MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

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2025 Equity Market Outlook

From start to finish, 2024 was a year of change with a multitude of implications for investors. Central banks transitioned to monetary easing after fighting inflation for several years. World leaders changed, and markets continued to diverge. In the fourth quarter of 2024, the S&P 500 Index had a total return of 2.41% for the quarter and 25.02% for the year. The MSCI EAFE Index (USD) Net had a total return of -8.11% for the fourth quarter of 2024 and 3.82% for the year while the MSCI World Index (USD) Net had a total return of -0.16 % for the fourth quarter and 18.67% for the year. Global economic uncertainty continues so investors need to address potential increased volatility from looming fiscal challenges tied to deficits, debt, and changing demographics.

Equity investors care about debt because rising interest rates influence asset pricing and project viability. At the current rate, total U.S. debt will be over $50 trillion by the end of the decade.[1] Global debt of governments, households, and financial and nonfinancial corporates has surged to $322.9 trillion at the end of 2024. Global debt rose over $12 trillion in the first three quarters of 2024, which increases repayment risk worldwide. This potentially exacerbates fiscal strains and makes debt management increasingly difficult. Without economic growth, particularly from the U.S., the global debt from the COVID-19 pandemic borrowing spree would now be 30% higher. Global emissions reduction targets are also expected to add $38 trillion to global debt worldwide by 2028.[2] Avoiding a debt crisis may require ensuring only productive new debt is deployed, writing down unproductive debt, curbing overconsumption, and restructuring loss making enterprises.[3]

At the end of 2024 domestic and international fund flows continue to increase the market capitalization of companies investing in Artificial Intelligence (AI). The U.S. Technology Sector and the Mag 7 account for most of the recent U.S. outperformance. The Mag 7 stocks' profit margins, earnings growth, and returns also dwarf the rest of the U.S. equity market representing 14% of S&P 500 Index sales, 31% of sales growth and 33% of earnings growth. The ten largest U.S. stocks have a higher profitability than market leaders of prior decades going back to the 1950s. Market concentration is at a peak, while the share of S&P 500 stocks outperforming the Index is close to its post-1990 low at 30%. While AI hyperscalers are immensely profitable, their capital spending and R&D outlays as a share of revenues have been moving up over the last year as new models with greater parameter intensity cost more to train.[4] While more companies are adopting AI, investors are increasingly sensitive to whether these companies are earning a positive return on their capex outlays and increased energy consumption used to service the data centers. "Will AI be able to overcome hallucinations and high energy requirements to deliver

profitable useful applications that boost productivity, thereby, ensuring that the U.S. economy maintains its extraordinary lead?" The danger is that growth has been a mere figment of huge government deficits.[5]

In 2024 the U.S. economy defied expectations with the above-trend GDP growth, robust job creation, over a 20% surge in the S&P 500 Index, and double digit earnings growth.[6] Although labor markets are easing, consumers and business spending are growing at a pace consistent with a 2.5% GDP growth. Inflation in housing continues to slow as supply increases. Credit spreads are tight and both high yield and leveraged loan delinquency rates are low. M&A activity is benefiting from the existing $750 billion in private equity funds. Promised deregulation may boost growth along with a Venture Capital recovery, which is already underway. While a U.S. soft landing endures, Michael Cemblast of JP Morgan notes that this would be one of the few times in the last 60 years that the Federal Reserve raised rates to stem inflation without triggering a recession.[7]

For investors though, there is little room for error with the existing high equity valuations. The S&P 500 Index just registered 20% returns two years in a row, something which has occurred just ten times in the past. This year may also end higher as there is plenty of liquidity available. Only during the 1990's bull market and the Roaring Twenties did the market continue higher for two more years.[8] Bank of America states that the U.S. equity market is high versus the rest of the world's equity markets. U.S. profits are 55% of global profits, which is high but not extreme, but valuations are at a record high. With European policies chasing capital away, this can go further, but it will become increasingly difficult to sustain as the flow is not generating enough economic returns in the U.S. to offset the loss of returns in Europe.[9]

The U.S. Dollar (USD) has risen against every major peer in 2024. Artificial Intelligence (AI) euphoria has lifted stocks and continues to draw in foreign investors, helped by the appeal of the USD for foreigners. Bank of America estimates the dollar is more than 20% overvalued. In 2025 the USD may rise more from Trump's policies to cut red tape, the impact those policies have on inflation, and the Federal Reserve's stance on interest rates. The U.S. dollar is expected to face upward pressure from the strength of the U.S. economy and a less dovish Fed compared to other central banks. Until there is clarity what fiscal, trade, and regulatory programs might impact the economy in 2025, the range of outcomes remains wide with tail events possible.[10] The dollar's decade long rise has confounded many professional forecasters, who point to a large overvaluation versus historical levels and ever wider U.S. budget and trade deficits.[11]

While the U.S. economy has been stable and equity markets robust, the conditions look more worrisome abroad. Fiscal policy uncertainty will dominate in the eurozone early in 2025 as consensus over budgets and policy will be made more difficult by political discourse. While there is uncertainty over easy fiscal policy at the start of 2025, the outlook for monetary policy is clearer. Further rate cuts from the European Central Banks (ECB) are all but certain in the first half of the year. Political uncertainty remains a center focus in the euro area's largest economies at the start of 2025.[12] Europe also

continues to suffer from a one size fits all policy. The new EU Corporate Sustainability Due Diligence Directive requires large companies operating in the EU to comply with its rules on carbon emissions and labor and human rights or face EU fines as high as 5% of the company's global revenues. EU industries pay power prices two to three times higher than the U.S. and three to five times more than China. Taxes make up 23% of the retail price paid by Europe's energy intensive industries. Difficult conditions for euro area manufacturing continues. Output remains under pressure from falling new orders, feeding through to falling work backlogs and employment.[13]

In 2024 the U.K. demand for workers has slowed with the sharpest fall in confidence as the economy slows. Household energy debt has soared 91% over the past two years. The Swiss National Bank (SNB) cut rates 50 bps, responding to weaker than expected inflation and growing uncertainty about the global economy. Swedish GDP fell, and the economy has stagnated for three years. Political uncertainty, tariff related concerns, and the Bank of Canada's sharp easing cycle has pushed the Canadian Dollar to its weakest level vs the USD since 2020. Even with very depressed yields, Japan is expected to spend 24% of this year's total budget on debt servicing costs. A credit rating downgrade in Japanese sovereign debt could boost the cost of raising funds for banks and firms. In 2024 Australia had its lowest pace of annual growth since the pandemic. Government spending did all the heavy lifting.[14]

For 2025 economists expect a global economic growth rate of 3.1%. Gradual pickup in bank lending and rising household incomes provides a tailwind in the eurozone. The growth improvement is being led by Spain, Italy, and France. Germany continues to struggle due to its trade reliance on China and the decline in its important auto industry. Moderating inflation has allowed the ECB to ease policy. The main risk to the eurozone expansion is a deeper downturn in the U.S. economy. Barring this, the recovery looks set to continue into 2025. European stocks are attractively valued and should perform well if earnings recovery is in line with the economy. The improvement in the U.K. economy is becoming more sustained and housing prices are beginning to recover. The FTSE 100 Index of U.K. stocks is relatively attractive with a 12 month forward price to earnings ratio of 11.5 times and a 3.37% dividend yield. Japan is on a steady footing with reasonable growth and inflation that is returning to target. The Bank of Japan will not take policy to a restrictive stand. Japanese equities are assisted by the reforms in corporate governance, share buybacks, and returns for shareholders.[15]

While Martin Investment Management, LLC realizes major changes will be occurring in the U.S. with new leadership, the present economic conditions at the end of 2024 both enable and limit the ability of the incoming administration to accomplish many of its goals.[16] We believe that post U.S. election dynamics, improving earnings, and attractive valuations for many companies may create compelling opportunities for investors. We believe that tax reforms and deregulation are likely to stimulate growth, particularly in domestic and cyclical sectors.[17] Because the U.S. has the world's largest consumer base, the U.S. will continue to insist that foreign companies invest in the U.S.

by producing in it rather than selling to it.[18] The Federal Reserve remains on an easing path, even if rate cuts might be shallower than expected a few months ago.[19]

Martin Investment Management, LLC believes the best way to navigate the shifting policy landscapes and evolving global market conditions is through thoughtful portfolio construction. We continue to seek quality companies with reasonable valuations and less headline risk, which support recurring and profitable revenue. We are reviewing investments in AI-driven companies that are proven to enhance productivity and reshape industries. Infrastructure is benefitting from long-term trends of digitalization attracting significant capital inflows. 2025 should be another year of overcoming challenges and redefining limits against a backdrop of U.S. equity market valuations, mega cap dominance, and the uncertainty surrounding the new global policy agenda.

Wishing the best for 2025!

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Note:

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