

## ECONOMIC OUTLOOK

### *Summary*

Gross Domestic Product (GDP) growth exceeded 3% in both the second and third quarters of 2024, following data revisions released in mid-December. Current projections for the fourth quarter suggest GDP growth near the mid-2% range, though official data will not be available until late January. If these estimates hold, 2024 will mark a full year of above-trend growth, defying initial expectations of slower growth due to the Federal Reserve's restrictive monetary policy. Growth in the fourth quarter was partly driven by another strong month of retail sales in November, indicating the consumer is still well positioned heading into 2025.

The labor market presents a more nuanced picture. The aftermath of hurricanes and labor strikes in the fourth quarter introduced noise into the data set, but December job growth is expected to be around 160,000, with the unemployment rate holding steady at 4.2%. As the data is stabilizing, the upcoming jobs report will prove even more critical in determining whether the employment market is softening under the strain of restrictive policy. Wage growth and labor force participation will also be closely watched, as both directly influence consumer spending, a key driver of future GDP growth.

The Federal Reserve has signaled a more cautious approach to monetary policy in 2025 after cutting rates by 25 basis points (bps) in December and 1% overall in 2024. The Fed's change in tone reflects their commitment to ensuring inflationary pressures are fully subdued. This comes after inflation's decline slowed in 2024, falling short of expectations after significant progress in 2022 and 2023. Market participants now anticipate fewer than two additional rate cuts in 2025, signaling inflation could remain above the Fed's 2% target in the near term.

Adding to inflation uncertainty are potential shifts in policy under the new administration. President Trump has discussed imposing tariffs and supporting tax cuts, which could boost demand and raise production costs. Historically, tariffs drive up prices on imported goods, while higher government spending and deficits could potentially fuel inflationary pressures.

As we enter 2025, the economy demonstrates resilience despite restrictive monetary policy, with solid growth and a steady labor market. However, additional clarity surrounding employment, inflation and the new administration's policies will shape the economic and market landscape in the months ahead.

### *Positives*

Third quarter GDP was revised higher from 2.8% to 3.1%

Retail sales beat expectations in November (0.7% vs. 0.6% est.)

ISM manufacturing reached its highest level in nine months (49.3)

### *Negatives*

Headline CPI year-over-year increased for the second consecutive month (2.7%)

Factory orders were negative and missed expectations (-0.4% vs. 0.3% est.)

Durable goods orders materially missed expectations (-1.2% vs. -0.5% est.)

## EQUITY OUTLOOK

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### *Summary*

The S&P 500 Index declined 2.4% in the month of December with a soft close to what was otherwise a very strong year for equity markets, with the S&P 500 up 25.0% for 2024. The post-election rally that saw breadth improve beyond the recent leaders of a handful of large-cap, growth-oriented stocks quickly reversed. This was evident in the weak performance of value and smaller companies. The Russell 1000 Growth Index closed December up 0.9% and the Russell 1000 Value Index was down 6.9%. The Russell Midcap Index lost 7.0% while the small-cap Russell 2000 Index shed 8.3%.

With economic data points largely constructive for equity markets, it is important to uncover what might be responsible for this quick reversal. After back-to-back years of 20%+ returns in the S&P 500, perhaps the market just needs to take a breather to digest recent gains. The markets may also be coming to terms with the pro-business, anti-regulation, lower-tax-policies agenda of the incoming administration and if they may be offset by the unpredictability of their actions and rhetoric. Regardless, the resumption of the narrow leadership is not considered healthy for equity markets.

As equity investors, we approach 2025 with a bit of caution. Corporate earnings, which have historically driven market performance, are still expected to rise. Improved productivity, driven by technology advances, will aid in that regard. The growth in corporate earnings should provide the positives for performance which may be muted given the recent strong performance of the equity markets.

### *Positives*

Consumer, labor markets and other economic factors remain favorable

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Artificial intelligence and other technological advancements

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Trump's pro-business policy agenda

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### *Negatives*

Market breadth has narrowed

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Elevated trade war risk

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Widespread geopolitical tensions

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### *Unknowns*

The Federal Reserve appears to be slowing the pace of future rate cuts

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## FIXED INCOME OUTLOOK

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### *Summary*

With nearly two months to digest the impact of Trump's return to the White House, as well as the Republican sweep, bond investors are increasingly unsettled. Concerns include the use of broad sweeping tariffs, which could put upward pressure on inflation and the potential for higher Federal budget deficits, which would increase the supply of Treasury debt. While plenty of analysis has been published about those issues, higher yields are most likely due to the well-entrenched expectation of a stronger economy which will require few Fed rate cuts.

Even with the economic outlook increasingly rosy, the Fed again lowered the overnight rate by another 25 basis points (bps) at their mid-December meeting of the Federal Reserve's Open Market Committee (FOMC). Many strategists and prominent investors questioned the need of further easing since the labor market has stabilized from the weakness seen over the summer. Since the first cut in mid-September (50 bps), the Fed has now lowered the overnight rate two additional times for a total of 1%. Yet interest rates continued to rise for the month with the 2-year note increasing by 9 bps to a yield of 4.24% and the 10-year Treasury note leaping higher by 40 bps to end the month at 4.57%. At one point during the month, the 10-year had increased a full 1% from the 3.62% level at which it was trading just a day prior to the first rate cut. The curve continued to steepen reflecting the first month-end since the summer of 2022 in which there was no inversion among the major tenors in any portion of the 2 to 10-year curve.

Corporate bonds offered no refuge either as for the first month since July, credit spreads widened by a handful of bps and corporate bond returns slightly trail those of Treasury notes. Overall, the sharp rise in longer rates led the full investment-grade bond market indexes to monthly returns in the bottom 10% of monthly observations over the past 49 years of index data (-1.64% for the Bloomberg U.S. Aggregate Bond Index). Intermediate maturity benchmarks were in the bottom 15% (-0.62% for the Bloomberg Intermediate Government/Credit Index).

At the December FOMC, the forecast of the individual participants indicated they no longer expect four cuts in 2025 and two more in 2026. Rather, the median forecast now projects just two this year and two additional in 2026. With the overnight rate projected to be 50 bps higher this year and next, it makes sense the rest of the curve would move somewhat higher. That said, we believe current yields adequately reflect the new, higher-for-longer forecast and are not likely to increase much further.

### *Positives*

Yields have moved sharply since the first Fed rate cut

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An increasingly positive slope allows bonds to appreciate as they "roll" shorter

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Fed to continue lowering the overnight borrowing rate, albeit slower pace

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### *Negatives*

Faster economic growth is widely expected

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Tariffs could elevate inflationary pressures again

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Republican control is feared to create larger federal budget deficits

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### *Unknowns*

Ability of the new administration to end Israeli conflict and Russia/Ukraine war

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Forthcoming tax policies and ability of DOGE to cut spending

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