Research @ Citi Podcast, Episode 19: 2025 Outlook — Expecting a Volatile Bull

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Transcript:

Lucy Baldwin (00:02)

Welcome to the Research @ Citi podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research. Welcome to our Research @ Citi Podcast. Today we'll be talking with Scott Chronert, who's the head of our U.S. equity macro strategy team and ETF team. And we're going to talk about the *North America Road Ahead,* or our forecast and our expectations for the U.S. equity market in 2025. Before we go there, obviously, you know, this is going to be potentially a tumultuous year, maybe not, but clearly we have a big change in the presidential administration, and that should actually, you know, given anything, affect policy one way or the other. But we're also looking at a lot of other things as well going into 2025: we're looking at fiscal concerns, we're looking obvious at policy changes, and we're also looking at things like, call it continued effect of AI, et cetera. So there's a lot of factors. But before we go there, Scott, can you tell me how is the market currently positioned? Because we did see a little bit of a selloff going into year-end. But how are they positioned? What is the market telling us right now, how they think 2025 is going to go? And how do you think of it in that context?

Scott Chronert (01:37)

Right. Thanks, Rob. Great question and good starting point for this. So let's step back and think about the setup ahead of the election. Our view at that point was that around 5,600, which had been our year-end target since the middle part of last year, we were at something close to what we would consider fair value. The market was at that point, in our view, discounting quite heavily soft-landing sentiment and ongoing AI tailwinds. The election provided its own component of, let's call it opportunity and risks, but was a tail risk versus that basic setup. So what's happened here, in our view, is that the election outcome, Trump plus Red Sweep, kind of triggered a positive Trump trade on the premise that you'd have a business-friendly administration coming in, which has its own nuances. But the point being to your question, as we hit 6,100, or just about, in the early part of December, we argued at that point you had really begun to push the envelope in terms of the euphoria around soft landing, AI growth tailwinds, and then Trump policy promise, OK? And a lot of this was predicated on a view that going into the first quarter of this year, we'd have to come to terms with a balancing act between longer-term Trump policy proposals that are presumably net-net business friendly, but a shorter-term dynamic where we're going to actually have to go through the noise around policy implementation. What exactly do tariffs look like? Where exactly can you get in terms of tax relief for certain parts of the market and so forth. So what our setup view has been: near 6,100, you want to lighten, going into a year where we think we'll have a noise factor kick in during the Q1 timeframe, which in turn should set up for more policy clarity and policy promise as we hit mid part of the year, begin to turn the corner in the back half of ’25, and look constructively at 2026.

Rob Rowe (03:54)

And what's your call for 2025 now?

Scott Chronert (03:57)

Yeah, so our base case for ‘25 is 6,500. From current levels, that's going to be about a 10% return. Um, and, you know, that takes into account the pullback we've had in the past couple of weeks. We have a bull case of 6,900 and a bear case of 5,100, a little bit more downside skewed to that bear case, but that's a function of a very high valuation starting point. We're looking at 25 times trailing earnings as we start off 2025. That's very high versus historic standards, and what it does is it puts a lot of burden on fundamentals to continue to deliver. Now, what I would say us versus consensus, a year ago at this time, we were comfortably ahead of consensus for strategists going into ‘24, and again, at mid-year ‘24, also comfortably ahead of consensus. This year we're a touch below consensus, and I would say comfortably there as well. So we're trying to stay attuned to a little bit different risk/reward dynamic as we go into the first part of this year, but ultimately with a perspective that we're looking at equities through a very constructive lens for the better part of 2025.

Rob Rowe (05:19)

And so where would you put forward earnings, then, for 2025? And where would you put forward P/Es versus where they are now?

Scott Chronert (05:28)

Right. So right now, the setup is that we think we're going to end 2024 — we need to get through the Q4 reporting period, obviously — around $242, $243 is our best estimate [for S&P 500 EPS]. We're using $270 as a base case for 2025, which is going to be roughly 13% earnings growth, just a tad below consensus, which right now is around $273, $274. Our guess, Rob, is that you'll see consensus come down towards our $270 as we wind through the Q4 reporting period.

Rob Rowe (06:03)

And what has to happen for either the bull case or the bear case to happen? As you said, this is asymmetric, right? You have a little more of a— a little more volatility on the bearish side than the bullish side, I guess, given that it's at 5,100. But what kind of factors would have to happen to achieve those two scenarios?

Scott Chronert (06:22)

So let's think about the S&P in terms of the Mag Seven versus the other 493, okay? And this is important because the Mag Seven is where you to a certain degree, feel that AI spending tailwind. What happened in last year, in 2024, was that you had this ongoing beat-and-raise dynamic for the Mag Seven, okay? While they were outperforming the market from a performance perspective, they were also dramatically outperforming from an earnings revision basis. The other 493, by contrast, has been looking at a downward sloping pattern for 2025 earnings for the better part of a year now. My point here being is that when you look at the full-year price action for 2024, the Mag Seven kind of earned their keep, right? They showed earnings growth via a beat-and-raise lens that kept the price action up into the right, whereas the rest of the market is still grappling with a number of fundamental issues that kind of begin with the lagging effects of a tight Fed, lagging effects of a downward trending industrial production dynamic.

All told, what's happened here is that 2024 evidenced a “show me the growth” setup, right, where if you are showing, demonstrating good beats and raises, you were being rewarded for that in the market. We think that persists into 2025, and this is critical, right? So right now, the Mag Seven is projected to show earnings growth north of 20% for 2025. I think that's pretty visible. We don't have any big qualms with that. The question is, can you continue to get a beat-and-raise dynamic out of them? On the other hand, the other 493 is positioned to show earnings growth closer to the 10–12% neighborhood — that would be an acceleration from 2024. Okay? And so what we're getting at here is that for the market to move towards a bull case above and beyond our 6,500, we need both working. We need Mag Seven to continue to beat and raise. We need the rest of the market to demonstrate an earnings growth persistency coming off of 2024. That's how you get to a higher 6,900 level.

Look, flip side, the bear case is going to be, you know, macros continue to sort of negatively surprise, which would be aligned with the Citi Economics view of risk of an economic downdraft in the first half of the year, and/or your Mag Seven fails to show a beat and raise. I'm not sure just making the already impressive growth expectations for 2025 will be sufficient to keep the stocks moving higher. Right? So you keep coming back to this story line where the markets really are, as we go into ‘25, a function of this “show me the growth” dynamic. We're pretty comfortable we're going to get it for the Mag Seven, but we need to see continued beats and raises. For the rest of the index, we need to see a more firm broadening of earnings growth. And with that broadening — this is an important theme — what you get is earnings growth convergence, right? So the Mag Seven begin to lap really difficult compares; the rest of the index, easier compares. Earnings growth convergence does a couple of things. It says you want to continue to hold your mega-cap growth exposure, but it also is encouraging in pushing out a broader implementation path, whether it be large-cap value or go into the small/mid-cap arena and potentially elsewhere in the globe.

Rob Rowe (10:17)

And let's shift to these actual Trump policies, because just prior to the call we were chatting and you were mentioning that you're not so sure they may be as impactful as we think. What's the argument behind that?

Scott Chronert (10:30)

Right. So I think what we learned in the last month of the year as we navigated this continued resolution issue is that the Trump win-and-sweep and the euphoria with that is probably going to run into a circumstance where it may not be quite as easy as might have been expected post-election for policies to take hold as distinctly as Trump has expected and perhaps as the market has begun to price in. Right? So we think it begins with appointees and the nomination process. It then kind of goes into what you can get done through executive order versus what is going to require a little bit more of a legislative support network kicking in. And all of this, in our view, suggests that a lot of the work that was going on ahead of the election in terms of the potential impact of Trump policies — whether it be tariffs, tax reform, deregulation — may not play out quite as distinctly as expected. Right? And so in there is where this noise factor kicks in. An example is going to be — and this is a really important example, if you will — on the tariff front. So our modeling pre the election was that a 10% across-the-board tariff could potentially result in a 6% earnings hit to expected growth for ‘25 and ‘26. That was all-in, across-the-board, 10%.

Importantly, if you look at what's priced into consensus is a very distinct expectation for improving gross margins in ‘25. Point I'm making here is that as you go down the tariff implementation path, we think there's a risk to gross margins, right? So that's on the negative side. On the other side, we learned in Trump 1.0 that exemptions from tariffs are negotiable in many cases. So there's an expectation from our perch that somewhere in here, as you go down a policy tact such as tariffs, there's going to be some good news and some bad news, and some of the good news may be by tariffs not being as onerous as feared. Right? And then you go down the same discussion path with the potential for lowering tax rates, may not be as easy to get done as one would hope given the deficit circumstance. And then on the deregulatory front, much more difficult to actually factor that into an earnings or fundamental perspective. What that really does is provide some comfort that longer-term fundamentals can be looked at with a higher degree of probability to show continued growth. And at the same time, I think the market at some level is looking for evidence that the Trump administration will have an eye on the ongoing deficit situation, which is an ongoing cause of concern for many people from an equity market valuation perspective.

Rob Rowe (13:32)

And I know that Nathan Sheets, our Global Chief Economist, and team did an exercise where they looked at reciprocal tariffs, or that reciprocal tariff strategy, and they saw an aggregate five-percentage-point increase in tariffs as opposed to 10%. They saw more extreme against China, say, 10–20%. If that were to come into fruition, how does that affect the forecast? So it's not 10% across the board. It's more like 5% across the board.

Scott Chronert (14:04)

Yeah. Yeah. So where we're going with this, Rob, is that we think this— the Q1 time frame is kind of critical to getting a little bit more granularity on where these policies are taking us.

Rob Rowe (14:13)

Devil’s in the details.

Scott Chronert (14:15)

Exactly. So if we're here looking at low-double-digit earnings growth expectation for 2025 — we’re at 13%, consensus is up 14% — our guesstimate is that in aggregate Trump policy impact on that is probably a percentage point or two either way.

Rob Rowe (14:36)

I got it. Mm hmm.

Scott Chronert (14:37)

So what we're getting at here is that there's an underlying fundamental inertia that's at work in the broader economy and in the equity markets, and the Trump policies — while they may have more distinct impact on certain companies, sectors, industries — in aggregate, we think the impact is going to be somewhat muted relative to the underlying inertia. Point being here, as I mentioned earlier, I don't know that there's that much on the tariff side that would dramatically change the way you think about the Mag Seven components that have sort of, say, a software exposure and— or an Internet exposure. So there are areas of the S&P 500 that may be more immune than others when it comes to tariff implementation, and all of this has to be factored in when you're trying to piece together a index level earnings growth expectation for next year.

Rob Rowe (15:32)

Let's delve a little bit into sectors and industries because now that you've set the backdrop for us, Scott, maybe you can talk a little bit about what sectors you think will play out well and which may be under pressure here.

Scott Chronert (15:46)

Right. So for the better part of last year, in the second half in particular, we were very much in barbell mode of having growth exposure married with some cyclicals exposure. And a lot of that was predicated on participating on the gradual shift in sort of the Fed rate trajectory. Going into 2025, we're taking a more balanced approach. As an example, we're maintaining our overweight on financials via the banks and overweight on communication services, which captures part of this Mag Seven component and a contrarian overweight in energy on the more cyclical side. But we also moved healthcare to an overweight after nearly a year of carrying that sector as an underweight, okay? So what had happened over the past year is that the earnings growth expectations for healthcare came down, the sector generally underperformed. Valuations had gotten to a more attractive entry point, making us more willing to come back to that sector as a quasi-defensive, but also as a potential fundamental improvement opportunity. On the flip side, consumer discretionary had been a— I'm going to call it a contrarian overweight for us during the second half of the year, which finally worked in the fourth quarter, we pulled that down to an underweight. Again, what's happened with the price movement in consumer discretionary is you've stretched valuations to a point where it's going to put an inordinate amount of pressure on fundamentals to really deliver. So all told, what I'm getting at here is that we're setting up our primary sector focus with this balanced view around growth, some cyclical exposure, but then also some more classic defensive exposure as well.

Rob Rowe (17:38)

Got it. And is this mostly valuation based, or is there an anticipation, for instance, you would stress the— as you mentioned, the communication services area as part of the Mag Seven, but not necessarily semiconductors or software or any of that?

Scott Chronert (17:53)

It's really a balance. I'm going to come back to my quip at the outset on “show me the growth.” When you look at that Internet/media cohort of communication services, valuations are up, but the PEG ratio, the P/E to growth ratio, is actually fairly reasonable. And so we feel like we're in pretty good position on that. And with healthcare, what's happened as a function of the underperformance, you've set this up where the need for this part of the market to deliver a beat-and-raise is not as heavy as it is for some of these market-leading growth parts of the market. So we're looking for this balance here between where valuations are, but relative to where growth expectations are and may be going as we go through the first half of next year.

Rob Rowe (18:42)

Got it. And, Scott, can you comment whether the U.S. equity market will benefit in a way from the underperformance or potential underperformance of other global markets?

Scott Chronert (18:53)

Yeah, I'll just kind of wrap up on that, Rob. I mean, look, I'm a U.S. equity strategist and so it's not going to come as a surprise if I'm going to say I'm a believer in U.S. equity exceptionalism.

Rob Rowe (19:05)

Right. Yeah. *[laughs]*

Scott Chronert (19:06)

And what I do think we have working for us longer term from a U.S. equity perspective, particularly in large-cap arena, is you got a lot of things. You've got the AI growth tailwinds, the mega-cap growth cohort, which you can't really replicate in the rest of the world. All of this sets up for ongoing improvement in capital markets activity, but also in forward-looking capex, share buybacks and a de-equitization playbook, and if you're not getting it right fundamentally, you can count on activists showing up at some point, right, to help with that discussion point. So all told, I think structurally, the S&P 500 continues to be in pretty good shape versus rest of the world. I do think the rest of the world does set up well, though, from a more traditional early-cycle playbook, and we may be approaching that. And so what you hear from us in our global strategy work is a barbell. We want overweight U.S. and we want overweight Europe as a offset to that where you do look like you're setting up for a more traditional early-cycle playbook into 2025.

Rob Rowe (20:10)

Fantastic, Scott. Thanks so much for your insights. I'm sure they'll be very informative for everyone and all of our listeners. Thanks again.

Scott Chronert (20:18)

Thank you, and have a good year.

Lucy Baldwin (20:21)

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