Market Commentary

First Affirmative
FINANCIAL NETWORK

Welcome to the Jungle

January 2025

Welcome to the Jungle

Overview

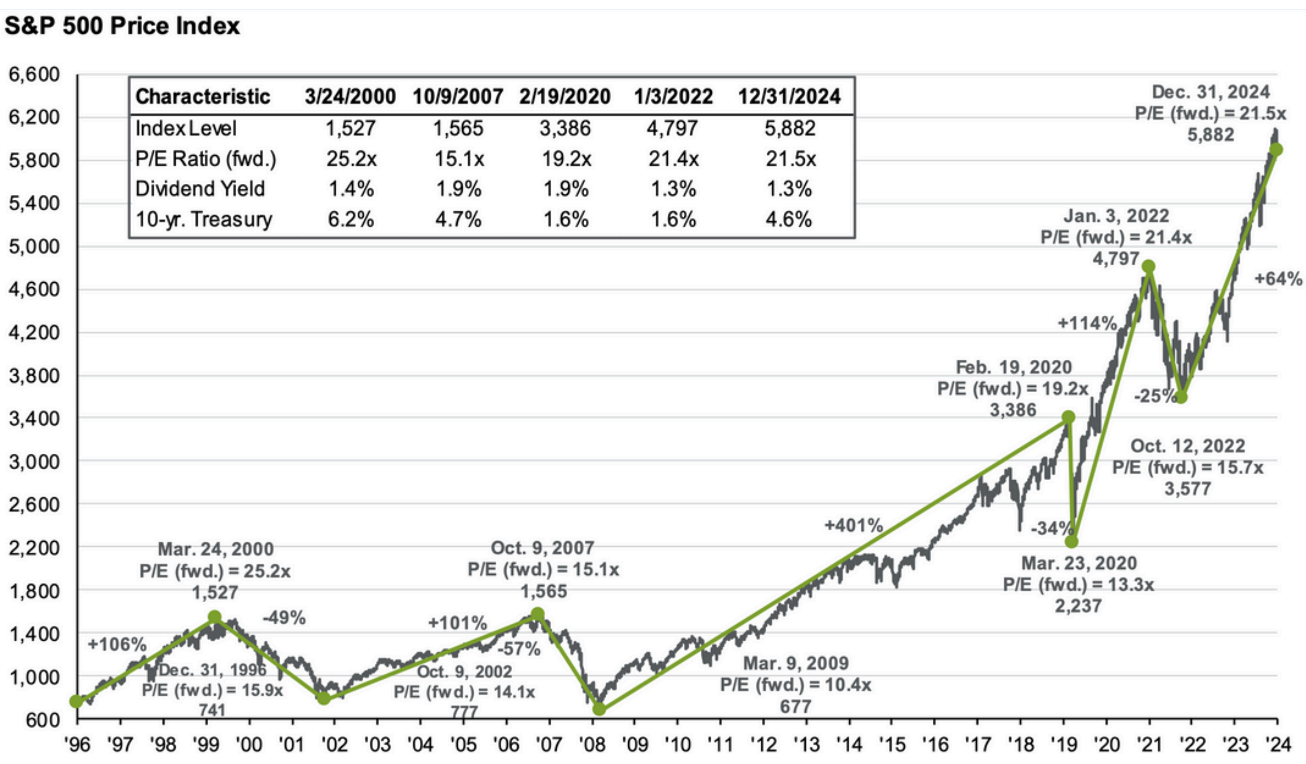
Theresa Gusman, CIO
January 30, 2025

US equities extended their impressive run in 2024, with the S&P 500 advancing 25%, building on the 26% gain in 2023. The index reached record highs, surpassing its January 2022 peak by 23% and the March 2020 COVID-19 low by a remarkable 163% (see Figure 1).

For the second consecutive year, the Artificial Intelligence (AI) revolution and the remarkable performance of the Magnificent Seven drove US markets in 2024, allowing the US to continue outperforming the rest of the world.

On January 27th, AI-related stocks experienced a sharp downdraft as Chinese innovator DeepSeek introduced an AI platform it claims is better, cheaper, and faster than existing platforms. As additional details emerged, the shares of Semiconductor, Nuclear, and Utilities companies and their suppliers rebounded. This volatility is a reminder that AI technology is advancing rapidly, disruptors will continue to emerge, and we must remain vigilant.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2024

Elections Have Consequences

Although we tend to focus on the US, four BILLION people in 70 countries went to the polls in 2024. According to the Financial Times, “every governing party facing election in a developed country this year (2024) lost vote share, the first time this has ever happened”. These outcomes must be viewed as a global mandate for change – particularly on immigration policies and growth, which were front and center worldwide.

As policy changes at home and abroad come fast and furious, market volatility may increase – particularly in the near term. That said, the US economy and corporate earnings have been resilient as inflation has stabilized at a lower level and the Fed cut interest rates. We do not anticipate significant US interest rate cuts from current near-equilibrium levels in 2025, and the new administration inherited a precarious fiscal situation. However, we believe deregulation, increased foreign investment, innovation, declining global geopolitical tensions, rising legal immigration, and unleashing “animal spirits” could underpin US economic growth, earnings, and the equity market this year.

President Trump's climate-related and diversity, equity, and inclusion (DEI) executive orders issued on January 20, 2025, are poised to influence the commitment of the country, corporate America, and large asset managers to further progress on environmental, social, and governance issues.

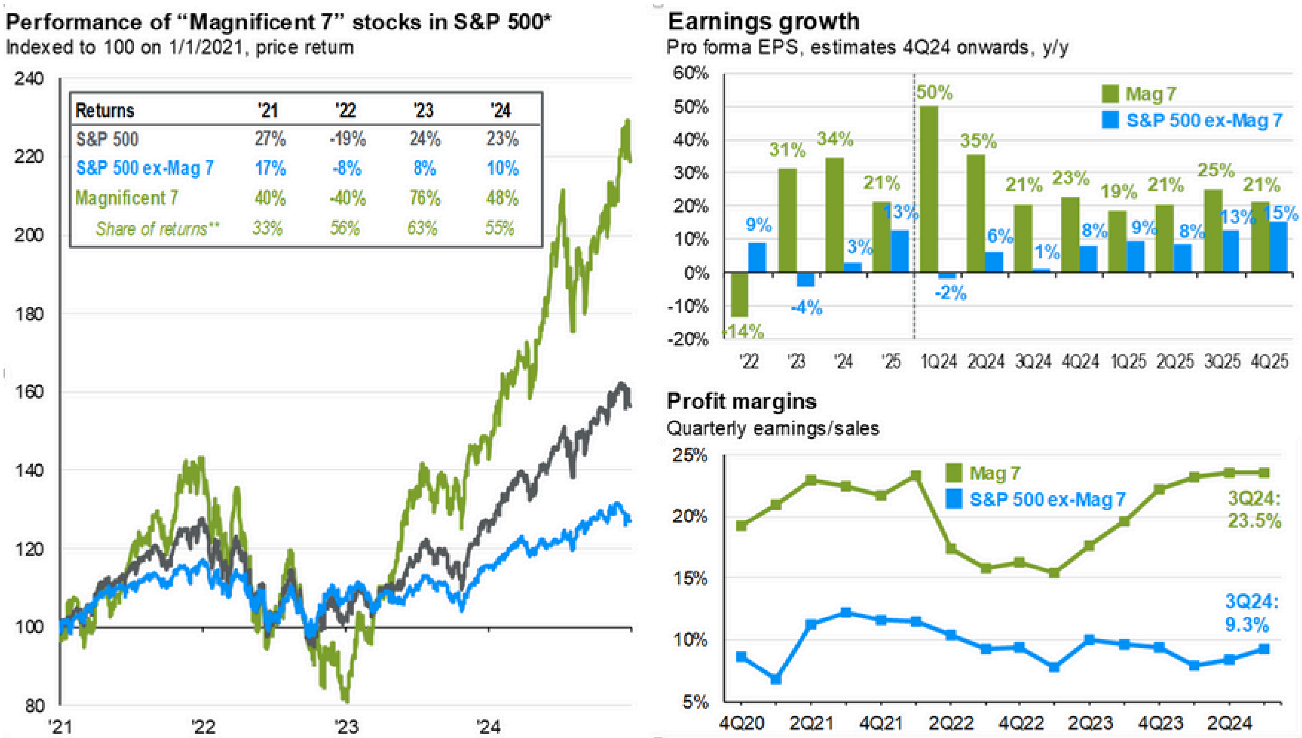
As policy changes at home and abroad come fast and furious, market volatility may increase – particularly in the near term.

Against this backdrop, we believe the best way forward is to focus on education, personalization, accessibility, and transparency in both portfolio management and proxy voting and corporate advocacy. Our **Values Aligned Direct Index Solution (VADIS)** and proxy voting and advocacy efforts enable advisors to educate their clients and work with them to identify the Values Set best aligned the client’s view of the world, incorporate those Values into the client’s personal Investment Universe, and construct a portfolio and advocacy plan targeting the client’s long-term financial and impact objectives.

2024 – Magnificent Seven and US Exceptionalism Redux

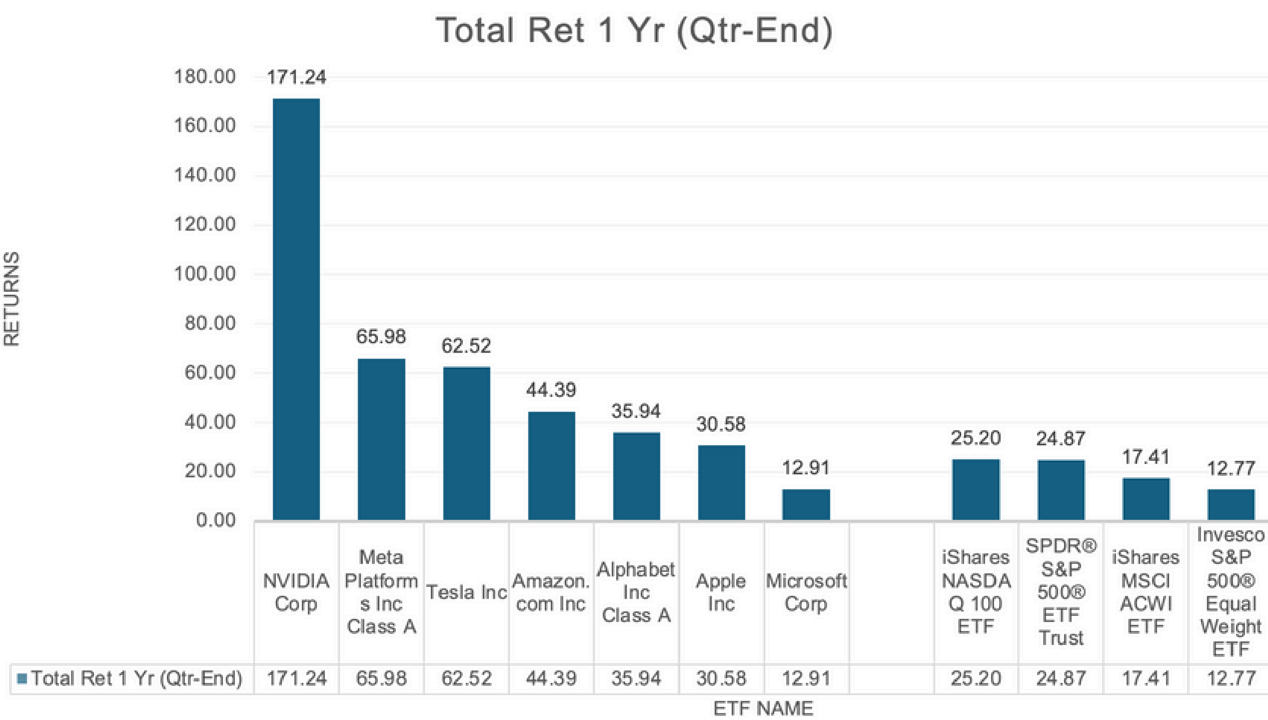
The "Magnificent Seven"—Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta—surged 48% in 2024 following a 76% increase in 2023 (see Figure 2). By comparison, the broader market (i.e., the other 493 S&P 500 stocks) advanced by a more pedestrian 8% in 2023 and 10% in 2024, respectively. In the fourth quarter, the equal weighted S&P 500 and the MSCI ACWI Index declined by 1.87% and 0.94%, respectively, as the S&P 500 rose 2.4% and the NASDAQ increased 6.4% (see Figures 3 and 4).

Figure 2. Magnificent Seven Performance and Earnings Dynamics, As of December 31, 2024



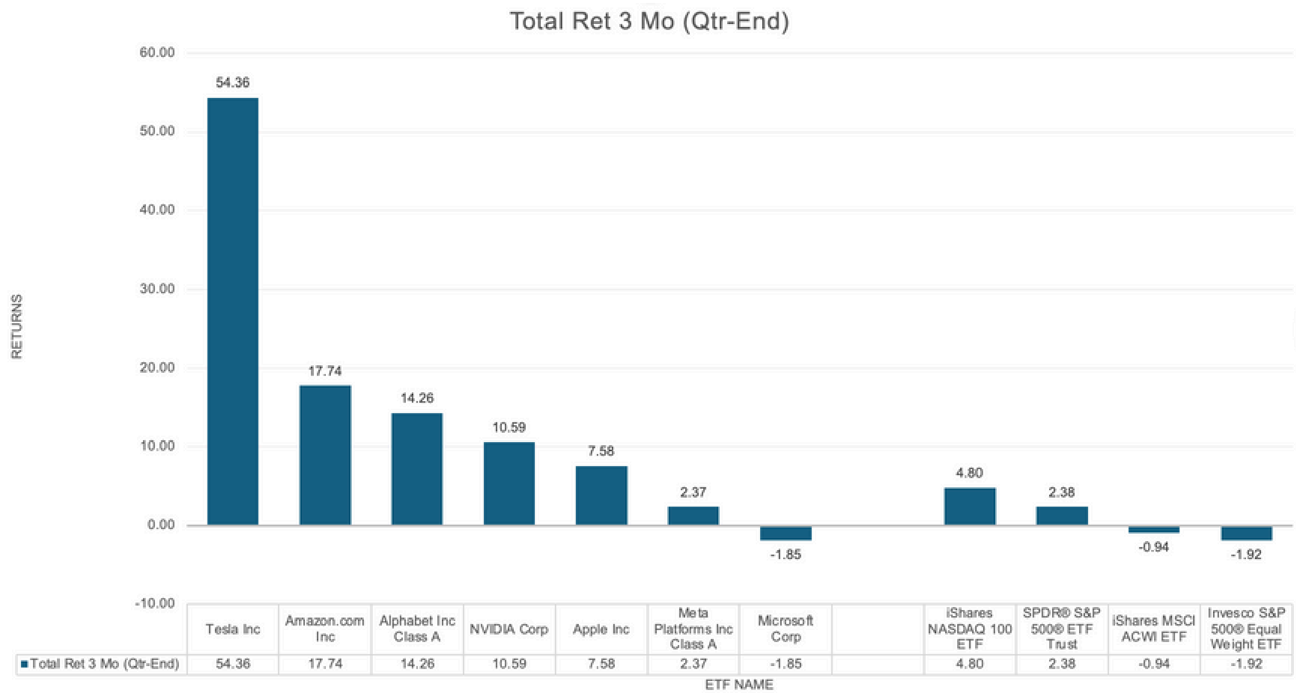
Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2024

Figure 3. Magnificent Seven Returns, Year Ended December 31, 2024



Source: First Affirmative, Data are as December 31, 2024

Figure 4. Magnificent Seven Returns, Quarter Ended December 31, 2024



Source: First Affirmative, Data are as December 31, 2024

Driven in part by the performance of the Magnificent Seven, US equities surged 25.0% in 2024, far outpacing international markets (see Figure 5). Only Taiwan – dominated by chip behemoth TSMC – outperformed the US last year. 2024 was only the latest in several years of "American exceptionalism" (as market pundits call this excess performance). Over the past 15 years, as US earnings growth outpaced the rest of the world, US stocks returned 13.9% annually, on average, more than double the 5.7% annualized return of developed international markets (EAFE) and triple the 3.9% annualized return of emerging markets. The US now comprises 67% of the global MSCI All Country World (ACWI).

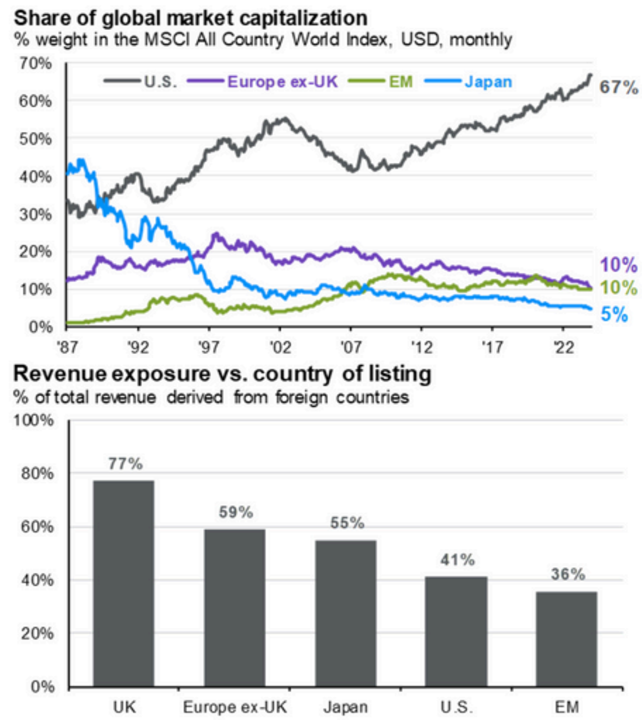
The concentration of companies within the US equity market and the United States in global indices has raised concerns among investors that a bubble has been inflated and is poised to burst. As evidenced by recent volatility, we must remain vigilant as disruptive technologies threaten Magnificent Seven dominance. However, this is not the Dot-Com bubble of the mid-1990s-2000 – a period during which investors were valuing companies based on "numbers of eyeballs", rather than earnings (which were non-existent for most Dot-Com companies). In contrast, as the Magnificent Seven stocks have surged higher, so have their earnings, particularly flag-bearer Nvidia's. According to FactSet, in aggregate, the Magnificent Seven are expected to report year-over-year earnings growth of 21.7% for the fourth quarter (see Figure 6). Excluding these seven companies, FactSet estimates the earnings growth rate for the remaining 493 companies in the S&P 500 will be (a still strong) 9.7% in the fourth quarter.

According to FactSet, robust growth for the Magnificent Seven will continue. Analysts predict the Magnificent Seven in aggregate will report earnings growth of more than 17% over the next four quarters, nearly double the expected growth of the other 493 stocks in the S&P 500. The case for continued strong growth in AI is underpinned by myriad productivity-improving applications across industries which will only accelerate as the cost of AI solutions declines.

One anecdote: Goldman's CEO recently said that 95% of an S-1 filing could be completed by AI applications in just a few minutes compared to 6 <highly paid> banker analysts spending two weeks drafting documents. The cost savings associated with using an AI application to compile the massive registration statement that a company must submit to the Securities and Exchange Commission (SEC) before going public with an initial public offering (IPO) are huge. And we are hearing about equally impressive productivity and outcome enhancing applications across industries. Adoption rates of productivity enhancing AI solutions will continue to accelerate as the cost of these solutions declines.

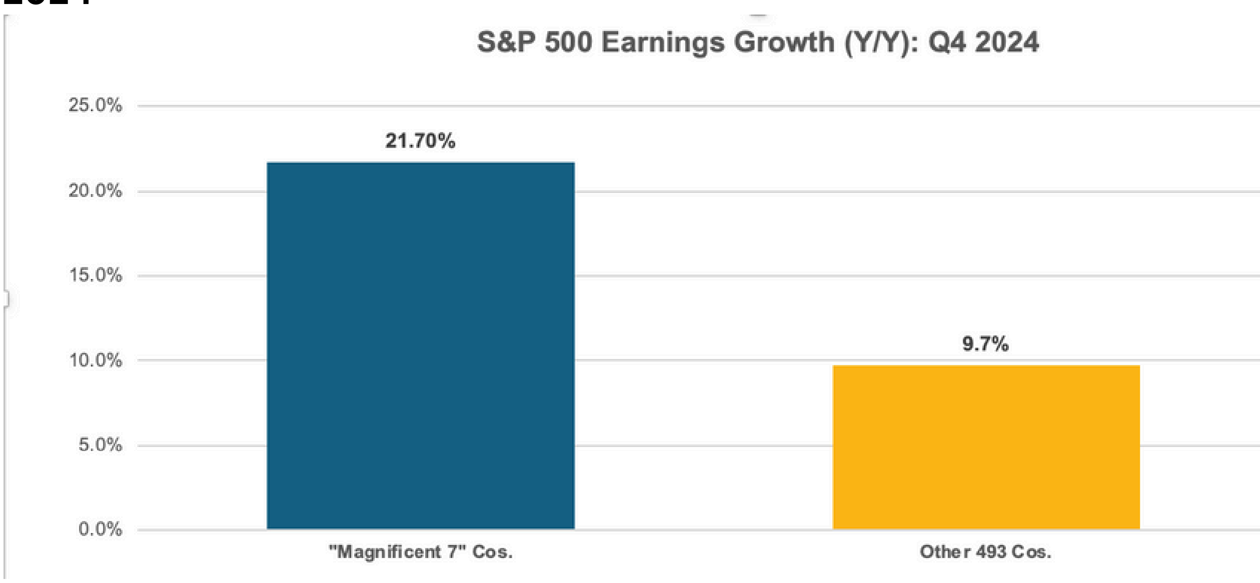
Figure 5. Global Equity Markets Performance, As of December 31, 2024

Returns	2024		2023		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	25.0	-	26.3	13.9	1.0
AC World ex-U.S.	13.2	6.1	14.7	16.2	5.2	1.0
EAFE	11.8	4.3	16.8	18.9	5.7	1.0
Europe ex-UK	8.1	1.0	17.3	22.7	6.0	1.1
Emerging markets	13.7	8.1	10.3	10.3	3.4	1.0
Selected Countries						
Japan	21.2	8.7	29.0	20.8	6.3	0.8
United Kingdom	9.5	7.5	7.7	14.1	4.9	1.0
France	1.8	-4.6	18.1	22.3	5.8	1.2
Canada	23.0	12.7	13.3	16.4	5.9	1.1
Germany	18.4	11.0	19.8	24.0	5.7	1.3
China	19.8	19.7	-10.6	-11.0	2.5	0.9
Taiwan	44.3	35.1	31.1	31.3	12.0	1.0
India	15.7	12.4	22.0	21.3	6.9	0.9
Brazil	-11.4	-29.5	22.7	33.4	-2.5	1.3



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2024

Figure 6. Fourth Quarter S&P 500 Earnings Composition, As of December 31, 2024



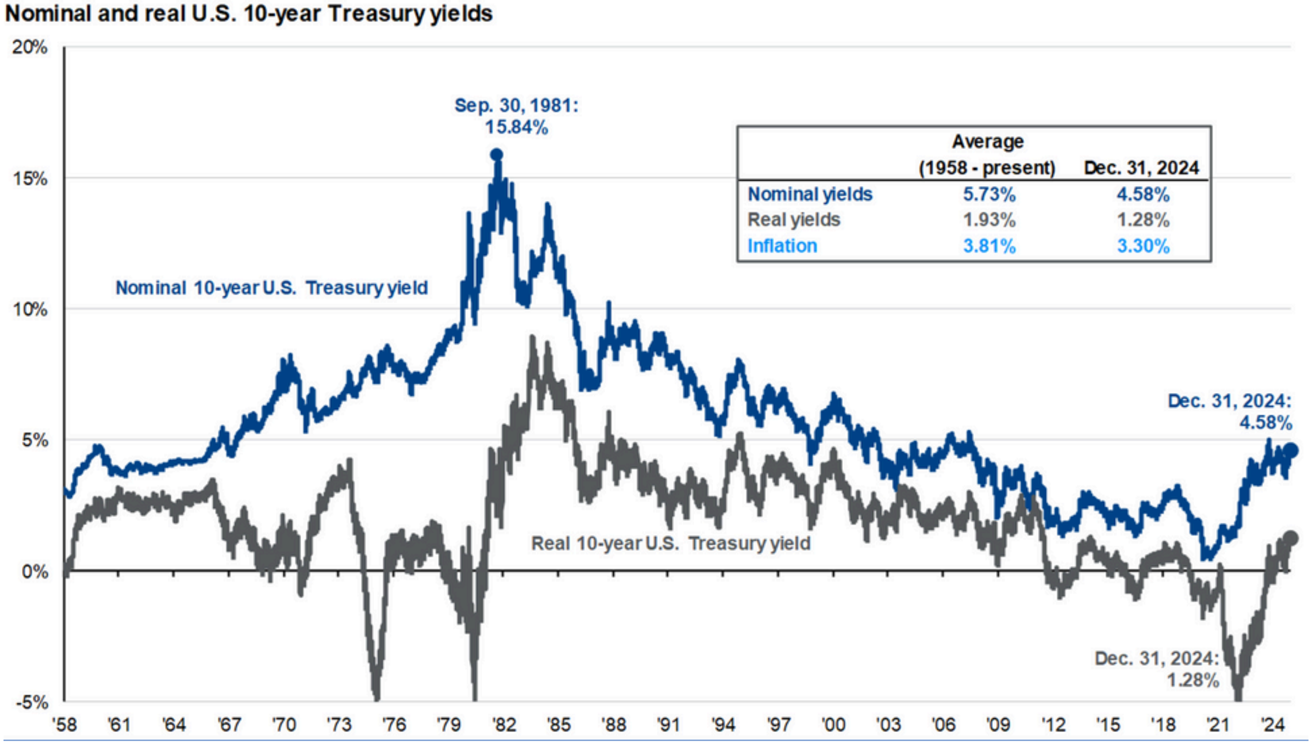
Source: FactSet, December 31, 2024

Inflation and Interest Rates – Higher for Longer Redux

At its September meeting, the Federal Reserve lowered the federal funds rate by 50 basis points from 5.33% to 4.83%, easing monetary policy for the first time in four years amid progress toward its dual inflation and unemployment mandates. Despite pressure to ease rates earlier in the year, the Fed maintained a “higher for longer” approach through September, emphasizing its commitment to fighting inflation.

As inflation continued to cool in the third quarter, moving toward the Fed’s long-term target of 2%, and unemployment remained steady, the Fed slashed interest rates. This is reflected in Figure 7, which shows that real 10-year Treasury yields are approaching their long-term average after a long period of significant divergence in inflation and interest rates.

Figure 7. Nominal and Real US 10-Year Treasury Yields, As of December 31, 2024

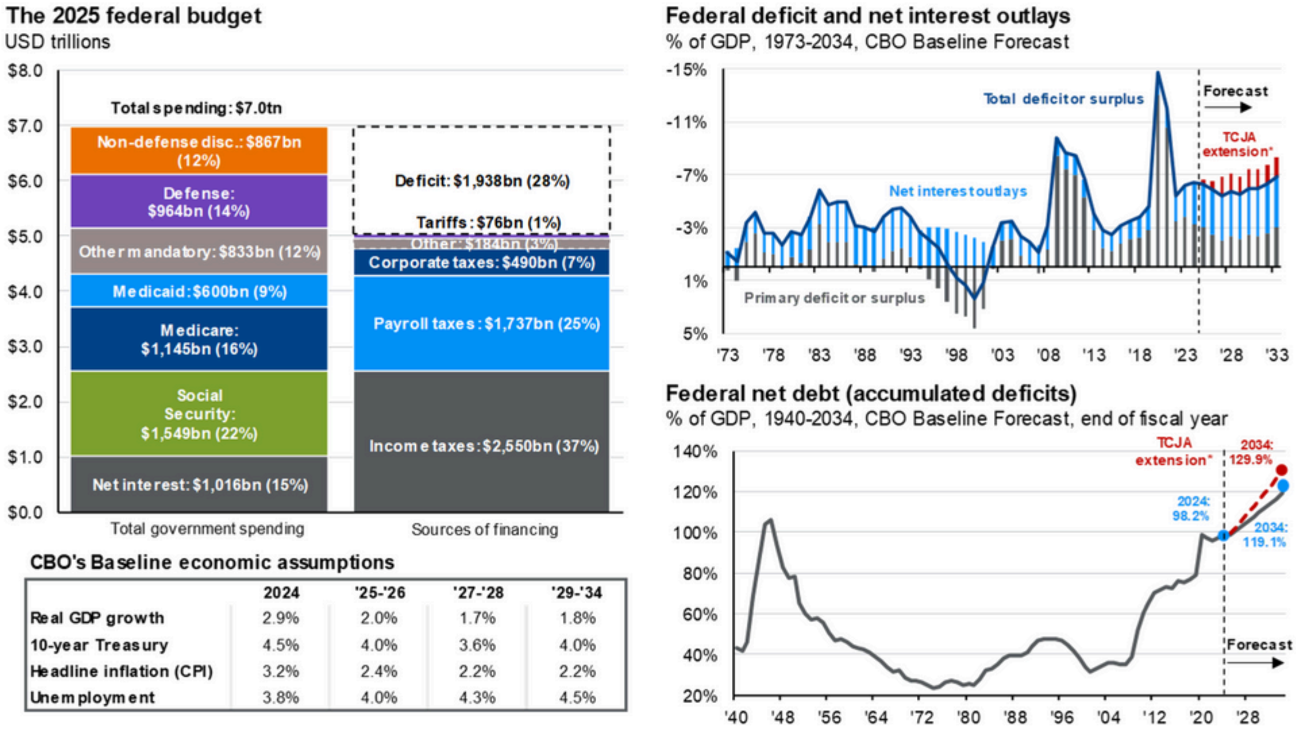


Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2024

Barring a US economic slowdown, which we view as extremely unlikely, we believe the Fed could hold rates steady around current levels. Higher for longer interest rates will not only affect consumers and debt-laden businesses, but also the federal government (see Figure 8). In 2025, the federal government is slated to spend $1.0 trillion on Net Interest Expense, 5% more than it spends on Defense and 17% more than Non-Defense Discretionary spending (i.e., everything other than Social Security and Medicare/Medicaid). The Congressional Budget Office (CBO) is targeting 2.4% inflation this year and next, declining to 2.2% thereafter. According to the CBO, interest rates will follow a similar trajectory. Given the magnitude of federal borrowings, even marginally higher for longer inflation and interest rates could have a significant impact on the federal budget – and by extension US taxpayers and the economy.

This brings us to DOGE (the Department of Government Efficiency headed by Elon Musk). It will be difficult for DOGE to cut costs – particularly by the targeted $2 trillion – given the composition of Federal spending. In our view, the new administration inherited a precarious fiscal situation, making its emphasis on private investment and deregulation monumentally important.

Figure 8. US Government Federal Finances



CBO's Baseline economic assumptions

	2024	'25-'26	'27-'28	'29-'34
Real GDP growth	2.9%	2.0%	1.7%	1.8%
10-year Treasury	4.5%	4.0%	3.6%	4.0%
Headline inflation (CPI)	3.2%	2.4%	2.2%	2.2%
Unemployment	3.8%	4.0%	4.3%	4.5%

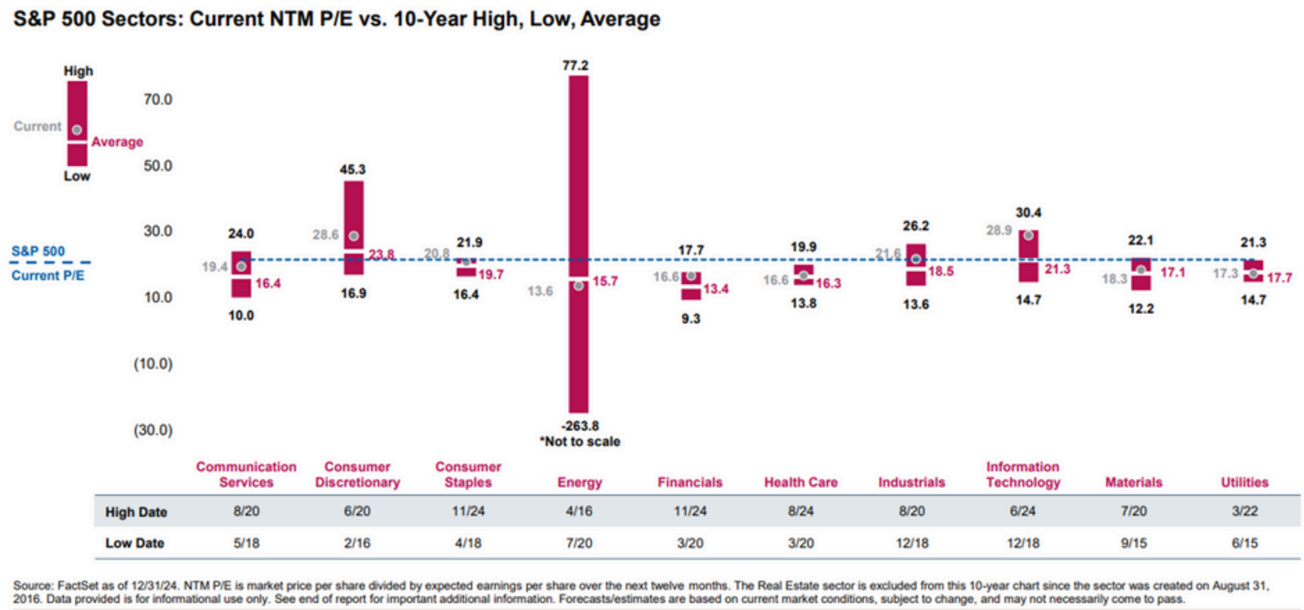
Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2024

Amid Economic Resiliency, Earnings Growth Remains Strong… Redux

We believe the US economy, corporate earnings, and the equity market will remain resilient. Against this backdrop, according to FactSet, analysts estimate the S&P 500 companies (excluding the Magnificent Seven) will report (year-over-year) earnings growth of more than 9% over the next four quarters. As a result, the S&P 500 overall is expected to report (double-digit) earnings growth rates of 11.6%, 11.6%, 15.2%, and 16.7% for Q1 2025, Q2 2025, Q3 2025, and Q4 2025, respectively. This strong earnings growth should drive the equity market higher amid “fair” valuations.

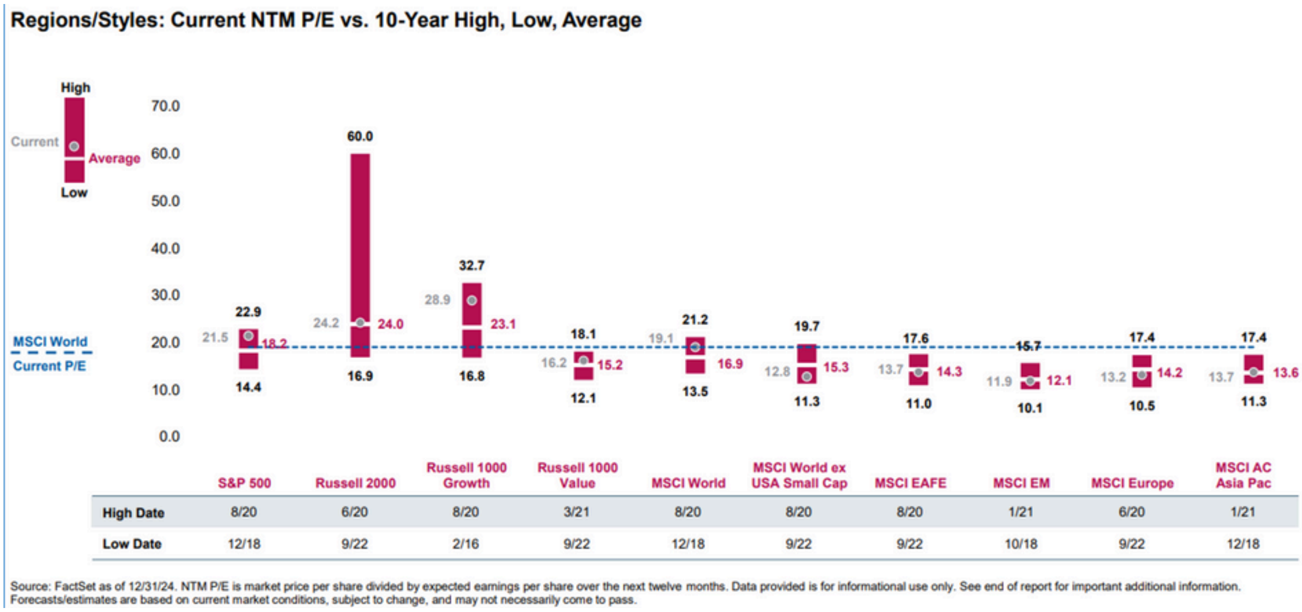
As shown in Figures 9 and 10, global equity markets are fairly-valued. The valuations of growth-oriented categories (Russell 1000, S&P 500) and sectors (Information Technology) are above their 10-year averages, while global small cap stocks and value-oriented sectors (Energy, Utilities) are below their 10-year averages.

Figure 9. Valuation Analysis – S&P 500 Sectors: Current NTM P/E v 10-year High, Low, Average



Source: Eaton Vance Monthly Market Monitor, December 2024

Figure 10. Valuation Analysis – Regions/Styles: Current NTM P/E v 10-year High, Low, Average



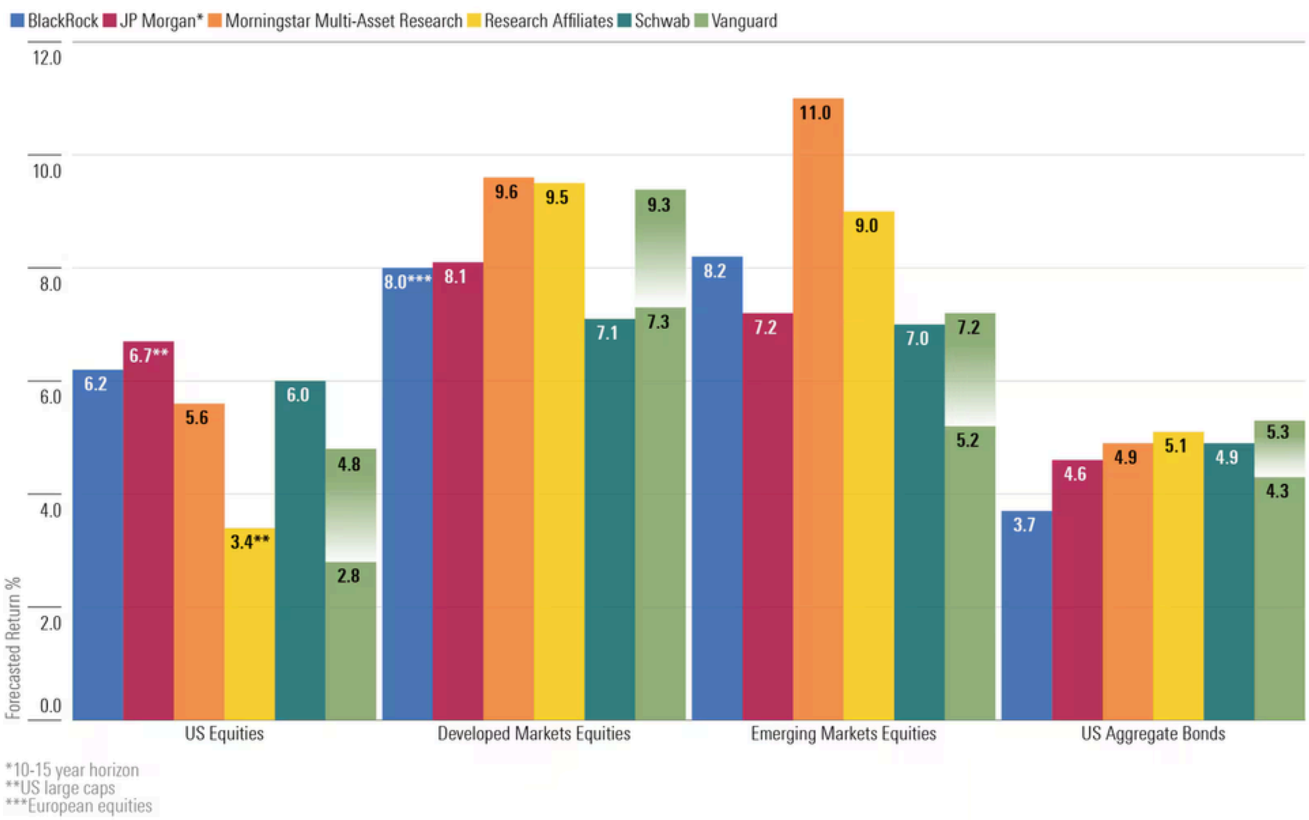
Source: Eaton Vance Monthly Market Monitor, December 2024

Expected Long-Term Asset Class Returns…Redux

As we enter a new year, we also wanted to share this excellent Morningstar summary of forecasts of long-term asset class returns from the largest asset managers (see Figure 11). As we've seen in previous years:

- Most investment firms reduced their return expectations for US stocks over the next decade.
- Higher returns are expected from non-US stocks compared to US stocks.
- Emerging markets performance is expected to exceed US performance.
- A few firms forecast higher returns for bonds than US stocks over the next 10 years.

Figure 11. Expert Forecasts for Long-Term Asset Class Returns



BlackRock and J.P. Morgan forecasts as of September 2024. Schwab as of October 2024. Vanguard as of November 2024. Morningstar Multi-Asset Research and Research Affiliates as of December 2024

Source: Morningstar: Experts Forecast Stock and Bond Returns: 2025 Edition

Values-Aligned Investments – Education, Accessibility, Transparency, Personalization

The narrow tenor of the equity market in 2024 resulted in continued underperformance of selected sustainability-themed strategies in both the full year (see Figure 12) and the fourth quarter (see Figure 13). The performance of sustainability-themed strategies was particularly subdued following the following the election as clean energy, social justice, and female empowerment themes dramatically underperformed the market-dominant Magnificent Seven and “Trump themed” strategies. In the end, in 2024, if portfolios were overweight Clean Energy (as are values-aligned strategies) and underweight or did not hold any/all of the Magnificent Seven, the portfolios significantly underperformed.

President Trump's climate-related and diversity, equity, and inclusion (DEI) Executive Orders issued on January 20, 2025, are poised to influence the commitment of the country, corporate America, and large asset managers to further progress on environmental, social, and governance issues.

The key edicts include:

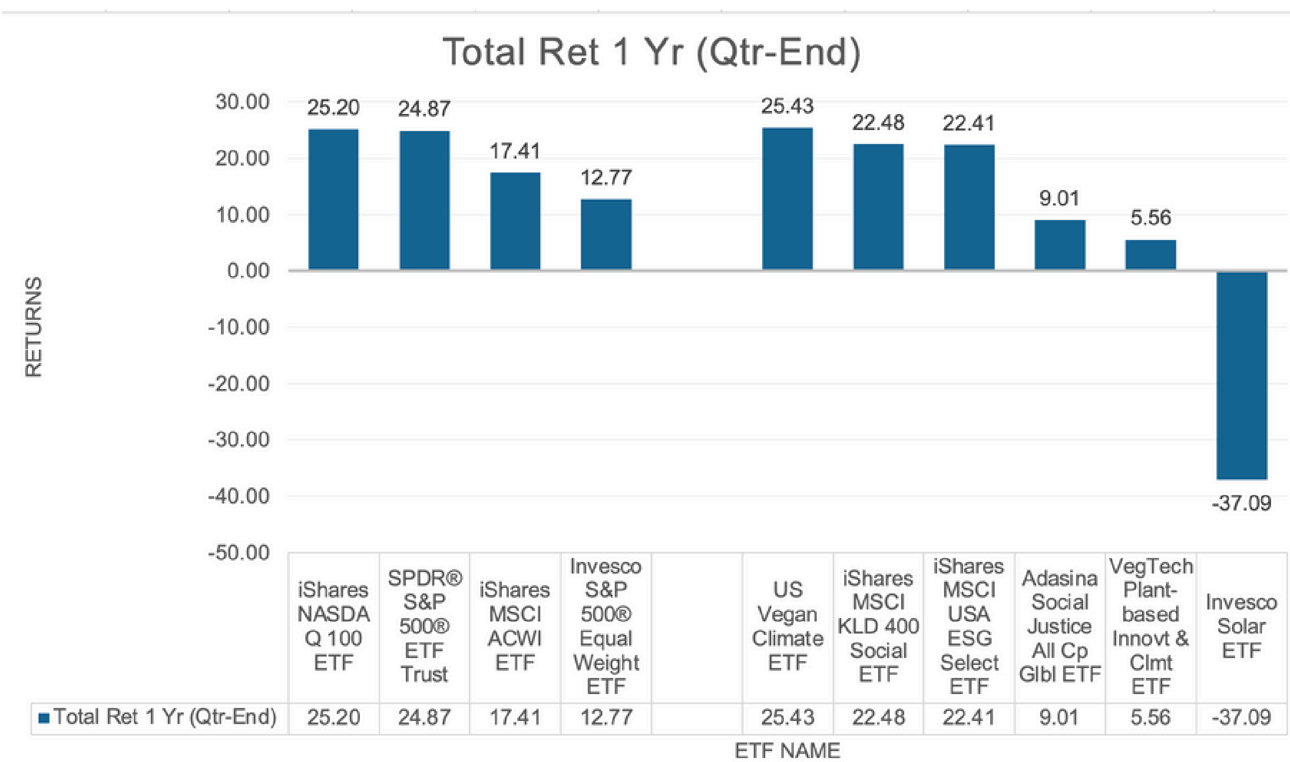
- **Withdrawal from the Paris Climate Agreement.** The order to withdraw from the Paris Agreement and other international climate commitments may reduce federal support for renewable energy projects and climate initiatives, potentially affecting investments in sustainable technologies.
- **Elimination of the Electric Vehicle Mandate.** A separate order rescinded federal requirements mandating the adoption of electric vehicles by automakers and their customers. This could reduce incentives for transitioning to EVs by eliminating emissions requirements for auto and truck manufacturers, incentives for EV purchasers, and the construction of EV charging infrastructure, likely slowing innovation and investment in sustainable transportation.
- **Elimination of Diversity, Equity, and Inclusion (DEI) Programs.** The end of DEI initiatives within the federal government may prompt corporations to reassess their commitments to social equity and inclusivity. This mandate could be particularly problematic for government contractors.
- **Redefinition of Gender Policies.** By restricting federal recognition to only two sexes (male and female), companies may face challenges in maintaining inclusive workplace policies, a critical factor in social and governance assessments.

As we know, the market reflects the world as it is today. Values-aligned investors invest in the world as they want it to be and look to achieve long-term financial and impact goals aligned with their values.

As the Executive Orders and their consequences are assessed, we believe the best way forward for values-focused Advisors and their clients is to emphasize education, accessibility, transparency, and personalization in in their interactions, and portfolio management, proxy voting, and corporate advocacy efforts. Our Values Aligned Direct Index Solution (VADIS) and proxy voting and advocacy efforts enable advisors to educate their clients and work with them to identify the Values Set best aligned the client's view of the world, incorporate those Values into the client's personal Investment Universe, and construct a portfolio and advocacy plan targeting the client's long-term financial and impact objectives.

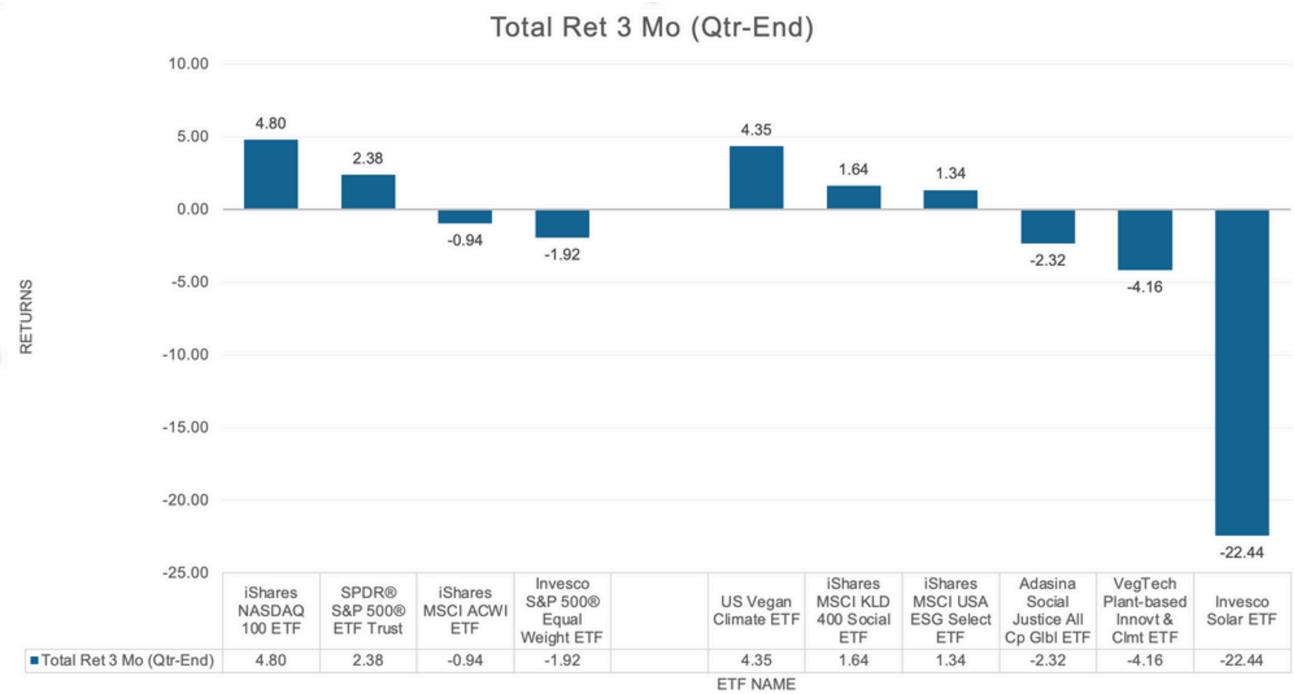
As we know, the market reflects the world as it is today. Values-aligned investors invest in the world as they want it to be and look to achieve long term financial and impact goals aligned with their values. At First Affirmative, we remain convinced investors must take responsibility for the impact their money has in the world. Since 1988, we have served individuals and institutions seeking to achieve financial returns and align their portfolios with their values to meet both their financial and impact objectives. VADIS represents the future of hyper-customized portfolio management and enables clients to invest in the world as they want it to be. By combining trusted personal financial advice, leading sustainable and responsible investment expertise, and scalable technology, VADIS enables advisors to provide personalized portfolios aligned to each client's financial goals and values.

Figure 12. Selected Sustainability-Themed ETFs – 2024 Returns



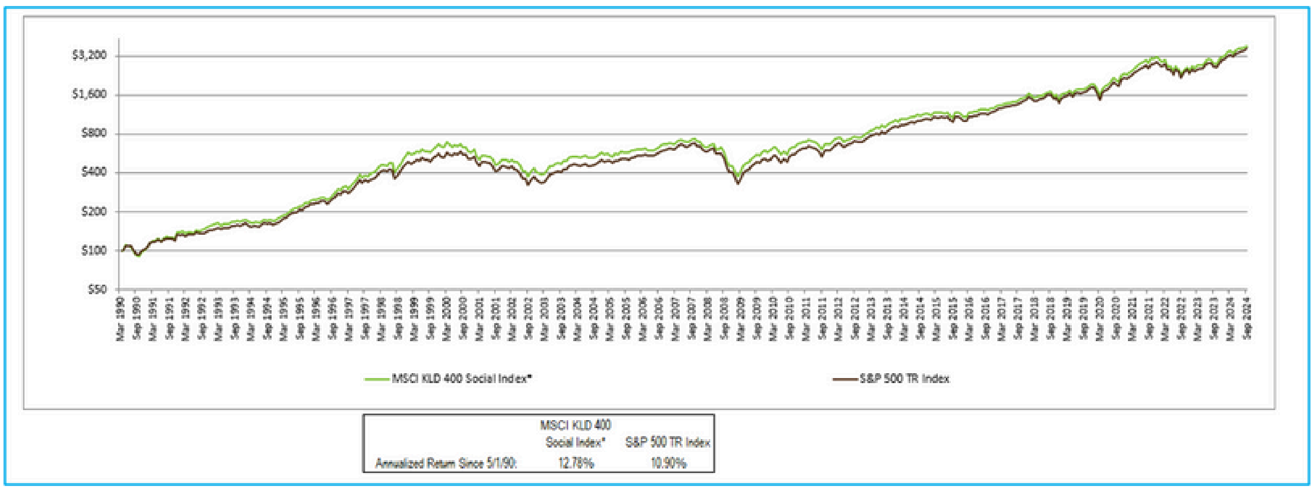
Source: First Affirmative, Data are as December 31, 2024

Figure 13. Selected Sustainability-Themed ETFs – Fourth Quarter 2024 Returns



Source: First Affirmative, Data are as December 31, 2024

Figure 14. MSCI KLD 400 vs S&P 500 Indices, December 31, 2024



Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indices are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indices but may purchase mutual funds or other investment products designed to track the performance of various indices.

Contact

First Affirmative Financial Network

5475 Mark Dabling Boulevard, Suite 320
Colorado Springs, Colorado 80918

719-478-7036
www.firstaffirmative.com
Registered Investment Advisor (SEC File #801-56587)

Advisor, Media, and Marketing Inquiries

phone: 719-478-7036
businessdevelopment@firstaffirmative.com

Service and General Inquiries

phone: 719-478-7036
service@firstaffirmative.com

Help your clients invest in the world they want it to be.

The opinions and concepts presented are based on data believed to be reliable; however, no assurance can be made as to their accuracy. Mention of a specific company or security is not a recommendation to buy or sell that security. Past performance is never a guarantee of future results. For information regarding the suitability of any investment for your portfolio, please contact your financial advisor.

The views expressed herein are those of First Affirmative and may not be consistent with the views of individual investment advisors or Broker-Dealers or RIA firms doing business with First Affirmative. Network Advisors may offer securities through various Broker-Dealers and Registered Investment Advisory firms. These affiliations, and all fees charged to clients, are clearly disclosed. First Affirmative's ADV Disclosure Brochure is available any time. Please write or call for a copy or visit firstaffirmative.com/about-us.