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Get ready for a broader US equity market

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We believe the variables are in place for continued improvement in market breadth. History tells us that when there is a global rate-cutting cycle, stable to improving real gross domestic product (GDP), and accelerating earnings power, index concentration will abate as investors discover fundamentally attractive ideas across style and capitalization size. In our analysis, these variables are in place as 2025 begins.

We believe the rotation that began in July of 2024 will likely persist given that the economy remains robust, and the breadth of forward earnings power is improving. The significant relative alpha generation from growth over value should moderate. Similarly, we believe breadth is poised to improve across the cap stack. Small-and mid-cap stocks should continue to participate alongside large-cap stocks.

This environment is bullish for the "average stock."

Historically, the S&P 500 Equal Weight Index[1] has outperformed the capitalization-weighted S&P 500 Index[2] with the following conditions in place:

- Lower interest rates/higher liquidity
- GDP recovery/acceleration
- Accelerating earnings-per-share (EPS) growth
- Index concentration

Lower interest rates/higher liquidity

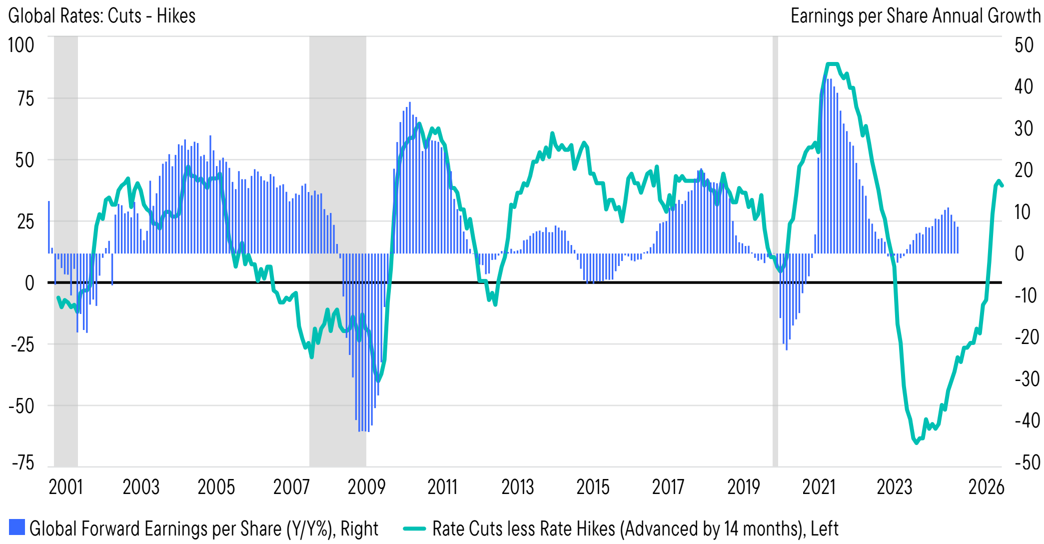
The fundamental drivers of the equity market are liquidity and earnings. Liquidity is shaped by monetary and fiscal policies, while earnings are closely linked to economic growth.

On a global scale, the monetary policy trend is evident: In 2024 alone, there were over 150 interest rate cuts, and more cuts are likely in 2025. These cuts highlight the synchronized global cycle of monetary easing that is currently underway. As Exhibit 1 shows, accommodative monetary policy seems to lead a rise in earnings growth by 14 months, on average.

Exhibit 1: Global Synchronized Easing Cycle Historically Supported Earnings Growth

Annual Global Earnings-Per-Share (EPS) Growth and Central Bank Interest-Rate Cuts Less Rate Hikes

As of January 9, 2025



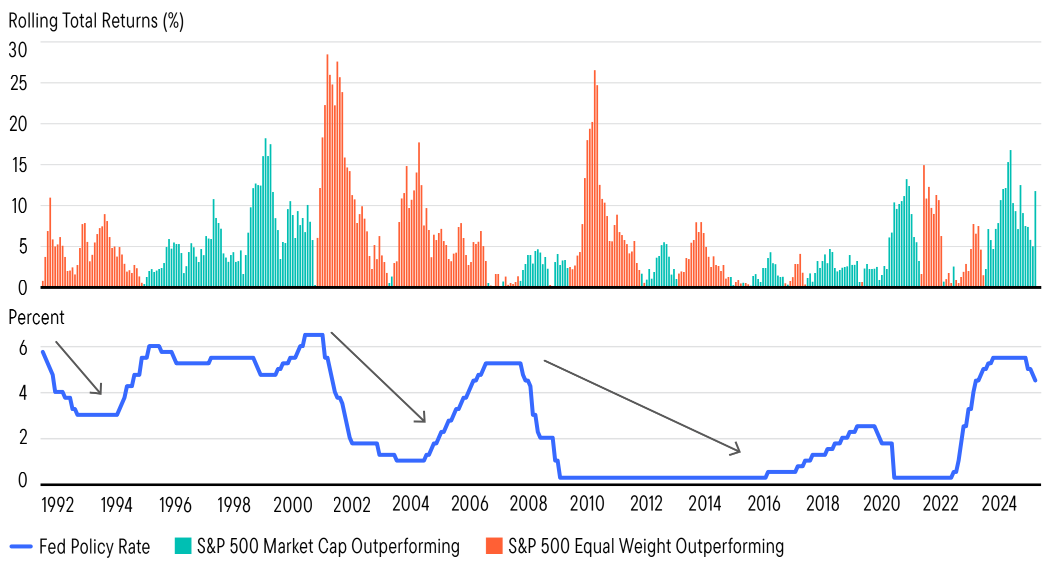
Sources: Global central banks, Macrobond. Analysis by Franklin Templeton Institute. Important data provider notices and terms available at www.franklintempletondatasources.com.

As Exhibit 2 illustrates, over the past 30 years, every instance of the equal-weighted index outperforming the cap-weighted Index coincided with a period of loose monetary policy. Typically, this outperformance accelerated following the start of a US Federal Reserve (Fed) rate-cutting cycle, as seen in 1991, 2001 and 2009.

Exhibit 2: Lower Rates Historically Supported Broader Equity Gains

Outperformance of S&P 500 Index and S&P 500 Equal Weight Index Relative to Fed Policy Rates

As of January 9, 2025



Sources: S&P Global, BEA, BLS, ICE, Fed, Macrobond. Analysis by Franklin Templeton Institute. As of January 9, 2025. Annual returns were calculated based on daily data. Important data provider notices and terms available at www.franklintempletondatasources.com.

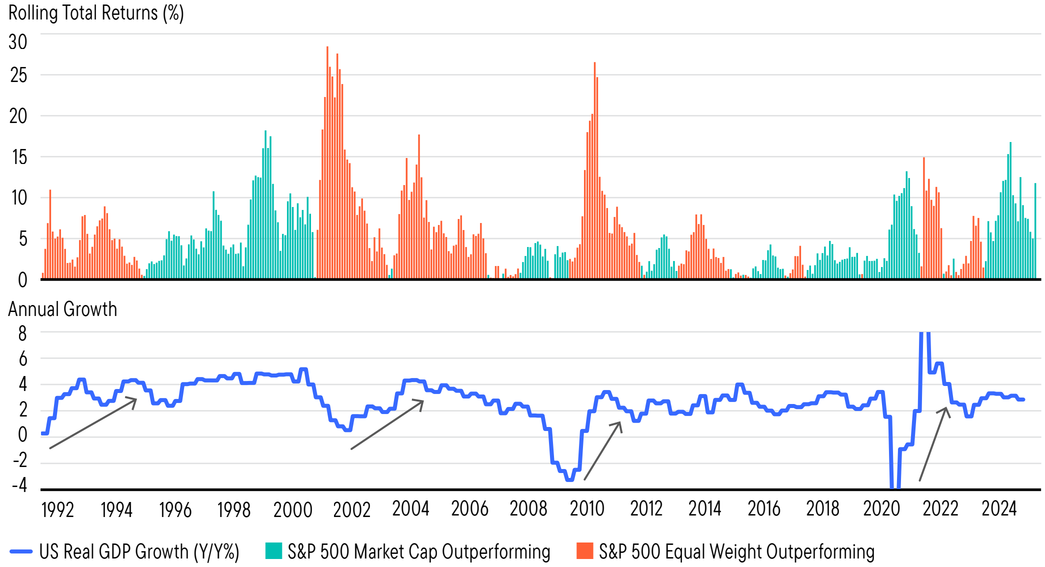
GDP recovery

Unsurprisingly, lower interest rates often align with improving economic growth, as stimulative monetary policy provides the necessary catalyst to support expansion. This combination of enhanced economic growth and abundant liquidity has historically led to strong equity returns across most sectors and investment styles.

Exhibit 3: GDP Acceleration Coincided with a Broadening Rally

Outperformance of S&P 500 Index and S&P 500 Equal Weight Index Relative to US GDP

As of January 9, 2025



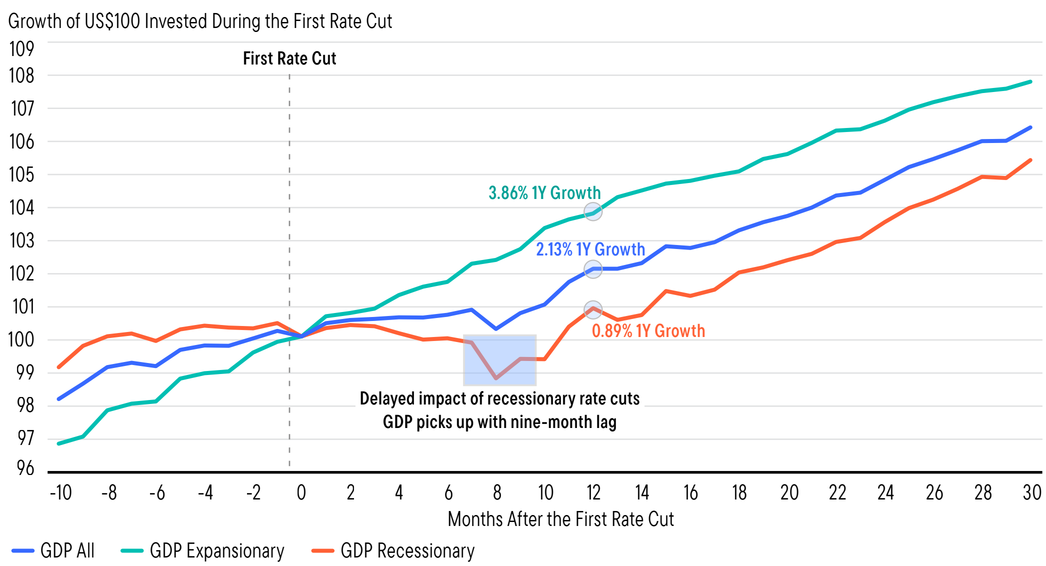
Sources: S&P Global, Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), Intercontinental Exchange (ICE), Macrobond. Analysis by Franklin Templeton Institute. Annual returns were calculated based on daily data. The 2020-2021 COVID-19 outliers were cropped (outliers). Important data provider notices and terms available at www.franklintempletondatasources.com.

Historically, when the Fed was cutting rates in economic expansions, economic growth tended to rise over 3.8% one year later (see Exhibit 4).

Exhibit 4: Average Performance of Real GDP around First Rate Cut of a Cycle

Hypothetical Growth of US$100 Invested at First Rate Cut under Three GDP Scenarios

As of January 2025



Sources: TCB, BEA, Institute of Supply Management (ISM), Macrobond. Analysis by Franklin Templeton Institute. Based on dates: July 15, 1974; April 1, 1980; June 15, 1981; April 15, 1982; September 20, 1984; November 4, 1987; June 6, 1989; July 6, 1995; September 29, 1998; January 3, 2001; September 18, 2007; August 1, 2019. Important data provider notices and terms available at www.franklintempletondatasources.com.

Recent US GDP growth has risen on substantial fiscal stimulus, a resilient consumer base, and a strong labor market. However, as the fiscal stimulus fades, the economy may find support from potential favorable policies under a new presidential administration, including lower taxes and deregulation, which could provide a critical boost to both the economy and corporate performance. Additionally, rapid advancements in AI innovation could lead to a wave of technological breakthroughs, driving productivity and economic growth. This scenario draws striking parallels to the 1990s, when technological innovation and pro-business policies fueled a period of robust economic expansion.

EPS acceleration

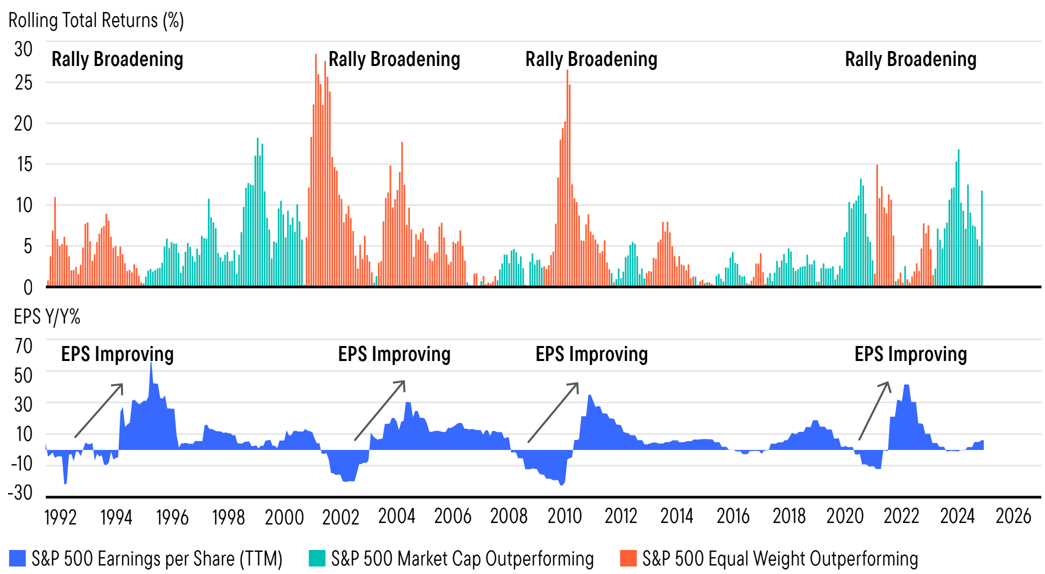
The previous sections demonstrated that the S&P 500 Equal Weight Index tends to outperform during periods of declining policy rates. As we know, one of the most critical valuation models is the discounted cash flow (DCF) model, which estimates a stock's intrinsic value based on expected earnings and prevailing future interest rates. Having explored the relationship between rates and the stock market, let's now turn to the second key component of valuation: earnings.

Exhibit 5 clearly shows that EPS acceleration has historically coincided with the broadening of market rallies, as seen in the early 1990s, 2002–2006, 2008–2010, and during the post-pandemic stimulus period (2021–2022). If we are indeed entering another phase of broad-based earnings acceleration, it is reasonable to expect an increasing number of stocks to participate in the current market rally.

Exhibit 5: Earnings Recovery Coincided with Broadening of Market Rallies

Outperformance of Equal- and Market-Cap-Weighted S&P 500 Mapped to EPS Trend

As of January 9, 2025



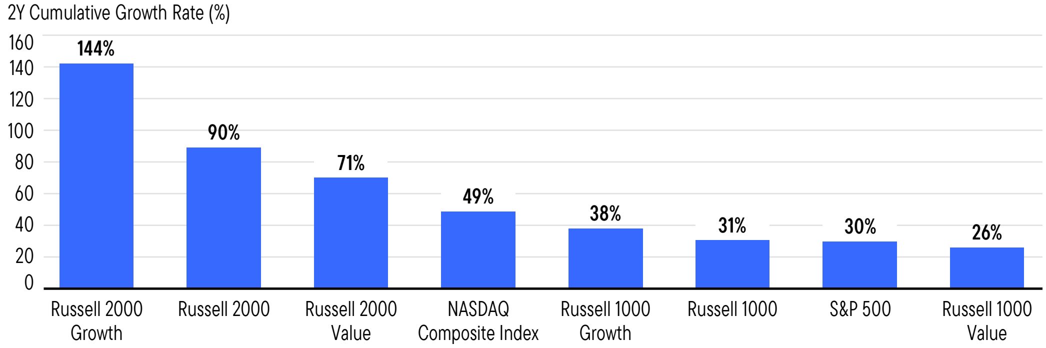
Sources: S&P Global, BEA, BLS, ICE, Macrobond. Analysis by Franklin Templeton Institute. Annual returns were calculated based on daily data. Important data provider notices and terms available at www.franklintempletondatasources.com.

Forward EPS cumulative growth rate is strong and broad across indices (see Exhibit 6). Forward EPS is strong and broad across sectors (see Exhibit 7).

Exhibit 6: Average Expected Earnings Growth for 2025–2026

Forecast Two-Year Cumulative Earnings Growth for Major US Equity Indexes

As of January 14, 2025

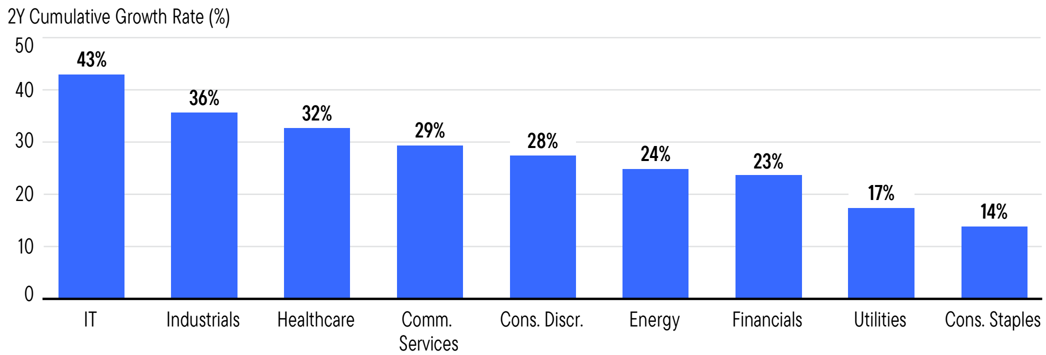


Source: Factset. Analysis by Franklin Templeton Institute. The expected earnings growth rate is calculated as the average compounded earnings growth rate for 2025-2026. There is no assurance that any estimate, forecast or projection will be realized.

Exhibit 7: Average Expected Earnings Growth for 2025–2026

Forecast Two-Year Cumulative Earnings Growth Rate for US Equity Sectors

As of January 14, 2025



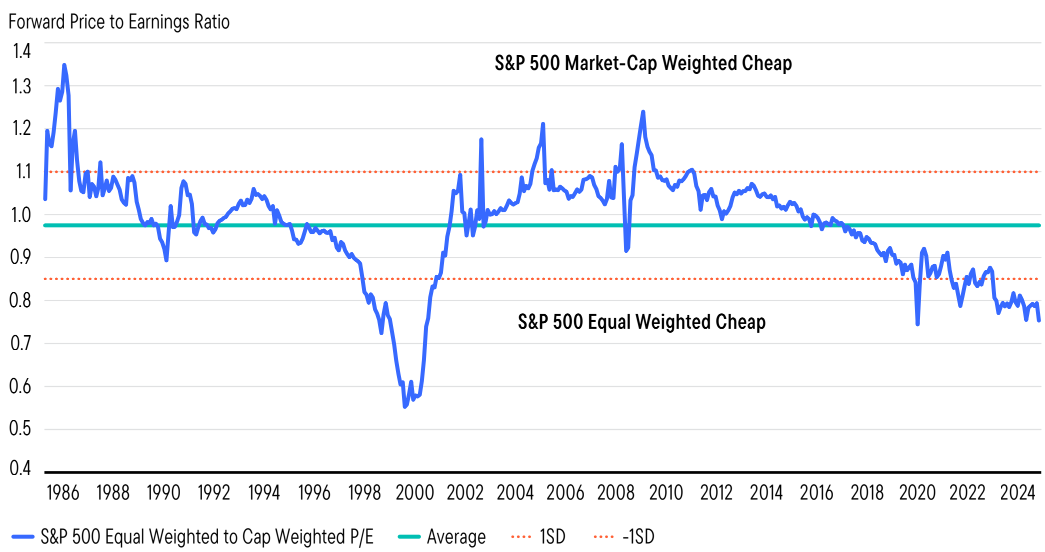
Source: Factset. Analysis by Franklin Templeton Institute. There is no assurance that any estimate, forecast or projection will be realized.

Within the S&P 500 Equal Weight Index, the "average" stock looks cheap on a forward price-earnings (P/E) ratio basis relative to the market-cap-weighted S&P 500 (see Exhibit 8).

Exhibit 8: The S&P 500 Equal Weight Index Appears Cheap Versus Cap-Weighted S&P 500 Index

Ratio of Forward P/E Ratios of S&P 500 and Equal-Weighted S&P 500

As of December 2024



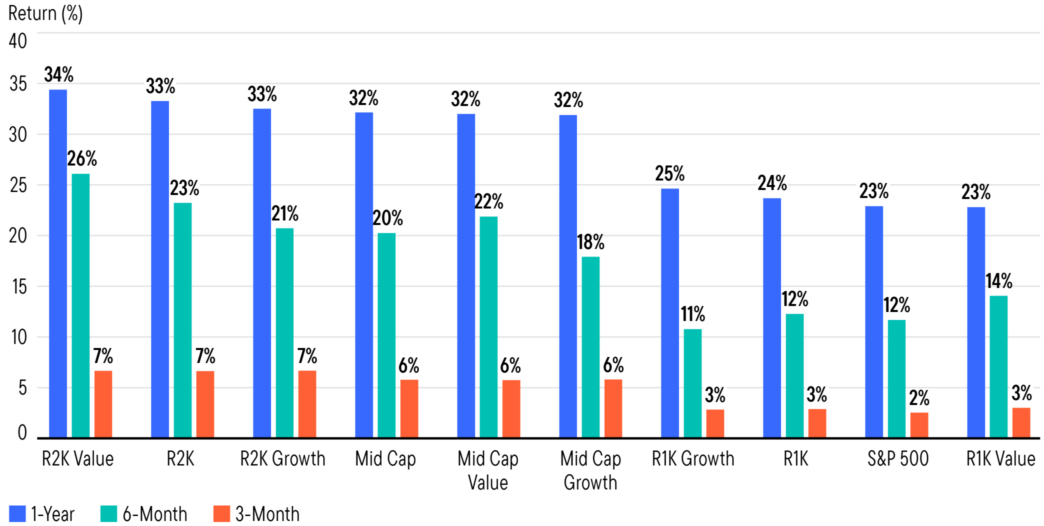
Sources: BofA, Factset. Analysis by Franklin Templeton Institute. As of December 2024: Forward price-earnings of S&P 500 Index, 24.6, and of Equal-Weight S&P 500 Index, 18.5. The expected earnings growth rate is calculated as the average compounded earnings growth rate for 2025-2026. There is no assurance that any estimate, forecast or projection will be realized.

Historically, when markets broaden out, small- and mid-cap stocks generate significant alpha relative to the market-cap-weighted S&P 500 (see Exhibit 9).

Exhibit 9: Equity Returns Following the Broadening of a Market Rally

Three-Month, Six-Month and One-Year Returns of Major US Equity Indexes

As of December 2024



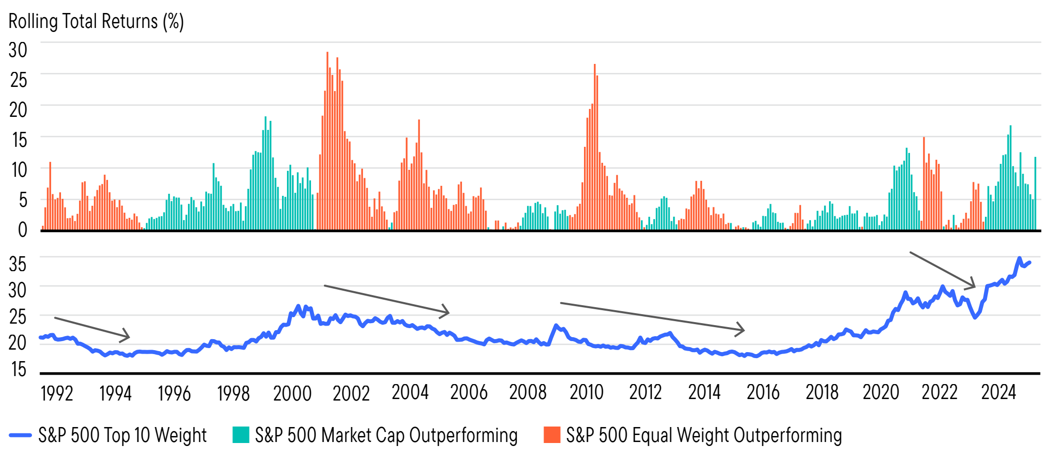
Source: Macrobond. Analysis by Franklin Templeton Institute. As of December 19, 2024. Returns following the broadening of a rally beginning on January 1, 2003, June 1, 2010, June 1, 2016, and October 1, 2020.

Index concentration

The final statistically significant factor that has historically coincided with the outperformance of the S&P 500 Equal Weight Index is decreasing market concentration. This makes intuitive sense, as bull markets entering their mature stages often see early winners remaining strong, but the continuation of the rally is driven by an increasing number of stocks participating. As a result, the composition of the index becomes more balanced, supporting broader market performance.

Exhibit 10: Following Concentration Peaks, Market Rallies Broadened

Outperformance of Equal- and Market-Cap-Weighted S&P 500 Relative to Index Concentration



Sources: S&P Global, BEA, BLS, ICE, and Macrobond. As of January 9, 2025. Analysis by Franklin Templeton Institute. Annual returns were calculated based on daily data. Important data provider notices and terms available at www.franklintempletondatasources.com.

Conclusion

While current stock market valuations appear frothy, history has shown that strong market performance alone is not a reason to turn bearish. While it is valid to have concerns about potential headwinds, such as tariffs or geopolitical shocks, how these possibilities may play out remains uncertain. Instead of basing strategy on uncertainty, it is important to focus attention on actual data, which presents a constructive outlook for equities.

The US economy is on solid footing, with healthy GDP growth and supportive liquidity conditions as the Fed continues its accommodative stance by cutting interest rates. Historically, this combination of loose monetary policy and rising economic growth has provided a favorable backdrop for EPS acceleration. Importantly, despite elevated valuations, the expected two-year earnings growth outlook remains strong across most US indexes and sectors, suggesting that earnings improvement could justify current price levels.

Our analysis indicates that we may witness a broadening of earnings growth and performance across styles and sectors. Four factors underpin this view: resilient GDP growth, robust earnings potential, a potential peak in market concentration and declining interest rates. These dynamics provide a strong foundation, we believe, for equities to continue performing well in the coming year.

Even given the risks of headwinds, we recommend that investors remain invested in equities, as we are projecting the S&P 500 to close the year in the 6400-6800 range. While we believe technology stocks are likely to perform well due to strong earnings momentum, we also see opportunities in small-cap and value stocks, which may catch up to the technology sector and potentially lead market performance in 2025. This diversified approach positions portfolios to potentially benefit from both ongoing market strength and the anticipated rotation in market leadership.

Endnotes

1. Source: S&P Dow Jones Indices. The S&P 500 Equal Weight Index is a size-neutral version of the S&P 500. It includes the same constituents as the cap-weighted S&P 500, but each company is allocated the same weight at each quarterly rebalance. **Past performance is not an indicator or a guarantee of future performance.** Indexes are unmanaged and one cannot invest directly in an index. Important data provider notices and terms available at www.franklintempletondatasources.com.
2. Standard & Poor's® 500 Index (S&P 500®) is a market capitalization-weighted index of 500 stocks designed to measure total U.S. equity market performance.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks. There can be no assurance that multi-factor stock selection process will enhance performance. Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods.

Active management does not ensure gains or protect against market declines.

Investments in fast-growing industries like the **technology sector** (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement or regulatory approval for new drugs and medical instruments.

Diversification does not guarantee a profit or protect against a loss.

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