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LESSONS TO CARRY FORWARD IN 2025

Executive Summary

- With another year in the rearview mirror, it is worth pausing and looking back on key lessons from 2024, that market participants can carry forward into 2025 and beyond.
- Every business cycle is different, none more so than this post-COVID cycle. The past few years have taught us that the driving forces of the U.S. and global economies are evolving, and that investors should remain open to new forces that may impact traditional forecasting models.
- Market forecasting is hard. Investors are better served being diversified and focused on long-term portfolio strategies, while retaining flexibility to navigate inevitable medium-term volatility. Moreover, assessing potential upside and downside risks to the base case scenario is an important component of a successful investment process, especially when market consensus is crowded around a specific outcome.
- Valuations alone offer only a partial understanding of a specific asset class. They may present an attractive buying opportunity when they are cheap or indicate increased vulnerability to unexpected risks when they are rich, but whether these opportunities or risks are unlocked is mostly determined by the evolution of underlying fundamentals. To this effect, the ongoing resilience of the U.S. consumer and robust profit growth is a powerful tailwind that can support further equity gains even against the backdrop of elevated valuations and geopolitical and policy uncertainty.
- We expect market volatility to be more frequent in 2025 as government and monetary policy uncertainty keeps the range of possible economic outcomes wide. In such an environment, harnessing the lessons learned over the past few years will be paramount, and we recommend investors stay diversified and anchored in their long-term asset allocations.

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With another year in the rearview mirror, it is worth pausing and looking back on key lessons from 2024, that market participants can carry forward into 2025 and beyond. Yes, equities recorded another strong year, with the S&P 500 up 25% including dividends. And yes, volatility was subdued for most of 2024, as the VIX (the closely followed gauge of stock volatility) averaged just around 15, compared to the long-term average of 19. But that doesn't mean that investors had an easy time forecasting such gains, or shrugging off several episodes of economic, geopolitical, and monetary policy uncertainty. To the contrary, 2024 proved to be another year in the post-pandemic era when old-school forecasting models and economic paradigms were challenged.

In our 2025 Outlook, we introduced four themes that we think are going to shape the economy and markets this year, and we outlined our base-, best- and worst-case scenarios. The following considerations have been key to shaping our expectations for what lies ahead.

1. **Every business cycle is different, none more so than this post-COVID cycle.**

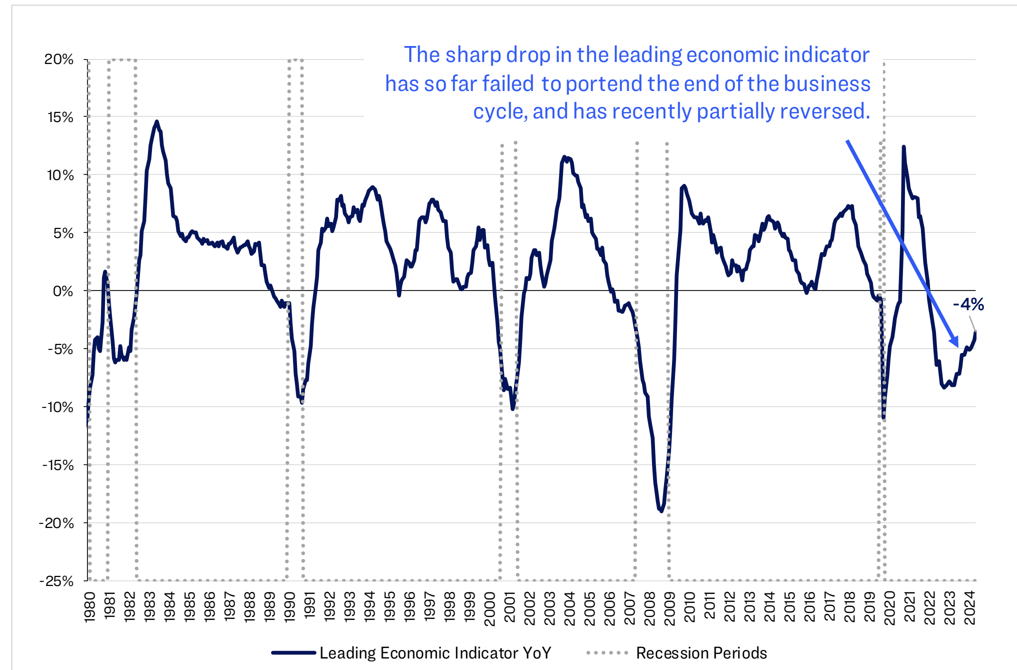
   - Traditional economic and market indicators that historically portended the end of a business cycle have so far provided a false signal (Figure 1). Despite a record inversion of the yield curve (the differential between 10-year and 2-year Treasury yields), persistently negative manufacturing data, and a broad-based decline in small-business and consumer confidence, the U.S. economy has continued to grow at a rate higher than the long-term trend (~2% GDP growth).

- Our view is that the economy, and in particular, household consumption was supported by several factors, from more than $2 trillion in excess savings accumulated during the pandemic, to a healthy labor market that has driven robust income growth, to the rise in household net worth and insensitivity to higher interest rates. In addition, the artificial intelligence (AI)-related wave of private and public investments, the strong rebound in productivity growth, and the positive impulse provided by immigration have all contributed to a resilient economic picture.

- The past few years have taught us that the driving forces of the U.S. and global economies are evolving, and that investors should remain open to new forces that may impact traditional forecasting models.

FIGURE 1

Traditional economic leading indicators have been less useful to assess the health of the current business cycle than they were in the past.



The Leading Economic Indicator aggregates ten leading indicators, from consumer confidence to credit spreads.
Source: Conference Board, Bloomberg, TIAA Wealth Chief Investment Office.

2. **Market forecasting is hard. A healthy skepticism, absorbing different perspectives, and remaining disciplined is important.**

    - The rapid Federal Reserve (Fed) monetary tightening cycle in 2022 led to a widespread consensus that a recession would materialize in 2023. Some of those calls were extended into 2024 as the economy continued to defy expectations, and instead the combination of the factors described above propelled the economy and markets towards solid performance yet again.

    - We take away two lessons from this: 1) investors are better served being diversified and focused on long-term portfolio strategies, while retaining flexibility to navigate inevitable medium-term volatility; 2) assessing potential upside and downside risks to the base case scenario is an important component of a successful investment process, especially when market consensus is crowded around a specific outcome.

3. **Valuations and narrow market breadth should be monitored, but matter less in the near term.**

- U.S. Large Cap stocks are now trading at valuations that are higher than 95% of all historical observations. But valuations were elevated at the end of 2023 as well, and managing one's equity exposure solely based on this indicator would have prevented investors from capturing another 20%+ performance for U.S. equities in 2024.

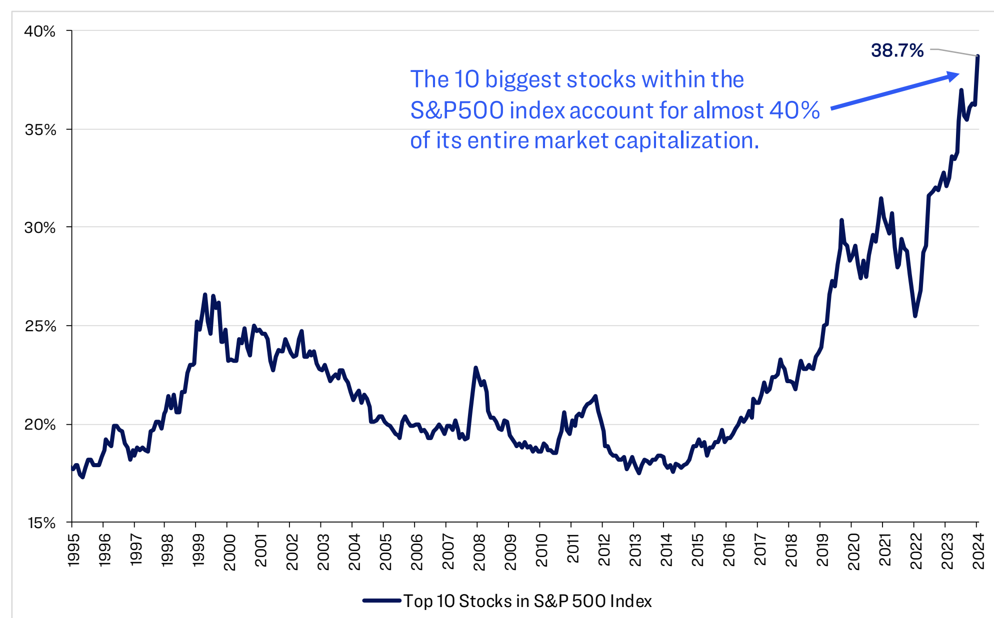
- Valuations appear elevated also in the credit market, where bond spreads are trading at some of the tightest levels of the past four decades. However, history shows that low spreads can persist for long stretches of time, especially when there is a lack of negative fundamental catalysts. Against the still healthy backdrop for economic and corporate profit growth, investors have so far instead focused on still attractive yields in both the investment grade and high yield corporate bond markets.

- Like elevated valuations, poor market breadth, defined as a declining number of stocks that contribute to gains for the overall index, may represent a risk to markets and should therefore be monitored. However, like elevated valuations, poor market breadth has now persisted for the past couple of years without triggering any significant downturn in stock prices.

- A key lesson learned is that valuations alone offer only a partial understanding of a specific asset class. They may present an attractive buying opportunity when they are cheap or indicate increased vulnerability to unexpected risks when they are rich, but whether these opportunities or risks are unlocked is mostly determined by the evolution of underlying fundamentals. As a result, investors have been willing to look through rich valuations or excessive market concentration (Figure 2) as fundamentals have remained supportive of further equity gains.

FIGURE 2

The U.S. equity market has become increasingly more concentrated.



Source: FactSet, TIAA Wealth Chief Investment Office.

4. **The positive outlook for corporate profits represents a powerful support for markets.**

    - Despite fears that elevated interest rates and labor costs would eventually hit profit margins, corporate profit growth for U.S. Large Caps accelerated in 2024 (likely to 9% year-over-year, up from 1.5% in 2023), and are now expected to grow ~15% for the S&P 500 index in 2025, expected to be powered by a still resilient economy and secular tailwinds from AI, datacenters and infrastructure spending.

    - Robust profit growth is a powerful tailwind that can support further equity gains even against the backdrop of elevated valuations and geopolitical and policy uncertainty.

5. **Counting the U.S. consumer out has proven to be a losing proposition time and time again.**

    - Low-income consumers have been on the back foot for some time, penalized by the ongoing decline in affordability for groceries to housing, and by the less exposure to those assets that have gained in value over the past few years. This has caused delinquency rates on credit cards and auto loans to spike since 2022. But consumers in the lower 40% of the income distribution account for only 22% of total household consumption in the U.S., and households in the upper end of the income distribution have continued to spend at a healthy clip.

    - Given strong personal finances and rising net worth, the U.S. consumer is unlikely to stop spending as long as employment conditions and therefore income growth remain solid, as we also discussed in the FocusPoint titled "The Household Wealth Effect – From Wall Street to Main Street."

6. **Negative headlines don't generally derail long-term investment strategies.**

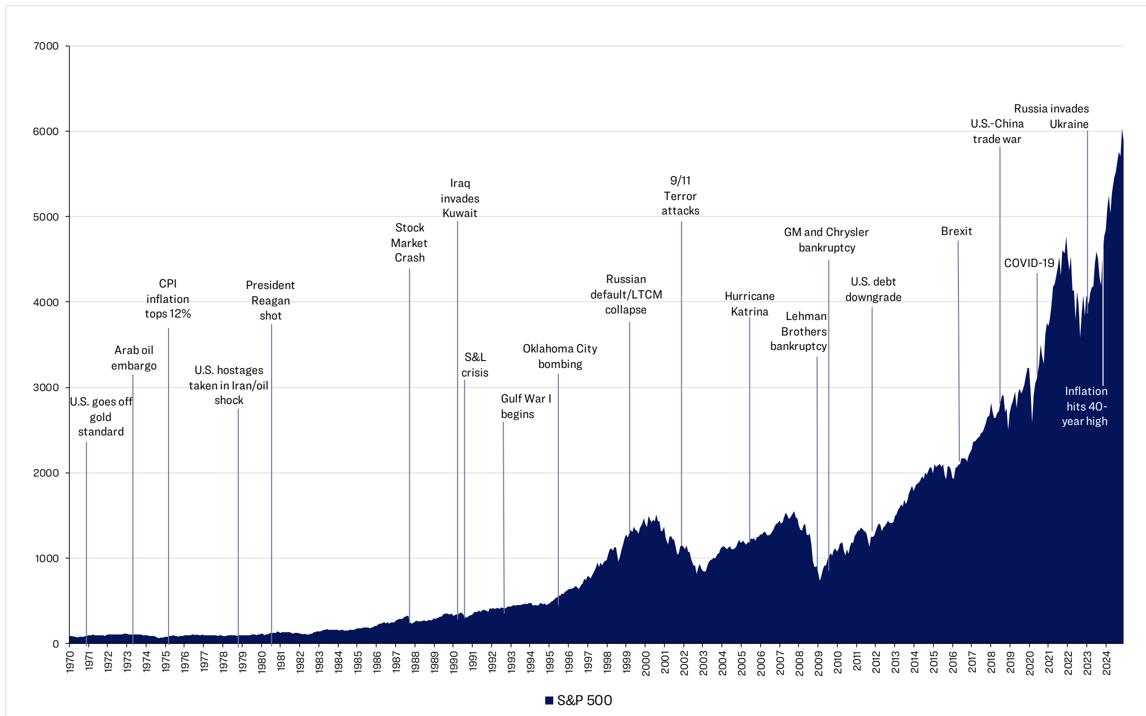
    - As noted above, low market volatility in 2024 should not be mistaken for an indication that nothing happened throughout the year. More than 70 countries held political elections, including the U.S.; geopolitical tensions constantly flared up in the Middle East and Ukraine; concerns about fiscal deficits and inflation kept bond volatility elevated and recurring; the U.S. unemployment rate rose from 3.7% in January to 4.1% in December - all of this has been conducive to significant business, consumer and investor uncertainty.

    - Once again, the lesson learned is that episodes of short-term market volatility tend to quickly fade once investors gain the necessary confidence that the underlying economic and market fundamentals have not been impaired (Figure 3).

    - A diversified and long-term investment approach guided by fundamentals is crucial to avoiding overreactions to short-term price swings.

FIGURE 3

Financial markets are known to recurringly climb a wall of worry.



Source: Morningstar Direct, TIAA Wealth Chief Investment Office. Data through 12/31/24.

Conclusions

We don't want to take these lessons for granted. The economy and markets are constantly fluctuating as technological progress marches on, regulations and government policy evolves, companies innovate and manage through competitive landscapes, consumer preferences change, and geopolitical uncertainties surge before settling into new paradigms.

We expect market volatility to be more frequent in 2025 as government and monetary policy uncertainty keeps the range of possible economic outcomes wide. In such an environment, harnessing the lessons learned over the past few years will be paramount, and we recommend investors stay diversified and anchored in their long-term asset allocations.

CIO PERSPECTIVES

TIAA Wealth Management

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