2025 *Capital Markets Outlook*

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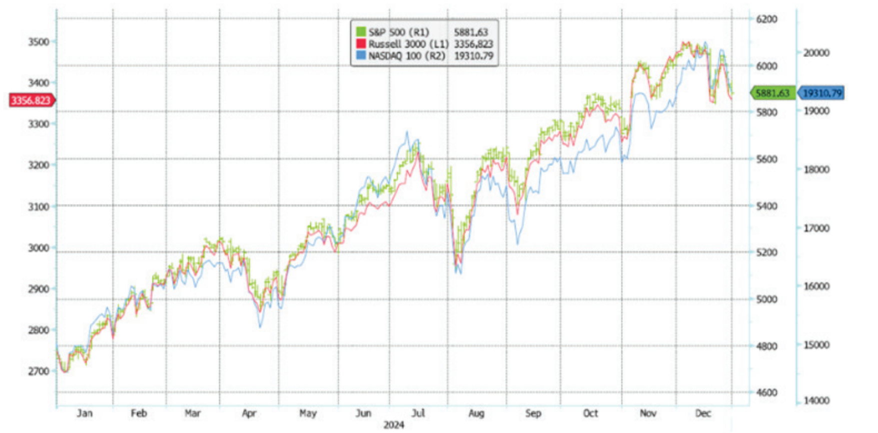
Where we were, where we are headed

US Equity Indices



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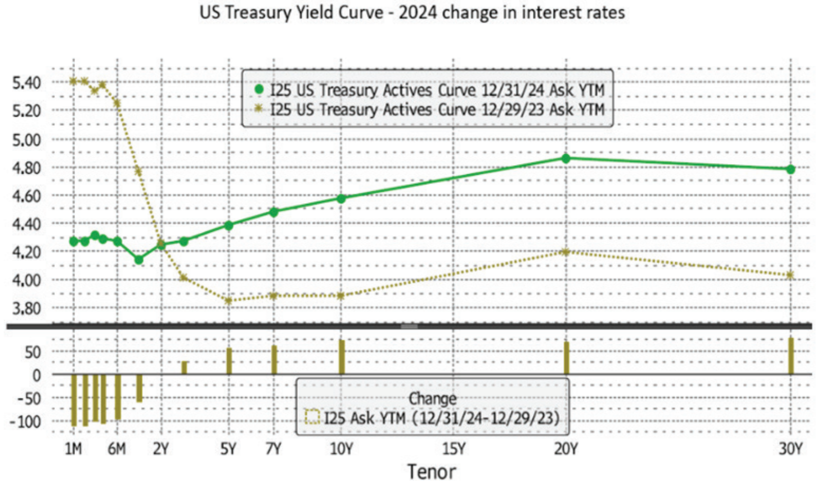
2024 was another remarkable year for the capital markets. The continuation of AI momentum combined with a pivot in US central bank policy along with pro-growth expectations for the incoming Trump administration powered equity markets to new heights. Despite a year-end pullback, the major equity indices S&P 500, Russell 3000, and NASDAQ still managed to post stellar performance, returning 23.3%, 22.2%, and 28.6% for the year. Including 2023, these indices generated an astounding 53.2%, 51.4%, and 84.5%, the strongest two-year performance since the late 1990's.

Credit markets moved largely in line with equities. Despite a meaningful sell-off in late Q2, investment grade corporate spreads reversed sharply to return 5.0% for the year while providing performance stability. High yield corporate bonds saw performance of nearly 9.0%, a level consistent with long-term equity returns.

Currencies reflected the elevated geopolitical risk and diverging economies around the globe. A resilient US economy relative to the rest of the world combined with delayed Fed policy action compared to other central banks resulted in a strong USD. Indeed, the USD gained against every major currency over the course of 2024, considerably so in many cases.

US interest rate volatility remained elevated as well. Expectations for a Fed policy pivot that was ultimately realized resulted in a rally across short-term interest rates. However, the persistence of inflation combined with rising concerns around US debt levels and the risk of increasing budget deficits caused long-term interest rates to materially sell off. The net effect was a substantial twist in the term structure. While these actions helped to normalize the shape of the yield curve, performance across varying bond maturities differed markedly.

US Treasury Yield Curve - 2024 change in interest rates



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As we assess this landscape and evaluate forward-looking geopolitical, economic, and policy data, it is our view that the capital markets will be driven by three key forces in the year ahead and beyond. Specifically, these are: diverging global economies, the path towards a neutral Fed Funds rate, and the incoming Trump administration's policy positioning. Our near to mid-term investment strategies are expected to center around these three themes as we believe they will prove to be consequential, providing tailwinds for certain market segments while acting as headwinds for others.

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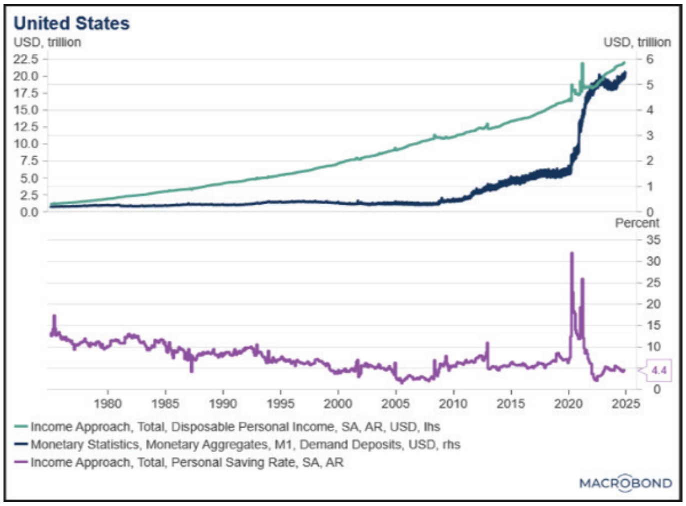
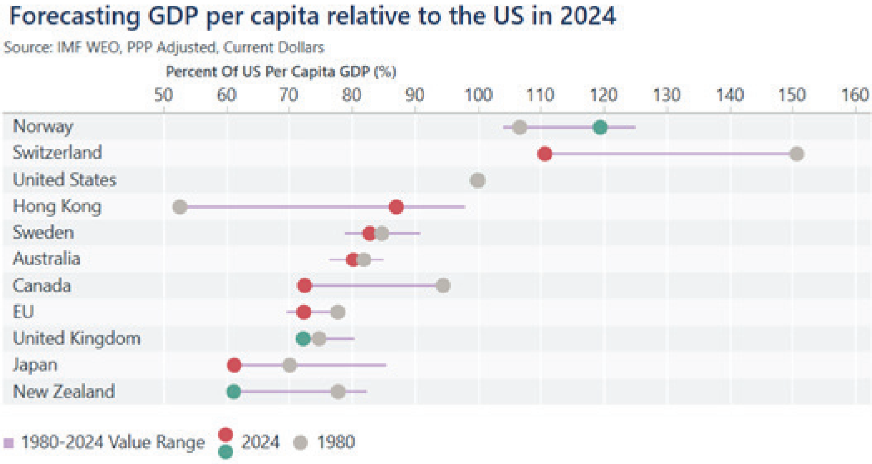
The Global Economy … US vs Rest of World

With a resilient labor market, steady consumer spending, and inflation that has moved towards the Fed's 2% target, the US economy seems poised to achieve a soft landing. The lagged effects of the Fed's restrictive policies should continue to combat inflation while the strength of the labor market and health of the US consumer is expected to propel the economy further. Disposable income and money supply, i.e. currency, savings, and demand deposits, have reached multi-decade highs at $22T and $5.5T. These data points indicate that ample capacity remains for consumption and investment. However, the total personal savings rate has fallen precipitously from the levels seen during the pandemic, though it could be argued that COVID-era savings levels were anomalies. Nevertheless, the current savings rate of 4.4% remains above the levels seen during the mid to late 2000's.



Outside of the US the outlook is less optimistic. Eurozone economic growth has been mixed, intermittently supported by the Paris Olympics and exports. The manufacturing sector has stalled, most notably in Germany. This complicates the outlook given the importance of German manufacturing to the EU economy. Further, the recent Draghi report identified that weak productivity and significant underinvestment are expected to progressively erode Eurozone competitiveness. Significant investments are required across technology, labor, and infrastructure to narrow the gap with the US and promote industrial policy. The UK outlook is stronger by comparison, however that economy is likely to suffer as an indirect consequence of Eurozone headwinds. Even after Brexit, the EU remains the most important trading partner accounting for over 40% of UK exports.

Among Asian economies, the outlook for China remains a key concern as economic growth has failed to meet the government's goal of 5%. Domestic consumption has been stifled as consumers deal with a notably diminished property market and high youth unemployment. Manufacturing and exports have softened, and the economy faces further challenges given the specter of US tariffs. While the investment community welcomed the announcement of coordinated monetary and fiscal support, details have yet to be specified by the government.



Japan continues down the path of raising interest rates after over a decade of negative-rate policy. This is in direct contrast to the actions of every other developed market central bank. Growth has been pedestrian given sluggish domestic consumption however expanding wage gains have improved the outlook. Be that as it may, labor force demographics and productivity are barriers to the long-term growth outlook of the Japanese economy.

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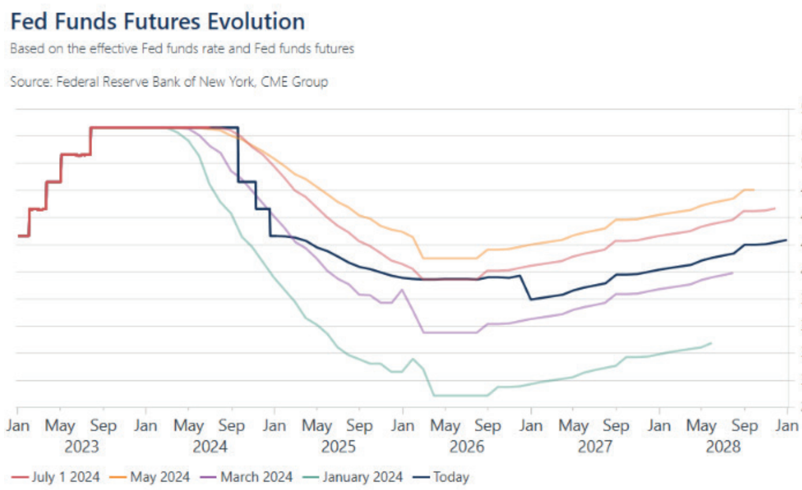
A comparison of per capita GDP shows all major currency economies trailing the US, except for the Nordic nations. Further, only Norway and Hong Kong are operating at the upper end of their 45-year per capita GDP range. The remaining major economies are producing near their 45-year range lows.

Following a year of significant elections around the globe where the incumbent party was overwhelmingly rejected, newly elected officials face the difficult task of managing fiscal deficits under precarious economic conditions. This is exacerbated by the ongoing military conflicts in the Ukraine and Middle East and further include the risk of military escalation along the Taiwan Strait. Despite the political and economic tightrope in the US, conditions abroad make a compelling case for a domestically focused investment strategy.

The balancing act of Fed policy

The unknown impacts of new government policies are expected to complicate the Fed's ability to manage its dual mandate. Labor conditions remain buoyant however the downward trend of inflation has stalled. Though well below peak levels, inflation persists in a range above the Fed's 2% target. Additionally, a real risk exists for an uptick in inflation given the policies under consideration by the incoming Trump administration. These conditions suggest that the central bank may not cut the Fed Funds rate as much as originally expected.

Market participants have adjusted, and current pricing of Fed Funds futures reflects a much shallower path for rate cuts going forward. While the Fed cut rates three times in 2024 for a total of 100 basis points (1.0%), markets now expect approximately two additional cuts totaling another 50 basis points (0.5%) between now and Jan 2027. This places the neutral Fed Funds rate near 3.75%, a full percentage point higher than earlier expectations, reflecting a significant shift in market sentiment. Still, the Fed's wish to orchestrate a soft landing keeps the option of further rate cuts in play.



The implications to fixed income strategy are clear. The recent rise in long-term interest rates makes long duration bonds more attractive from an income standpoint. However, given their sizeable price sensitivity and the risk of long-term interest rates moving higher, either from rising inflation expectations or an increase in US debt issuance, duration lengthening must be done judiciously. Conversely, with Fed rate cuts expected to slow and a yield curve that has largely normalized, the relative attractiveness of short-duration fixed income has lessened. Concerning credit assets, the rally in investment grade and high yield debt over 2024 has brought corporate credit spreads back to pre-pandemic levels. History shows that further credit spread compression is possible, however with equity valuations near historic highs, the risk of Fed policy error, and unknow effects from government policy, prudence recommends a fixed income strategy centered around quality with a controlled level of credit spread sensitivity.

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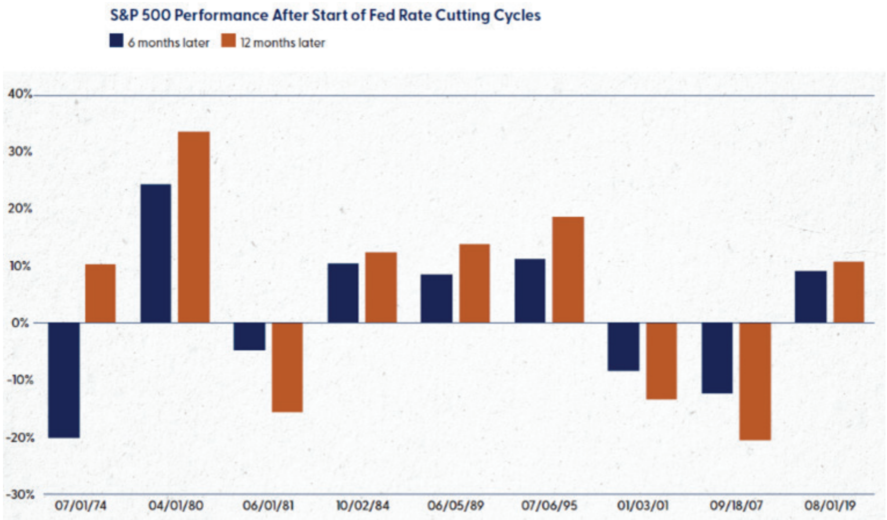

Equity strategy under a Fed rate cutting cycle is more nuanced. A study of the past nine Fed rate cutting cycles dating back to 1974 shows that equities typically move higher in the 6mos and 12mos periods following central bank rate cuts. The three cases where this did not hold, as in '81, '01, and '07, are attributed to recessions.

As prevailing economic conditions are inconsistent with an impending recession, history suggests that the equity bull market of the last two years has further room for expansion in 2025. That being said, return expectations should be tempered. In the six expansionary periods under review, S&P 500 performance ranged between 10% and 33% and averaged approximately 16% over the trailing 12mos following Fed rate cuts. This is in comparison to the benchmark's 2023 and 2022 performance of 23.3% and 24.2%.

In addition, we believe interest rate sensitive sectors such as financials, utilities, and real estate stand to benefit as the Fed continues down their rate cutting path, shallow or otherwise. Further, small and mid-sized companies should also gain from Fed rate cuts as their cost of capital tends to be floating or short dated in nature. We expect those sectors and segments to perform well as the Fed continues cutting interest rates, though we caution that investors will likely have to endure a higher degree of volatility along the way relative to Large Caps.

What might we expect with Trump 2.0?

On the campaign trail, President-elect Trump identified policy changes across four areas of focus: trade, fiscal, regulation, and immigration. Of the promises made, trade policy changes are likely to be enacted first. Since the 1930's Congress has authorized the President to negotiate trade agreements and adjust US tariff rates on behalf of the American government. With this unilateral authority, it is probable that tariffs will be put into effect soon after Trump enters office. Whether the 10% across-the-board tariffs on all trading partners, including the 60% levies on Chinese goods, are ratified remains to be seen. The overwhelming consensus among economists is that tariffs are ultimately inflationary and intrinsically this may moderate the scale and scope of the policies instituted. Furthermore, retaliation by trading partners is likely which could dampen economic growth. It is plausible that these considerations are part of Trump's decision calculus. Of course, Trump has threatened the use of tariffs to address issues such as the border and immigration, making the matter every bit a negotiating tool as it is a revenue generation mechanism.

Fiscal policy requires Congressional approval and as such are beyond Presidential mandates. Nevertheless, with Republican control over both chambers of Congress fiscal policy changes are likely in the coming year. Republicans seem intent on extending the 2017 tax cuts which were scheduled to expire in 2025. Other fiscal issues include, lowering corporate taxes for domestic manufacturing, state and local tax deductions (SALT), a proportion of overtime pay and tips tax exclusions, and limitations on "green" subsidies to name a few. While tax cut extensions are not expected to provide fiscal stimulus, additional corporate and individual tax relief should provide a lift.

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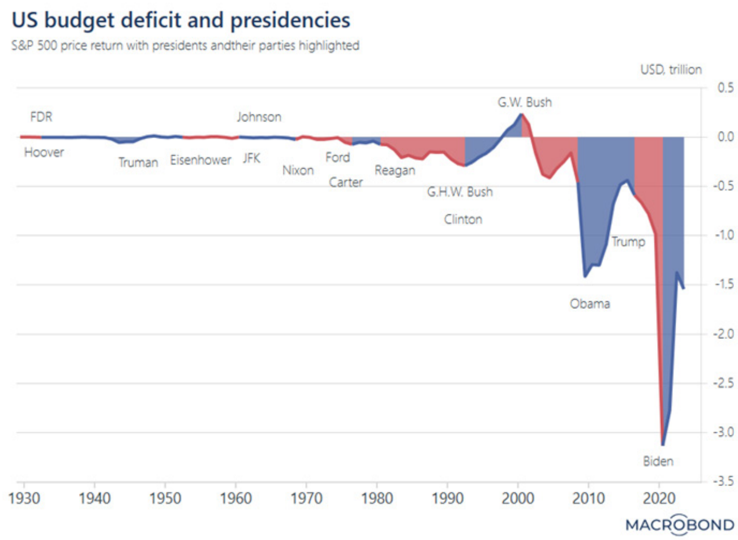
A more tolerant regulatory environment is expected to unfold under Trump's next administration, which could support economic growth over the near term. Details have yet to be provided however the industries expected to benefit from more lenient regulations include the financial and energy sectors. Yet, a restrictive immigration policy could counteract economic growth. US labor force grew 1.6% between 2022 to 2023, the highest growth in over 20 years. More than half of that growth was attributed to "foreign born" workers, likely including undocumented immigrants. Tighter immigration policies could lead to slower labor growth in the years ahead. This would reduce not only labor output but also consumption. The industry sectors most likely to be impacted by a reduction in "foreign born" labor supply include agriculture, construction, and leisure and hospitality.



The connecting thread between these policy agendas is government funding. The US budget deficit spiked significantly during Trump's first administration but has declined materially over Biden's term. Admittedly, this deficit was in response to the COVID pandemic and related recession. Nevertheless, deficit levels remain near the peak of the Global Financial Crisis (2007-2009), and well above the level when Trump first took office. The risk of a slowing US economy due to potential trade wars, probable reduction in tax revenue, and possible contraction in the labor force and consumption would ultimately require greater levels of debt financing and further increase budget deficits. The impact across the capital markets is an increase in long-term US treasury rates. As expected, the interest rate market has repriced for this risk. Since Oct 31, 2024, just prior to US elections, long-term treasury rates have risen 50 basis points (0.5%). While this move has been detrimental to fixed income valuations, it does set bond yields higher which is ultimately attractive for income-focused investors. That said, the risk of long-term rates increasing further does exist, and is a concern that must be closely monitored.

In Summary ...

We expect the capital markets to be driven by three macro forces in the year ahead: global economy divergence, US central bank policy action, and policy positioning of the incoming Trump administration. We recommend an overall investment strategy which looks inward to the domestic markets given the economic and geopolitical challenges abroad. Regarding fixed income, we advise monitoring Fed policy and the paths of interest rates across the short and long ends of the yield curve to guide strategy. Concerning risk assets such as equities and credit, we believe strategies should incorporate the policy effects coming out of the new administration. Lastly, we advise vigilance given elevated geopolitical risk and recommend diversification to protect against exogenous shocks, while at the same time advocate for maintaining flexibility to capitalize on market shifts and dislocations.