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The Long View: Mean Reversion or Gambler's Fallacy?

Key Takeaways

- ▶ Back-to-back annual gains of over 20% for the S&P 500 do not necessarily make U.S. equities due for a pullback, as history shows the market has typically continued to deliver solid, albeit more muted, returns in the following year. Further, the current rally is far from the longest without a correction.
- ▶ Supported by a ClearBridge Recession Risk Dashboard that saw four positive signal changes in December and remains firmly in green expansionary territory, we believe the U.S. economy and equity market will maintain their exceptionalism relative to the rest of the world in 2025.
- ▶ Earnings growth has largely been concentrated amongst a small group of stocks in recent years. This is expected to shift in 2025 with a broadening of earnings participation, which should lead to improved relative performance for small/mid cap and value laggards.

U.S. Equities: Know When to Hold 'Em

Many gamblers believe that after a long streak of a particular outcome, the likelihood of a different result has increased. For example, if someone were to flip a coin five times and in each instance the coin landed on "heads," many would believe that the odds of "tails" on the sixth flip are better than 50%, in order to bring the sample in line with long-term averages. However, the coin has no memory, and the Law of Large Numbers doesn't strictly apply to smaller data sets. The desire to seek balance can create a gambler's fallacy where past results skew perceptions on what is likely to occur (or not) in the future.

This dynamic can play out in financial markets as well. The S&P 500 Index delivered 25% including dividends in 2024, the second year in a row that U.S. equities were up by more than 20% following 2023's 26.3% total return. The gambler's fallacy may lead many to believe that the market is "due" for a bad year given a meaningfully lower long-term average annual return for the S&P 500. However, history shows that the market has typically continued to deliver solid (albeit more muted) returns in years following back-to-back 20% plus gains, with an average of 12.3% and positive returns occurring 75% of the time.

Exhibit 1: Duck, Duck, Goose?

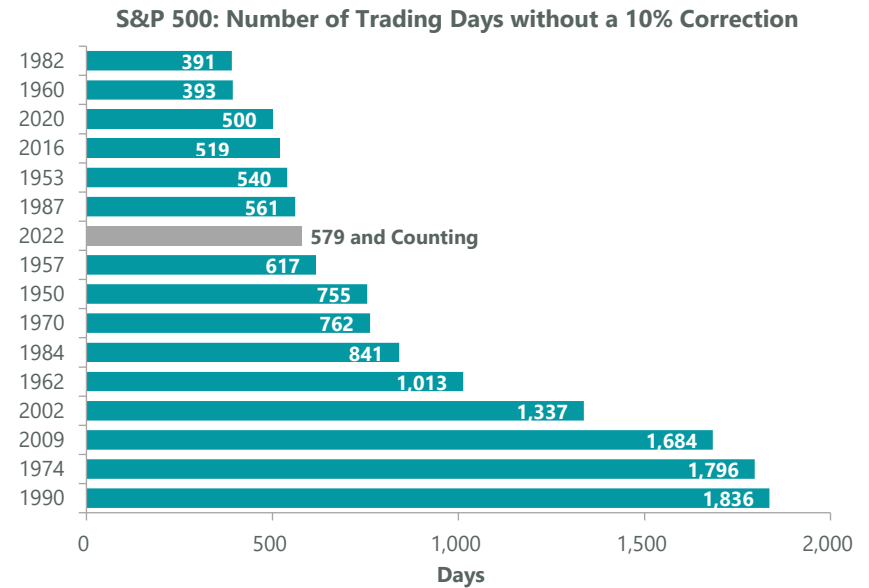
S&P 500 Returns After Back-To-Back 20%+ Returns (1950-Current)			
Years with 20%+ Gains	S&P 500 Total Returns		
	Year One	Year Two	Year Three After Back-To-Back 20%+ Gains
1950 & 1951	30.8%	23.7%	18.2% (1952)
1954 & 1955	52.6%	32.6%	7.4% (1956)
1975 & 1976	37.0%	23.8%	-7.0% (1977)
1982 & 1983	20.4%	22.3%	6.2% (1984)
1995 & 1996	37.6%	23.0%	33.4% (1997)
1996 & 1997	23.0%	33.4%	28.6% (1998)
1997 & 1998	33.4%	28.6%	21.0% (1999)
1998 & 1999	28.6%	21.0%	-9.1% (2000)
2023 & 2024	26.3%	25.0%	???
Average			12.3%
% Positive			75%

Note: Damodaran data used from 1950-1989; FactSet data used from 1990-current.
Data as of Dec. 31, 2024. Sources: NYU (Damodaran Online), FactSet.

The strength of the current bull market has taken many by surprise, with the S&P 500 up 70.1% including dividends since the October 2022 lows. Perhaps even more notable is the lack of a -10% (or worse) correction during this period. Although this run may seem like an outlier destined for mean reversion and materially lower equity prices, history shows that this may not actually be the case. Since 1950, the S&P 500 has experienced nine periods that went even longer without a -10% correction, including four stretches that lasted more than twice as long as the current run. Put differently, the fact that the market hasn't yet seen a correction in over two years doesn't mean one is a foregone conclusion in 2025 (Exhibit 2).

That said, 2024 ended on weaker note with the S&P 500 experiencing its second-worst month of the year, a sign that a period of digestion may be needed after previous strength. There are several potential catalysts for a pause, including investor complacency, higher rates/inflation and tariffs. Policy sequencing by the new administration may be one of the bigger hurdles in the near term, as visibility on the tariff front appears likely to emerge well before the green shoots from deregulation and tax cuts have time to sprout.

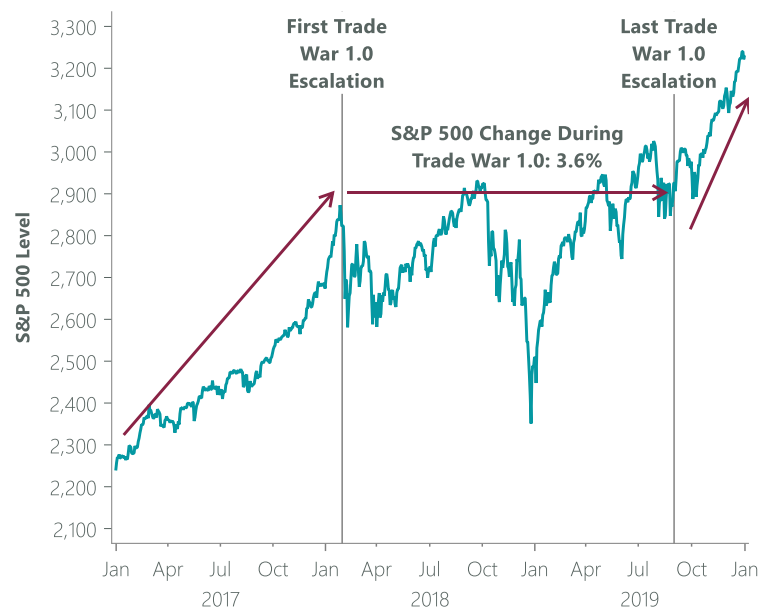
Exhibit 2: Correction not a Foregone Conclusion



Data as of Dec. 31, 2024. Sources: FactSet, S&P.

As such, potential market headwinds may come into greater focus before possible tailwinds are felt. This progression would be a reversal from the first Trump presidency when the benefits from deregulation and tax cuts were felt first, before giving way to 18 months of tariff-induced choppiness. Importantly, tariffs should come as less of a surprise to markets this time around, and robust fiscal support to the economy should overpower the tariff drag in subsequent quarters.

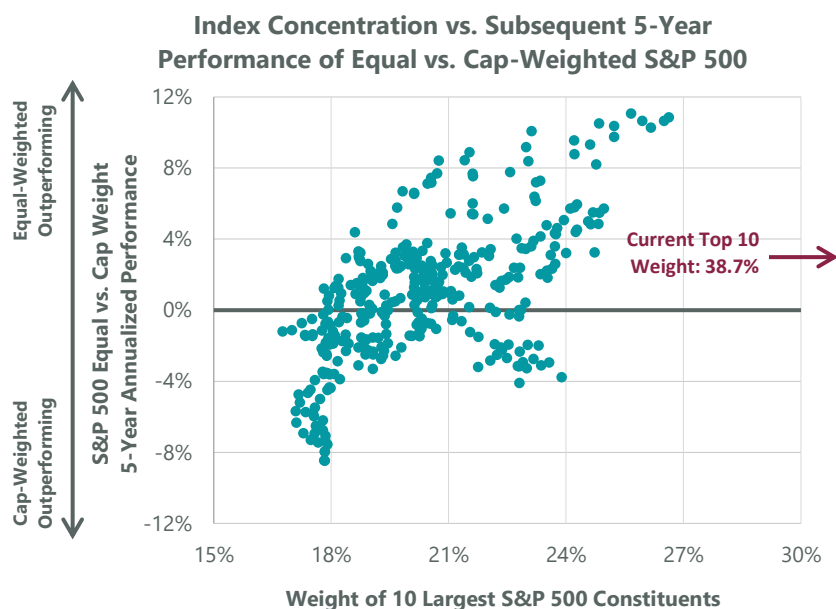
Exhibit 3: Tariff Turbulence?



Sources: S&P Global, Macrobond. Data last updated on Jan. 3, 2025.

A separate concern comes from elevated market concentration, with the 10 largest companies in the S&P 500 comprising a record 38.7% of the benchmark. While this has the potential to be problematic at the index level, it also presents an opportunity for active managers who tend to do better when the average stock is outperforming. In fact, when the top 10 weights in the S&P 500 have historically made up an outsize share of the benchmark, the equal-weight S&P 500 has handily outperformed its cap-weighted counterpart over the subsequent five years.

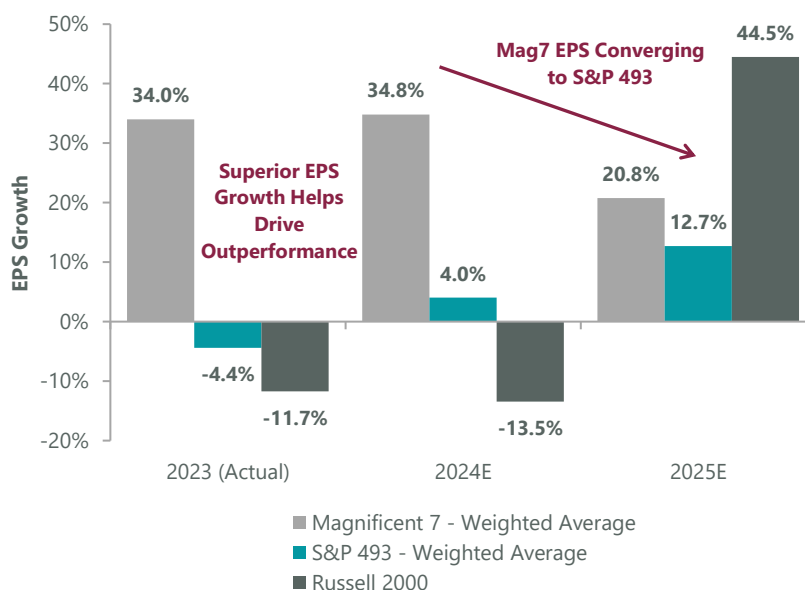
Exhibit 4: Concentration Leads to Broadening



Data shown is from Dec. 1989 – Dec. 2024. Monthly constituent level market cap data. Data as of Dec. 31, 2024. Source: FactSet.

Although the market could remain highly concentrated in the quarters to come, such as in December when the Magnificent Seven outperformed the equal-weight S&P 500 by 10%, history shows that mean reversion typically occurs around these levels of concentration. While in the past it has taken a recession to spark an inflection, broader earnings delivery after multiple years of superior mega cap earnings growth should lead to wider equity market leadership in 2025 with the laggards of this cycle (small cap, mid cap, value) catching up on a relative basis. Put differently, a market concentration mean reversion could begin to play out in 2025 due to fundamental drivers like relative earnings growth.

Exhibit 5: Mag7 Advantage Dissipating

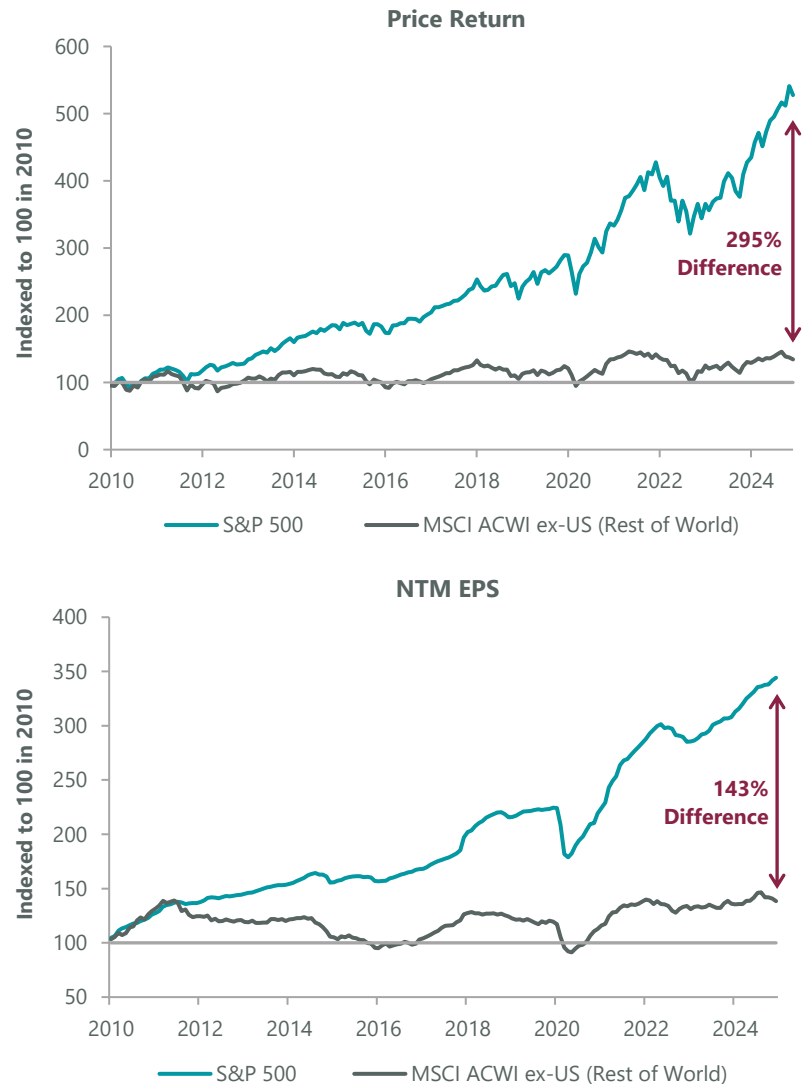


Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of Dec. 31, 2024. Sources: FactSet, Russell, S&P.

By contrast, another area ripe for mean reversion appears less promising; many believe a period of outperformance for international equities is “due” after many years of U.S. leadership. While this should occur eventually, global equity asset allocation decisions have been susceptible to the gambler’s fallacy for 15 years now. Over this period the U.S., as measured by the S&P 500, has outpaced the MSCI ACWI ex-US by 295% cumulatively and led in 13 of 15 years. Importantly, this large performance differential has been partially a function of superior earnings growth, with the U.S. outearning the rest of the world by 143% over the same time frame (Exhibit 6).

What this means is that U.S. relative outperformance in recent years has been driven in large part by better fundamentals, making a mean reversion less likely until those fundamental trends change. It also means that the premium multiple the S&P 500 trades at may be less stretched than many investors believe and could remain elevated for several reasons. First, there has been mix-shift within the U.S. benchmark toward growth-oriented companies that tend to have faster revenue growth, higher margins and greater levels of free cash flow generation, all of which typically coincide with higher multiples. Further, the cost of capital remains low as credit spread compression has largely offset rising Treasury yields, keeping discount rates low, which tends to result in higher multiples (all else equal).

Exhibit 6: U.S. Exceptionalism: Earnings



NTM = next twelve months. Data as of Dec. 31, 2024. Sources: FactSet, MSCI, S&P.

Finally, it has historically been unusual to see meaningful multiple compression in periods of above average (>7%) EPS growth and a declining federal-funds rate on a year-over-year basis. Going back to 1996, this combination has seen multiples expand by 1.7 turns on average, with a positive hit rate of 82%. Although it may be difficult for multiples to move materially higher from their already elevated levels, strong expected earnings growth and a supportive Fed suggest multiples should remain lofty in 2025.

It isn't just U.S. equities that have demonstrated better performance in recent years; the U.S. economy has also delivered more robust growth than developed peers. We believe that U.S. economic exceptionalism will continue in 2025 as [many of the key drivers of superior U.S. economic growth remain intact](#): the strength of the U.S. consumer, productivity gains, the AI investment boom and supportive fiscal policy. A fifth key component from the past several

years — labor supply growth — should become less of a benefit, but is unlikely to worsen enough that it could derail the U.S. economy.

Importantly, the ClearBridge Recession Risk Dashboard experienced four individual indicator changes last month, all in a positive direction. Retail Sales and Building Permits both improved from yellow to green, while the Yield Curve and ISM New Orders both improved from red to yellow. Given the progress other indicators made beneath the surface, it would not be a surprise to see further positive signal changes in the dashboard as we move through the first quarter. The overall signal is firmly in green expansionary territory with seven green signals, four yellow and one red.

Exhibit 7: ClearBridge Recession Risk Dashboard

	December 31, 2024	September 30, 2024	June 30, 2024
Consumer	Housing Permits	●	●
	Job Sentiment	×	×
	Jobless Claims	↑	●
	Retail Sales	●	●
	Wage Growth	↑	↑
Business Activity	Commodities	↑	●
	ISM New Orders	×	●
	Profit Margins	↑	↑
	Truck Shipments	●	●
Financial	Credit Spreads	↑	↑
	Money Supply	●	●
	Yield Curve	×	×
Overall Signal		↑	↑

↑ Expansion ● Caution × Recession

Data as of Dec. 31, 2024. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

We have maintained for some time now that near-term recession risks are low, a view bolstered by the improvement in the Retail Sales indicator. With this signal turning green, four of the five indicators on the dashboard in the Consumer section are green, reflective of a robust U.S. consumer. Retail Sales is a great barometer of how Americans are doing, a key reason why it is a top-ranked variable on the dashboard. The U.S. consumer has been a source of strength throughout the current cycle and a key contributor to why the economy has continued to defy consensus expectations for slower growth. The combination of strong individual balance sheets (household net worth has risen by \$49 trillion since 2020) and a strong labor market with sticky wage gains has helped boost spending power for many and kept inflation-adjusted (real) retail sales above the pre-pandemic trend. This stands in stark contrast to other major developed economies that have experienced more lackluster consumption growth.

Exhibit 8: U.S. Exceptionalism: The Consumer



Sources: Eurostat, U.S. Census Bureau, Japanese Ministry of Economy, Trade & Industry, Macrobond. Data last updated on Oct. 7, 2024, latest available as of Dec. 31, 2024.

Putting this all together, a key question heading into 2025 is whether the U.S. can maintain its advantage versus the rest of the world from both an economic and equity market standpoint. The economy appears to be on solid footing with the foundational elements of relative outperformance still intact. The U.S. consumer continues to be a workhorse, fiscal and monetary policy should remain supportive in the year to come and productivity gains continue to come through. This backdrop has helped set the stage for healthy corporate profits and outsize market gains. While it may be tempting to think the U.S. is due for mean reversion, investors will likely have to wait a little longer, given our expectation that the fundamental drivers of U.S. exceptionalism will remain in place in 2025.

We believe investors should remain cognizant of the gambler's fallacy, or the notion that the next coin flip will be influenced by the last. Should a period of near-term digestion emerge, we believe long-term investors would be well-served to take advantage and deploy capital. With an expectation for broader earnings growth, past laggards such as small/mid cap and value stocks could become leaders, and active managers with the flexibility to sidestep passive index concentration should be primed to take advantage.

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