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WEFO 2024 Review & 2025 Outlook 12/12/2024

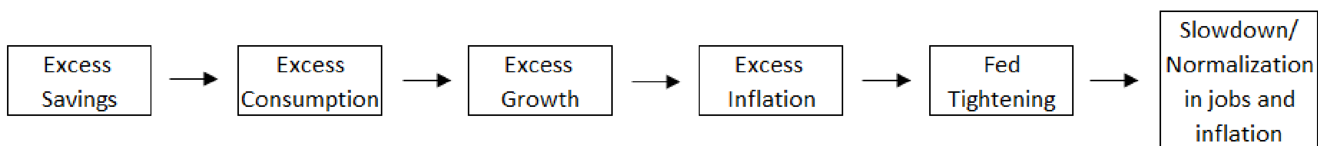
2024 will go down as a pivotal year. We witnessed the end of the Covid era as the economy transitions into a new era. This new era is being driven by long term mega forces that should drive markets for many years. In the two sections below, we will both review this year and see how it sets up 2025.

2024 Economic and Markets Review

Markets spent much of the year climbing a wall of worry about the economy falling into recession. That recession never occurred, in fact the US economy picked up strength as the year progressed. We believe that 2024 marked the beginning of a new cycle and put an end to the Covid-era cycle.

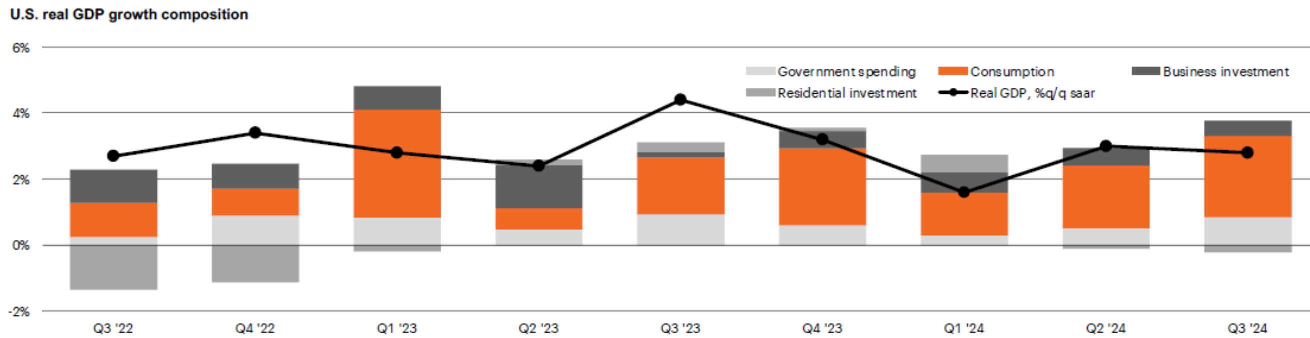
We think much of the fear about the economy was caused by a misunderstanding between normalization and a move into recession. During the Covid era, there was a tremendous amount of stimulus deployed. The result was both high inflation and artificially stimulated economic growth. The Fed responded by raising interest rates by 500 bps which led to two years of "rolling recessions" that slowed down both inflation and economic growth. For most of the year the fear was that the Fed tightened policy too much and the economy was going into recession.

That fear was misplaced in our view. The economy was slowing but the slowdown was a normalization. During the COVID era we believed massive stimulus led to excess savings with the following effects:



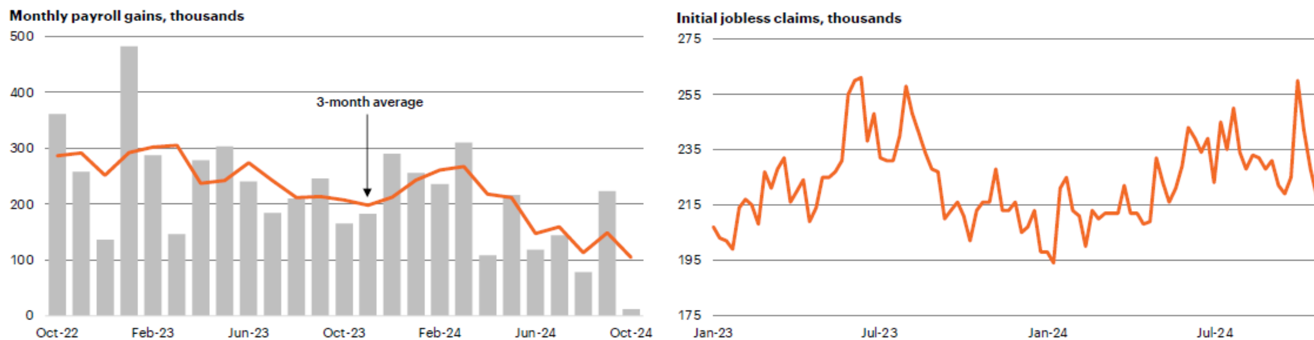
When the data slowed down, the economy was moving to a normal speed, not a recession. The underlying economy was rooted in a solid job market with income growth to support consumption. Economic growth and inflation both moved to Federal Reserve's target in the 2% range. The Fed finally lowered interest rates, not out of growth fears but inflation slowed toward its target. The markets had expected the Fed to lower rates by seven cuts. Due to the strength of the economy the Fed only engaged in two cuts.

Despite the fears, economic growth has held up and is above potential. It has held up due to both household consumption and business investment:



Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, as of November 11, 2024.

Consumption is supported by a healthy jobs market. The jobs market has normalized in terms of payrolls gained (October was significantly impacted by the recent hurricanes). Key for the labor markets are initial jobless claims, which outside of hurricane-related disruptions, have remained low.



Source left chart: Bureau of Labor Statistics, FS Investments, as of November 11, 2024. Source right chart: Department of Labor, as of November 11, 2024.

Importantly, when the yield curve turned positively sloped in September, it signaled an end to the Covid-era and the onset of the new cycle. This new cycle is based on increased investment in capital expenditures, infrastructure and housing. We believe that this is just the beginning of a long investment cycle underpinned by reindustrialization, re-electrification and demographics catalyzed by deglobalization and the AI revolution.

The markets spent most of the year climbing a high wall of economic worry. When it moved over the top of that wall, the S&P 500 had its best January to September return in more than twenty-five years. As of early December, the S&P is having its best return since 1998. The drivers of the new cycle should underpin the building blocks of return for US equities going forward.

Much of year was a narrow rally led by the “Mag 7” which had strong earnings growth. In the fall we started seeing a broadening out of the equity rally. The new cycle should see a broadening out of domestic equity participation to support value sectors (industrials, materials, financials and utilities) along with both midcap and small cap stocks. The major shift occurred with earnings. Earnings growth outside of the Mag 7 was nearly flat for two years during the “rolling recessions”. As a result, the other 493 stocks had flat returns during the same period. When earnings turned positive the broadening out occurred in value along with midcap and small stocks. Once the yield curve turned positive those sectors started to outperform.

In contrast, non-US stocks have not fared as well as those of the US during 2024. Below is a brief review:

- Continental Europe- in local terms did alright up in the single digit range. But in USD terms the returns have been anemic due to the strength of the US dollar vs. the Euro. European economies have been soft and the political situation has been concerning with.
- UK- has put up lower double digit returns but the economy has started to lose momentum.
- Japan- solid local returns in mid-double digits but a weaker yen detracted for dollar investors. Improving corporate governance has been a strong driver.
- China- rebounded very strongly in the fall based on expected stimulus. China has put in measures to stabilize its economy. Officials are still withholding fiscal firepower until they see what policies the Trump administration will use.
- India- continues to do well. Its economic growth rate is one of the strongest in the world and the market has put of low teens returns.

Real assets have been mixed. Gold is having a good year. It is likely global central bank buying that increased demand. Commodities have been soft due to weak current global demand but the long term demand drivers are strong. Global economies have been generally soft, particularly in China. Real estate prices have likely bottomed- cap rates have peaked and NOI growth appears to be recovering. REITs, which look ahead, are becoming attractive.

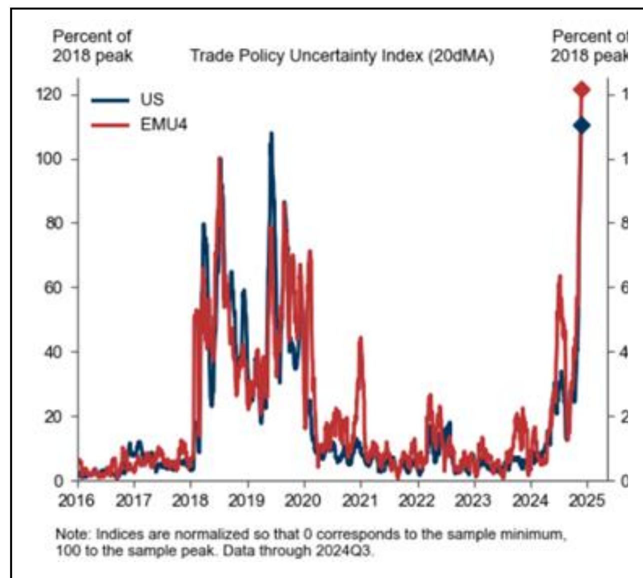
Core fixed income performed well through September on falling yields as the Fed reduced rates. By the end of September markets started to believe that goldilocks economy was possible. However, starting in the fall the markets started to look ahead at the political situation and yields started to rise due to expectations of both higher growth and inflation. As a result, fixed income has not performed as well as expected, but real yields are still favorable. After the election markets have reacted strongly on expectation of reflationary policies of the upcoming Trump Administration that is likely see higher growth, inflation and interest rates ahead in 2025.

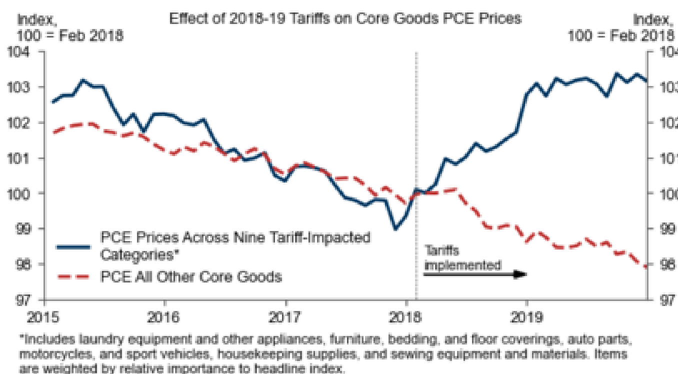
2025 Outlook

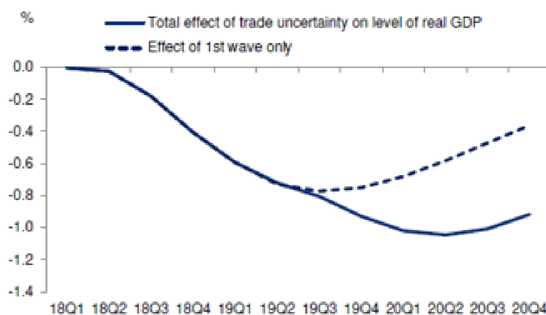
The US economy is currently performing well. Starting in 2025 the strong organic growth drivers of the new cycle will start to be overlayed with the reflationary economic policies of the new administration. The job market should remain strong with good income growth and underpinned by increased investment. With the addition of the new administration's policy goals, growth as well as inflation are also likely to pick up. The major policy initiatives that will impact both the economy and markets encompass deregulation, taxes, tariffs and immigration.

At this stage we do not have any details of the new economic plans. However, we do have its previous track record from 2016-2020 to give a sense. The impact is key and depends on the scope, scale, timing and ability to execute. As a result, the range of outcomes is extremely broad. **What we are likely to see is much more volatility with fatter tails**.

For example with regard to tariffs, President Elect Trump has already announced that he will immediately enact 25% tariffs on both Mexico and Canada along with 10% on China. It is unclear as to the goal. On the one hand, tariffs might be used as a negotiating tool. On the other hand tariffs might be used to decouple the US from the world leading to more isolationism. The former would be less inflationary while the latter more inflationary. As a result, trade policy uncertainty is high. Tariffs were used in the previous administration which raised inflation and reduced economic growth:

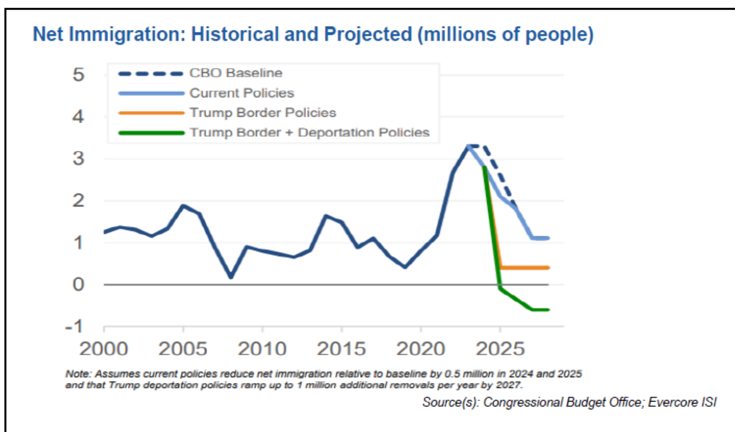






The result of lower economic growth accompanied by higher inflation was negative for both stocks and bonds. In the upcoming administration, a major trade escalation/ trade war would have significantly negative consequences for both the economy and markets.

Similarly, curtailing immigration can have a wide range of impact depending on the severity of the policy. For example, removing several million workers from a tight job market will have a greater impact than only removing a few hundred thousand. Both history and economic theory show that immigration is very positive to the economy by raising growth and lowering inflation. The increase in immigration post 2021 allowed the US economy to grow and keep wage inflation down.



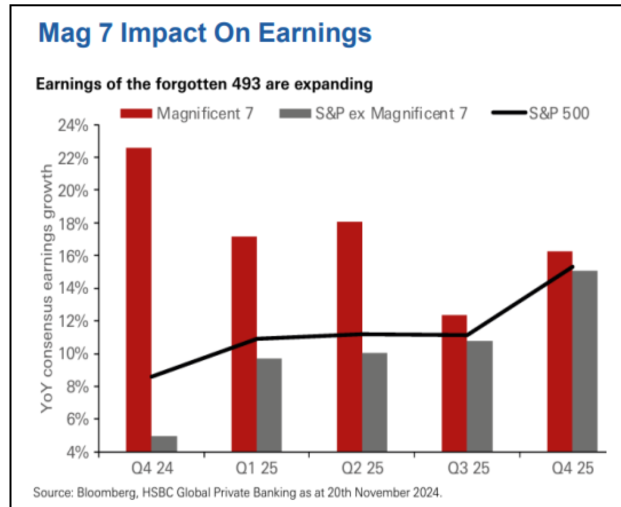
ISI estimates that the new administration's immigration policies will be a drag on GDP of 0.4% per year for 2025 and 2026. That stands in contrast to the 0.4% boost to GDP estimated in 2023. The chart to the right shows different scenarios comparing border restrictions as well as border restrictions plus deportations on net immigration. Tighter immigration has negative effects on growth and inflation is likely to be negative on both stocks and bonds.

Other than broad comments about deregulation, very few specifics have been mentioned. Deregulation eases the costs and frictions of doing business. It is broadly positive for the economy by increasing growth and reducing inflation. The 2017 Trump tax cuts (Tax Cuts and Jobs Act) are very likely to be renewed. For the economy, new tax cuts might have the most impact on capex investment which should support equities. However, by increasing the deficit interest rates might rise and be negative on bonds.

These are generalizations-- what is needed is actual policy pronouncements to ascertain scope, scale and speed. Moreover, execution of policy is key. But broadly, we have summarized the general impacts of the four major policy initiatives to the right. **The major risks are trade restrictions and immigration which have the potential to become supply side shocks.** However, those could take time to develop.

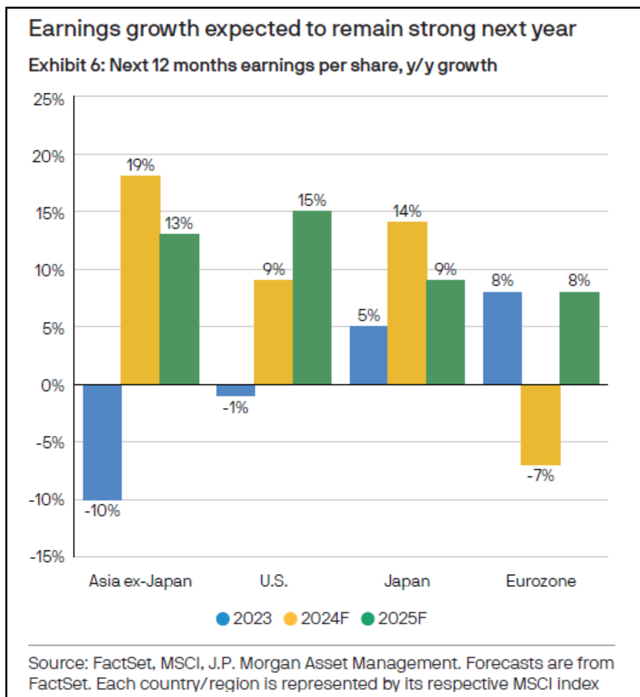
	Economic Impact			Market Impact	
Policy Area	**Growth**	**Inflation**	**Rates**	**Stocks**	**Bonds**
1. Deregulation	↑	↓	↓	↑	↑
2. Lower Taxes	↑	↑	↑	↑	↓
3. Less Trade	↓	↑	↑	↓	↓
4. Less Immigration	↓	↑	↑	↓	↓

Overall, the economic landscape is constructive for embracing investment risk in 2025, in our opinion.



We are positive on US equities. However, a lot of good news since the election has already been baked into valuations which are starting to look frothy. Due to high valuations, markets are unlikely to get significant multiple expansion, particularly if rates have bottomed. As a result, returns should be driven more by earnings growth and dividends. However, the broadening out which started in 2024 should continue in 2025 as seen in the chart on the right side. The broadening out means that value, particularly cyclicals such industrials, materials, along with utilities should perform well. These sectors benefit from higher domestic investment. Moreover, mid and small caps should benefit from deglobalization as these companies are more domestically oriented.

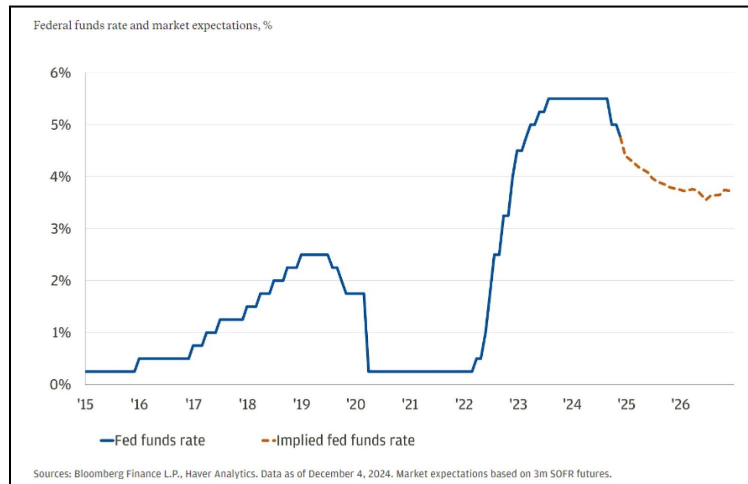
Near term drivers should also support the market. More concrete details of tax cuts and deregulation should not only boost sentiment but raise expectations of future earnings growth. This could also coax money of the sidelines and attract foreign capital into US equities thereby providing a liquidity boost.



Developed market equities are likely to be negatively affected by tariffs and see weaker currencies vs. the US dollar. Europe particularly should be more negatively affected. Japan should hold up better due to the domestic nature of corporate governance improvement.

Among emerging market equities, India should remain positive due to strong internal dynamics such has increased investment and consumption. However, China could face larger headwinds due to higher tariffs. China is likely to deploy more stimulus to offset a slowdown in exports.

Fixed income is likely to be tricky in 2025. Core bonds have attractive yields which can hold up if yields stay higher for longer. Recent comments from Fed officials along with strong economic data and stubborn inflation readings, lead us believe that the Fed will reduce rates much less than expected (if any at all). With the expectation of reflationary policies, markets have further reduced the number of expected rate cuts in 2025. As of December, it expects 2 to 3 rate cuts in 2025, down from 6 after the September FOMC meeting. If that number is reduced further, yields should rise.



Moreover, what is critical is the sequencing, scope and speed of a reflationary policy rollout could have a significant impact on inflation. Moreover, a higher debt/GDP caused by those policies may require an increased term premium as well. With higher economic growth, higher inflation, and a larger term premium becoming more likely, **we should be on guard to the risk that yields rise further**.

As a result, extending duration risk is not advisable. Instead, investing in the “belly of the curve” (3 to 5 year duration) allows an investor to obtain favorable yield without taking too much interest rate risk vs extending duration out too far in case rates rise. In the event that rates actually fall, the belly of the curve is still more advantageous than staying ultra short in cash due to reinvestment risk as rates come down.

The following is a brief outlook for other sectors:

- Leveraged credit- higher economic growth is supportive of credit risk and positive for both high yield bonds and loans. Although spreads are very tight, yields are attractive.
- Real assets are inputs to economic activity, and as result, we are positive for infrastructure and commodities. Energy is mixed—more supply is negative for oil prices but higher demand is supportive. Real estate prices, on the whole, have appeared to have bottomed, cap rates and peaked and net operating income should start to grow.
- Private equity should benefit from a regulatory regime that supports increased M&A.
- Hedge funds might benefit from higher volatility.
- Crypto might benefit from a more regulatory friendly backdrop.

While the economic backdrop and fundamentals are sound, we should caution that US asset markets have rallied strongly since the election on the back of very positive expectations of new policy. By and large, the risks associated with those policies have not been included, in our opinion. **Those risks should start to manifest and likely raise volatility as the polices of the new administration take shape over the course of 2025**. Organic economic growth, underpinned by the new cycle, is strong and supportive of markets. However, if negative policies such as trade and immigration are emphasized, markets will be more challenged. If the focus is on positive policies such as tax cuts and deregulations, markets can do well. This is the essence of the tail risks that will be faced in 2025 which can create **a broad range of outcomes for both the economy and markets**. The key will be the scope, scale and smoothness of policy execution and communication.

Our Global Macro committee will be meeting in coming weeks and we expect to publish specific and more detailed asset class guidance. We will be closely watching how end of year macro indicators come in and what policy unfolds from the new administration. The overall outlook appears favorable for US equities while the environment is generally challenging for equities outside the US. In fixed income the landscape should be supportive of "moderate" duration in the US.

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