KAR | Kayne Anderson Rudnick Investment Management

Market Review Commentary

4Q 2024

Market Review

The U.S. equity market pushed slightly higher in the fourth quarter, with the S&P 500 Index advancing 2.41%, bringing its return for the full year of 2024 to 25.02%. Large cap value stocks, as measured by the Russell 1000 Value Index, declined in the fourth quarter falling 1.98%, bringing the year-to-date return to 14.37%. Large cap growth stocks, measured by the Russell 1000 Growth Index, gained 7.07% for the quarter and 33.36% for the full year. Small capitalization stocks underperformed their larger cap counterparts with the Russell 2000 Index up 0.33% in the quarter and 11.54% for the year. International developed markets fell in the fourth quarter with the MSCI EAFE Index down 8.11% in the fourth quarter, resulting in a year-to-date return of 3.82%. Emerging markets also declined in the fourth quarter with the MSCI Emerging Markets Index dropping 8.01%, returning 7.50% for the full year.

In this commentary, we focus on five questions we believe are top of mind for investors.

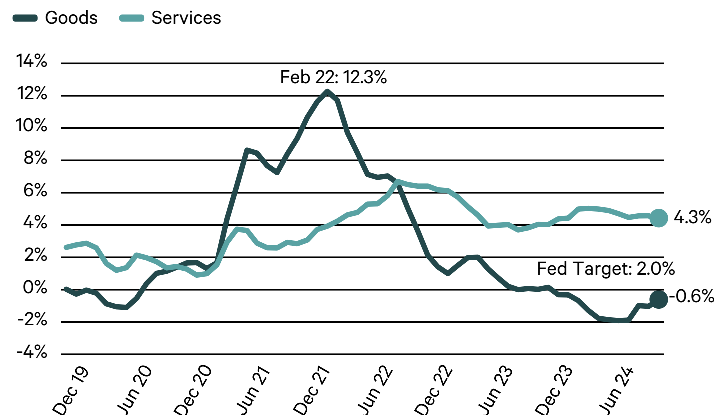
1. What is KAR's view on the U.S. economy and equity markets as we head into 2025?

At the beginning of 2024, the market had priced in modest GDP growth and more than half-a-dozen rate cuts. What we got instead was double the expected rate of growth and just three rate cuts. Much of the strength seen in the economy in 2024 was attributed to a healthy labor market that cooled just enough for the Fed to start cutting the fed funds target rate.

As we look to 2025, we continue to believe it is impossible to predict the unfolding economic outlook. We do see improved business confidence following the results of the election. The labor market remains solid, although not heated; new hires and job openings continue to be strong and the unemployment rate is still low, (albeit 0.3% higher than it was a year ago). Corporate debt levels are slightly above long-term averages but appear manageable.

Still, inflation has not been completely tamed. We have seen incremental strength in prices, most notably in the services sector production. This presents some challenges as the U.S. economy is driven more by services than goods production. To reach the Fed's 2% inflation target, we will need to see a softening in services prices.

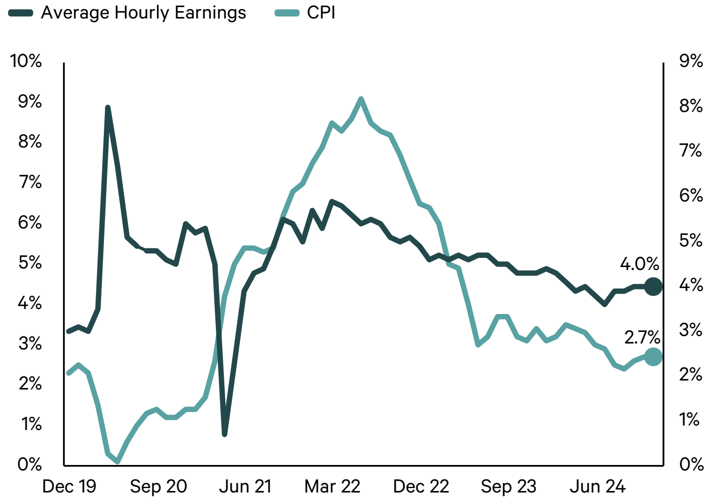
FIGURE 1: GOODS VS. SERVICES CONSUMER PRICE INDEX (CPI)
Prices in the Services Sector Remain Elevated



Data presented is as of January 6, 2025 and is obtained from BLS, Bloomberg, FactSet and UBS and is assumed to be reliable. ***Past performance is no guarantee of future results.***

The strength in services likely led to wage increases in 2024 that were higher than the overall inflation rate. This will make it challenging to return to the target of 2% inflation.

FIGURE 2: CPI VS. WAGE GROWTH
Wages Higher than the Target Inflation Rate



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Of course, the increase in wages is a big part of why the economy has been so resilient. Consumption accounts for 68% of nominal GDP and has had an outsized impact on economic growth over the last 12 months. Government spending in the ramp-up to the election was also a stronger contributor than its long-run average. All this consumption does have a downside: the personal savings rate, while better than initially feared, is approximately half its long-run average. This implies a smaller margin of safety for the average consumer should we encounter economic headwinds.

At the Federal Reserve's December meeting, the decision to cut the fed funds rate by 25 basis points was "finely balanced" — several members of the Fed now see the current policy rate as being much closer to neutral (neither restrictive nor stimulative) than when cuts began in September 2024. To us, this indicates the need to keep expectations in check regarding forecasts for rate cuts in 2025.

We believe this is particularly important for small cap investors. The Russell 2000 Index has twice the level of floating rate debt than that of the S&P 500, which means smaller companies are far more sensitive to rate cuts (or hikes) than large firms.

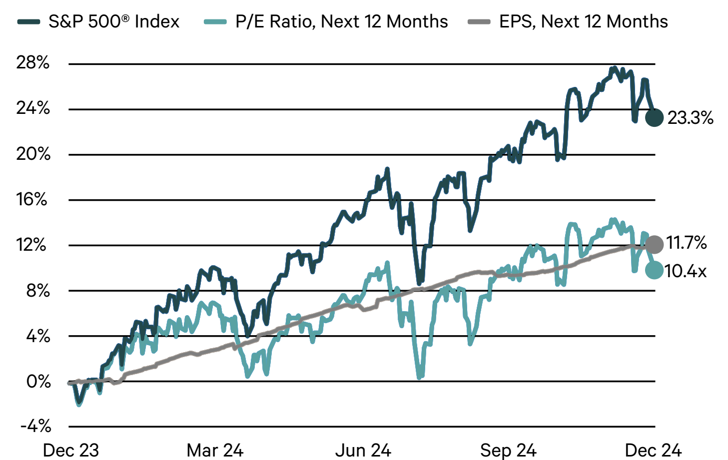
2. Do you expect the market to broaden out in 2025?

The hope for broadening in the market moved in fits and starts in 2024. The S&P 500 delivered a total return of 25% for the year, with the largest technology stocks (NVIDIA, Google, Apple, Microsoft, Meta, and Amazon) returning 48%. Excluding these large cap technology stocks, the S&P 500 rose 16%. Still, this was better than small caps, with the Russell 2000 Index returning 12%.

We attribute these disparities to an uneven distribution of earnings growth. Earnings per share (EPS) for the S&P 500 is expected to have grown 10% for 2024. If we exclude the largest technology stocks, that anticipated growth falls to just 4%.

Because EPS growth for the largest technology stocks has been so strong, half of the S&P 500's impressive return in 2024 was attributed to a higher price/earnings (P/E) multiple and the other half to earnings growth. A broadening could be driven by more widespread growth in EPS, higher valuation multiples in other sectors, or a combination of the two.

FIGURE 3: CHANGE IN S&P 500® INDEX, P/E AND EPS
Widespread Growth in EPS and Higher Valuations in Non-Tech Sectors Could Broaden the Market



Data presented is as of January 6, 2025 and is obtained from Standard & Poor's, Refinitiv, FactSet and UBS and is assumed to be reliable. ***Past performance is no guarantee of future results.***

For 2025, analysts expect earnings for stocks outside the technology sector to grow 9%, a large improvement year-over-year. Big Tech is expected to grow 20%, a slowdown from last year but still the strongest across all sectors.

While much of the attention in 2024 was on the narrowness of the rally among S&P 500 stocks, we saw a similar effect in mid and small cap stocks. Many of the best-performing mid- and small-caps are expected to benefit from investments in artificial intelligence. Some more than doubled in 2024 and "graduated" out of the small-cap index (or will graduate at the next index rebalancing). We saw a similar concentration of returns in mid-caps where the top 10 holdings accounted for a large share of the index's performance.

We can also see this concentration by noting the average return for the index is far in excess of the median return. For active managers, this outsized impact of a few outliers made it very challenging to match the index's performance without holding large positions in these names.

3. What was the role of quality in the fourth quarter of 2024?

Following the election in November, we saw broad-based, almost euphoric, buying in the U.S. equity market. In the S&P 500, the best performing sector was communication services, followed by information technology.

Across all measures of quality, lower-quality stocks saw much stronger performance than high quality in the fourth quarter. For example, stocks in the S&P 500 with P/E multiples ranging from 0-6x, which we would consider deep value, had the strongest returns of any other cohort.

Beta was also highly predictive of outperformance in the fourth quarter. While only accounting for 3% of the S&P 500, stocks with high betas of above 2.0 returned 49%, compared to a negative 8% return for the least market-sensitive companies, those with betas below 0.5. And despite a less favorable interest rate environment, companies in the S&P 500 with all-cash balance sheets returned a negative 18.5% versus a positive 2.4% return for the index. Good dividend payers were also penalized this quarter—in general, the lower the dividend yield, the better the stock performed.

To what do we attribute this phenomenon? Enthusiasm for the new administration, largely. Many investors are optimistic the new president will bring a more business-friendly approach to regulations and tax policies. Some believe we will see fewer restrictions on M&A and that many of these weaker companies trading at very cheap valuations could be takeover candidates.

Overall, as quality investors we do not think this rally merits a change in strategy.

4. What is the earnings outlook for small caps?

Small cap stocks have underperformed large caps for several years, which we largely attribute to weakness in small cap earnings growth. While this trend is forecast to reverse in 2025, we think it important to note that a recovery in small cap earnings has been predicted for several quarters, so the timing remains uncertain. With two years of double-digit earnings declines, small caps have a much lower bar to achieve earnings growth in 2025 compared to large caps.

FIGURE 4: 2025 PROJECTED EARNINGS GROWTH

Quarter/Year	Small Caps	Mid Caps	Large Caps
1Q25	3.7%	5.1%	11.4%
2Q25	12.5%	9.4%	9.7%
3Q25	19.9%	16.3%	13.1%
4Q25	26.0%	20.1%	16.4%
2025	**15.2%**	**12.2%**	**13.4%**

Quarterly data is as of December 28, 2024; annual data is as of January 1, 2025. Data is obtained from FactSet, Standard & Poor's and Jefferies and is assumed to be reliable.
Past performance is no guarantee of future results.

Keep in mind these are merely analyst predictions and they often change throughout the year, even intra-quarter. Therefore, we do not base our investment decisions on these forecasts.

Part of the weak earnings outlook for small cap companies over the past two years can be attributed to their higher floating rate debt loads. These companies have also been less able to raise prices to offset higher costs caused by inflation, including wage increases.

While we believe small caps should be a part of any balanced portfolio allocation, we would caution against passive investing in small caps, as 43% of the index is unprofitable companies.

Julie Biel, CFA
Chief Market Strategist

Julie Biel, CFA is Chief Market Strategist, Portfolio Manager, and Senior Research Analyst with primary research responsibilities for the small and mid-capitalization information technology and health-care sectors. Ms. Biel began her equity research career in 2004.

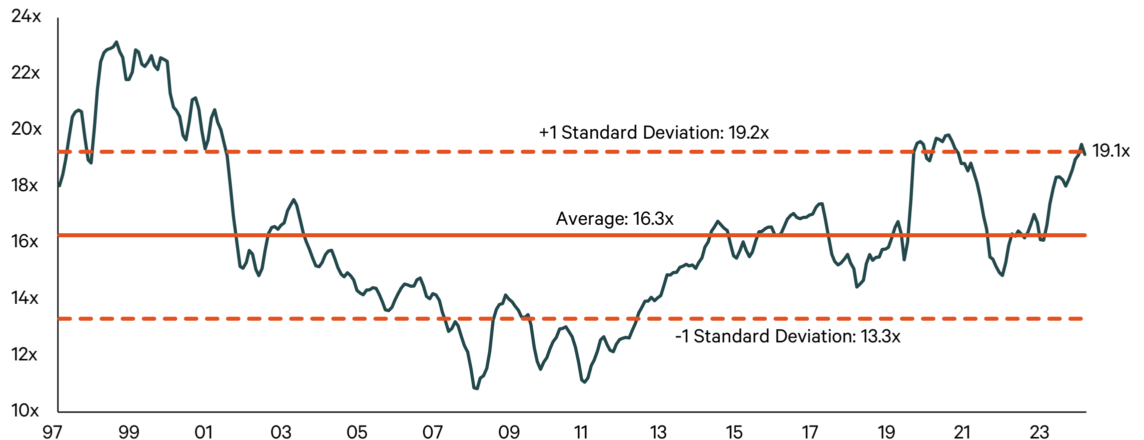
We continue to focus on seeking out high-quality small cap names that experienced only modest earnings contractions in the last two years and are already reporting growth year-over-year. In our view, their more durable competitive advantages better allow them to protect their market share and earnings.

5. What is your outlook on valuations?

Many view the market today as being relatively expensive, with the S&P 500 trading at 21.5x 12-month forward-looking EPS. These high valuations have been concentrated in the technology sector and parts of consumer discretionary, which includes Amazon and Tesla.

Beyond these outliers, the overall market looks more reasonably valued. If we look at the S&P 500 excluding large cap technology, the P/E multiple is at 19.1x, compared to the long-run average of 16x.

FIGURE 5: S&P 500® INDEX EX-BIG 6 TECH+ COMPANIES
Price-to-Earnings Ratio, Next 12 Months



Data is as of January 6, 2025. Data is obtained from Standard & Poor's, Refinitiv, FactSet and UBS and is assumed to be reliable. The Big 6 refers to 6 major technology firms which include NVIDIA, Apple, Google, Microsoft, Meta, and Amazon. ***Past performance is no guarantee of future results.***

Similar to what we noted in the discussion in #2 above regarding the concentration of returns, a handful of outliers have been driving index-level valuations, with each index's market cap-weighted average P/E above its median or equally-weighted P/E. As a result, we do not view the entirety of the market to be as expensive as headline numbers would lead you to believe, and we believe that opportunities for fundamental investors have not all been exhausted.

Large-capitalization stocks are represented by the S&P 500® Index which is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. Growth stocks are represented by the Russell 1000® Growth Index which is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Value stocks are represented by the Russell 1000® Value Index which is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Small-capitalization stocks are represented by the Russell 2000® Index which is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. Emerging markets are represented by the MSCI® Emerging Markets (EM) Index which is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Kayne Anderson Rudnick has chosen to include the securities in this commentary based upon objective criteria. It should not be deemed as a recommendation to purchase the securities mentioned, and it should not be assumed that securities recommended in the future will be profitable. ***Past performance is no guarantee of future results.***

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