The 2025 Outlook:

A Year of Political and Policy Change

SUMMARY OF EXPECTATIONS

THE ECONOMY

ECONOMIC GROWTH

We expect the US economy to keep growing throughout 2025, with no recession. However, current growth is only moderate, and because of elevated real interest rates and cooling labor demand, growth could slow in the coming year.

RECESSION RISK

As the economy loses momentum, it will become more susceptible to recession from an outside shock, such as a major geopolitical crisis or disruptive policy changes. Therefore, a recession cannot be ruled out entirely.

INFLATION & MONETARY POLICY

As the economy moderated in 2024, price pressures fell. Nevertheless, recent data suggests inflation may not slow much further. While moderating economic growth will encourage the Federal Reserve to keep cutting interest rates in the near term, sticky inflation may keep policymakers from cutting rates as much as some investors expect.

Continued-but-moderating economic growth, sticky inflation, and limited interest rate cuts lay the groundwork for the asset class returns we expect in 2025.

ELECTION IMPLICATIONS

BALANCING COALITIONS

Even though the Republican Party won control of the White House and Congress in the 2024 election, President-elect Trump's coalition will be hard to manage. Different constituencies in the coalition have dissimilar, and sometimes contradictory, goals. The actual policies put into place will be determined by Trump's bargaining skills and how he balances their varied interests.

FOREIGN & DOMESTIC POLICY

Despite this complex and fluid situation, we believe we can make some basic predictions about Trump's policies. In foreign affairs, we think he will adopt protectionism writ large, i.e., forcing increased defense burden sharing on US allies, while imposing import tariffs to protect US manufacturers and workers.

In domestic policy, we expect he will emphasize extending his first-term tax cuts and cracking down, to some extent, on legal and illegal immigration.

MONETARY POLICY

While Trump's actual policies are still in question, the major initiatives that we foresee could conceivably buoy price inflation. If so, they could further discourage the Fed from aggressive rate cuts.

Confluence
INVESTMENT MANAGEMENT

SUMMARY OF EXPECTATIONS (cont.)

MARKET OUTLOOK

Our asset class return expectations depend, in part, on our expectations for monetary policy and bond yields. After discussing those factors below, we address US and non-US equities and commodities.

FIXED INCOME

TREASURY YIELDS

As of this writing, the US yield curve is either slightly inverted or modestly upward sloping, depending on the calculation methods used. Our modeling suggests the yield on the benchmark 10-year Treasury note will end 2025 little changed from current levels. If the Fed cuts short-term rates very little, as we expect, the yield curve should remain fairly flat in 2025. Government bond returns are therefore likely to be similar to today's yields.

CORPORATE BONDS

Our modeling suggests US investment-grade corporate bonds are currently a bit overvalued, leaving their yields somewhat low compared with government bonds. Even if government bond yields only modestly change in 2025, as we anticipate, corporates are susceptible to repricing that would weigh on their returns.

HIGH YIELD

Our analysis suggests below-investment-grade corporates are more dramatically overpriced, leaving their yield spread over Treasurys much too low to compensate for their greater risk. These below-investment-grade bonds will therefore be even more susceptible to negative repricing in 2025, especially as the Fed moves slowly to cut rates and economic growth slows.

US EQUITIES

BASE CASE FORECAST

We see a much more positive outlook for US equities. Based on our expectation for continued economic growth, profit margins remaining close to where they are now, and P/E ratios staying at today's level of about 25.0x, our base case calls for the S&P 500 price index for large capitalization stocks to rise by 10.5% in 2025. We expect the index to end the year at 6,735, with a likely range between 6,500 and 6,800.

However, our modeling suggests there is significant upside to the P/E ratio. In a best-case scenario, it could go as high as 30.0x, boosting the percentage price gain commensurately.

CAPITALIZATION

If US equity prices rise as strongly as our analysis suggests, continuing their current momentum, then sectors and styles that have been outperforming recently may continue to do so. Nevertheless, because of the outperformance of large cap stocks in 2024, we think the better buys will be found among mid-cap and small cap equities.

GROWTH/VALUE

Similarly, the 2024 out-performance of growth stocks has left them relatively expensive versus value stocks, in our opinion.

SUMMARY OF EXPECTATIONS (cont.)

MARKET OUTLOOK (cont.)

FOREIGN EQUITIES

We continue to believe that the relative performance of non-US equities depends largely on the strength of the dollar. Given the US's relatively better economic growth, elevated real interest rates, and financial market momentum, we think it will continue to see strong inflows of capital from abroad, boosting the value of the greenback. That, coupled with the incoming administration's expected protectionist policies, will likely constitute headwinds for foreign stocks.

COMMODITIES

Finally, we continue to see evidence that global central banks are buying up gold, boosting the yellow metal's price despite our own modeling that suggests it is already richly priced. Because of central bank buying and increased geopolitical tensions around the world, we think gold and other precious metal prices may rise further in 2025.

In contrast, other commodities are likely to face a challenging price environment because of slowing economic growth in China, weak demand in other major economies, and ample supplies of some key products (such as crude oil).

A Year of Political and Policy Change

Each December, Confluence provides a comprehensive overview of our economic and financial market expectations for the coming year. We focus on developing economic trends to give a sense of what to expect for stock, bond, and commodity returns in the coming 12 months. This year, we also provide a detailed discussion of the political and policy changes that are likely to come about now that former President Trump has been elected to a new term. As of this writing, Trump has not yet finalized his specific policy priorities for the first year of his new term. Nevertheless, his nominees to date and his past policy statements allow us to provide this economic and financial market, which we are calling "A Year of Political and Policy Change."

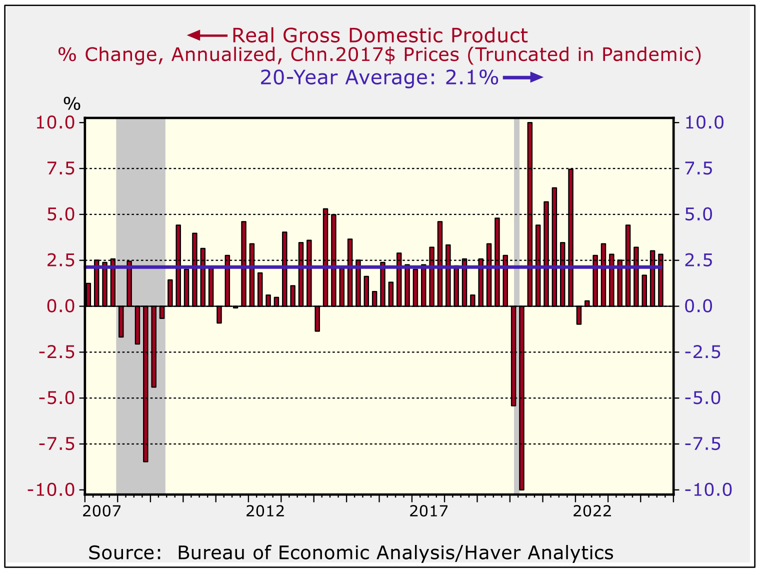
THE ECONOMY

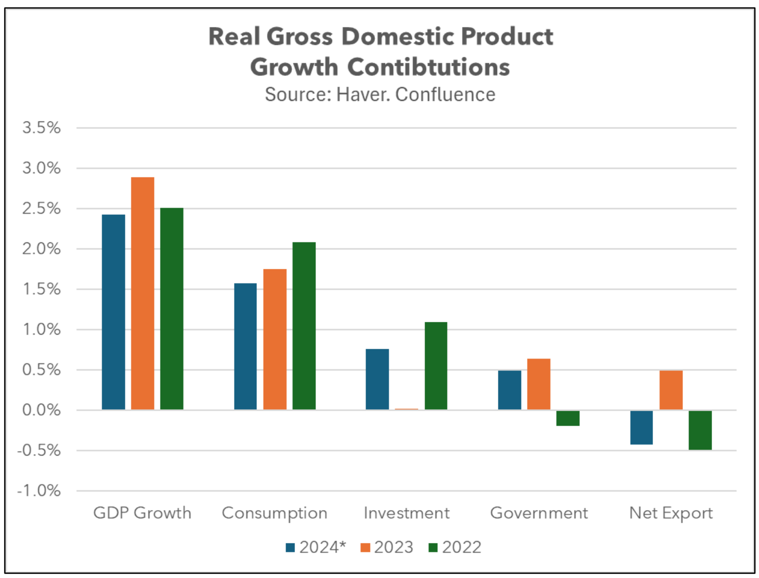
At Confluence, our Outlook reports always begin with a key question: Will the United States economy be in recession in the upcoming year? In this section, we begin by delving into that question in detail. Later in this section, we will explore the outlook for inflation and monetary policy as well.

GROWTH OR RECESSION?

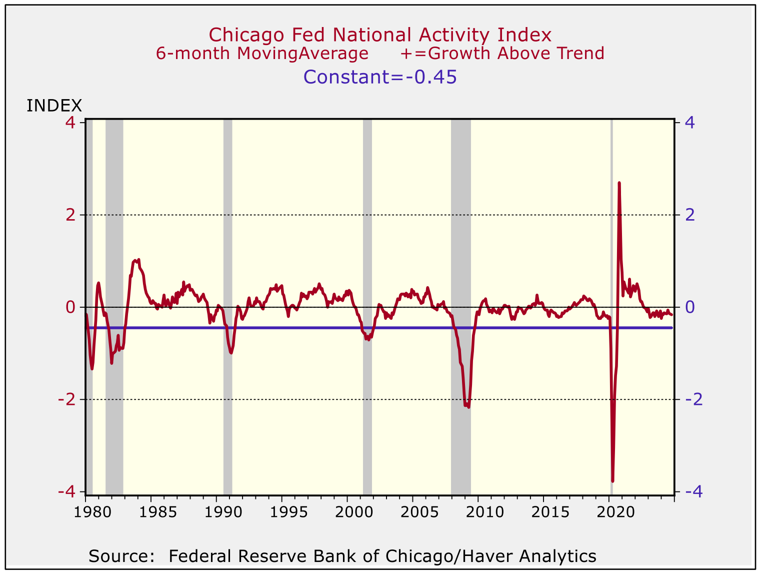
As of this writing, key coincident indicators suggest US economic activity is still growing. The economy is not in recession. All the same, today's economic growth is moderate, and some indicators show outright weakness. In some sectors, such as housing, and among many US households (especially at lower income levels), today's economy is bad. Since today's growth is moderate and some sectors are weak, we think the economy is somewhat susceptible to shocks, such as a domestic financial crisis or a major geopolitical event that undermines confidence. Key forward-looking indicators are also showing signs of slowing.

Quarterly GDP Report. The main gauge of economic output is the Commerce Department's quarterly report on gross domestic product (GDP). After stripping out seasonal variations and price changes, GDP in the third quarter of 2024 rose at an annualized rate of 2.8%, a bit weaker than the second quarter growth rate of 3.0% but still moderately above the 20-year average of 2.1%. Compared with the same period one year earlier, GDP in the third quarter was up 2.4%, also moderately above average. Most of the growth over the last year came from increased consumer spending as businesses created many new jobs and low unemployment drove up wage rates. Despite the strong job creation, investment spending grew relatively weakly, presumably due to high interest rates. Government spending provided only a modest boost to output, mostly reflecting higher defense spending and increased outlays by state and local governments. International trade detracted from growth on account of rising imports. These dynamics suggest that today's economic momentum could be at risk if labor demand cools, interest rates remain high, or fiscal policy is tightened sharply.

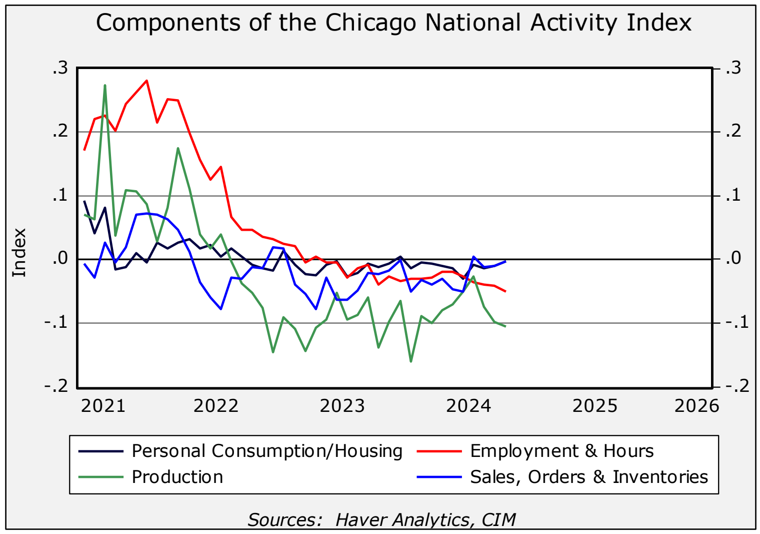




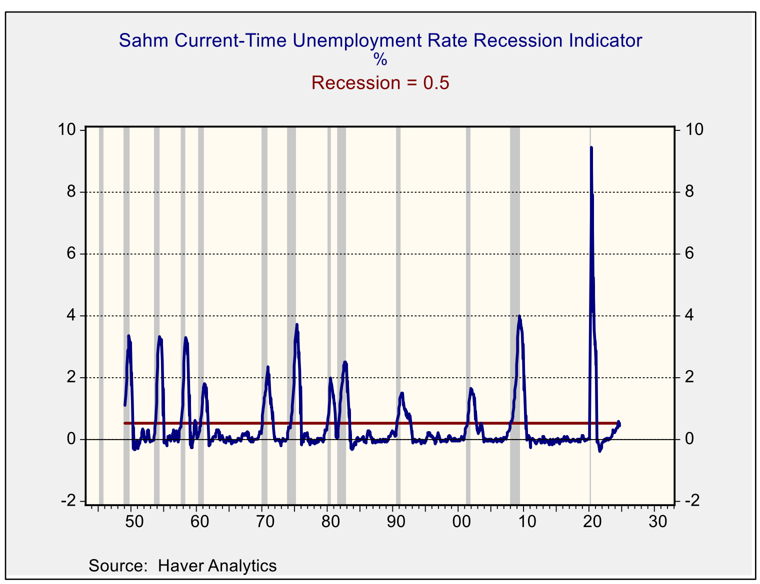
Chicago FRB National Activity Index. One shortcoming of the GDP report is that it is released with a long lag. The initial estimate is published about one month after the end of a quarter, and it is subject to revision in each of the following two months. For a more granular, nearly real-time measure of activity, we use the Chicago Federal Reserve's National Activity Index. The CFNAI encompasses dozens of frequent data series that provide a more current measure of output. It is designed so that readings of 0.0 represent the economy growing at its long-term trend rate. Our analysis shows that when the six-month moving average of the CFNAI falls below -0.45, the economy is typically falling into recession. As shown in the chart, the six-month average of the CFNAI currently remains above that standard. However, the index has persistently pointed to subpar growth ever since late 2022. Some of this weakness may reflect continuing data distortions from the coronavirus pandemic. Nevertheless, it also suggests the economy may have less momentum than meets the eye.



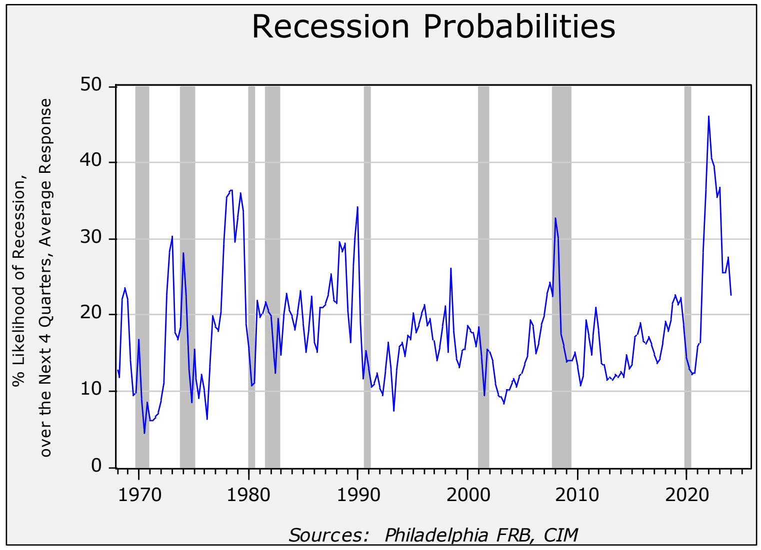
Looking at the four major components of the CFNAI, we see that all are below trend, but production and employment are showing the greatest weaknesses. Given that employment has suffered from multiple labor actions and hurricanes recently, we would expect a modest recovery in this component during 2025. Still, the CFNAI, for now, suggests that overall economic activity is modest.



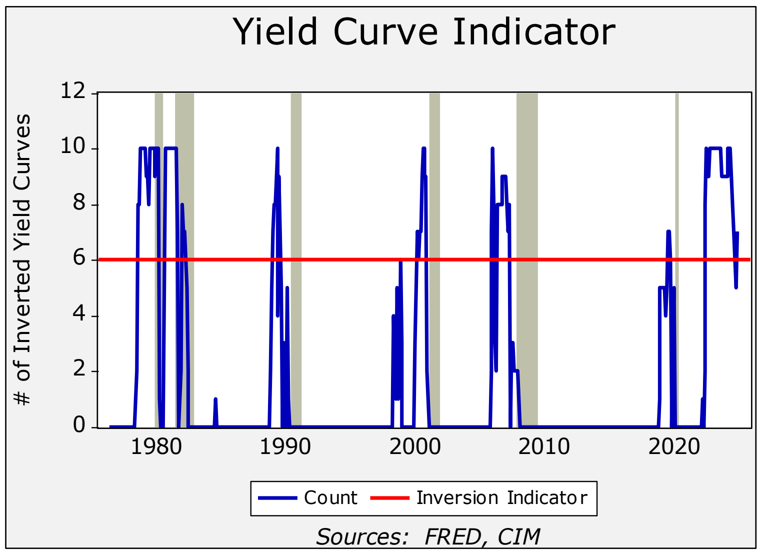
Sahm Unemployment-Based Recession Indicator. Another popular coincident indicator is the "Sahm Rule," developed by former Fed economist Claudia Sahm. Based on historical data, this indicator says the economy is likely in recession when the unemployment rate is 0.5 percentage points or more above its minimum over the preceding 12 months (all calculated on a rolling three-month basis). The indicator exceeded that level for three straight months in the summer of 2024, even though the economy was clearly not in recession. The false positive probably stemmed from the fact that unemployment remains historically low, even if labor demand has clearly moderated. All the same, we believe the Sahm indicator is a yellow flag regarding the health of the labor market and the risk of recession in the near term.



Philadelphia FRB Recession Probabilities Survey. Economists are often criticized for their inability to accurately predict recessions and for their frequent disagreements. Despite that, when enough economists think a recession is on the way, it can signal an impending downturn. Since 1968, the Philadelphia Fed has conducted a regular survey of economists regarding their outlook for economic growth, consumer price inflation, interest rates, and the like. One key question asks the economists to give their probability of a recession over the next 12 months. As shown in the chart, the average probability of recession hit a record high in 2022. The probability has more recently fallen to 22.4%, but that is still above the levels that were common before the pandemic.



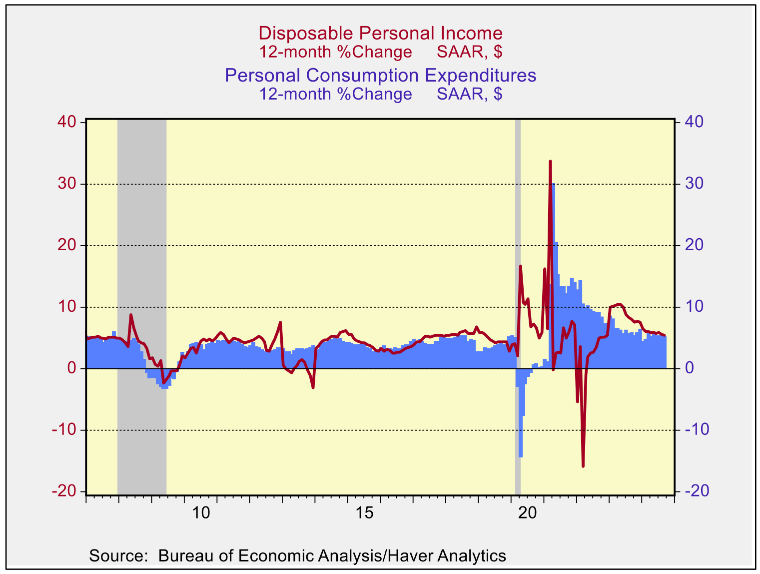
The Yield Curve. The leading indicator with the most storied reputation for reliability is the yield curve, defined as the progression of yields on US Treasury obligations from shorter maturities to longer maturities. The yield curve is normally upward sloping, i.e., yields on longer-maturity obligations are usually higher than yields on shorter-maturity obligations. Prior to a recession, the yield curve has historically inverted, with short-duration yields rising above long-duration ones. Of course, there are many ways to measure the yield curve. For example, you could look at the difference between the 10-year yield versus the two-year yield, or perhaps the 10-year yield versus the three-month yield. To address this issue, we've developed an indicator that tracks 10 different yield curves. Historically, recessions have occurred nine to 25 months after six or more of our yield curves inverted. As shown in this chart, all 10 yield curves were inverted for an extended period in 2023. This looks to be another false positive since the economy does not appear to be headed for a recession right now. As with the other indicators mentioned above, however, we do think the long inversion of the yield curve from 2023 to 2024 is a yellow flag that higher short-term interest rates could be slowing economic growth and creating financial risks.



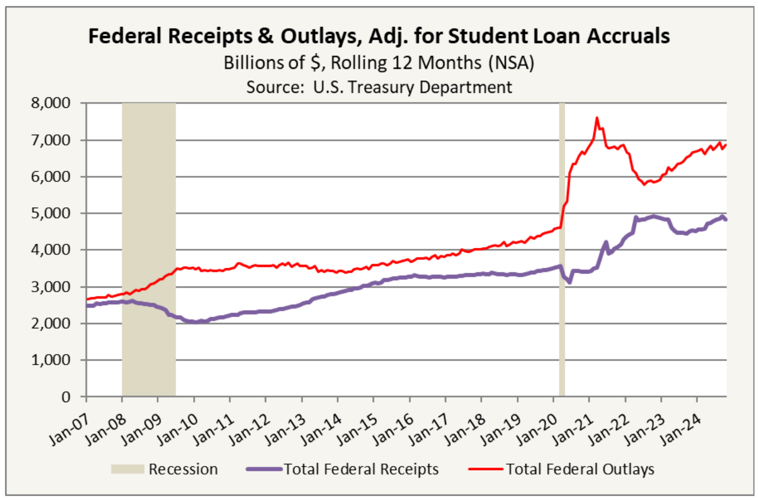
IS A RECESSION COMING IN 2025?

Looking forward, we judge that the US economy will probably keep growing without a recession in 2025, so long as it isn't hit with an exogenous shock. As noted above, the economy has cooled since the immediate post-pandemic period, but we think it retains meaningful momentum, mostly because of continued job creation, rising wage rates, and growing Social Security retirement benefits. All of those factors are driving up personal income and consumption spending, creating a self-reinforcing "virtuous cycle." We also see few of the major economy-wide imbalances that have sparked recessions in the past, such as excessive inventories or spiking production costs, although interest rates do remain restrictive and policy changes under the new administration are a risk. We discuss the key growth-supporting factors in greater detail below.

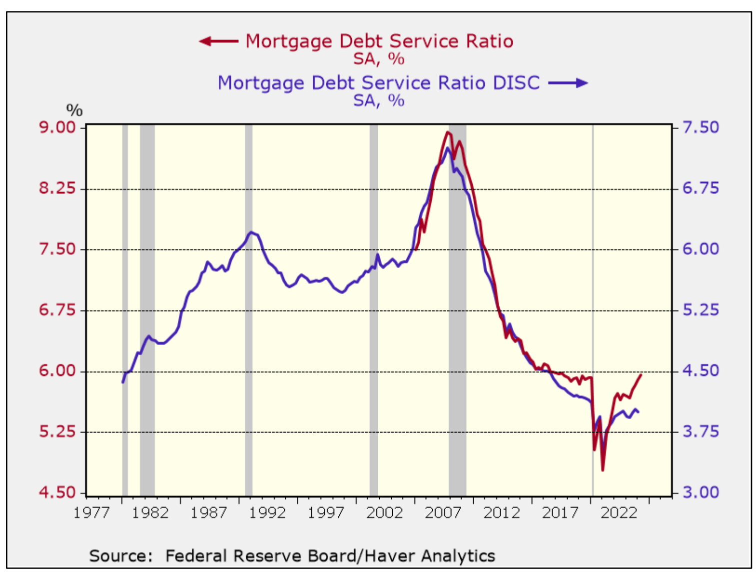
Tight Labor Markets & Rising Wages. The US labor market continues to reflect the mass retirement of baby boomers and the loss of other groups of workers during the pandemic. The loss of those workers has led to labor shortages and tight labor markets, especially in lower-skilled, entry-level jobs. Even though the unemployment rate has risen over the last couple of years, joblessness remains historically low, so the continued high demand for labor has driven wage rates sharply higher. Unrelenting job growth and rising pay rates have elevated disposable personal income. The result has been strong growth in consumer spending, which has helped buoy the economy over the last year. Disposable personal income and consumer spending are now growing basically in tandem, so as long as income growth remains healthy, the consumer will probably keep spending and driving the economy forward.



Fiscal Stimulus. At least for now, federal fiscal stimulus also remains robust, providing an additional boost to the economy. However, it's important to understand what constitutes that stimulus. Politicians often talk as if it's made up of big, new spending programs such as the 2022 infrastructure bill, the CHIPS and Science Act, or the Inflation Reduction Act. In reality, the spending provided by those programs is being rolled out over many years, and the outlays to date haven't been very large compared with the size of the economy. Rather, much of the new stimulus reflects the mass retirement of baby boomers since the pandemic. Newly retired baby boomers have started taking Social Security and Medicare benefits, which is giving a further boost to overall personal income, but they are no longer paying Social Security and Medicare taxes. Taken together, this puts upward pressure on federal outlays and downward pressure on federal tax receipts. On top of that, the sky-high interest rates of the last two years have propelled federal interest payments, some of which went to US investors. The result has been a wide federal budget deficit, i.e., more fiscal stimulus.



Termed-Out Debt & Lower Interest Rates. We think one key factor that helped avoid a recession despite the long period of high interest rates was corporate and household refinancing when interest rates fell to historic lows during the pandemic. Many firms were able to replace higher-rate obligations with new, low-rate ones that don't mature until 2025, 2026, or later. These companies, therefore, have been able to weather today's high interest rates, at least until now. They might even be benefiting if they have big cash balances that are now earning high yields. Similarly, many homeowners bought or refinanced homes during the pandemic, with the vast majority choosing fixed-rate mortgages that don't have to be refinanced anytime soon. Of course, those homeowners are now reluctant to sell their homes, drying up inventory and driving up prices, but their insulation from Fed rate

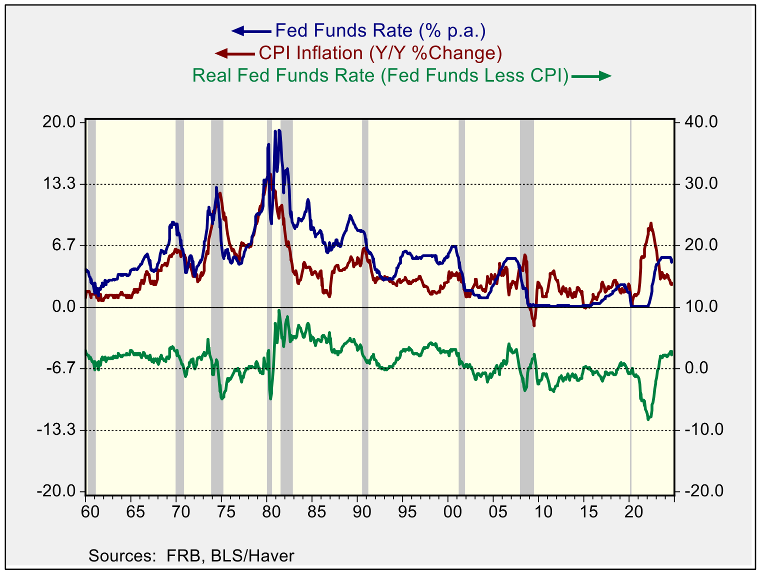


hikes has probably been a net benefit for the economy. Some student loan borrowers probably also refinanced, locked in low interest rates, and termed out their debt.[1]

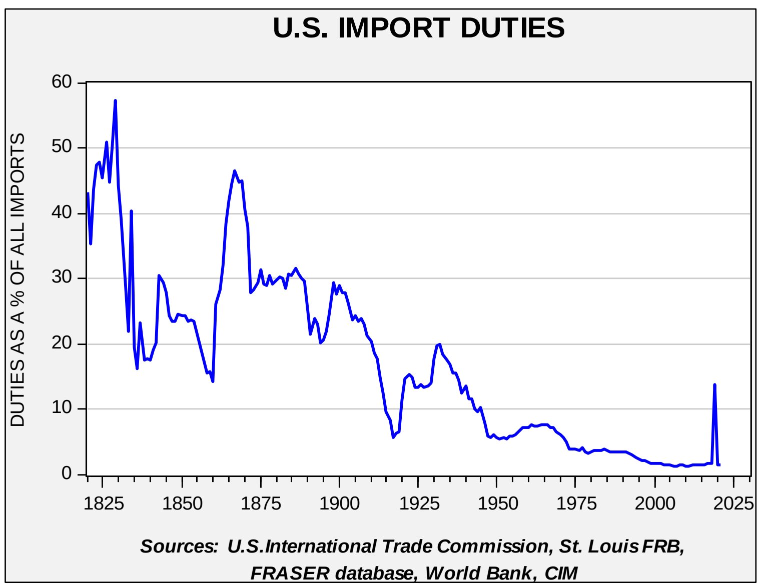
Remaining Excess Cash Balances. Many consumers may still hold more cash savings than they typically did before the pandemic, especially among the higher-income households that have driven consumer spending in recent years. Those excess savings may encourage greater consumption by those households. Today's still-elevated interest rates mean those savings are providing interest income that could also be spent. The key caveat is that the overall savings rate is currently quite low. That probably reflects some level of financial strain among lower-income and moderate-income households. The low savings rate means those households may eventually cut their spending if they sense economic risk and return to saving more.

Despite the positive forces described above, we do expect to see some moderation in economic activity in 2025. Although the Fed has begun to ease monetary policy, interest rates remain restrictive. In addition, slowing momentum will make the economy more susceptible to recession, depending on how the new administration moves on its stated policy agenda.

Relatively High Real Interest Rates. Even though the Fed began cutting its benchmark interest rate in August 2024, the cuts to date have been modest, and they haven't been substantially greater than the moderation in consumer price inflation. As a result, the "real" or inflation-adjusted fed funds rate remains near the high levels reached right before the Great Financial Crisis in 2007. The real rate on longer maturities is less elevated, but it is still above the average level of the last two decades. These high interest rates likely remain a drag on economic activity, especially in sectors dependent on borrowing for investment, such as real estate. At some point in 2025, many firms will face maturing debt and may have trouble rolling it over. The result could be sectoral financial strains that slow the economy sharply.

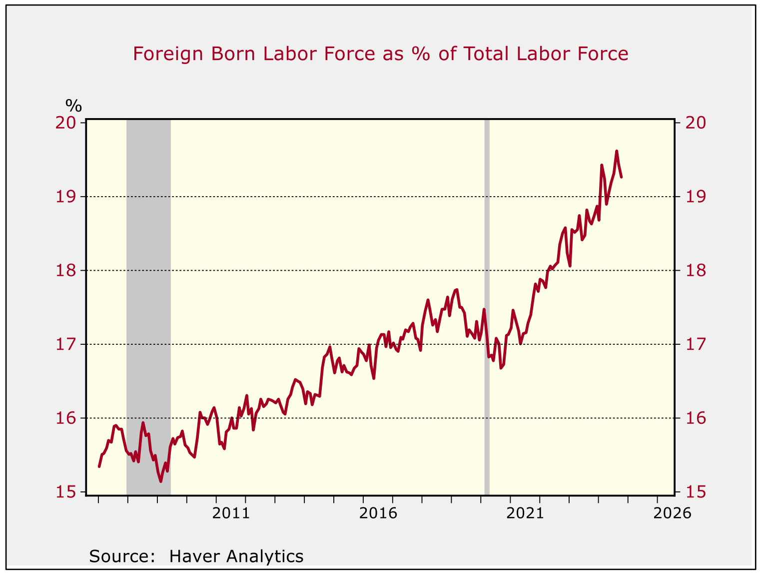


Tariffs. The remaining key risks relate to US politics and policy changes after the 2024 election. We will discuss the new political environment in greater detail below, but here we focus on President-elect Trump's vows to impose punishing new tariffs on imports from US allies and adversaries alike. Gauging the impact of tariffs can be tricky, since it depends on a range of factors, such as how broadly they are applied, the specific rate, how much pricing power the importing firm has versus its domestic customers, and whether the government uses its tariff revenues to reduce the budget deficit or fund new spending. Another key factor is whether other nations impose retaliatory tariffs against important US exports. Nevertheless, we think that big, sudden changes to tariff policy could potentially disrupt supply chains, inhibit production, and/or spark renewed price inflation. With the economy growing only moderately, that could potentially push the US economy into a contraction.



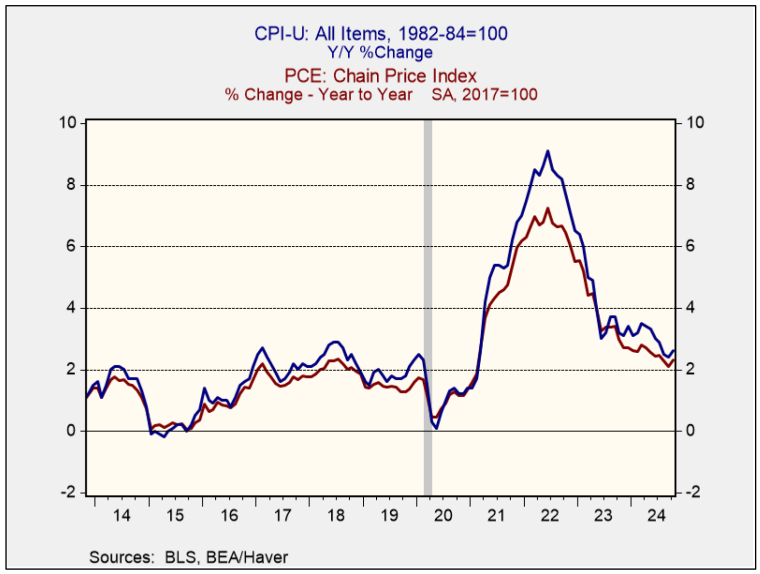
[1] In Q2 2004, the Federal Reserve changed its methodology in calculating the mortgage debt service ratio, using one from the credit rating agencies. It shows a higher debt service compared to the older one, but it is well below the levels seen before the housing crisis.

Deportations. Essentially, our concern about tariffs is that they could amount to a negative supply shock. If the new Trump administration clamps down hard on legal and illegal immigration in the US, it could also amount to a negative shock to the US labor supply. Still, we consider that outcome to be a worst-case phenomenon. Besides the legal challenges to rounding up immigrants and removing them from the country, the new administration will likely find it difficult to identify, arrest, detain, process, and transport these targeted people. Any resulting reduction in the labor supply could therefore be muted, at least in the near term. If that's the case, the program may not be very disruptive in the near-term to the economy or to economic growth.

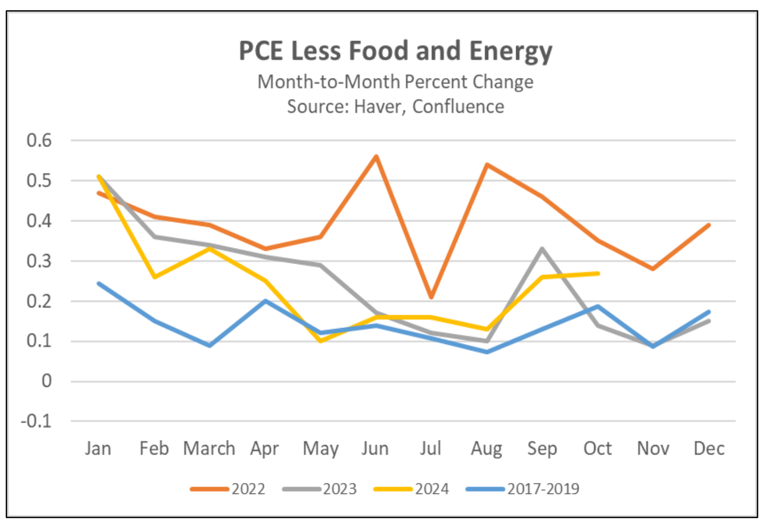


WHAT ABOUT INFLATION AND MONETARY POLICY?

While overall inflation showed signs of resurgence at the start of the year, the year-over-year increase in both the Consumer Price Index and the price index on Personal Consumption Expenditures (PCE), which is the Federal Reserve's preferred gauge, eventually dipped below 3% for the first time since 2021. This deceleration was most pronounced in the goods category, where overall prices have been flat to slightly down over the last year. Service prices, especially for housing, have continued to rise at a fast clip.



Excluding the volatile food and energy components, "core" CPI and "core" PCE inflation showed improvement. However, while core PCE inflation dipped below 3% year-over-year, core CPI inflation remained above this threshold. The discrepancy stems from how the indexes are weighted. Shelter costs, a major component of both indexes, constitute approximately 36% of the overall CPI and 45% of the core index compared to 16% of PCE and 18% of core PCE. Consequently, core PCE inflation has benefited from a broader decline in price pressures, allowing it to decelerate faster than core CPI inflation.



As we enter 2025, the Fed is likely to prioritize the core PCE index to assess whether inflation is on track to meet its 2% target. The first significant test will come in the first quarter, when policymakers will be looking to see if core PCE inflation accelerates less sharply than it did at the beginning of 2024. As the chart to the right shows, core PCE inflation (on a monthly basis) picked up dramatically in the first few months of 2024, only to subside in the summer months. If core PCE inflation remains well behaved in early 2025, annual inflation is more likely to move closer to the Fed's 2% target by the end of the year.

All the same, we think that continued economic growth and sticky price pressures will discourage the Fed from cutting rates aggressively in 2025. Given current projections that core PCE will end 2024 near 3.0%, only slightly below the initially expected rate of 3.1%, the Fed may push off any 2025 interest rate cuts until the second quarter or even later (unless economic growth unexpectedly weakens). During any such interregnum, policymakers would probably hope to see inflation rise at a monthly pace below 0.3% in the first three months, followed by even smaller increases later. If this trajectory materializes, inflation could potentially decrease to below 2.5% by year's end. This would mark an improvement from today's inflation, but it would still be above the Fed's target. Consequently, we anticipate the Fed will take a cautious approach to cutting rates in 2025, with about two rate cuts during the year.

POTENTIAL ELECTION IMPLICATIONS

Of course, one major consideration for the economy and financial markets in 2025 is the change in the US political situation and policy environment following the 2024 elections. The most salient fact is that Donald Trump was elected to a new term as president, winning both the popular vote and the Electoral College. In addition, the Republicans won control of both houses of Congress. Although this power is not absolute, the White House is now in a favorable position to make policy changes. Any cursory reading of the media offers all sorts of projections of what policies are going to be enacted. However, what we notice in these forecasts is a lack of accounting for the different groups within the GOP coalition.

BARGAINING & BALANCING IN THE NEW GOP COALITION

In general, there are two broad types of political arrangements in democracies. One is a multiparty system, where various groups form parties, some of which may be dedicated to a single issue. These systems are common in Europe and are often seen in parliamentary systems, where the legislature is the primary governing body. In these systems, it is rare for a single party to win an electoral majority. Instead, a leading party will attempt to gather various smaller parties into a coalition government. The leading party will offer various cabinet positions to smaller party leaders, which distributes power among the coalition's parties. The other system is a two-party arrangement where each major party is, in fact, a coalition of various interest groups. In that way, it's similar to a multiparty system, except that the coalition "horse-trading" occurs within the party. Thus, in the US, it's very common to see groups within a major party that are seemingly at odds. Indeed, one of the key roles of a party leader (a president, for the party in control of the White House) is to manage this coalition. Successful management leads to a large party that has a good chance of winning majorities. However, it should be noted that successful management is quite difficult. It usually takes a gifted politician to hold a disparate group together. Here is a rough breakdown of the constituents making up the new GOP coalition:

- ***Technology Sector Supporters:*** The key names in this constituency are Elon Musk and Peter Thiel. Its most important policy goals are to maintain globalization and immigration, promote cryptocurrencies, reduce regulation (especially to roll back anti-trust policies), and maintain tax relief. This group wants to normalize relations with China and generally wants to avoid war at all costs.
- ***Wealthy GOP:*** The representative names in this constituency are Harold Lutnick and Scott Bessent. The most important policy goals for this group are deregulation, maintenance of the dollar's reserve currency status (and, by default, the Treasury note as the reserve asset), continuation of tax relief, and preservation of the Fed's independence. Lesser goals include normalizing relations with China and supporting immigration.
- ***Small Business:*** There are no notable public figures in this group, but small business is a stalwart of the Republican party. This group wants deregulation, continued tax relief, weaker anti-trust enforcement, and immigration.
- ***Working Class/Trade Hawks:*** The key names in this group include JD Vance, Robert Lighthizer, and Oren Cass. This group has opposed globalization of both people and goods; it wants restrictions on trade and immigration. It opposes deregulation and supports anti-trust. It prefers decoupling from China and would not oppose ending the dollar's reserve currency status. It would also support a less independent Fed.
- ***China Hawks:*** The representative members of this constituency include Marco Rubio and Michael Waltz. This group's primary concern is decoupling the US economy from China and preparing for eventual hostilities with Beijing.

- ***Anti-Institutionalists:*** The key names in this group are Robert F. Kennedy Jr. and Tulsi Gabbard. This group's concern is the overarching power of the government's regulatory establishment. Its general position is that the government's regulatory bodies have become insular and are mostly concerned with their own power and prerogatives compared to the needs of Americans. Although it supports deregulation, this group is mostly interested in deconstructing the regulatory state.
- ***Evangelicals:*** There are no outstanding figures in this group. President-elect Trump has enjoyed strong support from Evangelical Christians, but our read is that he believes he has fulfilled his part of the bargain by overturning Roe v. Wade. This group's influence will likely be modest, at least in the first two years of the new administration. We would note, however, that groups that feel shunned in a coalition can become a problem when elections loom.

Clearly, the goals and aspirations of these groups within the Republican coalition are in conflict. It will be difficult, for example, to please both the Technology Sector/Wealthy GOP groups and the China Hawks. Successful presidents manage to keep major constituent groups happy by giving them enough of what they want without giving any particular group everything they want. It is in this bargaining and balancing that the president's policy direction will be determined.

LIKELY POLICY PRIORITIES

President-elect Trump prefers optionality: He tends to avoid being pinned down to any particular policy. For example, in his first term, he threatened North Korea with devastation, only to agree later to meet with its leader, Kim Jong Un. Thus, we cannot, with any degree of confidence, project what he will do with the new GOP coalition. However, we must make some general assumptions of where we think policy will move. Here are our best estimates:

1. **Defense Burden Sharing & Import Tariffs.** As we noted in the 2025 Geopolitical Outlook, we think the US is rewriting its hegemonic policy with the rest of the world. This is occurring because America hasn't been able to craft a foreign policy that is domestically acceptable. Fulfilling the security role of hegemony has become too costly and meeting the financial security goal of providing the reserve currency and reserve asset has caused too many economic distortions. Rather than abandoning US hegemony outright, we expect the new Trump administration's foreign policy will focus on (1) forcing foreign governments to fund more of their own defense, and (2) using tariffs (and perhaps some form of capital controls) to reduce the problems that stem from providing the reserve currency and reserve asset.
2. **Immigration Restrictions.** The US foreign-born population was 14.3% in 2023, near its peak of 14.8% in 1890. In this earlier immigration cycle, the foreign-born population was consistently holding around 14.5% into the 1920s. A wave of anti-immigration sentiment led to restrictions that remained in place until the 1960s, when legislation changed to support higher immigration. The ratio therefore troughed in 1970 around 4.7% and has risen steadily since. Although we can't scientifically prove the point, history does suggest that when the foreign-born population rises above 14%, sentiment toward immigration becomes hostile. We expect the administration to take actions that would at least give the impression that immigration is being restricted. Given America's aging population, immigration does offer some relief from that aging, but there is clear support for ending what appears to be a chaotic situation surrounding immigrants.
3. **More US Exceptionalism.** Although moneyed interests support continued globalization, we expect the emerging hegemonic policies described above to accelerate global fracturing. Tariffs will most likely be used to replace sanctions as the preferred tool to change the behavior of foreign governments. At the same time, the current tax cuts are expected to be extended, with tariffs providing some of the revenue offset.

Overall, these policies would tend to constrain supply and support higher inflation. It is possible that deregulation will act as enough of a factor to dampen inflationary pressures. In general, however, some degree of inflationary pressures will be hard to avoid.

On a final note, in a two-party system, coalition management is essential to political success. Our observation is that the various constituencies within the GOP may be willing to compromise. In general, if the groups within the party trust the leadership, then they may be willing to concede on some issues that will allow for policy progress. At this juncture, unfortunately, we still won't know where "the lines in the sand" will be drawn. It is this uncertainty on policy that may be the most potent "known unknown" in 2025. We will be monitoring how policy is enacted as the year unfolds and adjust accordingly.

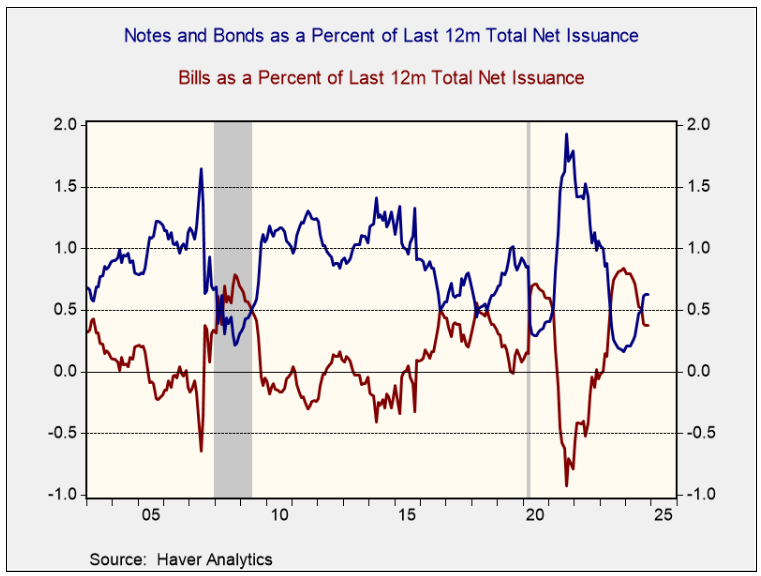
FINANCIAL AND COMMODITY MARKET OUTLOOK

As we noted in our Outlook last year, we think investors in the new year will increasingly accept that the financial markets have changed now that the post-Cold War era has given way to an era of East-West rivalry, with its fractured trade and investment flows, higher inflation and interest rates, and greater potential for instability. In the new world of US-China rivalry, we expect that reduced inflows of foreign capital, higher inflation, and bigger government fiscal deficits will erode the value of fixed income assets, keeping interest rates higher than investors have seen in more than three decades. The change will become more obvious in 2025 if the Fed is slow to cut interest rates further. Nevertheless, we do expect a few more rate cuts by the Fed. Coupled with the positive impact of renewed tax cuts and deregulation, those rate cuts will likely provide a boost to US equities, but foreign equities and most commodities could suffer from weak economic conditions abroad.

FIXED INCOME

The incoming administration's relationship with the Fed could have a notable impact on fixed income securities. During President Trump's first term, their relationship was tumultuous, with the president even calling Fed Chair Powell an "enemy of the state." However, a shift toward cooperation now appears likely, aimed at preventing long-term interest rates from spiraling higher. Closer coordination between the Treasury and the Fed could place downward pressure on Treasury yields, potentially affecting pricing across other fixed income markets.

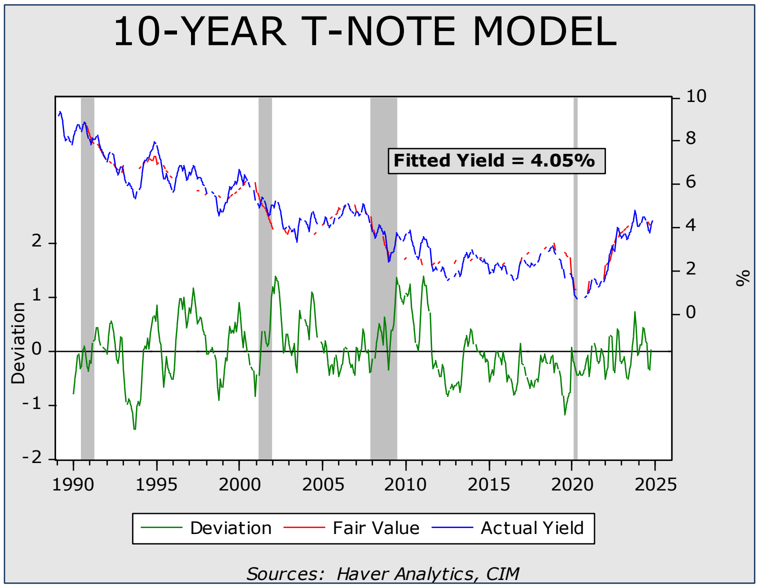
The bond market in 2025 faces a critical test with $7 trillion in Treasury obligations set to mature and needing to be refinanced. Along with the issuance needed to fund the big federal budget deficit, this enormous supply could heighten market volatility and drive interest rates higher, especially if investor demand softens. A similar challenge arose in 2024, but Treasury Secretary Yellen managed to mitigate its impact by increasing the issuance of Treasury bills. This strategy, dubbed "Activist Treasury Issuance,"[2] enabled the government to finance bond purchases largely by the transmission of funds from the overnight reverse repurchase (ON RRP) facility.



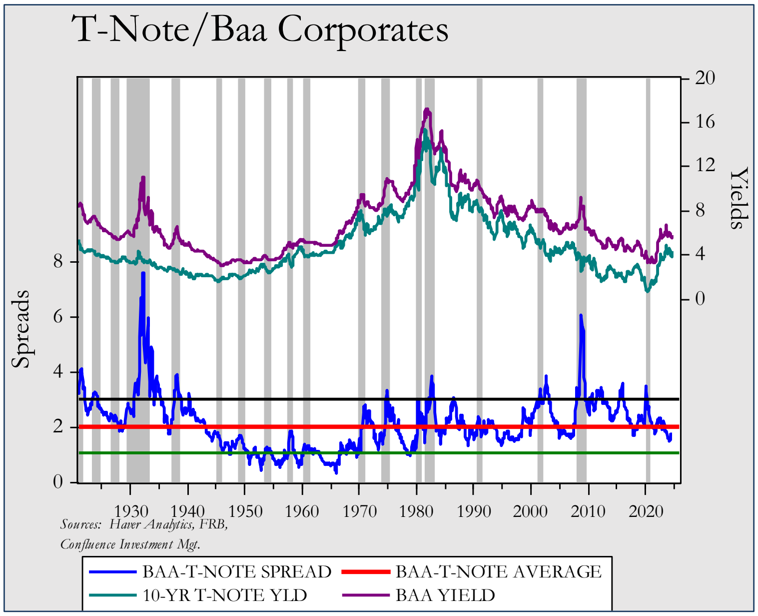
The incoming administration is expected to continue its predecessor's strategic approach to managing maturing bonds, potentially requiring support from Fed officials. A signal of potential rate cuts in 2025 could stimulate demand for Treasury bills, encouraging a shift of funds from the ON RRP facility. This would allow the Treasury to utilize the remaining funds in the facility. Subsequently, the Fed could pause its balance sheet reduction and maintain its size by repurchasing maturing Treasurys. This increased liquidity would enable the Treasury to allocate more of its bond issuance to longer-dated securities.

[2] We think "accommodative" is probably a better description of the actual dynamic.

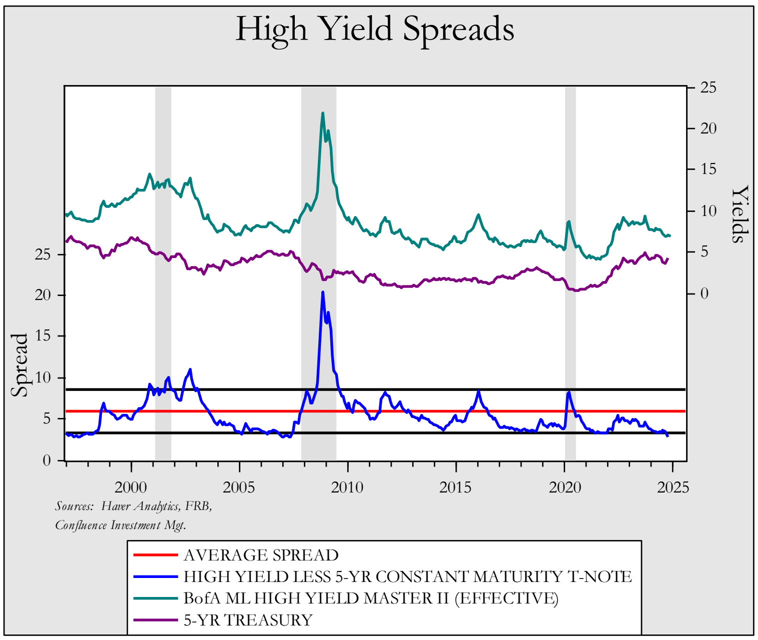
The Fed's future support will hinge on inflation trends, labor market conditions, and funding market stability. Given persistent underlying inflation and a tight labor market, ***we anticipate limited scope for aggressive rate cuts in 2025***. To mitigate turmoil in the Treasury bond market, we expect an early termination of quantitative tightening, perhaps late in the first quarter or early in the second quarter. This could potentially lead to lower long-term interest rates, possibly keeping the yield on the benchmark 10-year Treasury note to 3.5% to 4.5%. Our model indicates that today's 10-year Treasury yield of about 4.20% only slightly exceeds the fair-value rate of 4.05%. That would suggest that longer-term Treasury yields may fall only slightly in 2025. In other words, ***longer-term Treasury returns may be little more than their current interest yield***.



Meanwhile, credit spreads remain somewhat tight, with the excess of investment-grade bond yields over the 10-year Treasury yield near multi-decade lows. We think the strong pricing for corporate bonds reflects optimism about the Fed's ability to engineer a soft landing. However, as we noted at the beginning of this report, we believe economic conditions have softened to some extent, making the economy more susceptible to shocks that could trigger a recession. As a result, ***we consider corporate bonds to be modestly overvalued at this time.***



The yield spread is even narrower between below-investment-grade corporates and 10-year Treasurys. In fact, high-yield spreads are not only exceptionally tight, but they are approaching all-time lows. This level of tightness was last observed in the lead-up to the Great Financial Crisis, suggesting that a correction may be imminent. Currently, the narrow high-yield spreads reflect corporate behavior during the pandemic's era of ultra-low interest rates, when many companies extended their debt maturities. As with investment-grade debt, the narrow spread likely also reflects market optimism about economic prospects, with expectations of central bank rate cuts and potential corporate tax reductions already priced in. If these expectations fail to materialize, ***a revaluation of high-yield corporate debt could occur***, leading to widening high-yield spreads.

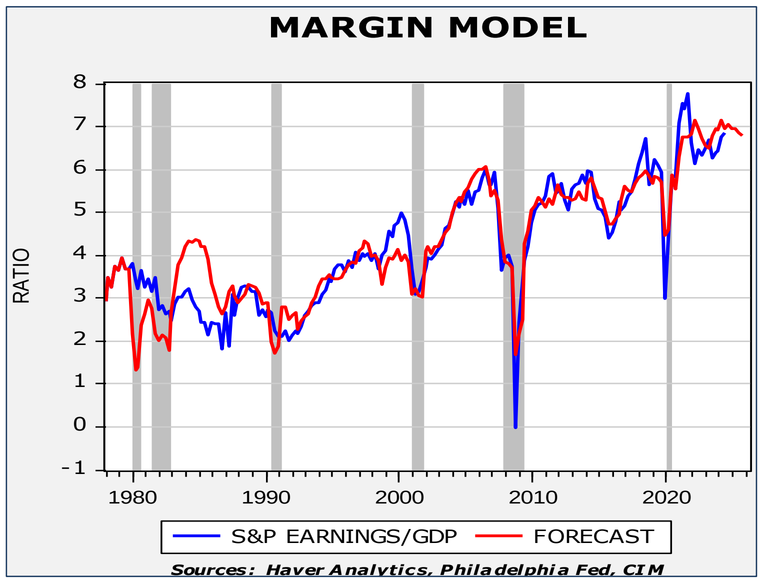


US EQUITIES

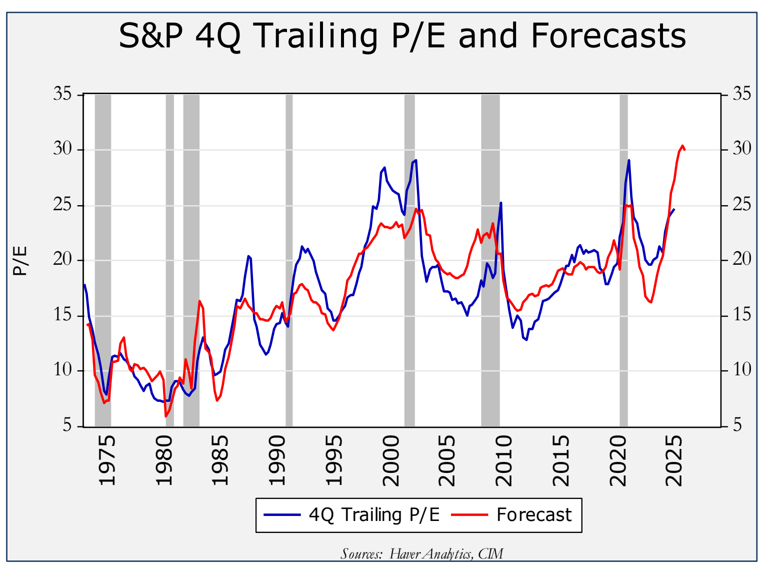
To gauge the likely performance of US stocks in the coming year, we start with an estimate of corporate profits. We then apply a price/earnings ratio to those earnings to calculate the year-end figure for the S&P 500 stock price index, which tracks stocks with large market capitalizations. Finally, we try to gauge the relative outperformance or underperformance of large cap stocks versus small cap stocks and "value" stocks versus "growth" stocks. As we will discuss below, ***we currently forecast that the S&P 500 price index will end 2025 between 6,500 and 6,800, with a single-point estimate of 6,735, up about 10.5% from today's levels***.

S&P 500/Large Cap Stocks. Our S&P 500 forecasts are based on several key sub-forecasts, as discussed in detail below. Based on our discussion of US economic trends above, we expect nominal GDP to be up about 4.4% from the previous year. We expect S&P 500 operating earnings to be about 6.9% of nominal GDP, or about $269.29 per share. Finally, we expect a P/E ratio of about 25.0x on those earnings.

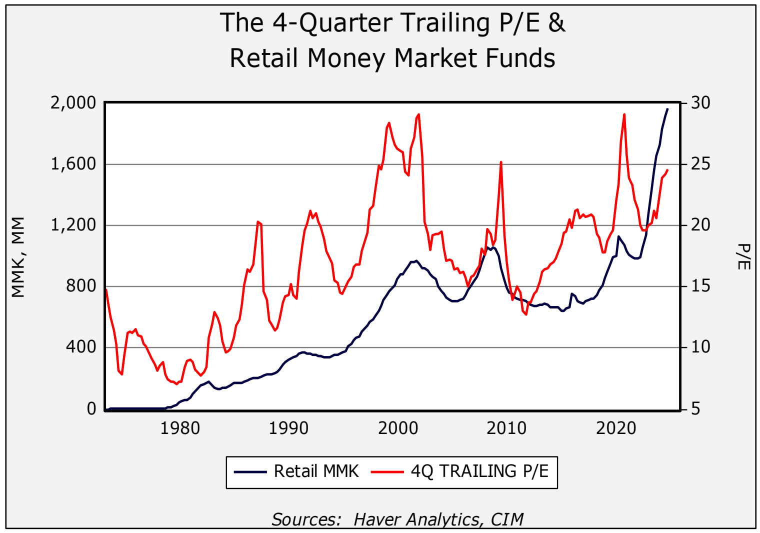
- Our expectation for ***nominal GDP growth*** assumes the economy will continue to cool but not fall into recession. It also assumes price inflation will soon bottom out. Our forecast assumes real GDP growth of about 2.2% and price inflation of 2.2%, for total nominal growth of 4.4%.
- As shown in this chart, ***S&P 500 operating earnings as a share of GDP*** have been trending upward since the end of the Cold War. S&P 500 operating earnings peaked just shy of 8.0% in 2021 and remain elevated. In 2025, we estimate they will stand at about 6.9% of GDP. One cautionary note, however, is that these elevated levels are far above the typical range of 2% to 3% of GDP in the last few decades of the Cold War, from 1965 to 1990. If we're correct that the post-Cold War era of relative peace and globalization is now over, it would not be unreasonable for margins to enter a period of secular decline. The process of margin compression would likely be gradual, and it may not begin until after 2025.



- To derive a figure for ***S&P 500 operating earnings per share***, we assume a divisor of 8,451.
- Finally, we use a model to estimate the ***S&P 500 fair-value P/E ratio***. Our model is based on annual CPI inflation, the five-year standard deviation of CPI inflation, the annual growth in the M2 money supply, the size of the federal fiscal deficit, the yield on the 10-year Treasury note, total money market fund balances, and a binary variable for recession. The model currently suggests the P/E multiple will end 2025 at about 30.0x. As this chart shows, this multiple would be a record for the trailing four-quarter multiple; since forecasting such a high multiple is imprudent, our base case assumption is that the current multiple of 25.0x will remain in place in 2025. Multiplying our estimate of S&P 500 earnings per share by this figure produces our estimate that the S&P 500 price index should stand at about 6,735 at the end of 2025, with the most likely range being 6,500 to 6,800.

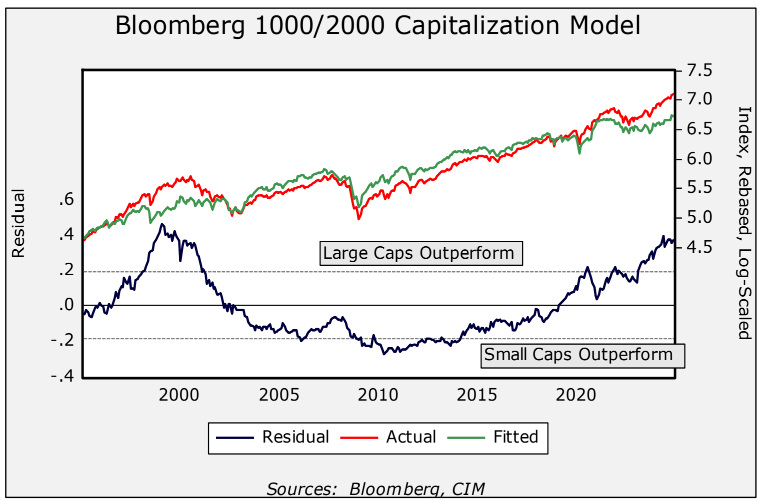


So, why is the model projecting such a high multiple? Almost every independent variable is projecting multiple expansion. We are not only expecting weaker inflation, but the volatility of inflation is projected to decline as well. The fiscal deficit, which is positively correlated within the model to the P/E, is expected to remain elevated. The fed funds rate is projected to decline, which is also supportive. The 10-year Treasury yield is also expected to decline, further boosting the multiple. However, the factor that is having the most impact is retail money market fund levels (RMMK).

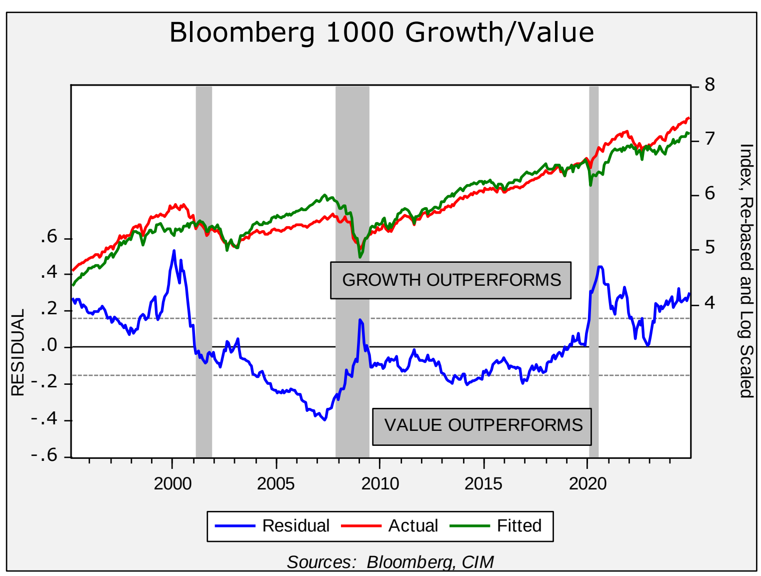


Over time, the S&P 500 P/E multiple is positively correlated with RMMK at the 75% level. Recently, RMMK has increased sharply, and the P/E has lagged somewhat. A careful observation of the data, however, shows that when RMMK is elevated and begins to decline, the P/E tends to spike higher in something akin to a "last hurrah" before the multiple turns lower. So far, we are not seeing signs of a downturn in RMMK. Perhaps the expected decline in the policy rate will lead to lower returns on cash and trigger outflows. Although that would tend to suggest that the end of multiple expansion is near, investors need to be aware that these outflows initially bring multiple expansion and can suggest unusually robust index gains.

In sum, investors should be cognizant that conditions are in place that support further multiple expansion. Although this is not our base case, the balance of risks is likely to the upside. Now, as we note in our 2025 Geopolitical Outlook, there are a myriad of exogenous events that could undermine equity markets. However, barring such an event, our base-case forecast is potentially too conservative.



Small Cap vs. Large Cap Stocks. Over the last couple of years, the US stock market has been extremely narrow, in the sense that the indexes weighted by market cap have been driven almost entirely by just a dozen or so stocks. The large cap indexes have outperformed, largely because of surging prices for a limited number of technology stocks in the artificial intelligence sector. The outperformance of those stocks has left small cap stocks languishing. As shown in this chart, the outperformance of large cap stocks versus small cap stocks has been extraordinary. Therefore, going into 2025, we think the relative value of small and mid-cap stocks is far more attractive than that of large cap equities.

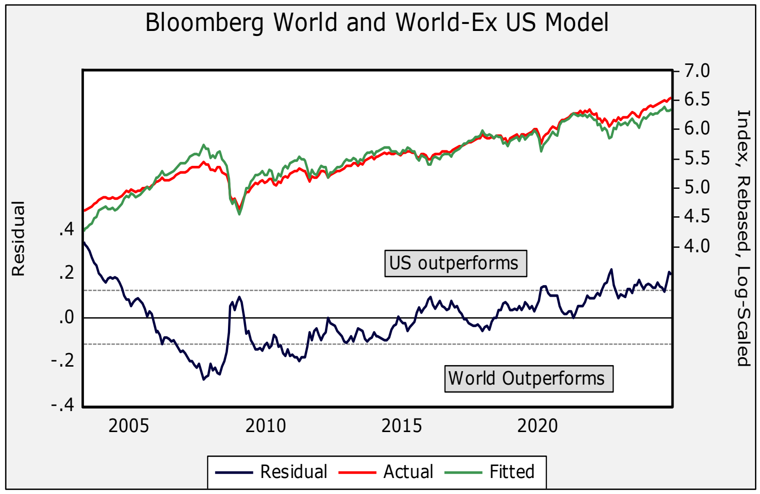


Value vs. Growth Stocks. Similarly, the recent outperformance in growth stocks and the lagging performance of value stocks tells us that value-style stocks are probably a better buy and should be poised to catch up at some point. Besides, as economic growth moderates further and the Fed demonstrates its intention to cut interest rates slowly and cautiously, it would be reasonable to expect investors to recognize the attractive pricing, higher average dividend payout, and lower volatility of value stocks.

FOREIGN EQUITIES

The longstanding outperformance of US stocks versus foreign stocks has left foreign valuations relatively low, but we don't think that necessarily points to a near-term rebound in international equities. Our muted expectation for foreign stocks is based on both our outlook for the dollar and policy risks under the incoming Trump administration.

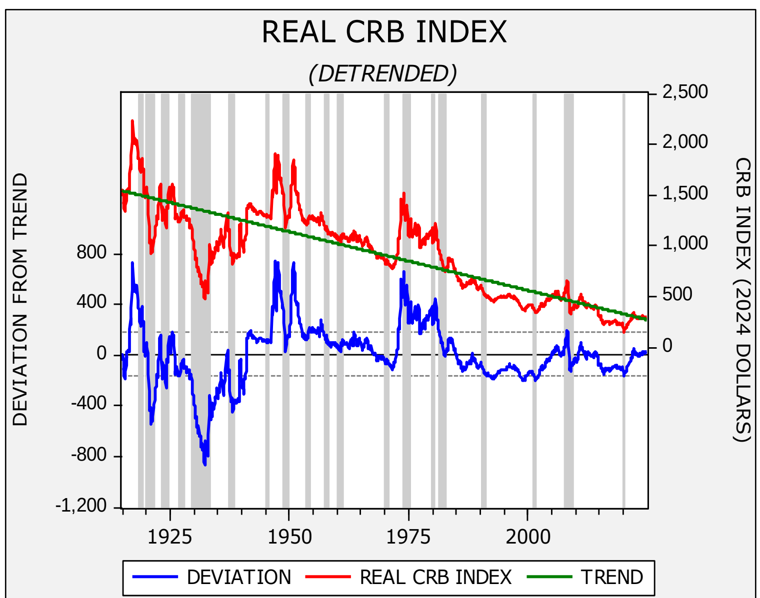
Impact of the Strong Dollar. Our research indicates that foreign stock performance is heavily influenced by the value of the US dollar versus other currencies. When the greenback is appreciating, foreign stocks typically struggle, and vice versa (see chart). In turn, our analysis suggests that the dollar's value can be driven by the US investment cycle and capital inflows from abroad. Relatively strong US economic growth can be a magnet for foreign capital, especially now that growth rates in Europe and China have slowed. The relative political stability and large, well-regulated financial markets in the US also make it an attractive safe haven for foreign investors as they face today's rising geopolitical tensions. Finally, the US investment cycle, such as the new surge of investment in artificial intelligence and domestic re-industrialization, can draw in capital. The recent upswing in US investment has proven more than enough to offset the efforts by China, Russia, Iran, and some other countries to reduce their use of the US dollar for trade. With the inflow of foreign capital pushing up the value of the dollar, ***we expect continued headwinds for foreign stocks in 2025***.



On a related note, President-elect Trump has signaled that he will prioritize imposing steep import tariffs and other trade barriers in an effort to reduce the US trade deficit, as we discussed above. His policy proposals to date suggest he will make it much tougher for foreign countries to export goods and services to the US beginning in early 2025. Since so many foreign countries and companies rely heavily on selling into the US, such barriers are likely to add to the headwinds for foreign stocks in 2025.

ALTERNATIVE INVESTMENTS

Finally, we address the prospects for gold and precious metals, mineral commodities, and other natural resources in 2025. First, we note that over the very long term, commodity prices typically fail to keep up with the rise in general prices. In other words, inflation-adjusted commodity prices tend to decline. That makes sense in a capitalist economy, which gives natural resource companies strong incentives to find and develop new supplies and increase their productivity in bringing those supplies to market. Capitalism also provides strong incentives for buyers to become more efficient in their use of commodities. Nevertheless, as shown on this chart, commodity prices often surge in times of elevated geopolitical tensions, as the world is seeing now with the intensifying US-China rivalry. We think these geopolitical forces, especially the potential for the China/Russia bloc to weaponize its commodity supplies, will help support commodity prices generally now and into the future.



Sources: Haver Analytics, BLS, CIM

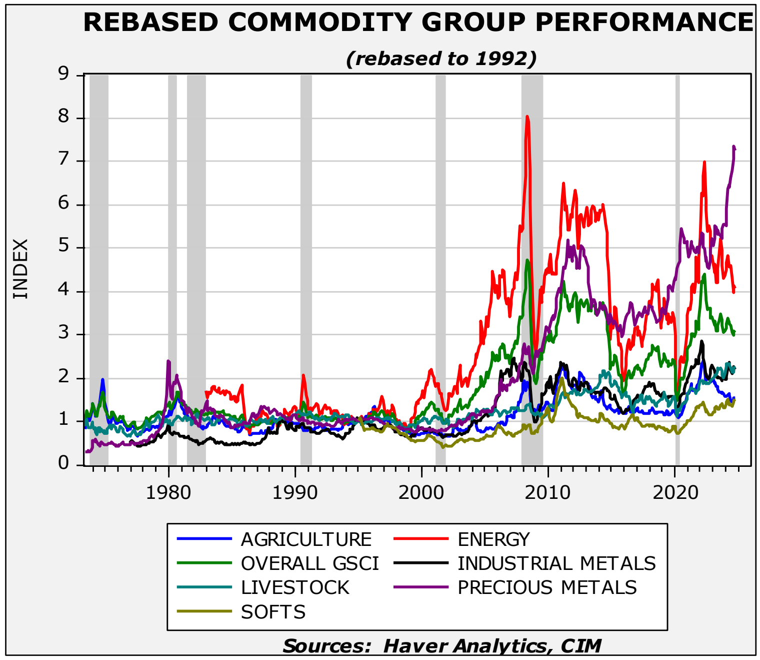
The other factor that tends to lift commodity prices are periods of currency debasement; this was the key driver of commodity prices in the 1970s. As the above chart shows, the inflation-adjusted CRB index is tracking trend, which means commodity prices are declining slowly in real terms.

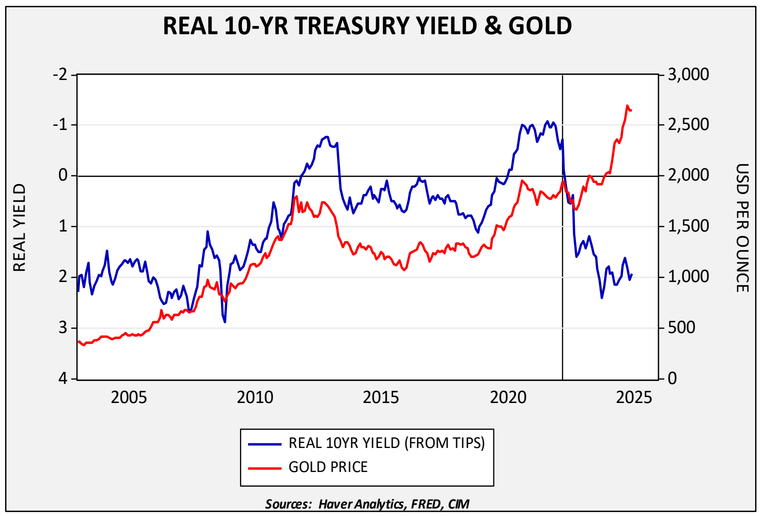
When we observe subgroups of commodity prices, precious metals prices have far outperformed the rest of the commodity complex.

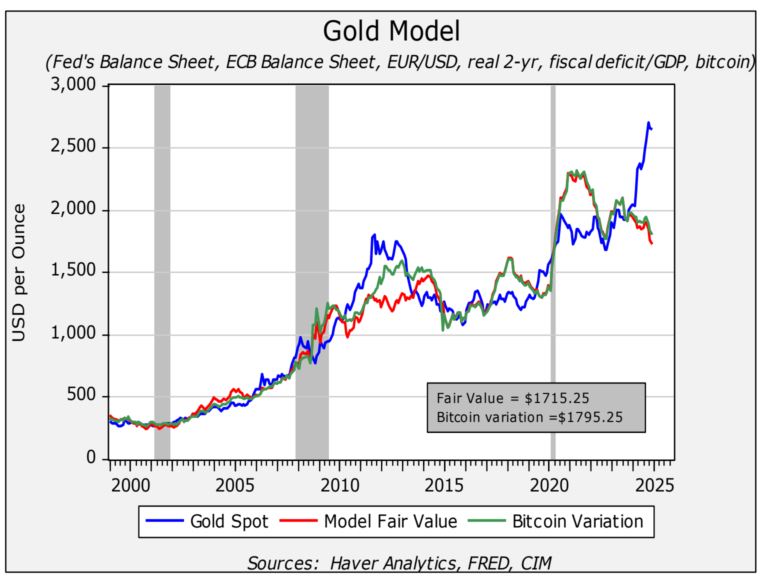
Gold & Precious Metals. Today's geopolitical backdrop is especially supportive for gold and other precious metals. Not only are some investors looking to precious metals as a hedge against geopolitical conflict, but many central banks have increased their buying after the US and Europe responded to Russia's 2022 invasion of Ukraine by freezing the Kremlin's US dollar holdings. Note on this chart that gold prices tended to track the real 10-year interest rate generated from the TIPS market. The vertical line represents when Russia invaded Ukraine. Obviously, there has been a significant divergence since then.

Nevertheless, precious metals have also faced competition as more investors buy cryptocurrencies on the belief that they will be a hedge against geopolitics and inflation. Finally, the Fed's still-elevated interest rates, coupled with lower inflation, have left "real" interest rates at their highest levels since the Great Financial Crisis of 2008. Historically, high real interest rates have been a negative for gold and other precious metal prices. Given that the Fed will likely cut rates relatively slowly going forward, we think high real interest rates will still tend to limit further gains for gold and other precious metals in 2025. Indeed, our gold model suggests that gold prices are wildly overvalued.

The reason for this divergence from fundamentals is that a new fundamental factor has emerged — central bank buying. In the wake of the Russian and Iranian sanctions, foreign reserve managers face the risk that if they lose favor with Washington, they could find that their primary reserve asset, Treasurys, are nearly worthless. This fear makes central bankers price insensitive. The fear of running afoul of the US is leading to strong demand for gold, which explains why prices are rising in the face of fundamental factors that are traditionally bearish. Given the state of the world, we expect this demand source to continue. At the same time, it is nearly impossible to determine whether or not the current price of gold is fairly valued. Our take, given our views on the state of the world, is that gold should remain well bid.







Other Commodities. Based on our expectation for slower but non-recessionary economic growth in the US and continuing economic struggles in the major markets of Europe and China, we foresee relatively slack demand in most global commodity markets. This means that our outlook for commodity prices generally hinges on our outlook for supply in the new year.

- ***Crude Oil:*** The US has become the world's leading oil producer, and the improved efficiency of US companies has enabled them to keep output at or near record levels despite relatively low prices. Expected supportive policies for the industry from the new administration will likely reinforce this trend. Meanwhile, OPEC+ enters the new year straining to find an opportunity to restore production levels that it had previously cut to support prices. Notwithstanding the potential for transient price shocks from geopolitical tensions, this abundant supply picture supports our outlook for soft prices in the new year.
- ***Natural Gas:*** Similarly strong supply dynamics are impacting the natural gas market, which would otherwise support an outlook for soft prices; however, a key difference will potentially influence demand for US gas. The growth of global infrastructure for liquified natural gas (LNG), including liquification facilities, export/import terminals, and the LNG tanker fleet, continues to unify the global market. Prices in the US have historically been lower than in either Europe or Asia, most recently due to the loss of the Russian supply for the European market. The combination of available US supply, growing LNG exports, and shortages in other global markets could lead to rising natural gas prices in the US.
- ***Industrial Metals (e.g., copper):*** Since demand for these metals tends to track economic growth, we expect demand for these metals to be relatively slack and in line with our general economic outlook. Supply in the new year, however, will vary from metal to metal, depending on production conditions in a small number of the world's biggest and best mines. The year 2024 saw declining ore concentrations, increasing labor unrest, and a rising tide of environmental protests affecting supply. This means that prices for these metals are likely to experience volatility and differing trends from one metal to another as the next year progresses.
- ***Uranium:*** After a fivefold price increase from the beginning of this decade to its peak in February, uranium has given back roughly a quarter of its gain over the balance of 2024. In our view, this reflects a market for the fuel source for nuclear power plants that got ahead of itself. As much as the resurgence of nuclear power has steadily gained durable support, the market is also getting reacquainted with just how long it takes to bring new plants online. We remain bullish about the long-term price for uranium, but a protracted consolidation phase around current levels will likely characterize the price picture in the new year.

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