FIRST QUARTER 2025

# INVESTMENT COMMENTARY

## Policy Uncertainty Will Drive the Markets in Early 2025

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Looking through the noisy data in recent months, we think the US economy is doing well. GDP growth is near its short-run potential, unemployment is low, consumers are spending, and manufacturing is showing signs of improvement. One risk to the near-term forecast is the potential for a US port strike. The International Longshoremen's Association ended a three-day strike at certain East Coast and Gulf Coast ports until mid-January. A further strike would cause full work stoppages at ports that handle nearly 35% of all US imports and exports, with the biggest impacts on trade coming from the Ports of New York-New Jersey and Houston-Galveston. We estimate that for each week a strike occurs, it would take a month to clear the backlog, partly because West Coast ports are approaching capacity. However, assuming this headwind is avoided the U.S. economy should start 2025 on a solid footing. Barring major external shocks on the geopolitical front – a big if, given the turbulence in the Mideast, the unsettled Russian/Ukrainian conflict and a looming trade war – it should deliver another year of decent growth. We look for GDP to increase 2.3 percent in 2025, following an estimated 2.8 percent in 2024.

Policy uncertainty is a big wildcard in our outlook. As expected, the Fed cut rates for the third time at its December 17-18 meeting but signaled that it would be more cautious going forward than predicted at the September meeting, when the Summary of Economic Projections (SEP) pointed to four rate cuts in 2025. At the December meeting, that number was scaled back to two, as growth has held up better than expected and inflation has been stickier. We agree that a shallower path of rate cuts is likely, but caution that the Fed relies heavily on backward-looking data that may be a poor guide for policy decisions, as they do not fully capture the lagged effect of past policies. What's more, government statisticians who compile the data are coping with ever-lower response rates from the sources providing the data. But as Fed Chair Powell has repeatedly said, "we deal the cards we have". Hopefully, the deck is not utterly misleading, resulting in bad policy decisions that can lead the economy down the wrong path.

In addition to potential missteps by the central bank, there is also the uncertainty surrounding fiscal policy. Will the tax and spending intentions of the incoming administration be contractionary or expansionary? The proposed spending cutbacks would argue for the former, while lower taxes would argue for the latter. Then there are the much-touted tariff increases, which could go either way depending what is actually implemented and on the response of trading partners. Keep in mind that the President proposes, but Congress disposes when it comes to spending and taxes, so campaign promises are not cast in stone. Simply put, speculation over monetary and fiscal policy will be a popular parlor game over the next several months, which sets the stage for heightened volatility in the financial markets.

## Tough Talk on the Budget

One of the top priorities of the incoming administration is to bring the Federal budget under control. The huge deficit financing underway since the Covid recession has sent the budget more deeply into the red. According to the latest estimates by the OMB, the U.S. deficit will exceed 6 percent of GDP in fiscal 2025 for the third consecutive year, an extraordinary share during expansions and high employment. Over the past 30 years, which includes the Great Recession and the steep, but brief, Covid recession, the deficit averaged less than 3 percent of GDP.

Scott Bessent, the nominee for Treasury Secretary, has called for slashing the deficit to 3 percent of GDP by the end of President-elect Trump's second term. The incoming president has also tapped Elon Musk and Vivek Ramaswamy to jointly lead the newly created Department of Government Efficiency, commonly referred to as DOGE to assist in the effort, and Musk has floated the eye-grabbing figure of $2 trillion in spending cuts. Unsurprisingly, there is a growing perception that federal outlays will be reined in significantly. However, we're not fully buying into all the tough talk.

For one, $2 trillion in spending cuts, which would amount for a third of the federal budget, is unrealistic. During the campaign, Trump promised to protect Social Security and Medicare, which together make up a third of federal spending. Net interest on the debt accounts for another 15% of spending, and interest payments cannot be missed. For another during his first presidency, Trump reliably requested more funding for the Departments of Defense, Veterans Affairs, and Homeland Security. It's hard to believe that these three departments would be on the chopping block, which removes another 20% of spending from any budget-slashing effort. Hence, two-thirds of federal spending would be off limits. Massive cuts to the remaining third of the budget would be a tough sell for members of Congress, who time and again have hesitated to cut even small programs they believe benefit their constituents.

## Muted Economic Impact

Nearly two months have passed since the election and the policy landscape under a second Trump presidency remains as uncertain as ever. We suspect that the Republican-controlled Congress will squeeze some savings out of the budget, but not enough to have a material impact on economic growth. Modest spending cuts will likely be mostly offset by lower taxes, rendering the fiscal impact a wash. The higher probability of tariff increases, however, could be felt, particularly in the form of higher prices.

True, the tariffs imposed during the first Trump presidency – which were largely retained under the Biden administration – did not have a significant impact on inflation, which remained well under control until Covid hit. But the tariffs then were imposed on a far more limited scale than is now being proposed. Many believe that the aggressive tariff proposals are more of a negotiating tool to force trading partners to meet certain conditions unrelated to trade, such as tightening borders and clamping down on illegal drug trafficking. That notion has merit.

What's more, an adverse reaction in the financial markets or in the polls might also cause a reassessment by the administration. Keep in mind that someone must foot the bill linked to higher tariffs. Either companies will pass on the additional costs of imports to consumers – boosting inflation – or they will absorb the costs, leading to lower profits. Neither would be favorably received by consumers or investors. Again, there is a lot of uncertainty overhanging the policy landscape so time will tell how the incoming administration's plans shape up and how they play out.

## The Fed's Hawkish Cut

To be sure, monetary policymakers will not sit idly by as events on the fiscal front unfold. The Federal Reserve, however, is in somewhat of a bind. Like everyone else, it too does not know what will be coming out of Washington in 2025 and is reluctant to base policy decisions on speculation.

That said, the message sent at the December 17-18 policy meeting suggests that some officials expect more inflation than otherwise due to higher tariffs and deportations that could reduce the labor supply and boost wage growth.

Hence, even as it cut rates by another quarter point, as expected, at the meeting, it also signaled that it would not be lowering rates as many times next year as the FOMC predicted in September. The median expectation of the 19 members of the rate-setting committee is for two cuts rather than the four penciled in three months earlier. True, the shallower path of rate cuts was expected in the financial markets, as both economic growth and inflation were running hotter than predicted a few months ago. But investors still reacted poorly, as stock prices tumbled, and bond yields spiked in the immediate aftermath of the meeting.

It’s unclear if the negative market reaction was a case of “buy on the rumor and sell on the news” or something deeper. Curiously, the outlook for growth and employment in 2025 hardly changed from the predictions made in September. GDP was revised up by a slim 0.1 percent and the unemployment rate was revised down a tick from 4.4 to 4.3 percent. Despite the small moves in these fundamentals that drive inflation, the forecast for inflation in 2025 was revised significantly higher, to 2.5 percent from 2.1 percent in the September SEP. This implies that, subjectively at least, some Fed officials view the Trump’s tariff and proposed deportations as having an inflationary impact.

## Shifting Perceptions Will Likely Continue

If one thing is clear from the experience over the past several months, nothing should be taken for granted. Back in September, when the Fed cut rates by a jumbo half-percent, conditions looked bleak. Many thought that the aggressive rate hikes in 2022 and 2023 aimed at curbing inflation would, in time honored fashion, also send the economy into a recession. Indeed, those expectations looked prescient over the spring and summer, as job growth slowed, consumers were pulling back, and household confidence was sinking. Importantly, inflation cooled significantly, moving rapidly towards the Fed’s 2 percent target.

Unsurprisingly, the Fed’s priorities shifted, from focusing on curbing inflation to keeping the job market – and the overall economy — afloat. Even as conditions stabilized during the fall, policymakers thought it prudent to take out insurance against the risk of recession, cutting rates by smaller amounts in November and December. But it soon became clear that the economy was holding up much better than the Fed expected and, critically, that the retreat in inflation hit a wall, remaining stubbornly elevated well above the Fed’s 2 percent target in recent months.

Predictably, the mindset of the Fed is changing once again. The latest decision on December 18 was dubbed a hawkish rate cut because of Powell’s signal that the path of future rate cuts will be shallower than predicted in September. Powell’s message is a tacit admission that the aggressive rate hikes in 2022 and 2023 did not inflict as much pain on the economy as expected. Hence, the risk of keeping rates higher for longer has diminished. At the same time, inflation is proving stickier than thought, smoldering rather than simmering, which could be rekindled if rates are cut too far.

As we enter 2025, the lesson to take from 2024 is that the Fed officials will remain nimble in shaping policy, and humble in their forecasting abilities as this post-pandemic economy is evolving unlike previous recoveries. Meanwhile, the incoming administration is pursuing controversial policies that could have unintended consequences. That combination sets the stage for sustained investor uncertainty and heightened market volatility. From our lens, the economy should extend the trends seen in the last half of 2024 – above-trend but moderating growth amid a bumpy disinflationary ride – but the markets will be driven by shifting perceptions as much as by fundamentals.

# Rates and Total Returns Quarterly And Annual Comparison

| U.S. Treasury Market | | | | Total Return (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| 6 Mo Bill | 4.41 | 5.25 | 4.27 | 1.15 | 5.43 |
| 2 Year Note | 3.65 | 4.25 | 4.25 | -0.19 | 3.79 |
| 5 Year Note | 3.56 | 3.85 | 4.39 | -2.69 | 1.19 |
| 10 Year Note | 3.79 | 3.88 | 4.58 | -5.19 | -1.73 |
| 30 Year Note | 4.12 | 4.03 | 4.78 | -9.38 | -8.09 |

| Municipal Bonds | Yield (%) | | | Total Return (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| Barclays General Obligation Index | 3.11 | 2.94 | 3.53 | -1.18 | 0.55 |
| Barclays New York Bond Index | 3.34 | 3.19 | 3.74 | -1.20 | 0.84 |
| Barclays California Bond Index | 3.10 | 3.01 | 3.50 | -1.09 | 1.02 |
| Barclays Revenue Index | 3.42 | 3.35 | 3.84 | -1.25 | 1.22 |

| Equities | Levels | | | Total Return (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| S&P 500 | 5762.48 | 4769.83 | 5881.63 | 2.82 | 25.37 |
| DJIA | 42330.15 | 37689.54 | 42544.22 | 1.00 | 14.98 |
| Nikkei (Tokyo) US $ Terms | 37919.55 | 33464.17 | 39894.54 | 5.31 | 21.14 |

| Commodities | US $ | | | Percent Change (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| Gold Comex Spot ($ per oz) | 2634.58 | 2062.98 | 2624.5 | 12.80 | -0.38 |
| CRB Future Com. Pr. Index* | 284.94 | 263.8254 | 296.72 | 2.15 | 4.13 |
| W. Tx Int. Crude ($ per bbl.) | 68.17 | 71.65 | 71.72 | -12.04 | 5.21 |

| Currencies | Levels | | | Percent Change (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| Yen | 143.63 | 141.04 | 157.2 | -2.29 | 9.45 |
| Sterling | 1.34 | 1.2731 | 1.2516 | -1.02 | -6.42 |
| Euro | 1.11 | 1.1039 | 1.0354 | -3.35 | -7.01 |

| Global Bond Markets** | Levels | | | US $ Terms (%) | |
|---|---|---|---|---|---|
| | 9/30/2024 | 12/31/2023 | 12/31/2024 | 4th Qtr | 1Yr |
| German 10 year | 2.12 | 2.02 | 2.36 | -1.17 | 0.23 |
| Japanese 10 Year | 0.85 | 0.61 | 1.09 | -1.63 | -4.28 |
| UK 10 Year | 4.00 | 3.53 | 4.56 | -3.89 | -4.60 |
| Barclays US Emerging Market | 7.13 | 7.04 | 7.13 | -1.43 | -0.96 |

Source: Bloomberg Financial Data

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

** Global Bonds Represented by Bloomberg Barclays Indices

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