The Advisor
A quarterly publication from Ables, Iannone, Moore & Associates, Inc.

Market Update - First Quarter, 2025

PREDICTIONS AND LONG-TERM EXPECTATIONS.

Predictions and resolutions are a normal cadence to the beginning of every new year, especially for Wall Street. Nothing magical or different happens to the stock or bond market when the calendar turns over, but it does provide a convenient time to assess where we are and forecast what might be on the horizon. Let's take a look at what Wall Street expects not only this year but over the next serval years and discuss the implications.

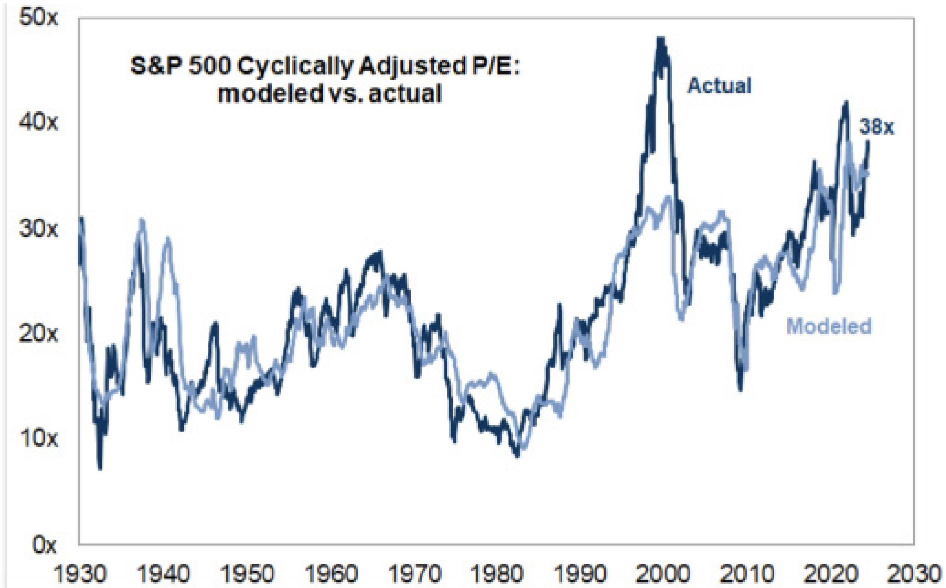
Predictions

The average 2025 year-end price target for the S&P 500, according to recent forecasts from twenty-two firms, was 6,541, suggesting just over a 7% increase for the year. The highest price target was from Oppenheimer at 7,100. The biggest bear was BCA Research at 4,450 or roughly a 27% drop for the index and basically NOT a happy new year.

Price, by itself, doesn't tell the whole story. We can look at relative valuation metrics such as the price-to-earnings (P/E) multiple (also called ratio) to gather more information about price levels. Calculating the P/E ratio is simple; divide the price by the earnings per share (EPS). This tells us how much investors are paying for earnings which can be compared historically or in this case, over the next twelve months (NTM), using forward estimates.

Taking the 2025 average price target of 6,541 and dividing by the average EPS estimate of $268, equals a P/E ratio of 24.4, NTM. The long-term average P/E multiple for the S&P 500 is about 16. Currently, it's around 23 as illustrated in the chart above from Morgan Stanley. For reference, the peak in the middle of the chart was around the year 2000 and the subsequent decline corresponds to the dot com bear market. More on this later.

It's important to understand that a relative valuation metric, like the price-to-earnings ratio using next twelve months estimates, doesn't tell us much about the economic environment. What it does is provide a clue about what investors perceive regarding future profitability, earnings growth and the prevailing interest rate environment. Maybe there are good reasons and times to "pay up" for earnings and other times, not so much. Smoothing out and adjusting the earnings-per-share over 10-year periods can capture more of the fundamental earnings backdrop over the various market cycles and provide additional insight into valuation. This is called the cyclically adjusted P/E ratio, or CAPE. Goldman Sachs has a nice chart that shows the actual CAPE ratio versus a modeled CAPE ratio.



S&P 500 total return CAPE modeled using LTM ROE, 10-year trailing inflation, 10Y UST yields, and market concentration

Source: Robert Shiller, Goldman Sachs Global Investment Research

This chart essentially compares relative market valuation to fundamentals. The dark blue line is Actual (market valuation) against the light blue line, Modeled (think fundamentals or what "should" be). Notice the Actual peak around year 2000 is highly disconnected from the Modeled line. Investors continued to pay more and more for earnings well beyond what some of the fundamentals were suggesting. We know how that ended.

Now look to the far right of the chart where we are today and notice that valuation is not egregiously disconnected from fundamentals. When viewed in a more fundamental context alongside the current interest rate environment and corporate profitability, it's not quite as alarming as the late 1990's and early 2000's, for example.

Long-term Expectations

Prices and P/E ratios do not predict the future. However, there is a relationship between forward market returns and starting valuation and according to Goldman Sachs that relationship gets stronger when looking at longer time periods such as forward 10-year returns. Simply stated, the higher the value at the outset of a forecast period, the lower the expected future return will be.

From this perspective, it comes as no surprise that several firms issued their longer-term U.S. stock return expectations below historical averages. One of the biggest bulls was J.P. Morgan, expecting 6.7% per annum over the next 10-year period while the biggest bear was GMO, forecasting -6.3% real returns over the next 7 years. Notably, Vanguard, Goldman Sachs, Morgan Stanley and Research Affiliates called for U.S. equity returns between 2% - 4% over the next 10 years. Regardless of the firm or specific forecast, what is loud and clear is the majority of firms have dialed down their U.S. stock return expectations for the next several years.

Our concluding point in this discussion is that yes, the S&P 500 is stretched on a historical basis by several valuation measures. It is undeniable that increasing market capitalization and index concentration of the leading technology companies is fueling valuation expansion on the back of the technological shift that is underway called A.I.

There is little debate about artificial intelligence being a technological revolution. The debate is what is A.I. worth?

If this revolution continues to deliver utility for the end-user it will continue to deliver mind-blowing revenue, margins and therefore cash-flow. And that means current market valuation could be justified and will likely be considered relatively cheap through a historical lens.

On the other hand, if A.I. application and utility stall-out for the end-user or if advances in technology and innovation disrupt this A.I. arms race unexpectedly then you don't need us to tell you how the market might react.

To be clear, we're not putting the entire U.S. stock market on the back of … will A.I pay off. We're simply trying to illustrate that current market valuation is high based on expectations that this truly could be a technological revolution that is different than the 2000 dot com bust. IF so (which is a big if) - it is still investable.

What we can say, with a high degree of certainty, is that volatility is to be expected from these valuation levels. Therefore, maintaining a well-diversified portfolio, an eye towards risk management and a long-term mindset to capitalize on opportunities is a time-tested recipe and one we believe can still position investors for success.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.

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