December 18, 2024

A year of surprises: 2024 in the rear-view mirror

We look back at the financial markets in 2024 - at least the first 350 days - to provide some context as to what may be coming in 2025.

A year ago, much of the talk surrounded the potential for, and timing of, an upcoming recession. The general narrative was that both inflation and interest rates were too high and would suffocate consumer borrowing and spending, leading to an economic decline. We disagreed and looked to the underlying strength of the U.S. labour market as a point of fundamental support. Even though we expected ongoing growth in 2024, the strength and resiliency of the U.S. economy surprised us.

This surprise fed right into our second surprise – the very strong absolute returns generated by nearly every global equity market. It wasn't so much the positive absolute returns but rather just how strongly equity markets moved in 2024. The clearest example was the higher-than-average U.S. equity performance. The S&P 500 Index returned 39% in Canadian dollars (to December 16). What makes this performance even more extraordinary is that it followed a very strong 2023 where that same index returned over 23% in Canadian dollars.

Canadian fixed income markets: Credit spreads compress

With inflation dropping from pandemic-era highs, policy interest rates fell from their peak as the Bank of Canada (BoC) cut its target for the overnight rate by 1.75% between June and December.

Interest rates were quite volatile across the yield curve. Shorter-term rates declined and longer-term rates increased, causing the yield curve to steepen in the second half of the year. Credit spreads rallied across the board and corporate credit spreads are currently at the tightest level since 2021.

This rally exceeded our expectations and may have gone too far. As an example, we point to the new-issue market in the second half of the year. Companies issued many new bonds with a negative new issue concession (NIC), highlighting the current exuberant state of corporate credit. In normal credit markets, a NIC is the additional yield an investor demands to buy a company's new bonds relative to its existing bonds already trading in the secondary market. When NICs turn negative, indicating a lower yield / higher price than existing bonds, it's a simple and irrational grab for product and reach for yield by the investors paying a premium to participate. Unfortunately, we have seen this phenomenon before, and it rarely ends well for the investors doing the grabbing and reaching.

Corporate security selection at FGP added notable value as the rally favoured some companies previously neglected by the market. Hybrids had strong returns. Subordinated bank investments – Limited Recourse Capital Notes (LRCNs) and $25,000 preferred shares - experienced notable spread compression and strong absolute and relative returns in 2024.

Canadian equities: Record highs, but still attractively priced

The Canadian equity market enjoyed strong gains in 2024, mostly in the second half of the year, with the S&P/TSX Composite Index hitting all-time highs. The exuberance might have been driven by valuation, interest rate decisions, and the impending second Trump presidency. Many Canadian companies and sectors were out of favour a year ago, and we were not surprised there were gains based on sentiment. For example, Canadian banks continued making provisions for credit losses and experienced improvements in their valuations in anticipation of lower credit losses in 2025.

We continue to think that Canada is an attractive equity market despite the threat of 25% tariffs from the U.S. We see earnings growth in 2025 in various sectors - such as consumer discretionary and financials - due to the benefit of lower interest rates and the related implied demand stimulus from short-term rate cuts.

The greatest surprise for us was the strength of the equity market. Many securities appreciated more than we expected. Generally, there are three key factors that drive total stock market returns: dividends, earnings growth, and market sentiment (or the price-to-earnings (P/E) valuation multiple investors are willing to pay for those earnings).

In general, we think that sentiment was a key driver of returns in 2024. As the valuation of a company increases, so does the market's expectations of growth. Therefore, we are generally of the view that 2025 may not be a repeat of 2024 given that sentiment was more powerful than earnings growth in 2024. While our Canadian equity portfolio had some strong performers in 2024, our portfolio had some laggards with inexpensive valuations. Consequently, we think our underperformers can potentially recover in 2025 while offering downside protection if the market meaningfully corrects.

The other surprise to us is that investors continue to follow the herd in owning very large-cap technology stocks. Whether in the United States or Canada, many investors view certain technology companies as being limitless in terms of growth prospects and valuation multiple expansion. We do believe there is a limit to everything and, ultimately, valuation cannot expand if the expected earnings growth doesn't materialize. Indeed, if growth doesn't meet expectations, then a company's share price can decline quickly.

Global equities: The U.S. trounces Europe (again)

Outside Canada in 2024, in local currency terms, major global developed markets were up the most in the U.S., with Europe lagging far behind. The year was far from an outlier. Over the past 10 years, the S&P 500 Index outperformed the STOXX Europe 600, an index of European stocks, by a cumulative 151%. On an annualized basis, the S&P 500 Index returned 11.9% in U.S dollars, compared with Europe's 4.7% in euros.

If we break down the average for the S&P 500 Index over the past decade, the market delivered about 7% earnings-per-share (EPS) growth and 4% annual multiple expansion. In Europe, annual EPS growth averaged 5% but the multiple expansion compressed by 1% annually over the past decade. Investors paid 16 times the earnings of European companies in 2014 but were only willing to pay 14 times earnings in 2024. The U.S. market is currently trading at 25 times trailing 12-month earnings, near a 10-year high.

If we zoom in on the performance of the markets in 2024, we saw a continuation of these longer-term trends, with the U.S. continuing to outperform Europe and the valuation spread continuing to widen. The U.S. market returned 29% in U.S. dollars year-to-date, with 8% EPS growth and the remaining 19% of the gain coming from multiple expansion. In contrast, the European market, with its approximate 8% return year-to-date in 2024, had no help from EPS growth, which was -2%, while the multiple increased 9%, delivering all the price return.

Measure	S&P 500 Index (USD)	STOXX Europe 600 Index (EUR)
10-year return to Dec. 16, 2024 (annualized)	11.9%	4.7%
From EPS growth	7%	5%
From multiple expansion	4%	-1%
YTD return to Dec. 16, 2024	29.1%	7.7%
From EPS growth	8%	-2%
From multiple expansion	19%	9%
P/E ratio @ Dec. 2, 2024	25.3	14.3
P/E ratio @ Dec. 31, 2014	17.0	15.8

Source: Bloomberg and S&P Capital IQ

U.S. stocks started the year trading at a 64% premium to the European market, double the 32% average premium over the past decade. We appreciate that the U.S. market delivered superior earnings growth over longer periods of time, including in 2024. However, we continue to be surprised by the valuation premium the market is willing to pay for what has historically been 2% greater annual earnings growth for the U.S. relative to Europe.

1 Adelaide Street East, Suite 2600
Toronto, ON M5C 2V9
Telephone: 416.362.4725 | Toll-Free: 1.844.FOYSTON (369.7866) | Fax: 416.367.1183
www.foyston.com