Sage Advice – 4Q24 Review & Outlook
January 2025

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Quarter in Review

Several major macro events and trends collided in the fourth quarter, leading to overall weaker returns and greater dispersion among assets classes. The US election was the most significant event, with Trump's victory stoking a post-election rally, while also leading to policy and inflation concerns and a surging dollar. Strong data supported risk markets during the quarter but prompted a significant repricing of Fed cutting expectations, pushing yields higher across the curve. The result was negative global equity returns in the fourth quarter (ACWI: -0.9%), US equities outperforming (S&P 500: +2.5%), and losses for bonds (Aggregate Index: -3%). For the year, risk assets exceeded expectations, with global equities +18% and the US +25%. For bonds, the repricing of yields by nearly 100 basis points since mid-September caused significant return damage into year end, but core bonds still saw positive returns for the year (+1.25%), highlighting the power of having a nice yield cushion to offset rate volatility. With stable spreads, investment grade credit and high yield had stronger returns (+2.5% and 8%, respectively) for the year.

Fourth quarter attribution for equities had a similar flavor to the year overall with the US outperforming, powered by large cap growth (+6.2%) and high momentum factor (+5%). All major international regions lagged the US, with both developed (EAFE -8%) and emerging markets (-7%) experiencing negative returns for the quarter. The post-election rally saw a brief break in trend with small caps and energy stocks surging, but ultimately both faded and underperformed.

Within fixed income, there was nowhere to hide from the rate move among core sectors; all major sectors suffered negative returns (MBS and credit were both -3%). Shorter duration (short credit: -0.4%), high yield, and floating rate exposure offered the best options (high yield: -0.1%, bank loans: +2.3%). International bond markets faired poorly amid a strong dollar and rising trade concerns, with broad international and emerging markets indices losing 6% to 7%.

Macro Outlook & Positioning

On the surface, macro conditions and confidence appear supportive into 2025, suggesting the table is set for another decent year across major asset classes. We believe this upside potential comes with greater uncertainty and hurdles, most prominently valuations and policy risk. Broadly, we see four key macro drivers for 2025. The first three – a healthy consumer, excess liquidity, and easing global policy are supportive and should continue to drive growth (2%-3% in the US and 3%-4% globally) and underpin spreads and multiples. The fourth macro driver is a high level of policy uncertainty, specifically trade and fiscal policy, which elevates risks and creates a wider range of outcomes. While trade may garner more headlines and has forced the Fed to account for possible future inflation pressures, we believe fiscal policy direction could be more impactful. Government spending has been a large factor in consumer resilience, job creation, and inflation this cycle. Any success by the new administration to temper spending could cause a drag on growth that is not priced into outlooks. This environment has made for a challenging rate market, with the Fed coming out of the gate with an aggressive cutting plan that has dissipated on strong data and renewed inflation concerns. The repricing in yields since September has been aggressive and should temper rate outlooks into 2025. With cuts being priced out almost completely, any growth or inflation disappointments will likely generate a rapid repricing in yields the other way. So, while momentum may carry yields modestly higher in the near-term, medium-term risk for 2025 looks skewed toward the downside. Given the magnitude of unknowns in 2025, our positioning leans on what we do know. We enter the year with higher and attractive core fixed income yields and curves that are no longer inverted. Paired against high price/earnings ratios in equities, this makes a strong case for rebalancing back to at least target allocations in fixed income. It also suggests staying high quality with less incentive to reach for yield, and despite rate volatility, carry duration to hedge macro risks and lock in higher yields with coupon bonds vs. cash. Within equities we continue to favor the US regionally but have geared allocations to have lower valuation and concentration risk vs. broad markets.

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Fixed Income Overview

A strong economy and stubborn inflation data have led to a more difficult environment for rates and fixed income returns. Although recalibrating risks and adjusting Fed expectations have been challenging, bond investors are better positioned for 2025 than it might initially appear. Markets have been highly effective in accounting for increased risks and largely discounting the Fed. This leaves rates better priced for fiscal uncertainty and a "no landing" scenario. Upward pressure on yields may persist in the near-term, but pricing risk now skews more to the downside for yields on any data disappointments and better fiscal outcomes. Our outlook for the year focuses on the structural support to fixed income in the form of attractive all-in yields, which provide a strong base for returns and relative value vs. other assets. Core investment grade yields above 5% offers a cushion to rate volatility and a nice baseline for returns. When compared to the earnings yield of just over 4% for the S&P 500, this yield gap is the best relative value for fixed income since 2007. Our game plan into 2025 is to lean into yield carry and drive yield through relative value opportunities and security selection but keep overall portfolio risk low. For credit allocations, risks are balanced with a strong fundamental and technical picture, but with very full valuations. Credit spreads do not spend much time sub-80 basis points but can travel in a low range for extended periods if conditions are right. These conditions appear to be in place for 2025, with low volatility, solid fundamentals, and positive profit outlooks. That said, we are defensively minded in our allocation, focused on selection instead of expanding spread risk. We favor sectors with earnings tailwinds, such as banks, air lessors, and companies that support AI infrastructure. A good portion of our spread risk allocation has been rotated to our securitized overweight, with the agency MBS sector offering the best relative value in core fixed income. Among core plus strategies, we carry a moderate allocation to non-core sectors, including emerging markets and preferred stocks, but we lowered our high yield exposure in favor of bank loans during the fourth quarter.

Equity Overview

Risk assets are priced for very favorable outcomes in 2025. While this optimism is well grounded in recent data, and expectations of deregulation and strong earnings, the year also begins with some hurdles and unforgiving valuations. We see further upside but lower returns than in 2024, along with higher volatility and greater dispersion. Policy unknowns will keep markets more off balance in 2025, and the new administration has less fiscal room to maneuver, which could impact growth outlooks. Additionally, the global growth outlook is more precarious given the strong dollar trend, weak growth in the EU, and a still unconvincing path for China. Finally, valuations by themselves aren't a catalyst for weak near-term returns but multiples suggest meaningful upside will be more difficult. Our baseline view into 2025 is to stay fully invested, with full beta, but be more mindful of valuations and concentration risk. Regionally, we believe it still makes sense to favor the US given the strong dollar, trade policy risks, and China growth concerns, which all remain headwinds for EM and Europe. While US markets are overvalued, it is mostly in larger or mega cap names. We believe an effective way to add diversification and tamp down US valuations is through small caps. This adds to an area that has significantly outperformed with a favorable outlook and more attractive valuations. Our other factor tilt is high free cash flow sectors, such as healthcare, which offer a better hedge in economic weakness, and energy, which has attractive valuations.