Homestead Funds

2025 Market Outlook

Strong Economy Guides Soft Landing; U.S. Election to Bring Policy Shifts in 2025

Summary

- The strong U.S. economy produced tailwinds for investors in 2024, as corporate growth, high employment and a healthy GDP helped fuel nearly 25% annual gains in the S&P 500 for the second year in a row. Bond market performance was mixed in 2024, with short-term yields declining notably since 2023 and long-term yields edging upward amid concerns over the increasing potential for higher inflation.
- The Federal Reserve (Fed) reached the coveted "soft landing" after more than two years of efforts to bring down inflation without tipping the economy into a recession. After a gradual decline in the Consumer Price Index (CPI) measurement of inflation from 9.1% in 2022 to 2.4% in September 2024, the Fed added three rate cuts totaling 1.0% in the third and fourth quarters of 2024. While the market was expecting six 25 basis point cuts at the beginning of 2024, in December the Fed signaled a more cautionary approach due to concerns over inflation and the impact of significant policy changes with the incoming Trump presidential administration.
- As the market has experienced robust growth over the past two years, some question how long the elevated bull run can last. The next year will offer some insights into those questions. And, while there are concerns over economic and inflationary forces, there are also new growth opportunities. The surge in adoption of generative artificial intelligence (AI) and its potential to impact productivity, efficiency and revenue streams is one example. While in its early stages, AI is now moving into a broader adoption role with many firms and could offer investors long-term growth that is not reliant on short-term economic cycles.

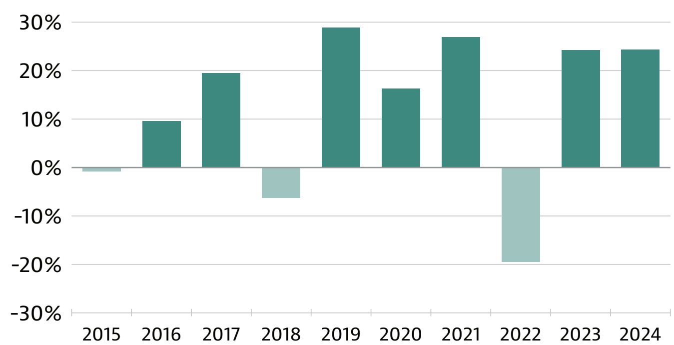
This commentary was prepared on December 23, 2024, and reflects our view of events at that time. Please visit our website, homesteadfunds.com, for the latest perspectives.

The Mixed Outlook for Political and Economic Landscape

The stock market experienced an impressive bull run in 2024, with major indexes reaching dividend-adjusted returns of about 25% (S&P 500) to 30% (Nasdaq). The market continued its robust run, mixed with some volatility, following the election of Donald Trump. Many investors are expecting significant shifts in economic, tax and regulatory policies that would support corporate growth and benefit the financial and industrial sectors, among others. The new administration is expected to extend expiring 2017 tax cuts and add other modest cuts, which could drive performance further.

Heading toward 2025, many economic indicators are solid, with strong employment and production in manufacturing and other sectors and U.S. GDP growth increasing by 3.1% annually in the third quarter of 2024. Many corporate valuations have reached elevated levels, however, raising concerns about the longevity of this robust cycle and the potential for instability if earnings projections fall short of expectations.

S&P 500 Historical Annual Returns



Source: Macrotrends

There are also concerns about the impact of the new administration's proposed tariffs and immigration policies on inflation, the supply and cost of labor, and geopolitical conditions. Tariffs could drive a modest increase to consumer prices and create uncertainty among businesses regarding potential trade tensions. Yet, unless tariffs escalate into a wider trade conflict, their impact may be softened by the positive aspects of tax cuts and a more business-friendly regulatory environment.

Strong Fixed-Income Returns Attract Investors

Fixed-income investments fared well in 2024, with a record $600 billion invested in the global bond market alone as investors focused on locking in higher yields and stability ahead of an uncertain 2025. Given higher interest rates, coupon and carry returns have been attractive to investors. Yields hovered around 4% most of the year, providing a cushion against any instability in the equity markets.

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At the end of 2024, the benchmark 10-Year Treasury posted a yearly average of 4.21%, a 6.24% annual increase over 2023. Liquidity in the fixed-income category has been robust, generating more attention from investors.

Positive Outlook for Stocks

The outlook for stocks is cautiously optimistic for 2025 given the presence of higher market valuations and high investor expectations. Large-cap stocks should benefit from improving macroeconomic conditions and the continued adoption of AI, which has driven significant growth in recent years as companies move from the adoption stage to more fully integrating it into their business operations to increase productivity, speed-to-market and revenue.

Small-cap stocks could benefit from lower interest rates and corporate tax reductions, which are favorable to companies with a concentration of domestic income. Value stocks are also appealing after underperforming growth stocks over the past decade, but this category can still offer solid growth prospects with attractive valuations.

U.S. Equities Market Attributes

				Annualized Returns	
Index	1-Month (%)	3-Month (%)	YTD (%)	1-Year (%)	3-Year (%)
S&P 500 Index	-2.38	2.41	25.02	25.02	8.94
Dow Jones Industrial Average	-5.27	0.51	12.88	12.88	5.40
S&P MidCap 400 Index	-7.12	0.34	13.93	13.93	4.87
S&P SmallCap 600 Index	-7.95	-0.58	8.70	8.70	1.91

Source: S&P Global. Data as of 12/31/2024. *Past performance is no guarantee of future results.*

Cautious Optimism Prevails Heading into 2025

Market sentiment heading into 2025 is generally optimistic, tempered with some caution. The U.S. economy has shown notable resilience coming out of a global pandemic, yet persistent inflation remains a concern.

With the presidential election decided, there is more certainty around some policies that would positively impact corporate growth. There are concerns that trade and monetary policies could create volatility and resurrect inflationary headwinds. The market will be closely monitoring the new administration in 2025 as policies are presented in more detail.

Index Definitions: The S&P 500 is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization. The Dow Jones Industrial Average is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities. The S&P MidCap 400 provides investors with a benchmark for midsize companies. The index, which is distinct from the large-cap S&P 500, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The S&P SmallCap 600 seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results. Forward-looking statements are subject to certain risks and uncertainties. Actual results, performance or achievements may differ materially from those expressed or implied. Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions. It should also not be construed as advice meeting the particular investment needs of any investor.

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Debt securities are subject to interest rate risk, credit risk, extension risk, income risk, issuer risk and market risk. The value of U.S. government securities can decrease due to, among other factors, changes in interest rates or changes to the financial condition or credit rating of the U.S. government. Investments in asset-backed and mortgage-backed securities are also subject to prepayment risk as well as increased susceptibility to adverse economic developments. High-yield, lower-rated securities involve greater risk than higher-rated securities.

Equity securities generally have greater price volatility than fixed-income securities. The market price of equity securities may go up or down, sometimes rapidly or unpredictably. Equity securities may decline in value due to factors affecting the issuer or equity securities markets generally.

Growth and value stocks are subject to the risk, among others, that returns on stocks within this style category will trail returns of stocks representing other styles or the market overall over any period of time and may shift in and out of favor with investors generally, sometimes rapidly, depending on changes in market, economic and other factors. Growth stocks can be volatile, as these companies usually invest a high portion of earnings in their business and therefore may not provide the dividends of value stocks that can cushion stock prices in a falling market. Also, earnings disappointments often lead to sharply falling prices because investors buy growth stocks in anticipation of superior earnings growth. Investments in value securities may be subject to risks that (1) the issuer's potential business prospects will not be realized; (2) their potential values will not be recognized by the market; and (3) they will not perform as anticipated.

As a general matter, securities of small and midsize companies tend to be riskier than those of larger companies. Compared with large companies, small and midsize companies may face greater business risks because they may lack the management depth or experience, financial resources, product diversification or competitive strengths of larger companies, and they may be more adversely affected by economic conditions. There also may be less publicly available information about smaller companies than larger companies. In addition, these companies may have been recently organized and may have little or no operational or performance track record. Diversification does not guarantee a profit or protect against loss in a declining market. It is a method used to help manage investment risk.

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