MILESTONE
WEALTH MANAGEMENT

2024 Fourth Quarter Wrap-up

Key Updates on the Economy & Markets

There was no shortage of market-moving events in Q4. The stock market opened the quarter with a slow start in October, but the outcome of the presidential election triggered a broad rally in November. The rally faded as the year ended, although the S&P 500 Index trades only a few percentage points below its all-time high. The credit market was equally active in Q4, with both the U.S. Federal Reserve (Fed) and the Bank of Canada cutting rates by another 0.50%.

However, the major development was the changing 2025 outlook. The central banks and the market both now expect fewer rate cuts in 2025 compared to the end of Q3, which resulted in a sharp rise in Treasury yields in Q4. This letter recaps the fourth quarter, looks back on the 2024 stock market rally, provides an update on the economy and the rate-cutting cycle, and looks ahead to 2025.

Looking Back on the 2024 Stock Market Rally

The past two years have been remarkable for investors, with the S&P 500 delivering strong returns in back-to-back years. The three charts in Figure 1 (next page) take a closer look at the U.S. stock market's rally in 2024, a year in which the S&P 500 set more than 55 new all-time highs. The top chart, which graphs the S&P 500's price return for each calendar year since 1980, shows the index posted gains of over +20% in 2023 and 2024. It marked the first time since the 4-year stretch from 1995 to 1998, and like the late 1990s, large-cap technology stocks played a major role in the S&P 500's gains. For the S&P/TSX Composite, its price return for 2024 was just under that mark (+18%), but on a total return basis it was over 20%. However, as opposed to the S&P 500, last year's return was only in the low double digits.

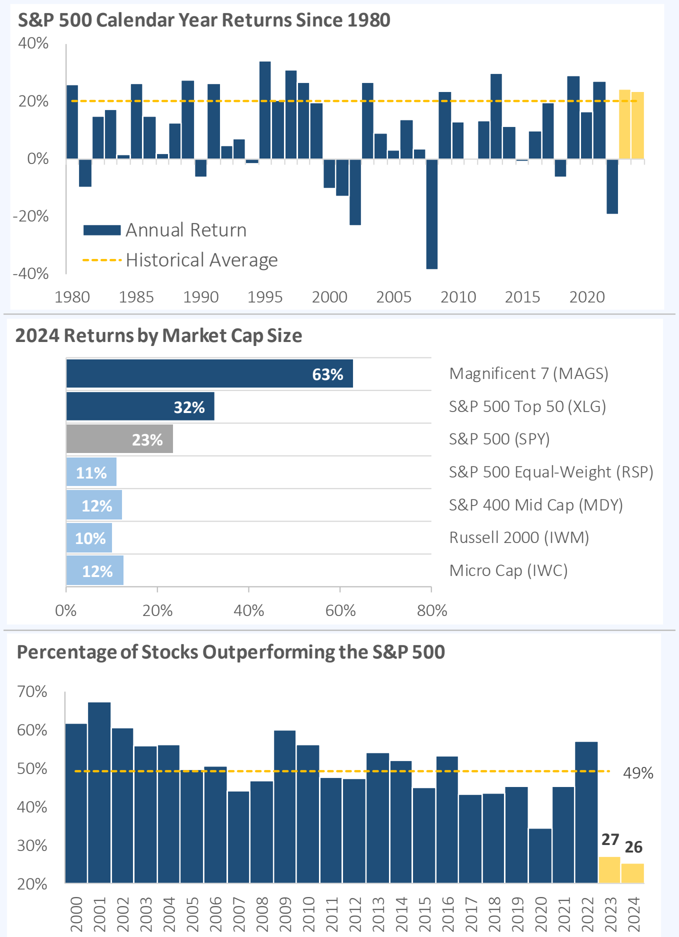
The middle chart shows the 2024 price returns of seven ETFs, each reflecting exposure to companies of different market cap sizes. The chart reveals a significant gap between the returns of large-cap and small-cap stocks in 2024. The top bar tracks the Magnificent 7, a group that includes Microsoft, Apple, Alphabet, Meta, Amazon, Nvidia, and Tesla. These seven companies, which now account for more than 33% of the S&P 500, returned over +60%. When the group expands from the Magnificent 7 to the 50 largest S&P 500 stocks, the return falls to +32%, still impressive but around half of the Magnificent 7's return. Broadening the group further to include all S&P 500 companies reduces the index return to approximately +23%, and weighting companies equally rather than by market capitalization lowers the return to +11%.

The key takeaway is that the largest companies contributed a significant portion of the S&P 500's return in 2024. Smaller companies delivered solid returns around +10%, but they underperformed on a relative basis. An index of mid-cap stocks returned +12%, while small-cap and micro-cap stocks returned +10% and +12%, respectively.

The concentrated U.S. stock market rally, which was driven by the outperformance of the largest companies, led to an unusual outcome. The bottom chart tracks the percentage of S&P 500 companies that outperformed the index during each calendar year. For the second consecutive year, fewer than 30% of S&P 500 companies beat the index in 2024. This is significantly below the average of 49% since 2000 and highlights the continued dominance of the largest companies in 2024.

Recently, we have seen a sharp rise in Treasury yields, with the 10-year yield going rom 3.74% from the end of Q3 to 4.57% at year-end (4.68% at time of writing). This could potentially be a headwind for growth equities going forward, as it signals that rate cuts may stop sooner than later, and that inflation could potentially start going back up again. More on this later in the report.

FIGURE 1 – Recapping the 2024 Stock Market Rally



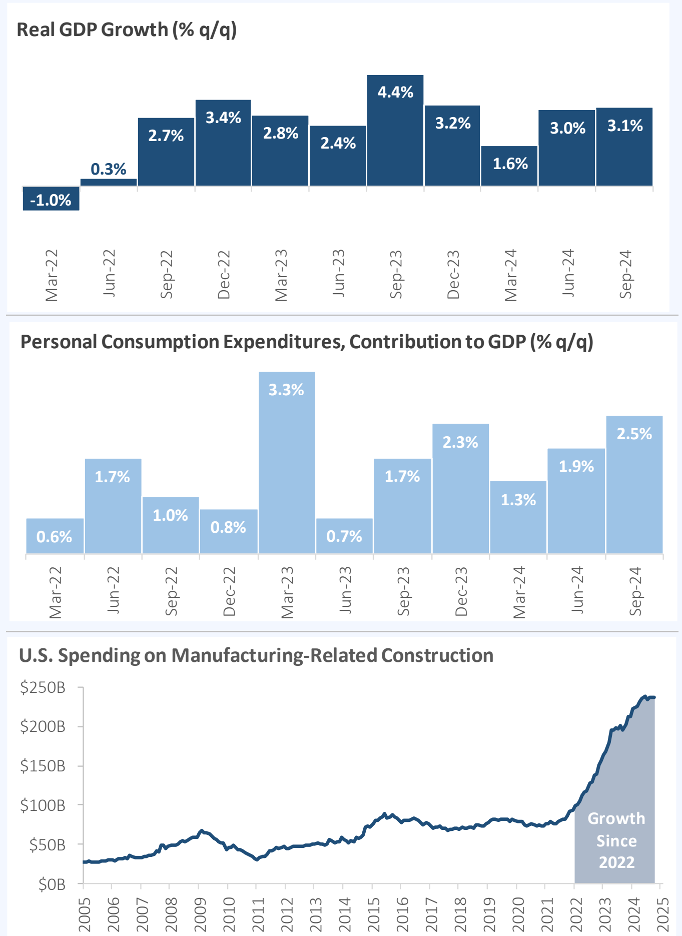
Source: Standard & Poor's. Past performance is no guarantee of future results. All performance data represents price returns. Latest available data as of 12/31/24.

Data Highlights the U.S. Economy's Resiliency

From an economic perspective, it is worth noting again that Milestone focuses on the U.S. economy, not Canada, to base overall views and recession probability when it comes to risk management for our portfolios. The Canadian economy, as reflected by the level of our nominal gross domestic product, still only accounts for about 2% of the world (our stock market capitalization represents about 3% of the world). For the US, those same numbers are close to 30% and about 65%, respectively.

The U.S. economy has consistently defied expectations of a slowdown since the Fed started raising interest rates in March 2022. Economists and market participants initially expected growth to slow as the Fed raised interest rates. However, it has now been nearly three years since the Fed's first rate hike, and the economy continues to grow at an above-trend rate. While higher rates have slowed housing demand and weighed on business investment, the U.S. economy has managed to defy expectations with solid GDP growth. The top chart in Figure 2 shows the U.S. economy grew at a +3.1% annualized pace in 3Q24, marking the third quarter in the past four with growth above +3%.

FIGURE 2 – Drivers of U.S. Economic Growth Since 2022



Source: Federal Reserve, U.S. Bureau of Economic Analysis, U.S. Census Bureau. Latest available data as of 12/31/2024.

The top two charts show key drivers of economic growth since early 2022. The middle chart tracks the contribution of personal consumption expenditures (i.e., consumer spending) to U.S. GDP growth. Despite high interest rates, consumer spending has remained a steady driver of growth in recent quarters. Multiple factors have increased household net worth and bolstered consumers' financial strength, including record-high stock prices, rising home values, and solid wage growth. Additionally, many borrowers locked in low interest rates during the pandemic, which has made the U.S. economy less sensitive to rising interest rates this cycle.

The bottom chart shows the surge in manufacturing-related construction in recent years. For a long time, manufacturing construction was relatively modest, as most activity was outsourced to China, Mexico, and elsewhere. However, that changed in late 2021, around the time U.S. Congress passed trillions in new spending on infrastructure, green energy, and subsidies to incentivize U.S. manufacturing. These spending bills have been extremely supportive of the U.S. economy and created a boom in the manufacturing of semiconductors, electric vehicles, batteries, and solar panels. The result is a surge in manufacturing-related construction, the largest on record, as companies build new warehouses, industrial facilities, and semiconductor plants. The artificial intelligence industry's emergence has provided another catalyst, as companies like Microsoft, Amazon, and Meta spend billions on data centers, information processing equipment like semiconductors, and energy production to meet growing power demand.

Economic growth is forecast to slow but remain solid next year, driven by the Trump administration's pro-growth policies. The new administration's policy agenda focuses on extending the 2017 tax cuts, reducing regulations across industries, and boosting domestic manufacturing through targeted incentives. These measures have the potential to stimulate capital expenditures, expand manufacturing capacity, and attract foreign investment to the U.S.

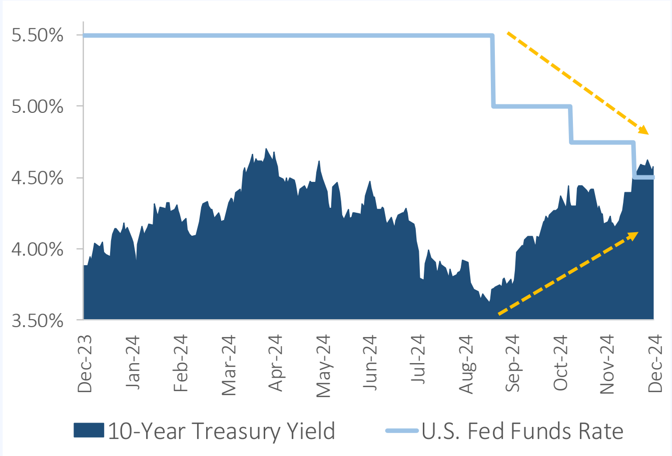
An Update on the Fed's Interest Rate-Cutting Cycle

The Fed continued its rate-cutting cycle in Q4, lowering interest rates by -0.25% at both the November and December meetings for a total of -0.50%. The two -0.25% rate cuts were well telegraphed by the Fed and widely expected, but the big development in Q4 was the changing outlook for 2025. Despite the two rate cuts, Fed Chair Jerome Powell and other Fed presidents indicated they are not in a hurry to cut rates further. The change in tone follows the U.S. economy's recent strength, which has caused the Fed to re-examine the need for additional rate cuts.

Recent economic strength has also led the market to re-evaluate its rate cut forecast. This dynamic can be seen in the bond market, where longer-maturity Treasury yields have risen sharply since the first rate cut in September. Figure 3 graphs the 10-year Treasury yield against the federal funds rate, which is the interest rate the Fed adjusts to set monetary policy. Since the first rate cut in September, the federal funds rate has decreased by -1.00%. Of interest, by comparison, in Canada the key target rate has now fallen -1.75%, indicative of a weaker economy here and this has put pressure on the Loonie which fell 8% in 2024 relative to the U.S. dollar.

While the Fed controls shorter-maturity interest rates, the market has more control over longer-maturity interest rates. Over the same period, the 10-year Treasury yield has had the opposite reaction: rising by nearly +1.00%.

FIGURE 3 – 10-Year Treasury Yield vs Federal Funds Rate



Source: U.S. Treasury, Federal Reserve. Latest available data as of 12/31/2024.

What caused Treasury yields to rise as the Fed cut interest rates? Two key data points contributed to the Fed's decision to start cutting rates in September: falling inflation and rising unemployment. Inflation declined from 3.3% in July 2023 to 2.6% in August 2024, while unemployment rose from 3.5% to a high of 4.3%. The two trends caused the Fed to shift its focus from lowering inflation to supporting the labor market.

However, since the Fed started cutting, the trends have reversed. Inflation progress has stalled since September, and unemployment has declined to 4.2%. Heading into 2025, the Fed and the market have similar rate cut expectations: approximately -0.50% in cuts for the entire year. The question is whether they are placing too much emphasis on recent trends and underestimating the need for rate cuts. As both the Fed and the market saw in 2024, forecasting Fed policy is difficult, especially this cycle. The result of this could have a significant impact on equities this year.

Equity Market Recap – Stocks End the Year Higher

The stock market ended Q4 higher, but the path included periods of volatility. In October, the S&P 500 ended its five-month winning streak, with most of the equity market finishing slightly lower. The sluggishness occurred as Treasury yields rose after the Fed's first rate cut in September, suggesting the sharp rise in yields may have played a role in October's market action. However, stocks rebounded in subsequent months.

In November, the quick and decisive election outcome became a tailwind for stocks. Investor enthusiasm fueled the post-election rally, with stocks trading higher in anticipation of tax cuts, deregulation, and U.S.-focused trade policies aimed at benefiting U.S. companies. Small caps led the way during the broad market rally, with the Russell 2000 rising +11% in November to set a record high. Bank stocks were another popular post-election trade as investors priced in expectations for financial deregulation and strong economic growth. Industrial stocks saw broad-based strength in anticipation of the Trump administration's pro-growth policies and protectionist policies, which could spark an industrial renaissance in the U.S. By the end of November, the S&P 500's year-to-date return surpassed +26%, putting the index on track for consecutive gains of more than +20%.

In December, the market's excitement cooled, with markets trading sideways and ending the month lower. Beneath the surface, a familiar trend from earlier in the year impacted returns, with smaller companies underperforming larger ones by a wide margin. The Russell 2000 Index was hit hardest, falling -8.4% and giving back most of its post-election gains. Value stocks also traded lower in December, with the Russell 1000 Value Index declining by -6.8%. In contrast, the Magnificent 7 stocks discussed earlier gained more than +5%.

Here in Canada, on a total return basis, the S&P/TSX Capped Composite Index fell 3.27% in December but still had a positive 3.76% in Q4, and finishing the year up 21.65%.

Shifting focus to global markets, international stocks underperformed U.S. stocks in Q4. The MSCI Emerging Market Index returned -7.2%, while the MSCI EAFE Index of developed market stocks returned -8.3%. Both major international equity indices underperformed the S&P 500 by nearly -10% due to currency headwinds (i.e., a stronger U.S. dollar) and the outperformance of U.S. mega-caps. Looking ahead to 2025 for international markets, the potential for tariffs under the Trump administration is creating significant uncertainty across several global regions.

Credit Market Recap – Bonds Trade Lower as Interest Rates Rise Throughout the Quarter

The sharp rise in Treasury yields weighed on bond returns in Q4. The biggest differentiator within the bond market was duration, or the sensitivity of a bond's price to interest rate movements. High-yield corporate bonds produced a total return of -0.1% due to their lower sensitivity to rising interest rates and higher absolute yields. In contrast, investment-grade bonds returned -4% as rising yields had a bigger impact on their longer maturities. Excluding interest received and only looking at price returns, an index of investment-grade corporate bonds posted its biggest quarterly loss since Q3 2022.

Full-year credit returns highlight the key themes that shaped the bond market throughout 2024. Higher-quality credit like U.S. Treasuries and Canadian Government Bonds, corporate investment-grade bonds, and mortgage-backed securities underperformed as the market debated and ultimately lowered its rate-cut expectations.

In contrast, lower-quality bonds outperformed as economic growth and corporate fundamentals remained solid. Corporate credit spreads, which measure the difference in yield between two bonds with a similar maturity but different credit quality, steadily tightened throughout the year. This provided a boost to lower-quality bonds in 2024 but has left credit spreads near their lowest levels in decades. For context, the U.S. high-yield corporate credit spread is near its lowest level since 2007, which means investors are receiving less yield in return for taking credit risk.

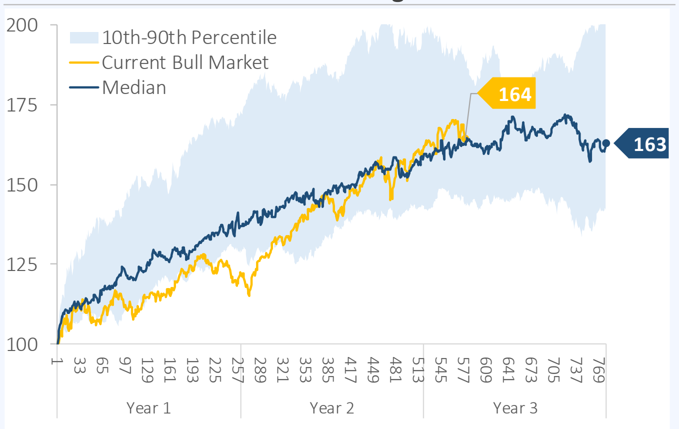
In Canada, the S&P Canada Aggregate Bond Index ended 2024 up with a 4.14% total return, while the S&P Canada High Yield Corporate Bond Index finished the year up 10.53%.

2025 Outlook – Key Themes to Watch

The equity indices' climb in 2024 reflects the market's growing confidence. Investors are optimistic about the artificial intelligence industry's growth potential. The U.S. economy outperformed expectations, growing at an above-trend rate in three of the past four quarters despite high interest rates. The stock market rally intensified after the election in November, as investors focused on the incoming administration's policy agenda. Expectations for tax cuts, deregulation, and energy production are fueling hopes for stronger economic growth. The bond market echoes the equity market's confidence, and corporate high-yield credit spreads are near their lowest levels in over 15 years.

However, the equity market rally has made broad market indices like the S&P 500 more concentrated and more expensive. The question on many minds is whether the momentum can continue in 2025. The S&P 500 currently trades at nearly 22x times its next 12-month earnings estimate, a level not seen outside of periods like the late-1990s tech boom and the recent post-COVID recovery, when interest rates were near zero. Investors have shown a willingness to pay higher multiples, but with valuations now at extremes, earnings growth will likely play an important role in determining the stock market's path in 2025.

FIGURE 4 – S&P 500 Returns During Bull Markets



Source: Standard & Poor's. A bull market is defined as a +20% gain in the stock market off a recent market low. The "Current Bull Market" started in October 2022, and the "Median" includes all bull markets since the start of 1930. Analysis is based on price and does not reflect any management fees, transaction costs, or expenses. Past performance does not guarantee future results. Latest available data as of 12/31/2024.

Figure 4 above tracks the current bull market, which started in October 2022 and is now in its third year. The current bull market has performed in line with historical norms, but the chart shows that returns often moderate as bull markets mature. This suggests that the market's focus could shift to fundamentals and earnings as the next catalyst to push markets higher. 2025 is shaping up to be a year where companies will need to deliver on investors' expectations to justify their high valuations.

Thank you for your continued trust in Milestone and for the opportunity to assist you in working toward your financial goals. We understand the risks facing both the markets and the economy and are committed to helping you effectively navigate this unique and at times challenging investment environment. Successful investing is a marathon, not a sprint, and even intense volatility is unlikely to alter a diversified approach set up to meet your long-term investment goals. Therefore, it's critical to stay invested, remain patient, and stick to the plan, as we've worked with you to establish a unique, personal allocation target based on your financial position, risk tolerance, and investment timeline.

Here is our Milestone Quarterly Market Report on economic data, capital markets, commodities, and currencies through December 31st, 2024:

Milestone Quarterly Market Report

Q4 2024

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Economic Data*

Canada - Key Indicators	Level	Report Date	Prior Quarter
Real GDP (YoY%)	1.0	30-Sep	2.2
Headline CPI (YoY%)	1.9	30-Nov	2.0
Core CPI (YoY%)	1.6	30-Nov	1.5
Unemployment Rate (%)	6.8	30-Nov	6.6
Consumer Confidence	48.6	30-Nov	50.1
Retail Sales (YoY%)	1.5	31-Oct	0.9
Housing Starts (000s, saar)	262.4	30-Nov	213.5
House Price Index* (YoY%)	2.4	30-Nov	1.1
U.S. - Key Indicators	**Level**	**Report Date**	**Prior Quarter**
Real GDP (YoY%)	3.1	30-Sep	3.0
Headline CPI (YoY%)	2.7	30-Nov	2.5
Core CPI (YoY%)	3.3	30-Nov	3.2
Unemployment Rate (%)	4.2	30-Nov	4.2
Chg NonFarm Payrolls (000s)	227	30-Nov	78
Consumer Confidence	108.7	31-Oct	103.3
Retail Sales (YoY%)	3.8	30-Nov	2.0
Housing Starts (000s, saar)	1289	30-Nov	1361
Case-Shiller House Price (YoY%)	4.2	31-Oct	5.9
ISM Manufacturing PMI Index	49.3	31-Dec	47.2

Equity Markets

Canada	Level	YTD Chg (%)
S&P/TSX Composite	24728	18.0
S&P/TSX Small Cap	816	16.0
U.S. (USD)	**Level**	**YTD Chg (%)**
S&P 500 Index	5882	23.3
S&P 500 Equal Weight Index	7101	10.9
Dow Jones Industrials Average	42544	12.9
Nasdaq Composite	19311	28.6
NYSE Composite	19097	13.3
Russell 2000	2230	10.0
International (Local)	**Level**	**YTD Chg (%)**
MSCI World	2938	19.3
MSCI EAFE	1510	8.4
MSCI EM	68031	10.5
Shanghai Composite	3513	12.6

Commodity Prices

	Level	YTD Chg (%)
Crude Oil WTI (US$/bbl)	72.44	0.8
Natural Gas (US$/MMBtu)	3.63	44.6
Gold (US$/troy oz)	2625	27.1

Fixed Income

Bond Indices	Level	YTD Chg (%)
S&P Canada Aggregate	508	4.14
S&P Canada Inv-Grade Corporate	350	6.64
S&P/TSX Preferred Share Index	2108	24.70
U.S. High Yield (ICE BofAM)	1721	8.20
Government Bond Yields	**10-Yr Bond**	**30-Yr Bond**
Canada	3.24	3.34
U.S.	4.57	4.78

Policy Rates

	Target (%)	Next Mtg
Bank of Canada	3.25	29-Jan
U.S. Federal Reserve	4.25 - 4.50	29-Jan
European Central Bank	3.15	30-Jan

Currencies

	Rate	YTD Chg (%)
US Dollar (per CAD)	1.4392	8.7
Euro (per CAD)	1.4895	1.8
British Pound (per CAD)	1.8012	6.8
US Dollar (per JPY)	157.342	11.6
US Dollar Index	108.49	7.1

Source: Bloomberg, Refinitiv, TD Asset Management, Trading Economics

*Teranet & National Bank National Composite House Price Index™

Note: Equity returns are price returns not total return

Disclosure:

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