Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

MONTHLY MARKET PULSE — JANUARY 2025

HIGHLIGHTS

- **Historic Performance:** The S&P 500 ended 2024 with its best consecutive calendar-year returns in 25 years.
- **Inauguration:** January 20 marks the start of a new Presidency. Within the first few days of the new administration, we expect policies related to tariffs and immigration to be introduced.
- **More Cuts or Pause:** Markets are pricing in a 10% probability of a Fed rate cut in January and a 55% probability of a cut happening by either January or March.
- **Small Cap Resurgence:** Increasing small-cap exposure could prove timely, given the macroeconomic backdrop and current valuations relative to larger firms. Analyze the relative value of small caps in this month's *Spotlight*.

MONTHLY SPOTLIGHT:

The Case for Small Caps

Author: Jason Ronovech

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MACRO INSIGHTS

Soft Finish to a Strong Year

The S&P 500 Index surged by 25% in 2024, marking consecutive annual gains of over 20% for the first time since 1998–1999. However, December finished lower, reflecting a more hawkish Fed forecast for 2025. The Fed's new forecast of only two 25-basis-point cuts in 2025 led to a 35-basis-point rise in 10-year Treasury yields on the month, weighing on stocks. While higher long-term rates are typically worse for growth stocks, growth outperformed value by 6.5% during the month as cyclicals and small caps underperformed.

Technology and related industries continued to dominate market performance in 2024. The "Magnificent 7" mega-cap stocks rose 50% for the year, while the communication services sector gained 40%, and technology advanced 37%. Growth stocks outpaced the broader market by 9% and outperformed value stocks by 19% (see nearby table). With mega-cap tech driving much of the rally, U.S. equities significantly outperformed non-U.S. developed markets.

Long-term interest rates rose substantially in 2024, with 10-year U.S. Treasury yields climbing by 69 basis points to close the year at 4.57%—with half of that increase occurring in December. The rise reflected a shift away from economic pessimism early in the year and more persistent inflation, which altered expectations for the Fed's policy path. Higher rates weighed on fixed income returns, though investment-grade bonds managed a modest 1.25% gain for the year.

After an 11% gain in November, small caps fell 8% in December and underperformed for the year. A shallower decline in Fed Funds is negative for small caps, though the setup for small caps looks promising entering 2025 (see this month's *Spotlight* below).

The 25% rise in the S&P 500 in 2024 was roughly split between earnings growth and valuation expansion. Forward earnings expectations increased by 12%, while the forward price-to-earnings ratio climbed from 19.7x to 21.7x. While elevated valuations should temper future returns, the sentiment toward the artificial intelligence theme in the U.S. remains justifiably positive and will no doubt act as a material determinant of returns in 2025.

2024 Russell Index Returns

Investors significantly favored growth over value and large-cap over small-cap in 2024.

	2024		
	Value	Core	Growth
Large	14.3%	24.5%	33.4%
Mid	13.1%	15.3%	22.1%
Small	8.0%	11.5%	15.1%

Source: Fort Washington and Bloomberg.

Chris Shipley, Senior Vice President, Co-Chief Investment Officer
Fort Washington Investment Advisors, Inc.

WHAT TO WATCH

After a few months of focusing on employment, investors have reverted their focus back to inflation. Short-term inflation has risen, and markets will monitor incoming inflation figures for implications on Fed policy. Although expectations are positive, investors will pay close attention to new data for any signs of labor market weakness.

- The first inflation readings for December will be on the 14th and 15th when the Producer Price Index (PPI) and Consumer Price Index (CPI) are released. The Fed's preferred inflation gauge, Personal Consumption Expenditures (PCE), is then released on January 31.
- The next non-farm payroll report will be available on the morning of January 10.
- In addition, the next FOMC meeting is January 29, and the initial Q4 GDP print is January 30.

MONTHLY SPOTLIGHT

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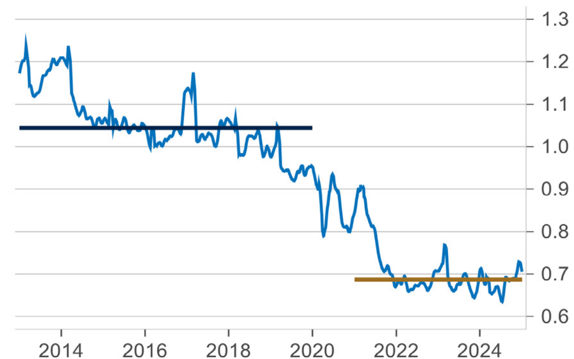
The Case for Small Caps

Small-cap stocks have received increased attention since the U.S. election but might be less noticeable in many investor portfolios, especially relative to large caps. This is because small caps are currently less than 5% of the total U.S. stock market capitalization, compared to roughly 10% historically. We believe increasing small-cap exposure could prove timely, given the macroeconomic backdrop and current valuations.

Recent political and economic developments have created a potentially more profitable landscape for smaller companies. The incoming administration's "America First" agenda encourages domestic sourcing and manufacturing, creating an environment likely to benefit smaller companies that generate a larger proportion of their revenue within the U.S. compared to larger firms. Deregulation, another agenda item, should provide a tailwind for smaller firms that are often more laden by compliance costs. In addition, deregulation could lead to increased M&A activity, for which small caps are more often acquisition targets. Tax reform, specifically a lower corporate tax rate, could also disproportionately benefit smaller companies, which often have higher effective tax rates than their large-cap counterparts. Meanwhile, a more accommodative Federal Reserve, which has cut rates by 1% in recent months, is lowering financing costs for smaller companies which tend to have more leverage and higher amounts of floating-rate debt.

In addition to the potentially improving earnings growth outlook, small caps appear to offer better relative value than large caps. While many large, global corporations have seen their multiples expand, making them look expensive compared to historical levels, small-cap P/E ratios remain closer to historical medians. In *Figure 1*, we can see that small caps historically trade at a premium P/E multiple relative to large caps, but since the pandemic, they have been trading at a substantial discount. The potential improvement in earnings growth, coupled with a convergence in the P/E ratios between large- and small-cap stocks, presents a compelling case for adding small-cap exposure or rebalancing from large to small caps.

Figure 1. PE Ratio of S&P 600 Relative to S&P 500



Source: Fort Washington, Bloomberg, and Macrobond.

Furthermore, small-cap stocks offer highly diversified exposure to the U.S. economy relative to the concentrated large-cap universe. The 10 largest names in the S&P 500 make up about 40% of the index's total market value, exhibiting a meaningful bias toward mega-cap technology. We believe the benefits of diversification, potential earnings growth, and relative value offered by small caps warrant additional consideration in today's environment. However, passive index exposure may not be an ideal vehicle to obtain exposure since about 25% of companies in the Russell 2000 have negative earnings. These negative-earning companies have underperformed positive earners by 9% over the past decade with 50% more volatility. As a result, we believe active managers are better suited to navigate the small-cap asset class, evidenced by 83%[1] of active managers outperforming the Russell 2000 over the past 10 years (93%[1] over the past 20 years).

[1] Peer rankings are relative to the eVestment US Small Cap Core Equity Universe (Peer Group).

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CURRENT OUTLOOK

Topic	View	MoM Change	Commentary
Macroeconomic Views			
Economic Growth		–	▸ Recent U.S. economic data has remained strong, **led by robust consumer spending,** especially higher income earners. ▸ Wage growth, low savings rates, and a significant rise in net worth (homes and investments) are supporting growth. ▸ The likely extension of the 2017 tax cuts, along with lesser government regulation, should support consumer and business activity. ▸ Proposed **tariffs present downside risk** from potential trade wars with our largest trading partners (Mexico, Canada, China).
Inflation		–	▸ **Inflation remains on a path toward 2%,** which is expected to continue as service inflation cools. However, FOMC members have recently articulated higher uncertainty over their projections, with risks weighted toward upside surprises. ▸ Market expectations for near-term inflation have increased following stronger-than-expected economic data and Trump's proposed policies; however, longer-term inflation forecasts remain largely grounded. ▸ **Inflation is being driven by shelter and other non-discretionary categories,** while goods inflation is negative.
Monetary Policy		–	▸ The Fed has cut rates by 100 basis points since September; however, strong economic growth and a balanced labor market have reduced consensus expectations for cuts in 2025. ▸ Investors do not expect a cut in January and **anticipate 50 basis points of cuts in 2025.** This implies a **terminal rate of around 3.8%,** up from below 2.7% in mid-September.
Fiscal Policy		–	▸ Flexibility within fiscal policy is being reduced as federal debt levels swell and **higher interest costs** consume a larger portion of government outlays. ▸ Deficits are expected to remain elevated under the Trump administration amid current policy proposals. However, cost savings through government efficiency programs could partially offset deficits.
Market Valuations			
Rates		–	▸ Yields moved higher in December as investors assessed current economic data amid the potential impact of new policy on inflation. ▸ We anticipate the **magnitude of expected rate cuts will continue shifting** with new economic data and developments around executive branch policies, presenting opportunities for tactical adjustments. ▸ Long rates are toward the higher end of our expected range and present compelling relative value.
Credit		–	▸ Credit spreads remain below historical averages as the market anticipates a soft/no landing scenario and plans for more rate cuts from the Fed. ▸ We believe **current fixed income valuations are expensive,** and credit spreads represent little upside. ▸ Investment grade spreads (10yr BBB Industrials) ended November at their 8th percentile and high yield (single B corporates) at their 5th percentile since the 1990s.
Equity		–	▸ Volatility largely eased following the election but jumped after the last FOMC meeting as investors priced in fewer rate cuts for 2025. As a result, equities struggled to advance into year-end while interest rates rose. Nevertheless, **valuations remain stretched,** following the S&P 500's 25% gain in 2024. ▸ Market breadth improved in the second half of 2024, but small-cap stocks will need more robust fundamentals to sustain that momentum. ▸ Corporate earnings for Q3 largely exceeded expectations but revealed mixed sentiment over the state of the U.S. consumer. Achieving 2025 earnings expectations may prove challenging, even under a soft-landing scenario for the economy.

MARKET DATA & PERFORMANCE | AS OF 12/31/2024

U.S. Snapshot	Current	6 Months Prior	1 Year Prior
Core Inflation (YoY%)	2.8	2.6	3.0
Unemployment Rate	4.2	4.1	3.7
Real GDP (YoY%)	2.7	3.0	3.2
Retail Sales (YoY%)	3.8	2.0	5.5
30-Year Mortgage Rate	6.9	6.9	6.6
10-Year Treasury	4.6	4.4	3.9
US Corporate IG Yield	5.3	5.5	5.1
US Corporate HY Yield	7.5	7.9	7.6

TOTAL RETURNS

Asset Class	MTD	QTD	YTD	1 Year	3 Years*	5 Years*
Equity						
Russell 3000 Index	-3.1%	2.6%	23.8%	23.8%	8.0%	13.9%
S&P 500 Index	-2.4%	2.4%	25.0%	25.0%	8.9%	14.5%
S&P Midcap 400 Index	-7.1%	0.3%	13.9%	13.9%	4.9%	10.3%
Russell 2000 Index	-8.3%	0.3%	11.5%	11.5%	1.2%	7.4%
MSCI World Index	-2.6%	-0.1%	19.2%	19.2%	6.9%	11.7%
MSCI World Excluding US	-2.7%	-7.4%	5.3%	5.3%	2.5%	5.6%
Fixed Income						
Bloomberg US Aggregate	-1.6%	-3.1%	1.3%	1.3%	-2.4%	-0.3%
US Corporate Investment Grade	-1.9%	-3.0%	2.0%	2.0%	-2.2%	0.2%
US Corporate High Yield	-0.4%	0.2%	8.2%	8.2%	2.9%	4.2%
Emerging Market Debt	-1.5%	-1.5%	7.0%	7.0%	-0.6%	0.1%
US Treasury (7-10 year)	-2.4%	-4.8%	-1.1%	-1.1%	-4.2%	-1.3%
Cash	0.4%	1.2%	5.3%	5.3%	4.0%	2.5%

Source: Fort Washington and Bloomberg. *Returns longer than 1 year are annualized. Past performance is not indicative of future results.

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