the year just 2.6% below its December 6 record high. The AC World ex-US index underperformed markedly with a gain of just 2.9%, and is now 9.6% below its June 15, 2021 record high after being just 0.7% below at the end of September. EM Asia was

2024's best performing region, with a gain of 10.0%, followed by EM (5.1%) and the AC World ex-US. EM Latin America was the worst regional performer with a drop of 30.4%, followed by Europe (-0.9), EMU (0.2), EAFE (1.1), and EMEA (1.7). Just nine of the 18 major selected country markets that we follow ended 2024 higher. The Taiwan MSCI index performed the best, with a gain of 31.9%, followed by the US (23.4), China (16.3), India (11.1), and Canada (9.4). Brazil was the worst performer, tumbling 34.6%, followed by Mexico (-29.5), Korea (-24.5), and France (-7.4).

US Stock Indexes (*link*): Forty-six of the 48 major US stock indexes that we follow rose in 2024, dominated by growth-related indexes for a second straight year. That broad performance comes on the heels of 47 indexes rising during 2023. The S&P 500 Growth index was the best performer for the year, rising 35.1%, ahead of Russell 1000 Growth (33.7%), Russell 3000 Growth (32.7), S&P 100 (29.2), and Nasdaq Composite (28.6). The S&P 500 Transportation index, with a decline of 1.4%, was the worst performer, followed by Dow Jones 20 Transports (0.0), S&P 600 SmallCap Pure Value (3.6), S&P 400 MidCap Pure Value (4.2), and S&P 600 SmallCap Equal Weighted (4.4).

S&P 500 Sectors Performance (*link*): Ten of the 11 S&P 500 sectors rose last year, and four were ahead of the S&P 500's 23.3% gain as the top three led the way for a second straight year. That compares to eight sectors rising in 2023 when only three sectors were ahead of the composite index's 24.2% gain. The outperformers in 2024: Communication Services (38.9%), Information Technology (35.7), Consumer Discretionary (29.1), and Financials (28.4). The seven sectors that lagged the S&P 500 in 2024: Materials (-1.8), Health Care (0.9), Real Estate (1.7), Energy (2.3), Consumer Staples (12.0), Industrials (15.4), and Utilities (19.6).

US Economic Indicators

US Manufacturing PMI (*link*): The ISM M-PMI in December continued to point to a contraction in manufacturing activity for the ninth successive month and 25th time in the past 26 months, though was only a shade below the breakeven point of 50.0. December's *M-PMI* increased to a nine-month high of 49.3, above the consensus expectation that it would remain at November's 48.4 and up from a recent low of 46.5 in October—which was the lowest level since July 2023. It remains below its recent high of 50.3 in March. "U.S. manufacturing activity contracted again in December, but at a slower rate compared to November. Demand showed signs of improving, while output stabilized and inputs remained accommodative," noted Timothy Fiore, chairman of the ISM survey. According to ISM, the

overall economy continued its expansion for the 56th month after a one-month contraction in April 2020. (A manufacturing PMI above 42.5% over a period of time generally indicates an expansion of the overall economy.) The *new orders* (to 52.5 from 50.4) measure moved further above 50.0, while the *production* (50.3 from 46.8) gauge was above 50.0 for the first time in seven months. Meanwhile, *factory employment* (45.3 from 48.1) declined at a faster rate last month, remaining in contractionary territory for the seventh successive month. The *supplier deliveries* (50.1 from 48.7) gauge moved back above 50.0, but barely—a reading that indicates slower deliveries. (The supplier deliveries index is inversed; a reading above 50.0 indicates slower deliveries, which is typical as the economy improves and customer demand increases.) Meanwhile, companies liquidated *inventories* (48.4 from 48.1) at a slightly slower pace, nearing the 50.0 breakeven point. *Turning to prices,* manufacturers' *input* (to 52.5 from 50.3) prices rose at a slightly faster rate in December.

Construction Spending (*link*): Construction spending continues to bounce around record highs. *Total construction* spending was unchanged (vs 0.3% expected) in November, following a downwardly revised 0.4% (from 0.5%) increase in October. Spending was 3.0% above a year ago. *Private construction* spending increased 0.1% m/m and 2.5% y/y in November, with residential construction up 0.1% and 3.1% y/y and nonresidential investment showing no change during November and a 1.7% y/y increase. Within *residential construction*, *single-family* building rose 0.3% m/m and fell 0.7% y/y, while *multi-family* construction fell 1.3% and 9.5% over the comparable periods. Within *nonresidential construction*, the biggest increases occurred in communication (1.0%) religious (1.0), and transportation (0.9) facilities, while health care (-0.6), lodging (-0.6), and educational (-0.5) building posted the biggest drags. Meanwhile, public construction investment slipped 0.1%, with residential increasing 1.6% and nonresidential down 0.2% during November; versus a year ago, they were up 4.6%, 12.2%, and 4.2%, respectively.

Global Economic Indicators

Global Manufacturing PMIs (*link*): The global manufacturing sector moved back into contractionary territory as 2024 came to a close. The *JP Morgan Global M-PMI* fell back below the breakeven point of 50.0 in December, after climbing from 48.7 in September to 50.0 in December. The index has been below 50.0 during five of the past six months—down from a recent high of 51.0 in May. Four of the five *PMI components* (output, new orders, employment, and stocks of purchases) all showed a deterioration in activity, with only the supplier deliveries' component recording a positive impact. *By country*, India posted the *strongest expansion*, followed by the Philippines, Spain, Greece, Taiwan, and Canada.

Spain and Greece bucked the trend in the overall Eurozone, where the rate of decline, on average, was the steepest in 14 months—with France, Germany, and Austria recording the *steepest declines*. Declines were also experienced in both the US and UK. Meanwhile, activity in Japan declined slightly, while China experienced a mild uptick. *By sector*, consumer goods production increased for the seventeenth straight month in December and was only partially offset by the decline in intermediate and investment goods production. *Turning to prices*, *input cost* inflation accelerated at a four-month high, while *selling price* inflation eased to a nine-month low.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Senior Global Investment Strategist, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102