# Wealthspire Advisors 2024 Q4 Review

## A Year in Review

By the Wealthspire Advisors Investment Team

This time last year we were asked to weigh in on how we thought typical stock/bond portfolios would perform; we answered "mid to high single digits." Most portfolios returned greater than that in 2024, led by equity performance.

Our Capital Market Assumptions (CMAs) for equities as of the beginning of 2024 were generally mid-single digits for U.S. equities and mid/high single digits for international stocks. U.S. stocks significantly bested their CMAs while international equities were in line to slightly trailing theirs. For many reasons, robust equity performance was warranted in 2024. The long-predicted recession/landing (hard or soft) never materialized. Further, with Q4 2024 earnings still to be released, corporate earnings of S&P 500 companies for the entire year likely increased more than 10% versus 2023, providing a robust foundation for equity performance.

However, with earnings of large cap U.S. stocks increasing ~10% and returns increasing over 25%, valuations (Price/Earnings) have increased from ~23x to 27x, which is expensive from a historical standpoint. This suggests to us that 2024 performance of equities has pulled forward a moderate amount of future returns. The narrative on fixed income is different as bonds with maturities greater than one year generally faced the headwinds of higher rates. U.S. Treasury 10-year yields increased 0.65% throughout 2024. A point we have made many times over the years is that a fixed income's starting yield is a good barometer for its likely total return. With such starting yield near zero up until 2022, the rise in yields we saw in 2024 would have produced negative fixed income returns. However, as we started at a higher rate level, that higher yield more than cushioned the decline in fixed income due to the rise in rates in 2024. The same strong economic backdrop which benefited U.S. stocks also aided the more credit intensive fixed income sectors with high yield bonds and bank loans both returning mid/high single digits and outpacing the more interest rate sensitive "core" fixed income.

So, in updating our answer to last year's question ("How is a typical stock/bond portfolio going to perform?"), we answer similarly, expecting less from equities versus last year given higher valuations and slightly more from fixed income given the rise in longer term interest rates. Related, and potentially indicative of these relative valuations between asset classes, the equity risk premium (ERP) provides one straightforward way to compare the relative attractiveness of equities versus fixed income. The ERP asks how much more return one would need or expect by investing in volatile equities as compared to something that is "risk-free". Oftentimes, the 10-year U.S. Treasury as the risk-free rate. One mechanism to calculate expected equity returns is to use earnings yield. It is calculated as the amount of earnings received per price of a share of the index. This is simply the inverse of the Price/Earnings. As previously mentioned, this valuation metric is currently a high 27x trailing earnings, so the inverse of this is ~3.7. Subtracting the current 10-year of 4.6% leaves a negative equity risk premium. One must go back to the dot-com days of the late 1990s to see negative ERP. Normally, an investor would expect to receive a premium investing in equities given the incremental risk. Luckily, trailing earnings yield typically underestimates forward equity returns because it does not account for future earnings growth. Most capital market assumptions still have equities outperforming bonds. That said, the aforementioned ERP is as low today as it has been for several decades, suggesting more tepid relative equity performance.

Another point we have made previously is that with a long run average of 6-8% per year, equities get there not by stringing together 4%, 6%, and 10% years but by enjoying the +20% and weathering the -15%. 2024's mid-20% for U.S. large cap is actually typical for a year when equity returns are positive.[i] We have pointed out above a few reasons to be cautious on near term equity returns, but we also recognize that with the incoming administration we may be witnessing a generational attempt at modernizing how the government solves problems and funds itself. New approaches may spur investment and unleash animal spirits. We thus have further reason to anticipate 2025 equity performance to reside in the left or right tails of equity return distribution rather than the mid/high single digit median.

One question we have received multiple times since the Fed began its rate cutting cycle in September is, "With the Fed cutting rates, why are interest rates rising?" As a refresher, the Federal Reserve explicitly controls the shortest of short-term rates, the Fed Funds rate. The market's relative supply and demand controls all other interest rates, namely all rates longer in maturity than the short-term Fed Funds rate. Since September, the Fed has indeed moved the Fed Funds rate down by a total of 100bps or 1% in three successive rate cuts, including the initial "jumbo" 0.5% cut. However, the 10-year Treasury yield has in fact ***risen*** by almost the same amount the Fed Feds rate has ***fallen***. And perhaps the single most popular interest rate that the average consumer fixates on, the 30-year mortgage rate, has risen in lockstep with the 10-year, up 0.72% since the Fed cutting cycle began. How can the 10-year and mortgage rates rise when the Fed is cutting short-term rates? The market is likely concluding that the economy is not showing the slowdown typically associated with a Fed cutting cycle and that the cutting may actually reaccelerate the economy and thus inflation as well. Investors are demanding additional yield compensation for such risk.

Finally, we observe that 2024 saw the continuation of product development by quality asset managers aiming to bring private capital (private equity, private credit, etc.) investments to wider audiences. Most of these funds provide some limited right of liquidity (typically quarterly). We have been allocating to interval funds for four years, and now we see the evergreen structure particularly widely used. While naturally we find some funds appealing and others less so, we generally applaud this continued development, as we do think investors should enjoy incremental returns by giving up liquidity.

[i] https://www.advisorperspectives.com/commentaries/2022/05/18/the-one-thing-the-market-almost-never-does?firm=wealthspire-advisors