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Economic & Market Update

December 2024 Outlook

Global Economy

- The 2024 presidential election is now officially in the rearview mirror. Some people are pleased with the results. Some are not. As far as financial markets are concerned, the range of outcomes has narrowed considerably. Now, the uncertainty revolves around the specifics of the Donald Trump 2.0 administration's priorities. From a policy perspective, Trump's agenda will likely give markets reasons to be both cheerful (e.g., a full tax cut extension) and fearful (e.g., looming tariff threats).
- Investors are now digesting Trump's cabinet nominations. The most important is likely his pick for secretary of the Treasury, Scott Bessent. Bessent has been a vocal supporter of many of Trump's policy proposals, but the former hedge fund manager is also viewed as mindful of potential economic and market repercussions. He has written about the risks of fiscal deficits and has advocated for a measured approach to tariffs as a foreign policy tool. If confirmed, Bessent will have his hands full when he takes up the office in January. The federal debt limit will be reinstated at the beginning of the year, which would halt Treasury issuance and rely on the $700 billion in the Treasury General Account to pay the government's bills. Assuming the debt ceiling gets resolved, he would then need to decide how to refinance a wave of expiring Treasury bills. Bessent was critical of current Secretary Janet Yellen's strategy of prioritizing shorter-term bills over longer-term notes for the government's financing needs. To increase the duration of the Treasury's liabilities, he must contend with the market impact of signaling an increasing supply of longer-dated Treasuries at a time when deficits are at the center of the conversation and inflation pressures smolder in the background.
- Labor markets have softened enough to bring supply and demand back into balance. Many were concerned that minor weakness would snowball into major weakness, as it often can. So far, that does not appear to be the case. The unemployment rate held at 4.1% for the second straight month. Initial jobless claims reversed their recent weather-driven spike to end November at the lowest level since April. Continuing jobless claims are creeping upward, but that may be more an effect of the softening we have seen than a harbinger of further weakness.
- Inflation seems to be settling into a level that would be comfortable, if not for the Federal Reserve's 2.0% target. October's Consumer Price Index (CPI) was up 0.2% for the month and 2.6% over the last year, which places it near the long-term median for annual inflation in the United States. Under the surface is a familiar dynamic: sticky shelter and services inflation is being offset by steady or even falling prices for energy and goods. Goods don't make up a large portion of the CPI basket,

but they've been a reliable offset to recent sticky shelter and services inflation. This was also the general trend in the period of low inflation between the Great Recession of 2007–2009 and the COVID-19 crisis. We believe this makes tariffs a very important variable heading into 2025. Any disruption to the disinflationary trends in goods prices could make it very difficult to see inflation rates below 3%, particularly considering the stickiness in the other components.

Equity Markets

- Equity markets put together an impressive month after moving past election uncertainty. Evidence of a sustained broadening in participation continues to build. In the S&P 500 Index, consumer discretionary was the best-performing sector in November, up 13%. Financials, the second-best performer in November, overtook the communication services sector as the year-to-date leader, up 38% over the last 11 months. Information technology and communication services, previous stalwarts that house most of the "Magnificent Seven," have fallen to the middle of the pack in recent months but are still on track for very solid performance. We see this as an encouraging sign that the rest of the market is catching up to the mega-cap tech names that have buoyed the index for the last several years.
- Small-cap stocks also joined the party, with the Russell 2000 Index up an impressive 11% in the month. Investors seem to be excited about the prospect of easing monetary policy, continued economic strength, and a pro-business Trump 2.0 agenda. We will want to see this optimism materialize in the form of an earnings recovery. 2024 is on track to be the second consecutive year of declining earnings for the S&P SmallCap 600 Index. Any sign of a durable recovery in 2025 would likely fuel continued outperformance for small caps, which are being primed by attractive valuations.

Bond Markets

- It was another volatile month in Treasury markets, owing initially to the view that the Trump policy initiatives could have a "high deficits, high inflation" outcome. However, soon after his election, 10-year U.S. Treasury yields halted their three-month ascent to nearly 4.5%, ultimately ending the month at 4.17%—lower than where they started. In 2016, yields spiked higher after Trump's surprising victory. This time around, they seem to have gotten out in front of a similar move. Going forward, we believe the current range is a fair reflection of our economy's strength, which leaves room for a normalized yield curve as short rates slowly come down.
- A bullish risk appetite in equity markets continues to spill over to credit spreads. High-yield bond spreads ended November at their tightest levels in over 15 years. We believe much of the optimism around corporate fundamentals is warranted. On the other hand, the reward for taking credit risk is historically low, which leaves little room for error if we encounter any speed bumps in the near future.

Monetary Policy

- Markets are pricing a two-thirds chance of a rate cut at the December Federal Open Market Committee (FOMC) meeting. The FOMC will have one more package of labor market and inflation data at its disposal as it deliberates. Looking ahead, markets are expecting only a handful more cuts over the course of 2025. We believe the Federal Reserve is inclined to continue cutting and approach a terminal rate before it loses its grip on the soft landing. However, strong economic momentum and potentially inflationary tariffs may make life more difficult next year.

Commodities and Currencies

- The U.S. dollar strengthened against a basket of major currencies in November. The U.S. economy is in better shape than most other developed nations, which likely means that central banks overseas will have more room to lower interest rates. Trump has expressed a desire for a weaker dollar, which would help offset the negative impact of tariffs for his constituents, but he may find it difficult to achieve alongside his fiscal agenda.

What This Means for Investors

- 2024 is shaping up to be another stellar year for equity markets. Seasonality tailwinds, paired with relief over a swift resolution to election uncertainty, have left little to get in the way of stocks as we approach year-end. Much of the performance has been warranted by a solid year of earnings growth. Looking forward, valuations are elevated but may still be appropriate if earnings can continue their momentum as expected into 2025.
- Bond yields seem to be settling into a new normal that is more akin to an era before zero-interest-rate policy. For investors, this means more income, even if volatility remains elevated. Looking forward, investors will continue to have their hands full as they consider strong economic growth, an uncertain path for policy easing, and the impacts of the Trump administration's policy agenda for both growth and inflation.

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