2025 Outlook: Bridging the Divide

From Market Fragility to Portfolio Durability

January 2025

Building a Lifelong Partnership

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OCTAVIA
WEALTH ADVISORS

With 2024 now in the rearview mirror, we reflect on our outlook, titled "Prepare, Don't Predict," as well as the dynamic and unpredictable nature of financial markets. Two of our themes came to pass in 2024, with inflation remaining in the **Messy Middle** by not falling all the way to 2%. Our focus on **Preparation over Prediction** played out as the economy avoided recession, yet markets faced bouts of volatility around unexpected events.

Meanwhile, our focus on **Concentrated Consequences** carries over into 2025. We highlighted potential fragility within U.S. equities, driven by the narrow leadership of the "Magnificent 7," and the potential for opportunity in areas beyond U.S. large cap. The "Mag 7" once again led markets in 2024, with those stocks posting an average return of 60% for the year and six of the seven outperforming the S&P 500 index. As we step into 2025, we maintain our focus on resilience and adaptability to allow us to navigate any environment that may lie ahead.

2025 Themes

We see markets at a fascinating crossroads today. While opportunities and optimism remain, the path forward for allocations is anything but straightforward. This year, our outlook centers on three pivotal themes: fragility, durability, and the age of alpha.

Fragility examines the vulnerabilities embedded in global markets due to high valuations, concentration, and persistent inflationary pressures. It is a call for caution and foresight to prioritize risk management along with return maximization. **Durability** shifts the focus to building resilience through thoughtfully diversified allocations designed to withstand today's risks and position portfolios for long-term success.

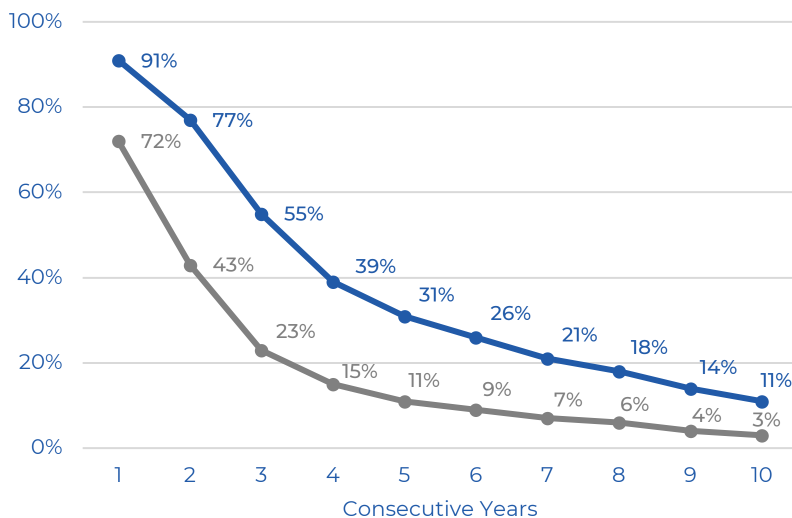
Finally, **The Age of Alpha** highlights the growing potential for active management and alternative investments to drive outcomes in a market where passive investing may present additional risk. Together, we believe these themes provide a framework for both addressing uncertainty and identifying attractive opportunities.

1. Fragility

Elevated valuations, intensified market concentration, and the risk of a second wave of inflation sow the seeds of vulnerability in markets today. Both equity and fixed income valuations currently hover at historically high levels. U.S. equity markets surged in 2024, with the S&P 500 index returning 25%. Valuations for that index, measured by the price-to-earnings ratio, sit near 22x, close to the highest in 20 years and more than one standard deviation above the long-term average. When compared to global counterparts, U.S. large caps appear even more stretched, adding a layer of risk for investors overly concentrated in domestic investments. Meanwhile, credit spreads on corporate bonds compared to government (one measure of valuation) have tightened close to levels last seen before the Global Financial Crisis.

Further, much of the rise in valuations has been fueled by continued strength among the handful of large cap companies that dominate the top of the market. This narrow market leadership means that the fortunes of just a few companies will disproportionately influence the broader market, whether for better or for worse.

CAN THE PARTY KEEP GOING?



Graph interpretation: 91% of companies that appeared in the S&P 500 since 1985 grew sales by 10% or more in at least one year, but only 11% ever did so for ten straight years.

This suggests that sustained high growth is difficult over long periods. For high-flying mega cap names, slower growth may weigh on stock performance, which would in turn cause greater market volatility.

Source: Fiducient Advisors. Data originally sourced from Goldman Sachs.

Further adding to this complexity is the threat of reinflation. While inflation has eased in recent years (U.S. CPI at 2.7% in November 2024, compared to 9.1% in June 2022), it has not vanished, and several inflationary pressures still lurk. Should reinflation materialize, it could upend expectations for financial markets.

INFLATION REIGNITION?

Inflationary	Disinflationary
• Deglobalization / onshoring • Political factors—e.g. tariffs, immigration policy, etc. • Large (and growing?) deficits • Money supply • Decarbonization	• Slowing population growth • Technology • AI productivity enhancements

Near-term risks of a resurgence in inflation appear to be rising.

Policy changes around tariffs & immigration, high deficits, expanding money supply, and interest rate cuts could spark further price increases.

Market expectations remain anchored for moderate inflation. Should these expectations shift, it could meaningfully impact both prices and volatility.

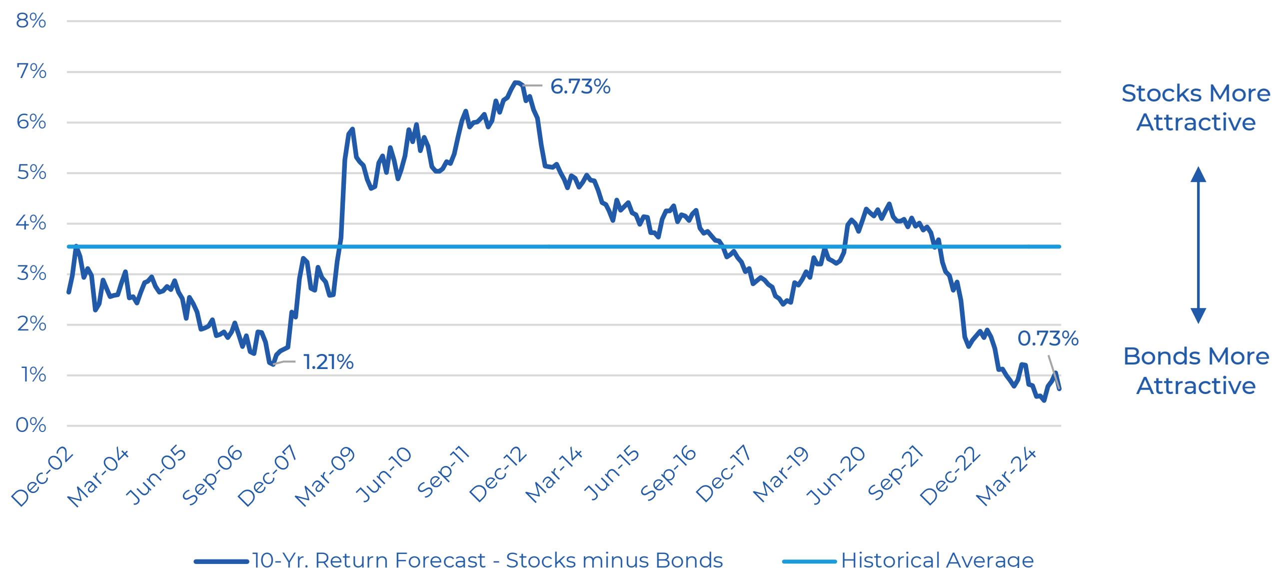
HOW MIGHT FRAGILE MARKETS AFFECT MY PORTFOLIO?

As we look ahead in an environment of potentially higher volatility, we believe that the number of clear-cut opportunities in today's market may be more limited, compared to the constantly rising equity markets experienced in three of the past four years. We encourage investors to ensure that their portfolios are properly diversified, that active managers are carefully selected, and that their asset allocation matches their tolerance for risk.

2. Durability

Taking risk is a critical aspect of investing, as there are few, if any, investments that generate sufficient returns without it. While the risks outlined so far are not new to investing, we see them as particularly pronounced in today's market, making portfolio durability critical. The good news is that, relative to history, adding durability to portfolios via assets like fixed income may come at a surprisingly modest "cost" relative to history, as the forecasted return difference between stocks and bonds has narrowed meaningfully.

RELATIVE VALUE OF STOCKS VS. BONDS



Source: Fiducient Advisors. Based on proprietary Fiducient forecasts as of October 31, 2024. Further information can be provided upon request. See the Disclosures for more information on the use of forecasted data.

The graphic above illustrates the difference between Fiducient's forward-looking return forecasts for U.S. large cap stocks vs. core bonds. A wider spread indicates a more compelling case for stocks, whereas narrower suggests less incentive to take on risk. The 2025 forecasted spread is just 0.73%, among the lowest levels since Fiducient began forecasting returns.

HOW MIGHT I INCREASE THE DURABILITY OF MY PORTFOLIO?

First, we do not simply recommend wholesale shifts from stocks to bonds, or vice versa. We believe that any sizable shift in allocations should arise only from a meaningful change in your circumstances—a change in investing time horizon, income needs, or life situation.

That said, we believe it is better to proactively review your goals and risk tolerance during calm periods in financial markets rather than volatile ones, when it may be too late to correct a mistake. We encourage all investors to evaluate their current portfolios in light of recent returns and consider whether current equity weights are appropriate for their goals and ability to take risk. If you're uncertain about the appropriate risk level for your personal situation, reach out to your Octavia advisor!

We also note that concentration amplifies outcomes, whether positive or negative. A striking recent example is the gap between the S&P 500 (weighted by company market cap) and its equally weighted counterpart. Over the past five years, the headline S&P 500 index has outperformed by nearly 4% per year, or more than 30 percentage points in total, thanks to its largest companies constantly beating the rest of the market. However, while recent history shows only the upside of concentration, the downside risks remain just as real. Investors have numerous options to mitigate this risk and increase durability.

THE IMPACT OF CONCENTRATION

		Flat Top 10	Top 10	Top 5	Top 3
	Top X Return	0%	-13%	-19%	-28%
	Remainder	7%	7%	7%	7%
	Return	**4.5%**	**0.00%**	**0.00%**	**0.00%**
Name	**Weight (%)**				
NVIDIA Corp.	7.2%	0%	-13%	-19%	-28%
Apple Inc.	6.7%	0%	-13%	-19%	-28%
Microsoft Corp.	6.2%	0%	-13%	-19%	-28%
Amazon.com Inc.	3.9%	0%	-13%	-19%	7%
Meta Platforms Inc. Cl A	2.5%	0%	-13%	-19%	7%
Alphabet Inc. Cl A	2.1%	0%	-13%	7%	7%
Tesla Inc.	1.8%	0%	-13%	7%	7%
Alphabet Inc. Cl C	1.7%	0%	-13%	7%	7%
Berkshire Hathaway Inc. Cl B	1.7%	0%	-13%	7%	7%
Broadcom Inc.	1.6%	0%	-13%	7%	7%
JPMorgan Chase & Co.	1.3%	7%	7%	7%	7%
Eli Lilly	1.3%	7%	7%	7%	7%
UnitedHealth Group Inc.	1.1%	7%	7%	7%	7%
Remaining Constituents	60.9%	7%	7%	7%	7%

Interpretation: At current market weights, the S&P 500 would return 4.5% if its top 10 stocks were flat while all others rose 7%.

Further, 28% drops in just the top 3 stocks could negate a 7% increase by all other constituents.

While many of these top names are exceptional companies, sustained exceptional performance is exceedingly rare, as referenced on page 2.
The index's largest stocks will likely face headwinds at some point.

For illustrative purposes only. Not intended to represent any specific market outcome.
Source: Fiducient. Index weights originally sourced from Factset as of October 31, 2024.

One simple way that we mitigate the risks of concentration is by reducing reliance on top-heavy indices. This can mean diversifying into other types of equities (small caps, non-U.S., etc.) or incorporating fixed income. Simply put, at this point in the cycle, we acknowledge that U.S. equities may continue to produce higher returns, but given the balance of risks, we see a globally diversified portfolio as likely to be more resilient.

3. The Age of Alpha

At Octavia Wealth Advisors, we do not directly manage ETFs or mutual funds, so we have no specific bias toward active or passive management. Our goal is to make many good options available to our clients, selecting for each the strategy that best fits their goals and tax situation. That said, we do believe there are certain asset classes and situations where active management is preferable, and see three factors in markets today providing a stronger thesis:

- **Valuations:** With U.S. markets trading at elevated valuations, forward-looking return expectations have moderated. This presents a relatively low hurdle for other asset classes to outperform in the coming years.
- **Concentration:** Heavy reliance on a handful of stocks may make it more difficult for market cap-weighted indices to maintain their level of performance.
- **Volatility:** Higher market concentration typically results in increased volatility. This, coupled with potential inflation volatility, may create fertile ground for stock selection and targeted opportunities within active management.

Final Thoughts for 2025

Full valuations, index concentration, and the potential for a resurgence (or at least a longer-term lingering) of inflation have set the stage for a fragile market environment. To be clear, we are not sounding the alarm on an immediate market crash, which is inherently impossible to predict. Many of the considerations mentioned in this outlook were also true a year ago, and have not yet caused issues for investors. It is absolutely possible that equity markets continue to push higher into 2025 on the back of economic strength and solid earnings growth. Yet we consider the possibility of setbacks to be equally real, underscoring the importance of prudence and durability in portfolio allocations.

We always encourage our clients to discuss with their advisor any changes to their investment outlook that would warrant a change in strategy. Such discussions are even more important in light of the current market environment. While we are not proponents of market timing, we believe that the current long-term outlook for stock and bond markets creates an opportunity for thoughtful conversations about risk and reward expectations.

Please reach out to your Octavia advisor if you wish to consider a change in your investment strategy, or to discuss potential opportunities in the year to come.

Past performance shown is not indicative of future results, which could differ substantially.

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