



2025 INVESTMENT OUTLOOK

The year just ended continued momentum from 2023, with the stock market rallying further on expectations of rate cuts, falling inflation and strong economic growth. The Federal Reserve cut the federal funds rate by 100 bps, inflation declined from 3.1% in January of 2024 to 2.7% in November and US GDP growth remained resilient, expanding 3.1% in the third quarter despite a slowing global economic backdrop. The wars in the Middle East and Ukraine remained active while economic growth in Europe and China continued to disappoint. The geopolitical backdrop remained volatile with a new government in the UK and the US, a brief period of martial law in South Korea, a no-confidence vote in France and the fall of Bashar Al Assad in Syria.

The year began with a rally driven largely by the Magnificent 7 companies, with the S&P 500 rising by 15.4% through June, outperforming the S&P 500 Equal Weight index by 11.1%. The NASDAQ Composite rallied 19.8% through the first half of the year as the excitement around artificial intelligence continued its momentum into 2024. Despite the 10-year US Treasury yield rising from 3.86% at the end of 2023 to 4.40% at the end of June, market multiples continued to expand as economic growth surprised to the upside. The second half saw the rally somewhat broaden out beyond the Magnificent 7 due to dovish commentary from the Fed, a 75-basis point reduction in the federal funds rate, resilient consumer spending and enthusiasm for President-elect Trump's policy implications.

December introduced volatility into the markets and the indices gave back some gains as Fed commentary turned hawkish. Progress on slowing inflation has stalled in recent months while economic growth has remained resilient, driving the 10-year US Treasury yields to a seven-month high of 4.57% as of this writing. While the market has begun to temper expectations around the pace of further rate cuts, valuations remain elevated with more speculative corners of the market leading the charge. Valuations of companies seen as beneficiaries of artificial intelligence have thus far been immune to rising interest rates which has driven index concentration in the 10 largest stocks to new all-time highs of 39%. Both the Nasdaq and S&P 500 reached record highs in December while the Dow Jones Industrial Average experienced a 10-day losing streak, its longest in 50 years.

Despite the spike in yields at year end, investor sentiment remains bullish as the US economy continues to defy the challenges afflicting economic growth in the rest of the world. The lack of economic and political stability globally has driven capital flows into US assets as evidenced by the lackluster performance of the MSCI ACWI ex USA index.

Equity Markets – 12/31/24

	<u>Index Price Level</u>	<u>2024 Total Return</u>
Dow 30 Industrials	42,544	+14.9%
S&P 500	5,882	+25.0%
NASDAQ Composite	19,311	+29.3%
MSCI All Country World Index ex-USA	326	+6.1%

The Dow 30 Industrial Index is a price-weighted index of 30 US blue-chip companies. The S&P 500 Index is a market capitalization-weighted index of 500 large capitalization stocks commonly used to represent the US equity market. The NASDAQ Composite Index is a market capitalization-weighted index of over 2,500 companies listed on The NASDAQ Stock Market. The MSCI ACWI ex USA Index is a market capitalization-weighted index representative of developed and emerging market stocks excluding the US.

Outlook

As we transition into the new year, sustaining the elevated pace of US economic growth from 2024 ultimately depends on the combination of productivity and payroll growth. US economic growth exceeded expectations coming into the year because productivity grew 2.7%, well above the long-term annual average of 1.5% from 2007 to 2019. Economic growth was also aided in part by a larger labor pool, which benefited from an inflow of migrants, despite fewer hours worked per employee. This combination of faster productivity growth and a larger labor pool helped slow the pace of inflation, enabling the fed to reduce interest rates in an environment experiencing accelerating economic growth.

This “goldilocks” scenario, however, may be disrupted going into 2025 as the impact from these tailwinds abates. The inflow of migrants has already begun slowing and it remains to be seen if productivity growth can stay elevated above its long-term average. While optimists anticipate that artificial intelligence and renewable energy investments will boost productivity, history suggests that productivity growth is volatile.

From a demand perspective, outside of the low-income consumers, spending remains strong with household wealth at record highs and wage growth consistently outpacing inflation. The economy added an average of 180,000 jobs per month in 2024, above the 10-year average of 162,000 monthly jobs, and the unemployment rate appears to be settling at a healthy 4.1%. Growing real wages and a stable job market indicate healthy demand for goods and services moving forward. However, a less productive workforce or changes to the supply of labor could begin to put upward pressure on inflation.

While progress on slowing inflation has been made over the last year, in recent months that progress has stalled. The latest inflation reading showed overall CPI rose 2.7% from a year earlier in November and has risen for two consecutive months after reaching a multi-year low of 2.4% in September. Less volatile core inflation has remained at an elevated pace of 3.3% for four consecutive months after falling from 3.9% in December of 2023 to 3.2% this past August. The fed’s preferred inflation gauge, the core personal consumption expenditures (PCE) price index, has shown a similar trend rising from a pace of 2.6% in June to 2.8% in November. This inflation data reinforces the likelihood of inflation persisting above the central bank’s 2% target for an extended period. Fed officials now see the core PCE price index rising by 2.5% at the end of 2025, up from their expectations of 2.2% in September. Further progress on inflation is partially impeded by persistent inflation in housing, which accounts for roughly one-third of the overall price index. While rents have come down, housing inflation remains stubborn due to structural issues limiting supply relative to demand. Beyond housing, the strength of consumer demand fueled by rising real wages presents an obstacle towards making progress on the last mile of inflation.

The prospect of inflation staying above the Fed’s 2% target has steepened the yield curve, with the 10-year Treasury yield rising 71 basis points compared to the 2-year yield remaining flat during 2024. Moreover, 2024 marked the fourth straight year of rising 10-year Treasury yields, the longest stretch since 1981. Indeed, the latest Federal Reserve’s Summary of Economic Projections show that policymakers do not expect to reach their 2% inflation target until 2027. The central bank now sees a 50-basis point reduction in the fed funds rate this year, half of what was expected in September, bringing the projected year-end fed funds rate to a range of 3.75% - 4.00%. This shift in policy stance marks a significant pivot in strategy from September when officials were more concerned about the prospect of a softening labor market. The balance of risks between a softer labor market and higher inflation has reverted to the risk of stalled inflation progress. The median estimates for both core and headline inflation rose in the Fed’s December forecast, an admission that inflation will take longer to stifle. Chairman Powell has communicated that further progress on bringing down the pace of inflation would be required before further rate cuts. On the bright side, the strength of recent economic data gives the Fed room to keep rates at a higher level without risking a significant pullback in economic activity.

While the interpretation of economic data is the most important input into the Federal Reserve's rate projections, the latest change in policy stance in part can be attributed to the implications of President-elect Trump's policy proposals. One important catalyst for November's election results was voter dissatisfaction with the elevated cost of living. While real wage growth has outpaced inflation over the last two years, it has yet to fully recover from the post-pandemic inflation surge in 2021. Since the pandemic hit in 2020, incumbents have been removed from office in 40 of 54 elections in Western democracies according to Steven Levitsky, a political scientist at Harvard University.

Progress on inflation over the last 18 months has benefited from supply-chain healing and labor force growth boosted by immigration. Economists are concerned that the incoming administration's plans for fresh tariffs and tighter immigration rules run the risk of reversing these deflationary forces. Proponents of President-elect Trump's agenda contend that inflationary impact from these plans can be offset in part by deregulation, boosting energy production, reducing fiscal spending and improving government efficiency. While it remains too early to forecast how these policy proposals will be implemented, our trading partners, including China have begun easing monetary policy as a safety measure ahead of potential tariffs.

China's economy is more vulnerable to tariffs now than it was eight years ago as decades of indiscriminate infrastructure investments fueled by unsustainable borrowing has resulted in a property bust that has wiped out trillions of dollars of household wealth. Waning consumer and business confidence have resulted in persistent deflation, with prices falling for six straight quarters, the longest streak this century. The Chinese government has announced stimulus measures to revive anemic consumer demand. This shift in focus from export-driven growth to consumer-led growth is partly driven by the looming threat of US tariffs, which could severely damage China's export-dependent economy. This shift in fiscal policy will raise the Chinese fiscal deficit next year from 3% to 4% of GDP, further increasing the country's debt burden to as high as 160% of GDP when accounting for off-the-books local government debt. Indeed, the central government has outlined a \$1.4 trillion debt swap to refinance "hidden" local debt onto public balance sheets. If China is unable to rejuvenate economic growth, its debt burden could become unsustainable over the longer term as its population is expected to decline further by 51 million over the next decade.

A high debt burden is not unique to China with the US on track for a 6.7% fiscal deficit this year, up from 6.3% last year, and a current debt-to-GDP ratio of 120%. The incoming administration has voiced concerns related to federal spending and has targeted \$2 trillion in spending cuts but has shared scant details outside of proposals to reduce civil service headcount, closing federal agencies and cutting regulations. Reducing \$2 trillion in federal spending would require cutting popular entitlement programs as \$5.9 trillion out of a total \$6.8 trillion of federal spending is allocated toward mandatory outlays, interest expense and defense. Moreover, if congress succeeds in extending the 2017 tax cuts that are set to expire at the end of this year, it will reduce \$4.6 trillion in federal revenue over the next ten years. While this pace of expanding deficits is unsustainable, the US can continue running deficits in the short term due to its unique position as the world's reserve currency. The level of global government debt hit a new record of \$100 trillion at the end of 2024, leaving few foreign currency alternatives to the US dollar. Indeed, the Bloomberg Dollar Spot Index rose more than 7% in 2024, its best run since 2015.

The dollar's strength in 2024 was due in part to capital flowing into the US equity markets with the S&P 500 Index earnings expected to grow 11% in 2025 after growing an estimated 12% in 2024 according to Refinitiv. Excitement around artificial intelligence combined with the prospect of deregulation and corporate tax cuts proposed by the incoming administration has boosted market sentiment. Household ownership of stocks has exceeded the high reached in 2021 as the share of consumers expecting stocks to rise over the next 12 months has hit an all-time high of 56.4%.

Institutional investors are equally bullish with record low allocation to cash and record high allocation to US equities. This excitement is reflected in the S&P 500's forward P/E multiple of 22x, just shy of the 22.5x earnings multiple in January of 2021 and only 12% below the all-time high multiple of 24.5x during the dotcom bubble in 2000. American exceptionalism appears to be very fully priced into the market with the S&P 500 trading at the widest valuation gap to non-US stocks in history. The valuation gap between the S&P 500 and small caps has shown the greatest dispersion since 2000 with 59% of the gains since the October 2022 bottom driven by the top 10 stocks.

Investment Conclusion

The strong stock market appreciation over the last two years has driven earnings multiples to elevated levels, suggesting that the market is at a higher risk of disappointing expectations. The relatively narrow rally concentrated in the perceived AI beneficiaries leaves the market particularly vulnerable to a shift in sentiment. Despite justified enthusiasm for AI's potential, history suggests that significant time is necessary for society to implement a revolutionary technology before it can deliver on its initial promise. Barring a recession, buoyant inflation and wide fiscal deficits will likely keep interest rates from moving sharply lower. A steepening yield curve appears to be signaling concerns about the market's appetite for financing fiscal deficits with extended maturities. Higher interest rates and elevated earnings multiples are unlikely to coexist longer-term.

Rising real household incomes bode well for economic growth in the US. However, tepid economic growth globally concurrent with two active wars remains concerning. While the current market environment is challenging for disciplined long-term investors, our emphasis on attractive risk-adjusted returns has led us to select opportunistic investments in out-of-favor corners of the market recently such as healthcare. With stocks trading at a multi-decade premium relative to bonds, broader buying will likely require a market correction. In the meantime, cash, shorter maturity Treasuries and corporate bonds offer an excellent alternative for patient investors.

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