

# Disciplined investing amid a dynamic U.S. market environment

From the Field

## Key Insights

- The U.S. equity market has rallied back strongly from a period of heightened volatility in August 2024. While some of the root cause headwinds have eased, they have not disappeared.
- The outlook for U.S. equities appears finely balanced. In 2025, we anticipate a higher level of volatility, with markets more sensitive to macro/corporate news flow.
- While U.S. equity returns are likely to be harder earned, for disciplined investors who stay anchored to fundamentals and reject false narratives, this environment provides opportunity.



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After a turbulent period in August 2024, U.S. equity markets have rallied back in recent months, soothed (initially) by U.S. jobless claims data, falling inflation, and a larger-than-anticipated cut in interest rates. But, while sentiment has certainly improved since August's downturn, an undertone of nagging uncertainty remains. Early in 2025, the U.S. equity market outlook appears finely balanced. On the one hand, tailwinds including a growing economy, robust corporate earnings, moderating inflation, and easier monetary policy are all reasons for encouragement. However, these are balanced out by various headwinds,

including a volatile jobs market, negative earnings revisions in the equal-weighted S&P 500 Index, prospective policy uncertainty, as well as heightened geopolitical tensions.

Given these competing forces, sensitivity to news flow—and the prospect of a higher level of market volatility—is expected to be a feature moving forward. While this can be unsettling, it is also a broadly supportive backdrop for active, process-driven stock picking, as company valuations and fundamental quality come sharply into focus, and the potential for investor overreaction also increases.

## Expectations remain for an economic soft landing

The larger-than-expected 50-basis-point<sup>1</sup> rate cut by the U.S. Federal Reserve in September—the first in four years—followed by another 25-basis point reduction in November, are decisive policy moves, designed to shore up consumer confidence and underpin a flagging labor market. Interest rate cuts are a boost for sentiment in the near term, even though more tangible impacts will take time to flow through to the economy.

<sup>1</sup> A basis point is 0.01 percentage point.

We do not envisage any looming credit stress at either a consumer or a corporate level. Consumer balance sheets are certainly less flush than a couple of years ago, but they are still relatively healthy compared with history. At a corporate level, some concerns have been raised about the massive investment that companies are making in artificial intelligence (AI), for example. However, this looks like it is being funded largely from free cash flow rather than from a ramping up of debt.

In 2025, our baseline expectation is for an economic soft landing in the U.S., but our conviction is closely tied to the U.S. labor market. Recent jobs data updates underscore the difficulty in formulating a clear view of what is a volatile and “noisy” dataset (Fig. 1). Having been revised lower in the previous months, jobs data surprised strongly to the upside in September, with

employers adding an expectation-busting 223,000 new jobs. However, the latest figures for October show an almost polar opposite result, with just 12,000 new jobs added, the lowest level in nearly four years and well short of the expected 117,500 jobs. It is too early to say which of these signals is more reflective of the actual landscape, or how near, or otherwise, we are from seeing a stabilization in the U.S. jobs market.

**Examining the “broadening market” narrative**

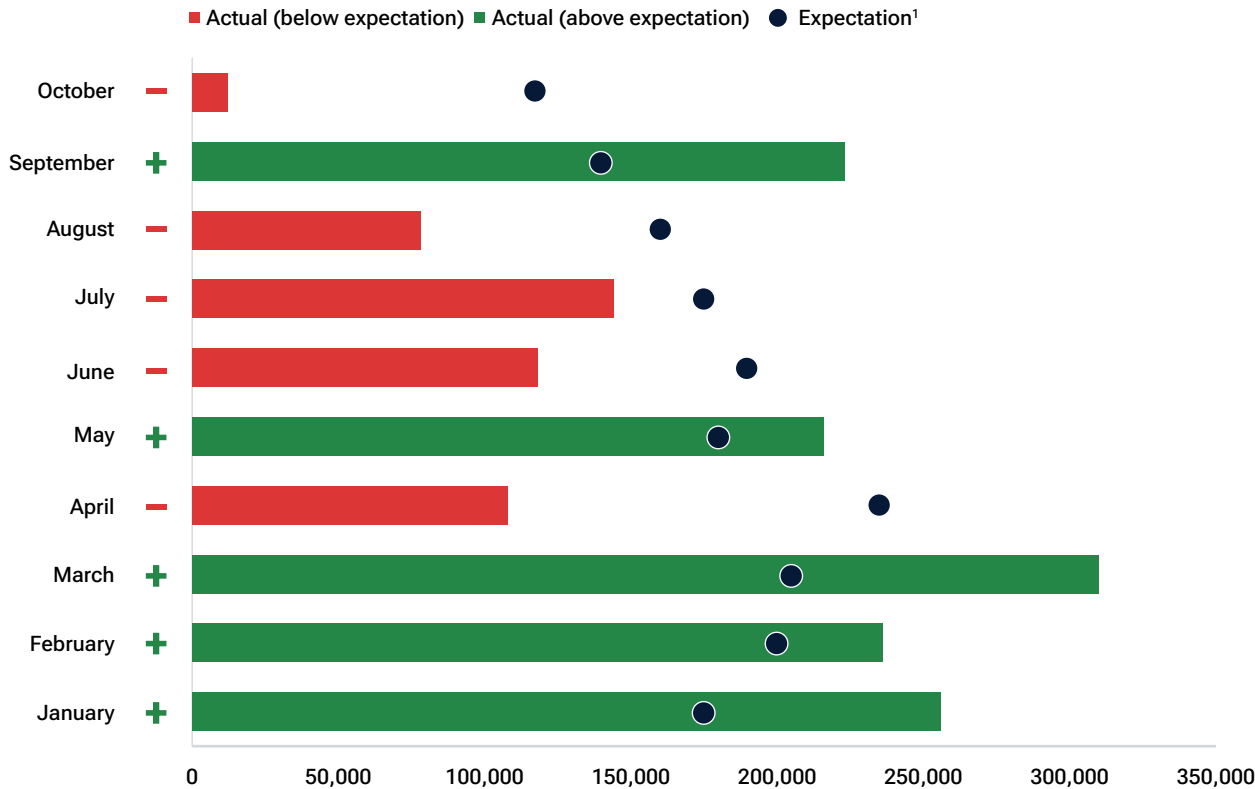
From a market perspective, we anticipate a slow grind higher on the U.S. equity market in the near term, interspersed with periods of heightened volatility as markets react to macro data and corporate earnings surprises.

While some of the root cause headwinds behind the August 2024 market correction have been diluted, they have not disappeared altogether. High market concentration, for example, remains an ongoing issue to negotiate.

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**U.S. employment data continues to be volatile**

(Fig. 1) Total non-farm payroll data—monthly new jobs created



As of November 5, 2024.

<sup>1</sup> Median estimate.

Source: The Bureau of Labor Statistics (BLS) and T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

Encouragingly, the “broadening market” narrative is gradually being borne out in reality, at least across industries/sectors. This is certainly beneficial for larger, growth-oriented holdings outside the “Magnificent Seven” stocks. However, the broadening of market performance is much less apparent down the market capitalization spectrum. Company scale is benefiting the larger players in most industries, and this is creating an earnings divide between large and smaller U.S. companies. Furthermore, substantial investment in artificial intelligence (AI) is being dominated by large companies with deep pockets. Smaller companies simply cannot compete, putting them at a relative disadvantage, given the enhanced productivity and decision-making potential that AI offers.

With so much investor attention focused at the top end of the market, smaller companies have effectively been relegated to the background in recent years. As a result, rather than being driven by individual company or industry-specific fundamentals, the small-cap market is currently moving in broad unison, swayed by headline macro data, as well as basket purchase programs such as exchange-traded funds. On the release of each important data point, it seems the market decides if the associated narrative is uniformly good for small-caps or uniformly bad. Given the less liquid nature of the small-cap market, this can result in heightened price volatility, and we are seeing more instances of these kinds of directional moves. Looking ahead, we see underappreciated value in U.S. smaller companies, but we would need to see some sort of catalyst or fundamental shift in the landscape in order for this value to be broadly realized.

### **Earnings remain supportive**

The third-quarter 2024 U.S. corporate earnings season proved broadly positive, with the number of S&P 500 companies

(75%) reporting positive earnings surprises in line with long-term averages.<sup>2</sup> Expectations are for this positive earnings momentum to continue in the near term, albeit with a potentially lower number of aggregate companies announcing upside earnings surprises. It is also worth noting that the magnitude of earnings surprises weakened in the third quarter, suggesting that gains will likely be harder won moving forward. Within the technology sector, for example, the size of earnings per share beats (versus expectations) was the lowest in multiple quarters.

Nevertheless, consensus earnings expectations remain bullish in 2025. Analysts are predicting double-digit earnings growth for the year, as lower inflation and interest rate cuts begin to flow through to provide further support for company earnings.

### **Amid volatility, markets behaved rationally**

One of the most encouraging features of the heightened August volatility was that U.S. equity markets generally behaved rationally. Most sectors and stocks performed in line with their respective earnings per share revisions, while any stocks that exceeded or missed expectations were rewarded and punished, respectively. This is precisely how efficient markets should function, leading to a broader dispersion in returns as better-quality companies with improving fundamentals separate from lower-quality ones. In this environment, the importance of a consistent, process-driven stock-picking framework increases greatly.

### **Health care offers attractive attributes**

The health care sector, for example, is currently presenting attractive investment opportunities, in our view. The sector

encompasses a range of industries and a wide array of businesses, many of which we believe appear reasonably valued. In addition to the health care sector’s inherent defensive characteristics, many companies appear to feature compelling idiosyncratic and durable growth stories.

Looking longer term, it is going to be fascinating to see how AI impacts the health care sector, from advancement in robotics and precision surgery to enabling the discovery and diagnosis of novel treatments. The technology is still in its infancy, but AI could have a disruptive impact in terms of greatly improved patient treatment/long-term care. Identifying the likely winners at an early stage represents a potentially huge investment opportunity.

### **Conclusion**

The sharp market downturn in August 2024 and subsequent strong rebound are a reminder as to just how quickly market confidence can change. Sentiment has certainly been boosted by the larger-than-expected cut in U.S. interest rates, along with company earnings that have also remained strong. At the same time, however, industrial activity is softening, post-election policy and geopolitical events add uncertainty, and there are signs that consumers—at least at the lower end of the earnings scale—are moderating their spending.

Given the finely balanced outlook, U.S. equities could see a higher level of volatility in 2025 as sentiment shifts in reaction to the latest macroeconomic data and earnings updates. While returns will be harder earned in this environment, volatility presents opportunities for active managers who stay anchored to fundamentals and reject false narratives to find mispriced companies. In our view a robust process for identifying good-quality businesses that are reasonably priced will be the key to outperforming.

<sup>2</sup> FactSet, as of December 20, 2024.

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