

# Schwab Market Perspective: 2025 Outlook

December 13, 2024 • [Liz Ann Sonders](#) • [Kathy Jones](#) • [Jeffrey Kleintop](#) • [Kevin Gordon](#)



We expect gears to shift as potential policy changes under the Trump administration add to uncertainty about inflation and the global economy.

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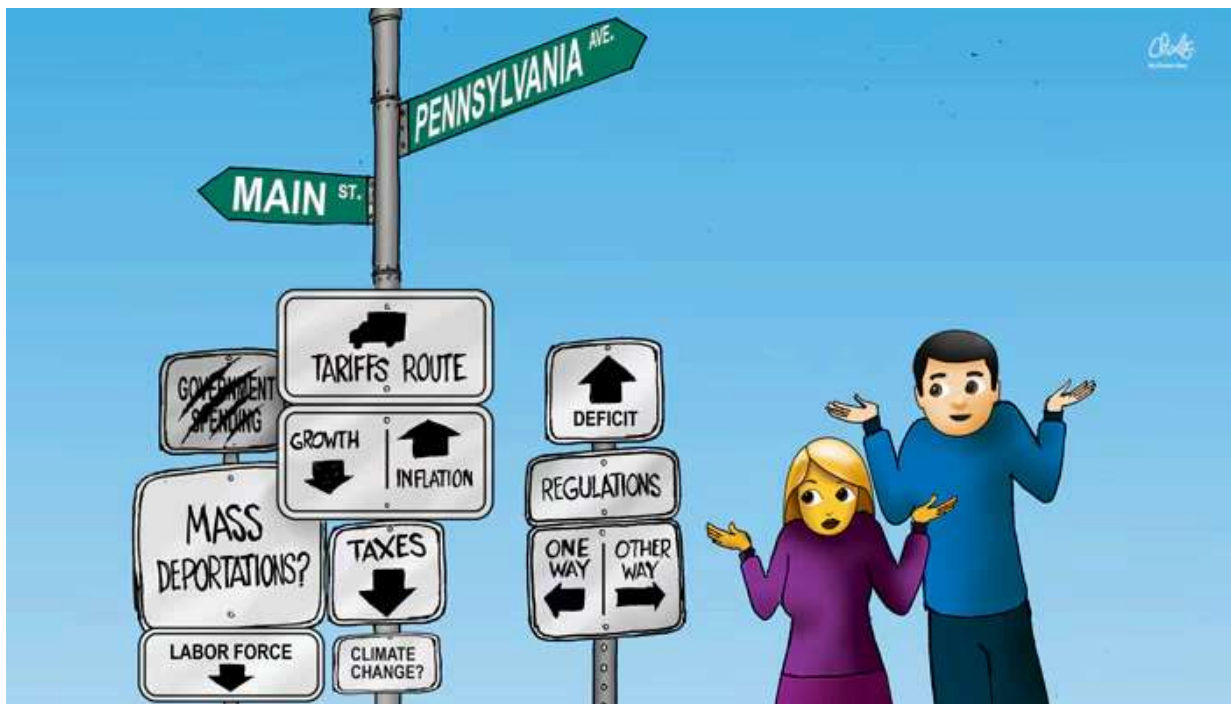


The U.S. stock market generally did well in 2024 and may continue strong in 2025. However, we expect to see gear shifts and increased market volatility as potential policies from the incoming Trump administration combine with uncertainty about inflation and global economic strength.

Although the stocks in the S&P 500<sup>®</sup> index are expensive by historical standards,<sup>1</sup> current market momentum and breadth—that is, how many stocks are advancing vs. declining—tend to bode well for returns over the next 12 months. As of December 9, 2024, the S&P 500 was up nearly 27% year-to-date, and up 31.46% on a trailing-12-month basis. During the past seven decades, there have been only two bull market peaks (when an extended rally ends) that occurred when the trailing one-year gain in the S&P 500 was above 30%. But most historical studies do point to heightened risk of volatility spikes and periodic drawdowns, which is why investor discipline is warranted.

## U.S. stocks and economy: Good luck figuring this one out

We've often chuckled at comments about "markets hating uncertainty"... as if there have ever been periods of certainty. But as we close the books on 2024 and peer into 2025, perhaps the uncertainties this time are [of a magnitude beyond the norm](#).



President-elect Donald Trump campaigned on a platform of lower taxes and less-stringent regulations—seen as growth-positive—but also higher tariffs on imported goods and mass deportations of illegal immigrants—seen generally as stagflationary, at least initially (stagflation is a situation with high inflation, low economic growth and high unemployment). These crosscurrents and the uncertainties they are breeding make it difficult for stakeholders (both domestic and international) to plan for the future, potentially creating an environment of caution and concern across policy areas. Add to this a Federal Reserve operating in data-dependency mode, and we have a backdrop of reactionary market behavior and policy decisions.

The good news is that the past two decades have brought more sustainable and resilient growth in the domestic economy, and more self-sufficiency in terms of food and energy production, lessening the reliance on trade. This has led to higher returns on U.S. capital and in turn ample capital inflows alongside a strong U.S. dollar.

But there are other uncertainty wrinkles looking ahead, a key one being immigration policy. Regardless of your view about our immigration problem and appropriate solutions, unquestionably, slower immigration coupled with mass deportations will lead to a downshift in labor force growth and labor supply—also likely denting the economic demand side of that equation.

For now, the labor market remains healthy. The rise in the unemployment rate from 3.4% at the start of 2023 to its current 4.2% was largely a function of a significant increase in the labor force due to immigration—not due to layoffs. Assuming immigration falls and deportations pick up alongside a slowing in the labor force, the downward pressure on wage growth could reverse. That, plus a lower sustainable rate of payroll growth could put the Federal Reserve in a bit of a pickle trying to adjust policy to that downshift, especially if inflation heats up.

On the pro-growth side of the ledger are tax-related proposals (including the extension of 2017's tax cuts and the possibility of a further corporate tax cut). That's in addition to pro-growth deregulation policies being proposed. There may be a timing issue given policies around tariffs and immigration can largely be done via executive order, while tax changes require congressional approval.

Transitioning to the stock market, we think overall that equities can do well from point A (the beginning of the year) to point B (the end of the year). However, the volatility backdrop is likely to be different from what investors got used to in 2024. This past year was defined by incredible sub-surface churn with minimal relative scarring at the index level: The maximum drawdown for the S&P 500 was -8.5%; the average member's maximum drawdown was -20%. The likelihood of a similar dynamic in 2025 is low, in our opinion.

One of the reasons for a step back in performance after such a strong year might be tied to valuation. Based on a five-year normalized price-to-earnings ratio,<sup>1</sup> the S&P 500 is looking quite stretched, and in fact has only been more expensive in the late 1990s and

2021—of course, periods which preceded weakness in the market. However, we tend to view valuation as more an indicator of sentiment, and we believe the stretched valuation environment is a product of enthusiasm around equities, not necessarily in and of itself a risk to the market's near-term performance.

We continue to recommend staying up in quality, looking for stocks of companies with factors like improving profit, balance-sheet strength, ample interest coverage ratios (which measure a company's ability to pay interest on its debt) and healthy free cash flow.

## **Fixed Income: How low can the Fed go?**

It looks like another bumpy ride is in store for fixed income investors in 2025, with a [wide range of potential outcomes](#) . For much of 2024, the soft-landing scenario of moderate growth and falling inflation amid low unemployment drove Treasury bond yields lower, but yields rebounded later in the year amid upward revisions to growth estimates and concerns about policy proposals that could boost inflation in 2025.

The Federal Reserve began cutting the federal funds rate—the rate at which banks lend to each other overnight—in September 2024. By November, the Fed had brought the rate down by 75 basis points (or 0.75%), to a range of 4.50% to 4.75%.

However, if inflation pressures rise—whether through stronger-than-expected economic growth or government policy changes, such as higher tariffs or tax cuts without spending cuts—the Fed's scope for lowering interest rates in 2025 will be limited. Given the upside risks to inflation, it's likely that the Fed will take a more cautious approach to cutting rates by holding policy steady at some of the 2025 meetings. Unless the labor market weakens significantly, the path for the Fed rate cuts is likely to be slower and shallower than previously expected. An ending or "terminal" rate between 3.50% to 4.0% seems reasonable to us for this cycle.



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The bond market is caught between the Federal Reserve's plan to cut interest rates and the risks to higher inflation and debt levels in 2025. Given the uncertain outlook and timeline for policy, we favor adjusting duration (a measure of bonds' sensitivity to interest-rate changes) to benchmark or lower to help mitigate interest rate risk. We use the Bloomberg US Aggregate Bond Index, whose duration is currently 6.2 years, as a benchmark for investment-grade bonds, but every fixed income investor should have their own benchmark based on their investing timeline and risk tolerance. Investors might also consider a [bond ladder](#) —a portfolio of individual bonds with staggered maturity dates—as a helpful way to spread out maturities of bonds over time and manage duration.

We also favor higher-credit-quality bonds, such as [investment-grade corporate](#) and [municipal bonds](#). Valuations are high, with the yield spreads compared to Treasuries at very low levels. However, the fundamentals currently look solid and yields are at attractive levels.

## Global stocks and economy: Clearing the hurdles

The year 2025 may bring hurdles for stocks in the form of uncertain trade policy, tighter fiscal policy, and slower-than-average growth in the global economy and corporate earnings. All these may drive volatility. But improving growth, along with a rise in stock valuations, may support solid returns overall for [international stocks](#) in 2025, with differing opportunities by region.





For illustrative purposes only.

A trade war could pose the biggest risk to global growth in 2025. Trump initially threatened 60% tariffs on all Chinese imports and 10%-20% tariffs on imports from all other countries. Taken at face value, this would calculate tariffs increasing to the highest level in over 100 years, above the rate of the 1930s Smoot-Hawley Tariff Act enacted concurrently with the start of the Great Depression.

Fortunately, there are reasons to believe this extreme tariff scenario won't be implemented in full. During his first presidential term, despite threats of implementing across-the-board tariffs on goods imported from China and ending a trade agreement with Mexico and Canada, Trump not only forged a "Phase One" trade deal with China but also successfully renegotiated the United States-Mexico-Canada Agreement (USMCA), formerly the North American Free Trade Agreement (NAFTA). He also renegotiated existing free trade agreements with South Korea and Japan. If history is any indication, the extreme tariff threats may simply be negotiation tools leading toward agreements with China and other countries, and potentially much less disruptive to economic growth, inflation, sales, and operations of multi-national corporations.

Nevertheless, tariffs may still rise to some degree, which poses a downside risk to economic and earnings growth. But the impact may be [less than is often feared](#), based on recent projections from the International Monetary Fund.

Our base case is for international economic and earnings growth to clear the hurdles it faces and improve. Faster, though still below-average, growth may combine with rising valuations, supported by central bank rate cuts, to boost returns for stocks in the

developed-market international MSCI EAFE Index. But heightened volatility could result from risks, both foreseen and unknown, in 2025. Investors may want to consider diversified portfolios across sectors and countries to help manage the potential exposure to volatility.

<sup>1</sup> Source: Charles Schwab, The Leuthold Group. Based on the five-year normalized price-to-earnings (P/E) ratio as of 11/29/2024. This normalized P/E reading uses five-year average earnings (18 quarters of historical results combined with two quarters of future estimates) and takes the midpoint between reported and operating earnings.

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