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Is 2025 Going to Rhyme with 2000?

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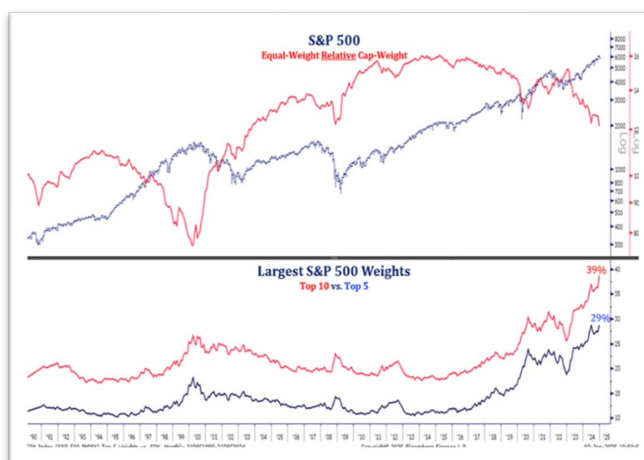
Market Outlook

After back-to-back years of over 20% return for the S&P 500 Index, a question arises about the outlook for 2025. With a lot of dynamics at play, such as the move back to a Trump administration and fewer forecasted rate cuts, we will lay out some of our thoughts. On top of our mind is whether 2025 will rhyme with the year 2000. Of concern is the market sector concentration, which is approaching dot-com era levels. However, an important lesson learned from that period is there were still opportunities to make money in the market.

Trying to Learn from History

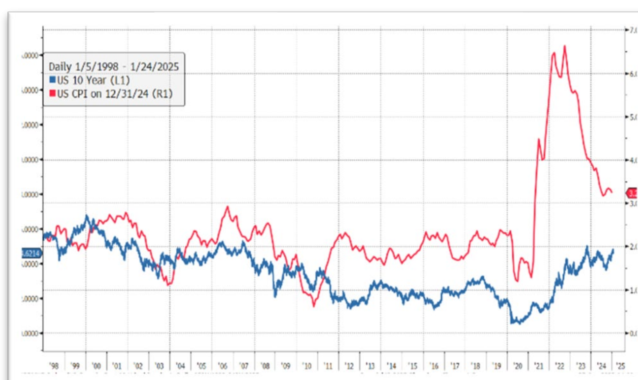
There are a lot of similarities between the year 2000 and 2025. There was and is a two-tier market in both periods. In 2000, it was the internet bubble. Now in 2025, there is a lot of enthusiasm around artificial intelligence (AI). While valuations are not as extreme as the dot-com bubble, the AI bubble is more extreme in terms of market concentration. Specifically, as seen in the chart below, the top ten weights in the S&P 500 now represent 39% of the Index and the top five are 29%, with nearly all focused on technology and AI.



Source: Strategas

Both years were also characterized by moderately growing economies with supportive earnings growth and benign financial conditions. A new Republican administration was assuming the presidency with a pro-growth agenda highlighted by tax cuts. In 2000, 10-year yields on government securities were around 4% and as we enter 2025, CPI (ex food and energy) is running at an unalarming rate of about 3%.

U.S. 10-Year Treasury Rate and CPI (ex Food & Energy)



Source: Bloomberg

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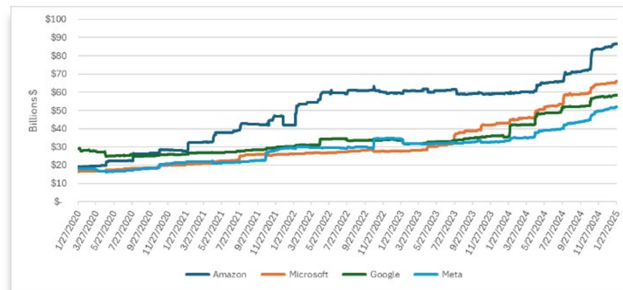
The Bursting of the Internet Bubble

In March 2000, the dot-com bubble began to burst. Interestingly, the burst came with no overt catalyzing event or any news to speak of. It was only much later that we learned that internet data traffic had been overestimated by Wall Street in part because of the grossly overstated data traffic being released by WorldCom, the operator of a large fiber optic data transmission network. We now have concerns that the tens of billions of dollars going into AI data center Capital Expenditure (CapEx) may not generate a near term return. While it may be profitable over 20 years, the revenue opportunity over the next five years is questionable. While AI will certainly be a powerful tool and is evolving rapidly, we know of no "killer application" that can drive revenues and profits so far that justifies the rapid, massive investments in the space.

As highlighted in the chart below, Capital Expenditure (CapEx) budgets for the four main players building out AI data centers have doubled or tripled in recent years. A fear of missing out has created an environment where we question whether costs are properly being factored into the equation, or more specifically the ultimate return on investment.

Capital Expenditure for Major Data Center Vendors



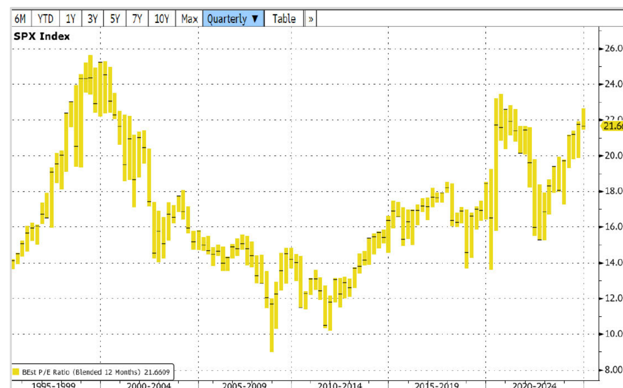
Source: Bloomberg

How Much Risk is There in the Mega-cap Stocks of Today

Is the past a prologue to the future? The bursting of the dot-com bubble occurred over roughly a three-year period (i.e. 2000 through 2002). During that time, the S&P 500's cumulative total return was negative 37.65%. The heavy weights in the Index, which had previously outperformed but were at extreme valuations, fared the worst. The broader market went down less, with the equal-weighted S&P 500 down 15.32%. Certain parts of the market that were previously ignored, like small-cap value, did very well and were up 23.57% during this time period.

Today, valuations are not quite as extreme as 2000. Highlighted in the chart below, the Price to Earnings ratio for the S&P 500 peaked at nearly 26 times earnings in late 1999 and again in early 2000. With the current valuation at 21.66 times earnings, caution is warranted. Especially in those mega-cap stocks trading above the average. It is worth highlighting though, that the large index names today are of higher quality than some that existed during the dot-com bubble. All have dominant market positions, high margins and true revenue, earnings and cash flows. This was not the case for some of the companies in the dot-com era.

S&P 500 Price to Earnings Multiple



Source: Bloomberg

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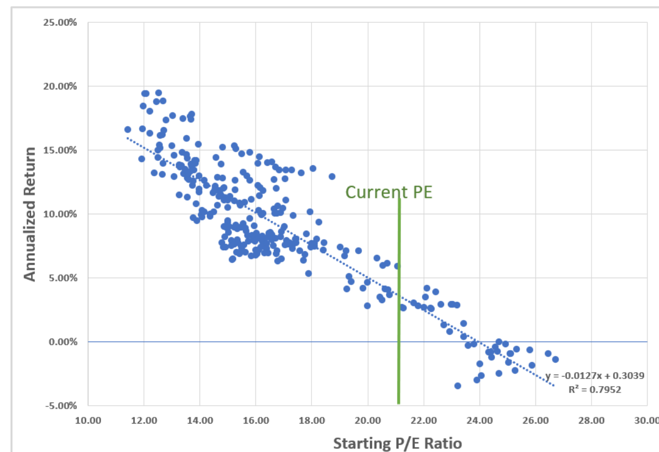
What Does Current Valuation Mean for Future Returns?

Within financial markets, we are always looking for good predictors of future return. Whether at the market level or the individual stock level, a lot of value can be gained by identifying factors that have been predictive and then analyzing whether they will continue to be predictive. Perhaps one of the strongest correlations is between the starting valuation when you buy into the market and what is your next ten year total return.

The next chart highlights this correlation, where each dot represents a starting month going back to 1990. The bottom axis is the starting Price to Earnings Multiple and the left axis is the next ten year total return. The far right of the chart, where valuations were 24-26 times earnings would represent buying into the market at the peak of the dot-com bubble, in which case it took more than ten years to recoup your investment.

Highlighted is the current valuation for the market cap-weighted S&P 500, which is 21.66 times earnings. From this level, we are cautioning our clients that future returns for the cap-weighted index will likely be more modest than the strong returns over the past couple years. Based upon this analysis, it would suggest mid-single digit total returns. However, we also highlight that the equally-weighted S&P 500 is trading at a more reasonable valuation of 17.03 times earnings, which would suggest some opportunity for close to 10% return on the average stock.

Starting P/E versus next 10-year annualized return (1990 - 2024)



Source: Bloomberg

Concluion

Only time will tell the market return for the next several years. However, for some of us that experienced the dot-com bubble, we see some striking similarities in the current market. In particular, the enthusiasm around a new technology that didn't have a well-defined revenue opportunity. As well as a race to invest in technology before knowing the return on that investment. In addition, the combination of high valuations and the concentration of the index in a handful of names adds risk to the market. But, by broadening the lens beyond the Magnificent 7 stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Tesla, NVIDIA), there is still value to be found in the other 493 stocks in the index. We believe this will set up an environment where active management will outperform the S&P 500 for several years similar to what we saw in 2000.

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