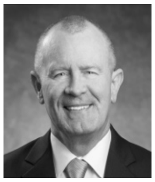
February 27, 2025

MARKET SIGHT LINES



Signals From the Noise: How Our 2025 Base Case Might Unfold

By Michael O'Keeffe, *Chief Investment Officer*

In the last couple of weeks, we've discussed two of the three scenarios from our annual Outlook (report, video, webinar) -– a more negative "bear case" and a more positive "bull case." The potential for dramatic markets garners much attention in the media, which focuses investors on possible big moves. But it is helpful to remember that our "base case," which is modestly positive, is the scenario we see as most likely. In this week's Sight|Lines, we discuss how we must look through the media noise to see the signals showing how our "base case" might unfold in 2025.

THE TAKEAWAY: A MODESTLY POSITIVE ENVIRONMENT IS OFTEN ACCOMPANIED BY A RANGE OF EMOTIONS, ESPECIALLY GIVEN CHANGES IN WASHINGTON

These days, we're bombarded by dramatic news stories, often about the economic and market implications of policy shifts in Washington. But the data signals we're seeing for anticipated consumer engagement and forecasted earnings remain mostly positive so far. In summary:

- The January retail sales report showed a larger-than-expected pullback in spending to start the year, a pause after a healthy holiday shopping season.
- University of Michigan Consumer Confidence levels declined in February, including an indication that consumers are worried that inflation will heat up this year.
- But consumer discretionary companies ended the year strong, with earnings growth much better than expected for the fourth quarter.
- That said, the consensus forecast for 2025 earnings growth for the consumer discretionary sector has fallen some, in part, on expectations that the labor market may soften.
- The earnings calls from retail companies provide insights into the companies' views on the consumer, and comments signal some uncertainty but a still-positive environment.
- The tight labor market and related robust wage growth have driven strong consumer spending, and that, supported by the wealth effect of housing and stock market gains, is set to continue.
- Turning back to the broader business environment, S&P 500 earnings growth estimates for 2025 have been revised lower but remain well above long-term levels.

IN-DEPTH: A MODESTLY POSITIVE ENVIRONMENT OFTEN INCLUDES WORRIES AND/OR ELATION, ESPECIALLY WITH BIG CHANGES IN WASHINGTON

The media is publishing stories, many dramatically negative, some quite positive, about the economic and market implications of policy shifts in Washington. However, the data signals that consumer spending and earnings will remain positive. Going deeper:

- January retail sales retreated more than expected following a healthy holiday shopping season:
  - Retail sales were down 0.9%, but the December gain was revised to 0.7% from 0.4%.
  - Consumers spent $994.1 billion over the holiday season, a 4% increase over 2023.
- The February University of Michigan Consumer Confidence report showed some worries:
  - The final number was revised down to 64.7 from an earlier estimate of 67.8, a 15-month low.
  - The one-year inflation expectations rose to 4.3%, down from 3.3% in January and 3% last year.
- Consumer discretionary companies had better-than-expected earnings in the fourth quarter:
  - 88% of companies reporting so far have posted earnings growth of 28.8% year-over-year, well above the consensus estimate of 11.9% on September 30, 2024.
- The consensus forecast for 2025 earnings growth for the consumer discretionary sector has fallen some:
  - The earnings growth rate was estimated at 8.2% as of December 31, 2024 but now sits at 6.3%.
- We routinely learn a lot about the consumer from the earnings calls of retail companies.
  - Walmart – "Our outlook assumes a relatively stable macroeconomic environment but acknowledges that there are still uncertainties related to consumer behavior …"
  - Airbnb – "The consumer and, in particular, the North American consumer has been strong and in particular, has been strong in terms of contemplating future travel."
  - Delta Air Lines – "The U.S. consumer is financially healthy …"
- A tight labor market and wage growth have driven consumer spending, and that is expected to continue:
  - Unemployment is 4.0%, while wage growth was 4.1% (2024) and is estimated at 4.2% this year.
  - Despite some retreat from all-time highs, elevated stock markets support a positive wealth effect.
- The broader business environment, as reflected in earnings growth, is expected to remain positive:
  - The consensus earnings growth in 2025 for the S&P 500 now sits at 11.8%.

CONCLUSION

The media often projects drama, so we're constantly bombarded with predictions that the economy and the markets may be headed for a dramatic shift, driving us toward our more negative "bear case" or our more positive "bull case" in 2025. However, our view is the most likely scenario is our "base case," which calls for modestly lower or higher positive economic growth, increased market volatility, and lower, but positive, stock market returns. The consumer and businesses seem poised to remain positive and engaged this year, setting the foundation for a modestly positive environment despite the dramatic headlines we'll see.

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