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# Economic & Market Update

2024 Review & January 2025 Outlook

## Review of 2024

- The resilience of the American consumer was the most important piece of the economic puzzle in 2024. At nearly 70% of gross domestic product (GDP), our modern economy hinges on the consumption of goods and services. That spending slowed briefly in the first quarter but regained momentum as the year went on. It was impressively adaptable to a variety of headwinds, including inflation, housing costs, higher interest rates, and softening labor markets.
- One reason for the momentum in consumption is that average wages are still rising faster than inflation. In fact, since January 2020, average pay has increased more than the cumulative increase in consumer prices. Thanks to a period of deleveraging after the Great Financial Crisis, households don't carry excessive debt, and most of it is fixed-rate (e.g., 30-year mortgages), which has shielded many consumers from the impacts of rate hikes. Continued government transfer payments, all-time highs for stock markets, and more income from bonds added to the "wealth effect," allowing the baby boom generation to continue to spend and maintain lifestyles even as they begin to retire en masse. To be clear, not everyone is thriving. Despite solid wage growth, many lower-income Americans continue to struggle under the weight of high price levels, particularly for nondiscretionary items like housing, medical care, insurance, education, and food. But when we zoom out, we see an aggregate consumer that has been able, and willing, to roll with the punches and continue to spend. In spite of prolonged weakness in smaller pockets of the economy, like manufacturing and housing, strong consumption was enough to power overall economic growth in the range of 3%, above most estimates of long-run trend by economists.
- Labor markets spent the year searching for equilibrium after a period of historic strength. Companies cut back on hiring but have been reticent to resort to mass layoffs. Economist Claudia Sahm's recession indicator, known as the "Sahm Rule," made headlines in the middle of the year as the unemployment rate began to creep up. The rule, which was triggered when the unemployment rate's three-month moving average moved 0.5% higher than its 12-month low, is meant to serve as an early indicator of a recession. In labor markets, small increases in the unemployment rate tend to precede larger increases. This time around, that was not the case. After rising to 4.3% and triggering the Sahm Rule in July, the unemployment rate stalled and shifted

back down before creeping back up to 4.2% in November. And even though jobs became harder to get and unemployment crept higher, those employees with jobs are still enjoying solid wage gains.

- A downside of above-trend economic growth was the difficulty in stamping out the "last mile" of inflation. After falling throughout 2023, consumer price inflation trended near 3.0% for most of 2024, falling as low as 2.4% in September before creeping back up to 2.7% in November. Shelter inflation remains elevated, while higher wage inflation and consumption kept services inflation north of 4% for the year. Most of the good news came from energy and goods prices.
- Despite the stickiness of inflation, the Federal Reserve (Fed) saw enough progress to shift its focus to softening labor markets, intent on keeping that softening from getting out of hand. It took longer than investors had expected going into the year, but the Federal Open Markets Committee (FOMC) finally ended a historically long "pause" and delivered a rate cut in September. The Committee opted to start big with a 50 basis point (bp) "jumbo" cut and ultimately cut twice more to wind up with short-term rates 1% lower than where they started the year.
- While economic growth remained strong in the United States, other major economies have been forced to watch with envy. Europe and the United Kingdom struggled to deliver marginally positive growth for the second straight year. Stalled economic growth led to stalled corporate earnings in foreign markets that have not been enjoying structural growth trends like artificial intelligence. That lack of growth combined with weak currencies to drive another year of underperformance versus domestic markets.
- The Chinese economy also struggled to find its footing, hampered by battered property markets and an overhang of debt in the public and private sectors. Chinese authorities tried to stem the bleeding with a series of stimulus announcements aimed at spurring domestic consumption and reviving equity markets. The measures were initially met with enthusiasm from equity investors, but the excitement fizzled soon after as markets decided that more would be needed to achieve economic growth targets. Unlike the United States, China's economy relies on manufacturing and exports, which have become even more important as its property sector languishes. Those exports are now in the crosshairs of President-elect Donald Trump, whose campaign promised substantial additional tariffs.
- Turning back to the United States, one of the biggest storylines of 2024 was the presidential election. This election cycle was unprecedented and unpredictable, with a last-minute candidate change and contentious campaigns with two starkly different agendas. In the end, with Americans still reeling from the first major inflation wave in decades, the incumbent party lost in a decisive fashion. The outcome moved markets, reflecting changing outlooks for countries, currencies, and individual companies. Now, investors will need to sift through the pile of Trump's campaign promises regarding tax cuts, deregulation, tariffs, and immigration policy.
- Treasury yields began to rise in September, having previously fallen in reaction to softening labor markets. The 10-year U.S. Treasury yield ended the year near its highs at 4.62%. Credit spreads went from tight to tighter over the course of the year, but higher rates drove another year of mediocre returns for bond investors.
- For equity markets, many of the year's prominent themes were continuations from 2023. Superficially, it was another good year, with the S&P 500 Index again up by over 20%. We saw brief hints of broadening equity markets, but any momentum shifts away from the "Magnificent 7" technology giants proved short-lived. Enthusiasm for AI propelled another stellar year for U.S. large-cap stocks, but smaller stocks failed to keep up. Most of the performance disparity can be explained by earnings. 2024 earnings for the large-cap S&P 500 index are expected to be up nearly 10%, but for the small-cap S&P 600 cohort, contracting margins are driving falling earnings for the second year in a row.
- The outperformance of the 10 largest stocks in the S&P 500 has reached unprecedented levels. These 10 stocks now represent over one-third of the index's market capitalization. Unlike other periods of high market concentration, the top stocks have been able to back up their soaring share prices with impressive earnings growth.

# Outlook for 2025

## U.S. ECONOMY

- With the threat of broader based and increased tariffs by the incoming U.S. administration, and expected retaliation by trading partners, deglobalization is a growing risk to the global economy as these moves will slow global trade and economic growth. Markets will need to handicap both the timing and magnitude of what the administration can accomplish unilaterally.

- The United States has a stronger economy than its trading partners, so a trade war should have less impact on its economy, particularly with the promise from the incoming administration to extend the 2017 tax cuts, enact additional corporate tax cuts, and decrease the regulatory burden on U.S. corporations.

- The U.S. consumer should be the driver of domestic economic growth and an important contributor to global growth. Continued job and wage growth will help fuel consumer spending as the labor market remains healthy, although job growth will likely slow somewhat in 2025.

- Some 2025 consumption may be accelerated into year-end 2024 in anticipation of the additional tariffs. We expect greater divergence in spending among income groups as the wealth effect of higher asset prices will help offset the impact of tariffs and slower job growth which will disproportionately impact lower-income consumers.

- Another promised Trump administration initiative is mass deportation of undocumented immigrants. Concerns are growing that this could cause an increase in wage inflation, perhaps leading to a second round of economy-wide inflation given the GDP growth forecast of 2.0%–2.5% for 2025. Another potential implication of a decrease in the labor force is the impact this could have on certain sectors, such as housing, where the demand for new homes is outstripping supply. Lack of sufficient labor could slow growth in this sector and, ultimately, the entire economy. The incoming administration is likely to understand this and should take a more targeted, gradual approach to deportation.

- The need to increase productivity given the tight and relatively expensive labor force should drive capital spending, particularly in the productivity-enhancing technology sector.

- The European economies are struggling to grow, with Germany, the continent's largest economy, expected to show anemic growth of only 0.0%–0.5% in 2025. Political unrest in France, which led to the government's collapse in December, may also be an impediment to growth. The threat of U.S. tariffs will weigh on the outlook, as will stretched fiscal budgets, which will limit any meaningful fiscal support of these economies. While easier monetary policy will help, the European economy is expected to produce only 0.5%–1.0% GDP growth in 2025.

- China will struggle to hit the government's 5.0% growth target given the expected impact of U.S. tariffs, the ongoing property recession, and the very weak demographics that will worsen over the coming years. The government appears willing to provide more meaningful monetary ease although the forecast for 2025 GDP is roughly 4.5%.

## MONETARY POLICY

- The Fed should retain its dovish monetary policy in 2025 despite the expected achievement of trend-like economic growth. The current estimate of the real federal funds rate is quite high given the level of nominal rates and the expectation that inflation is approaching the Fed's 2.0% target. To get back to a more neutral federal funds rate and reduce the chances of a monetary policy-induced recession, the nominal federal funds rate will need to decline by another 100 bps.

- Slowing disinflationary trends and an economy that is growing at a healthy rate should lead to only 50 bps of rate cutting after the 25 bps reduction in December 2024. Further ease will then be extended into 2026. Under these conditions, Donald Trump may be less likely to remove Fed Chair Jerome Powell, which would be somewhat comforting to markets.

- The European Central Bank (ECB) will be able to ease in a more conscience-free approach as economic growth is low and inflation is very close to the 2.0% target, which should be achieved by year-end 2025. The expectation is for 125 bps in cuts, taking the policy rate to 1.75% by the end of 2025.

- As the Japanese economy appears to have finally achieved a growth rate that can break the deflationary cycle, the Bank of Japan should be able to restart its tightening program. The central bank will be careful not to cause substantial appreciation to the Japanese yen, which could hurt its export-driven economy.

- The Peoples Bank of China (PBOC) has pledged to support the economy through a series of rate cuts over the coming months. However, the magnitude of cuts will likely be limited as the PBOC will be cognizant of any resulting capital flight as the interest rate differential with other key currencies narrows.

## BOND MARKETS

- With the Fed clearly embarking on what should be a cautious easing campaign, short-term rates in the U.S. should continue to decline in 2025. Longer-term rates may stall and actually rise in an environment of trend-like economic growth and the need to fund growing deficit spending with a greater supply of notes and bonds.

- Incoming Treasury Secretary Scott Bessent wants to bring the deficit down to 3% of GDP, which has temporarily assuaged concerns at the longer end of the yield curve. However, it appears that markets are anticipating the end of the inverted curve environment by treading more carefully in the intermediate to longer end of the maturity spectrum and concentrating purchases at the short end. The ten-year U.S. treasury note should trade in a range of 4.25%-4.75% during the first half of 2025.

- High-yield bonds appear rather expensive at current levels as spreads have narrowed to record lows against Treasuries. With no recession on the horizon, spreads should remain at these levels although the risk of eventual widening appears higher than any further benefit accrued by additional narrowing.

## EQUITY MARKETS

- It is difficult to make a compelling case that U.S. large-cap equities are cheap at current levels, but if the Magnificent 7 stocks are removed from the benchmark index, stocks in this space are not expensive. As economic and profit growth should be comfortably positive moving into 2025, the rest of the market should catch up somewhat to the top 10 names that have been phenomenal performers over the last two years.

- It may help to have a U.S. president who often uses the stock market as a barometer for his administration's economic performance. But caution may be advised after two straight years of 20%+ returns in the U.S. large-cap space. The technology sector, which has been the primary driver of these strong returns, looks somewhat vulnerable to an earnings growth slowdown in early 2025. Given lofty expectations, any concern over the pace of AI expansion could also weigh on performance.

- The more cyclical sectors of the market should be able to pick up some of the slack, although total returns should settle in the 5%-10% range for calendar year 2025. Some of the policies that will be introduced by the incoming administration, such as lower corporate tax rates and a reduced regulatory burden, will likely benefit both top-line revenue and bottom-line earnings, but perhaps more so in the second half of 2025 into 2026.

- Small and mid-cap equities finally began to outperform U.S. large caps during the summer of 2024 and after the presidential election before trailing off again at year-end. Maintenance of this outperformance will likely depend on stronger earnings growth with some multiple expansion.
- European equities remain relatively cheap but are largely reflective of the relatively weak fundamentals of low GDP and earnings growth as well as insufficient capital spend to drive the needed productivity improvement in a demographically challenged economy. A more dovish ECB may help these markets achieve some multiple expansion if the economy does not fall into recession.
- The promise of both fiscal and monetary policy ease may help offset the effect of tariffs within the Chinese equity market. But it is difficult to assess the impact of deglobalization on large Chinese corporates, so returns are expected to be muted.

## COMMODITIES & CURRENCIES

- OPEC and Russia seem to have lost much of their price-setting power as production cutbacks have been offset by greater production of non-OPEC countries, particularly the U.S. Weak Chinese demand is another factor that should continue to pressure the cartel to accept lower prices in 2025.
- Gold produced strong returns in 2024 as most global central banks ended their tightening campaigns and began to reduce rates. While the price of gold should trend higher as interest rates continue to decline in many countries, the expected slowing of monetary ease at the Fed may put some downward pressure on prices at the beginning of the year.
- U.S. dollar bullishness is likely to continue into 2025 as better U.S. GDP growth and a more cautious Fed combine to increase the attractiveness of U.S. assets.