Sit Investment Associates

Global Investment Outlook and Strategy

January 2025

Key Points

- U.S. GDP Growth Base Outlook Increased but So Has Range of Outcomes
- Tug-of-War Between Rival Agendas Dictate GDP Growth & Inflation View
- Higher U.S. Tariffs, Stronger US$, & Weaker China Are Global Headwinds
- Fed Has Abundant Room to Cut Rates; Deficit Concerns Steepening Curve
- Municipal Market Continues to Digest Record Supply With Few Hiccups
- Opportunities for Stock Pickers Outside Big Tech as Market Gains Broaden

In Focus: Valuation and Earnings Trends Signal Broadening but Moderating Market Gains

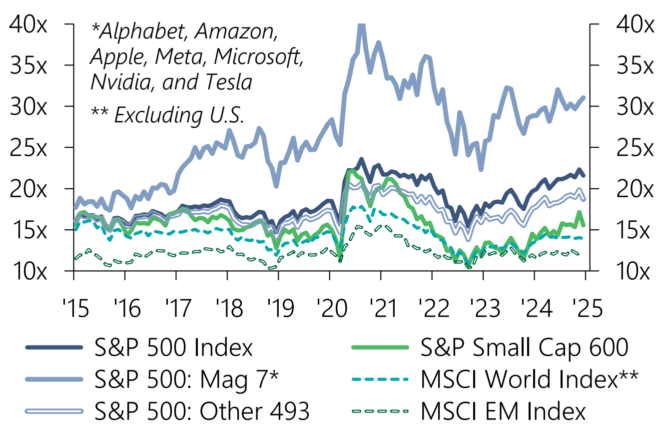
1 Huge Return Dispersion by Style & Region

Total Returns in U.S. Dollars
As of 12/31/24

		Annualized		
	2024	3 Yrs.	5 Yrs.	10 Yrs.
Magnificent Seven	49.1	16.7	28.5	27.3
NASDAQ Composite	29.6	8.1	17.5	16.2
S&P 500®	25.0	8.9	14.5	13.1
S&P 500® (ex. Mag. 7)	15.8	5.8	10.2	10.0
S&P Mid Cap 400®	13.9	4.9	10.3	9.7
MSCI AC Asia Pac	10.0	0.7	3.9	5.6
S&P Small Cap 600®	8.7	1.9	8.4	9.0
MSCI Emerging Markets	8.1	-1.5	2.1	4.0
MSCI World (ex. U.S.)	5.3	2.5	5.6	5.8
MSCI EAFE	4.3	2.2	5.2	5.7

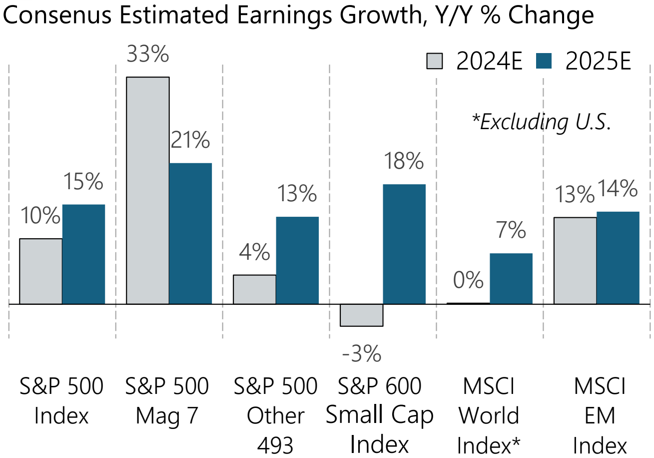
2 Valuations Reasonable Outside of "Mag 7"

Foward Price-to-Earnings Ratios



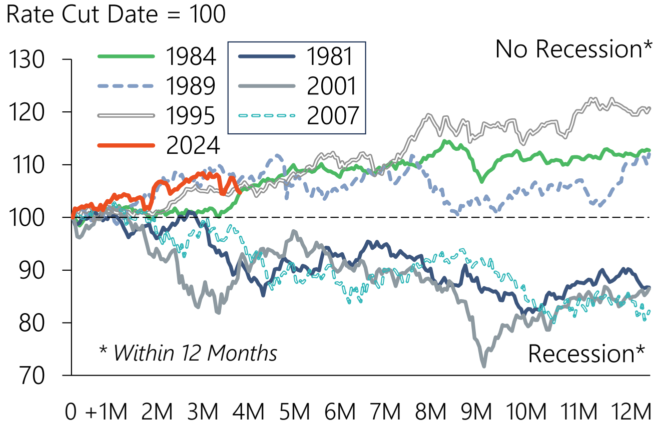
3 Earnings Growth Augur Market Broadening

Consenus Estimated Earnings Growth, Y/Y % Change



4 Easing Cycle Will Lift Stocks as GDP Grows

Avg. S&P 500 Performance After First Rate Cut of Cycle
Rate Cut Date = 100



Sources: FactSet, 12/31/24

Market Will Broaden, and Gains Will Moderate

After two consecutive years of exceptional stock market returns, investors should temper their expectations for this year, as elevated valuations and earnings estimates limit upside potential. Heightened policy uncertainty will also likely lead to higher stock market volatility and more pronounced price swings than seen in the last two years. Be that as it may, resilient GDP growth, slowing inflation, ebbing interest rates, and pro-growth policies support prospects for further market gains. A looming rise in M&A activity and IPOs might also buoy stocks. Low double-digit forward earnings growth and a likely modest contraction in the price-to-earnings ratio imply a possible mid-single-digit gain for the S&P 500 Index in 2025. But much is contingent on President Trump's agenda: is he a master negotiator or a radical disruptor?

The U.S. economy and equities performed much better in 2024 than many had initially expected. As for bonds, not so much. Whereas the yield on 10-year Treasuries and stock price-to-earnings valuations were (inversely) connected at the hip in the preceding years, they parted ways last year. At the onset of 2024, fed funds futures discounted nearly seven 25-basis-point rate cuts for the year against the equivalent of four the Federal Reserve delivered, as economic growth was better and inflation stickier than predicted. Thus, instead of declining as it typically does into monetary easing cycles, the 10-year Treasury yield increased by 69 basis points for the year. Specifically, the yield soared through April, fell through mid-September, and soared again into year-end.

Rising 10-year Treasury yields are usually bad news for stock valuations, especially longer-duration technology stocks. However, the robust earnings growth led by the Magnificent Seven (or Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), equity investors' sunnier outlook, and a dose of fear of missing out (for those not as optimistic) easily overwhelmed any yield pressures. The S&P 500 Index's price-to-earnings ratio expanded by 190 basis points to end 2024 at 21.5 times estimated forward earnings of $273 per share (+15 percent year over year). Hence, the S&P 500 returned +25.0 percent in 2024, on top of its +26.3 percent gain in 2023. High concentration remains a significant issue for large-cap (and tech-centric) equity benchmarks.

At year-end, the Magnificent Seven stocks constituted an astonishing 31 percent of the S&P 500 Index and 52 percent of the Russell 1000 Growth Index. The seven stocks gained +49.1 percent in 2024 (+76.3 percent in 2023) on a market capitalization-weighted basis versus the still-very-robust +15.8 percent return for the other 493 stocks. They also contributed over 13 percentage points to the S&P 500's +25.0 return in 2024 and over 16 percentage points to its +26.3 return in 2023. While market participation broadened considerably in 2024's third quarter, it narrowed again in the fourth, with only 35 percent of S&P 500 constituents outperforming the overall Index (21 percent in December).

Estimated 2025 earnings growth of +21 percent for the Magnificent Seven exceeds the projected cap-weighted growth of +13 percent for the other 493 stocks in the S&P 500 Index However, equity market gains should broaden as the growth gap increasingly narrows. Pro-growth policies should also broaden (and lift) earnings growth and market participation. On the other hand, mounting policy and geopolitical risks may upend the economy and financial markets. Our base estimate for U.S. GDP growth has increased in recent months, as has the range of potential outcomes. While we expect President Trump's policies will not be as punitive as his campaign rhetoric, there will be a tug-of-war between competing agendas (tax cuts and deregulation versus tariffs and immigration).

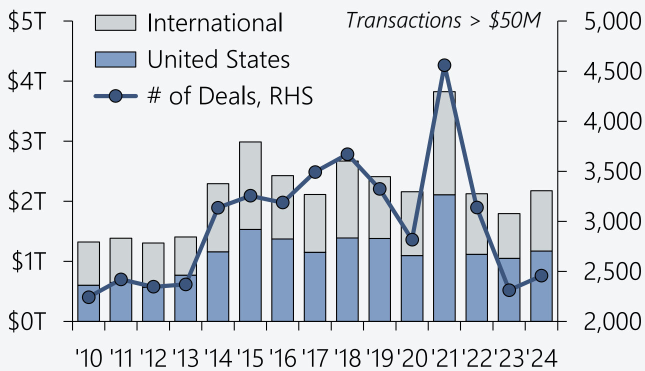
The U.S. economic and financial market setting differs greatly from when President Trump initially took office in 2017. The economy has limited slack, national debt has swelled, corporate profits are at all-time highs, the stock market is more richly valued, and GOP majorities in Congress are far thinner. To avoid pushing the U.S. into recession, the Trump administration and Congress will almost surely extend the expiring provisions of the Tax Cuts and Jobs Act. Yet, passing additional tax cuts will likely be difficult. So, the administration must lean into deregulation and other pro-business initiatives to bolster investment and productivity. The stock market, which Trump views as a barometer of his success, may also help blunt some of the pro-inflationary impulses.

Fiscal policy and its effect on inflation will play a sizable role in the trajectory of interest rates and stock markets. As shown in the chart on the cover, equities historically perform well in monetary easing cycles if a recession is avoided. In December, the Federal Reserve adjusted its forecast to reflect two 25-basis-point fed funds rate cuts in 2025 versus the four predicted in September. Yet, its projections tend to be fickle and should be viewed with some skepticism. With real rates still highly restrictive, the Federal Reserve still has a lot of room to cut further. Nonetheless, given limited slack, policymakers must be cautious not to rekindle inflation by injecting too much stimulus or inducing shocks, possibly via trade wars or overzealous immigration crackdowns.

Lower interest rates, alongside a more lenient approval process under the new administration, could also boost M&A activity, offering support to equities. In 2024, the total deal value of U.S. M&A was -12 percent below the 10-year average, with the number of deals -24 percent below. Per S&P Global, private equity firms worldwide have record dry powder of over $2.6 trillion. Plus, there is another $1.9 trillion in cash and equivalents on the balance sheets of S&P 500 companies alone, excluding the circa $325 billion at Berkshire Hathaway. Industry insiders also predict initial public offerings will rebound in 2025, driven by a rising backlog of candidates. There were 164 IPOs in the U.S. in 2024 (market cap>$50B, ex. SPACS), down from the recent peak of 433 in 2021.

Stage Set for Merger and Acquisition Rebound

Total Deal Value, $ Trillion



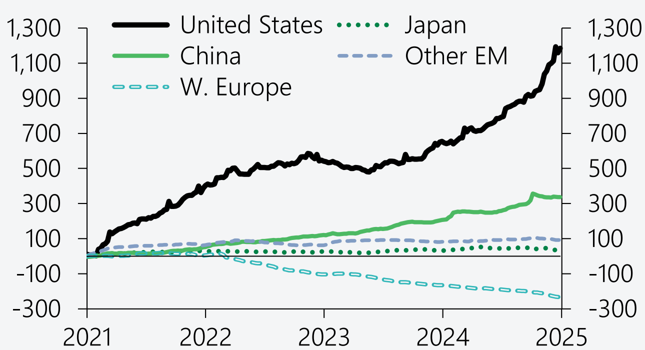
Source: MergerMetrics, 12/31/24

New equity issues will likely meet a receptive audience, with retail investors outright euphoric. The percentage of U.S. consumers expecting higher stock prices twelve months hence spiked to an all-time high in November. Over $260 billion flowed into U.S. equity mutual funds and ETFs in the fourth quarter, taking the running total to over $535 billion in 2024. On the other hand, active U.S. portfolio managers reduced their stock holdings in December and are now at historically average exposure levels, increasing the prospect of incremental buying in the months ahead. Alternatively, Citi's Panic-Euphoria Index signals a high potential for negative stock returns this year, and Goldman Sachs' Bear Market Indicator remains in its "danger zone."

U.S. Equity Mutual Fund and ETF Flows Surging

Global Equity Mutual Fund and ETF Flows

$ Billions, Cumulative



Source: EPFR, 1/2/25

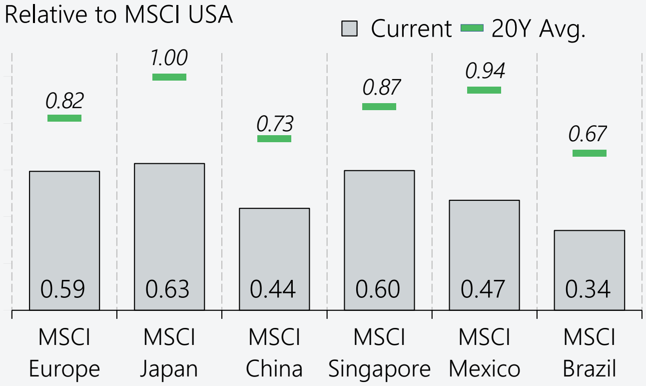
Given the wide range of potential economic and policy outcomes in 2025, portfolio diversification will be vital. Moreover, investor focus will likely shift to sectors and companies well-positioned for growth despite the near-term headwinds. Market gains should also broaden to include dividend-paying, small-cap, and international stocks. Dividend-paying stocks have underperformed since about mid-2022 (coinciding with Fed tightening) but are well-placed to generate better performance as interest rates ebb and earnings growth in key dividend-paying sectors – financials, healthcare, and industrials – accelerate in 2025. Together, dividend-payers should offer downside protection in bouts of increased market volatility.

Small-cap stocks, which have faced challenges owing to stagnating earnings and high interest rates, are attractively valued relative to large-caps and will benefit from a cyclical improvement in the U.S. economy. Smaller firms should also benefit most from any potential tax cuts and a pickup in M&A activity. Still, selectivity is key, given the high debt burdens and margin pressures many small-cap firms face. International stocks also offer compelling investment opportunities, particularly those in markets such as India, Singapore, and Mexico. Although challenges continue in Europe and Japan, selective investments in these regions also offer upside potential. Yet, U.S. dollar strength and potential tariff risks are key issues to monitor.

International Relative Valuations Compelling

NTM Relative PE Multiples, by MSCI Region/Country

Relative to MSCI USA



Source: FactSet, 12/31/24

In conclusion, 2025 promises to be a year replete with opportunities and challenges for investors. While the U.S. economy is on a solid footing and AI investment is poised to propel growth, volatility, policy uncertainty, and geopolitical risks will form the outlook. The lagged impact of higher interest rates may also dampen GDP growth more than expected, and inflation may re-ignite if policies become too stimulative or widespread tariffs are introduced. Focusing on earnings growth, diversification, valuation, and prudent stock selection across sectors and geographies will be vital to navigating risks and seizing opportunities in the year ahead.

U.S. GDP Growth Poised to Slow in 2025, But Base Case Increased to +1.5 Percent

Our base projection for U.S. GDP growth increased following continued economic strength and the Republican sweep, as has the range of possible outcomes. The incoming administration is inheriting an economy on a steadfast growth trajectory, with the Atlanta Fed's GDPNow model projecting real GDP growth of +2.7 percent in 2024's last quarter. While many other developed economies have struggled, U.S. GDP has tracked above its pre-pandemic trendline (Exhibit 1). Pro-growth fiscal policies, including tax cuts and deregulation, will help offset the lagged effects of still-tight monetary policy that tilt the 2025 outlook downward. However, with limited slack in the economy, policymakers must be careful not to inject too much stimulus and avert supply shocks via trade wars or overzealous immigration crackdowns. Absent a boom in productivity, President Trump's pledge to curb inflation and expand the economy is incompatible with heavy tariffs and mass deportations. For this reason, we anticipate that his actual policies will not be nearly as harsh as his campaign rhetoric. Otherwise, there are substantial downside risks.

Immigration an Economic Growth Headwind Following Extraordinary Influx

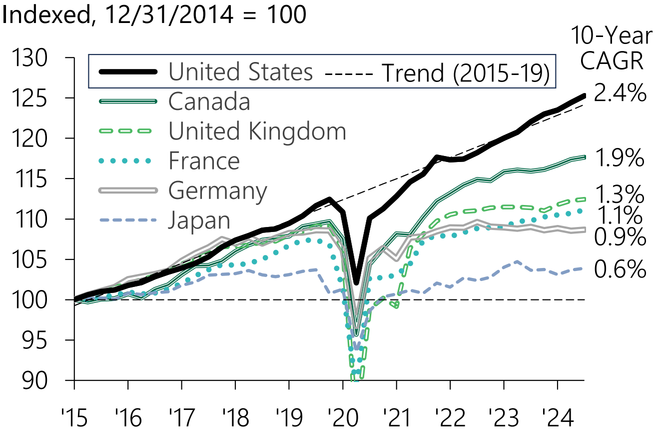
The Congressional Budget Office (CBO) estimates that net migration grew to about 9.3 million people over the past three years from circa 2.4 million for the three years prior. Albeit politically divisive, the leap in immigration has been essential for resolving supply constraints, mitigating inflationary pressures, and expanding the economy. Foreign-born workers account for all the incremental growth in the labor force since 2019, offsetting the rise in retirements (Exhibit 2). To recall, potential GDP growth is a function of labor force and productivity growth. A natural return to average net migration of about 1.1 million people yearly will detract from GDP growth in 2025 and 2026, even before considering additional border security, higher deportations, and potential knock-on effects. In a zero-immigration scenario, the U.S. Census estimates that the age 18 to 64 population will fall by 4.2 million between 2025 and 2030 – the low immigration estimate puts the figure closer to -700 thousand. A drop in labor force growth or a very possible contraction will put the onus on productivity to drive GDP growth and keep inflation in check.

Higher Confidence, Tight Labor Supply, & Favorable Policies May Lift U.S. Capex

Tax cuts and deregulation may unleash animal spirits, accelerating capital investment that lifts the economy's output potential. Or, at least, that is the aim – it is classic supply-side economics. As expected, small business confidence spiked upward following Trump's election win, as it did in 2016 (Exhibit 3). Large and small business confidence (and profits) have diverged in recent years as smaller companies have generally found it more difficult vis-à-vis larger ones to pass through higher costs and tackle mounting regulation. Small firms have also been more interest rate-sensitive. Rate cuts will help, as will deregulation, lower taxes, and less competition from imports. At the same time, many smaller businesses may again find themselves on the losing

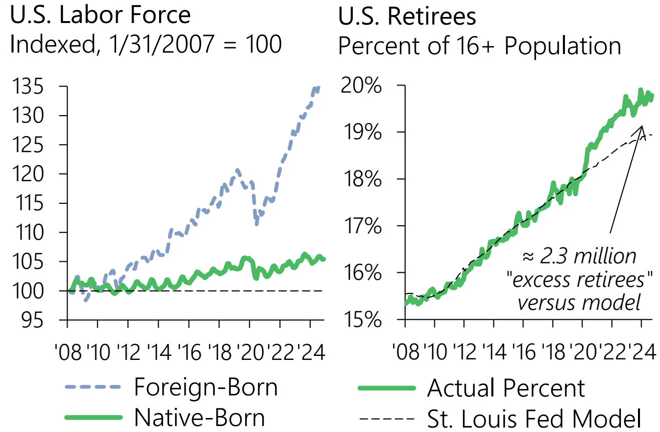
Exhibit 1: Real Gross Domestic Product

Indexed, 12/31/2014 = 100



Source: BEA, Statistics Canada, ONS, Eurostat, JCO, 12/31/24

Exhibit 2: U.S. Labor Force and Retirees



Source: BEA, Federal Reserve Bank of St. Louis, 12/31/24 end of any trade war-related supply constraints and renewed inflationary pressures. Whether "America First" policies will drive a U.S. manufacturing renaissance remains to be seen. Yet, as shown in Exhibit 4, surveys point to an improving outlook for capital spending for both large and small firms. Along with likely tax incentives to do so (e.g., extending expensing provision), secular labor tightness should compel firms to raise spending on productivity-improving tools.

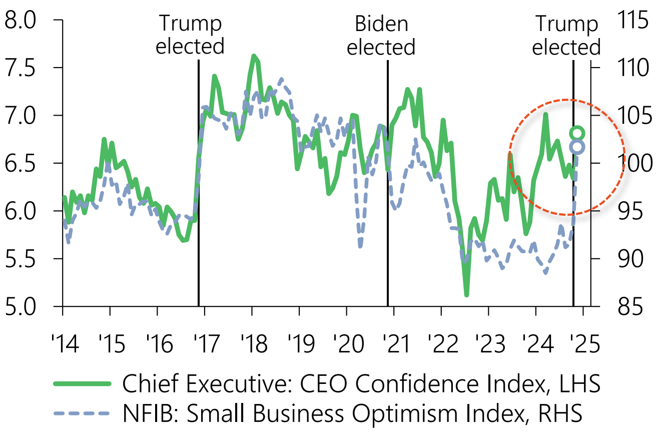
Economic Growth Upside Hinges on Investment-Driven Productivity Boom

Given the demographic headwinds, the bull argument for U.S. economic growth rests primarily on mounting expectations for a productivity boom – an elixir that cures many economic ills. Higher productivity raises the economy's output potential and allows it to expand quicker than it could otherwise without triggering an inflationary reaction. It contributes to better business profits, higher real wages, and healthier government finances. Productivity, or output per hour worked, has grown at an average annual rate of +2.1 percent since 1948 (Exhibit 5). However, the economy has had stints of strong productivity gains aided by technological advancements, capital deepening, and industry mix shifts. Productivity has expanded at an annual rate of over +2.0 percent for the last five quarters versus the average pace of just +1.1 percent for the decade preceding the pandemic. Yet, some of the better productivity is due to methodological changes and easy comparisons. As shown in Exhibit 6, the CBO predicts that productivity will expand by +1.5 percent yearly through 2034, but AI and automation offer promising upside potential.

Narrow Congressional Majorities Could Blunt Republican's Economic Initiatives

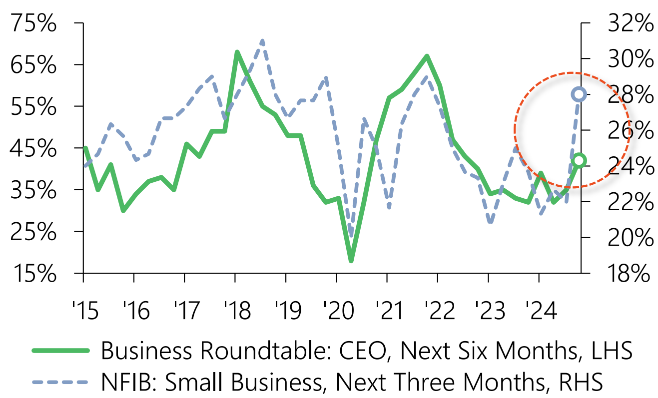
Before Congress can pass another round of corporate tax cuts, it must first address the so-called elephant in the room – a substantial fiscal cliff as vital provisions of the 2017 Tax Cut and Jobs

Exhibit 3: U.S. Business Confidence



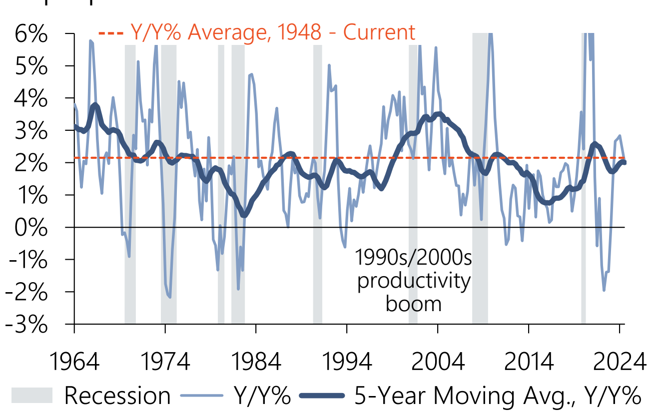
Source: Chief Executive Magazine, NFIB, 12/31/24

Exhibit 4: U.S. Business Capital Spending Plans
Percent Expecting Higher Spending



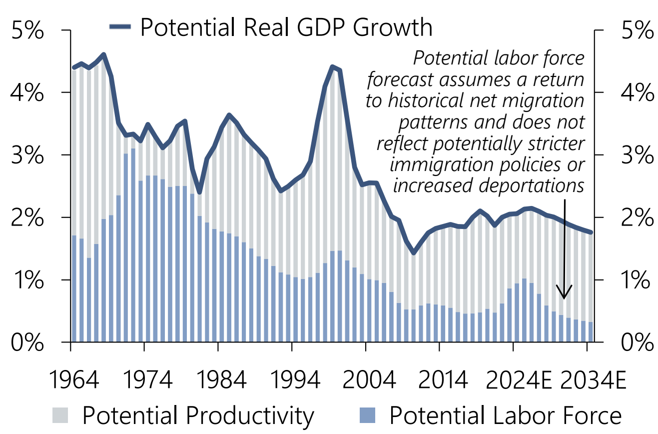
Source: Business Roundtable, NFIB, 12/31/24

Exhibit 5: U.S. Nonfarm Productivity Growth
Output per Hour



Source: Bureau of Labor Statistics, 12/10/24

Exhibit 6: U.S. Potential Real GDP Growth



Source: Congressional Budget Office, 12/31/24

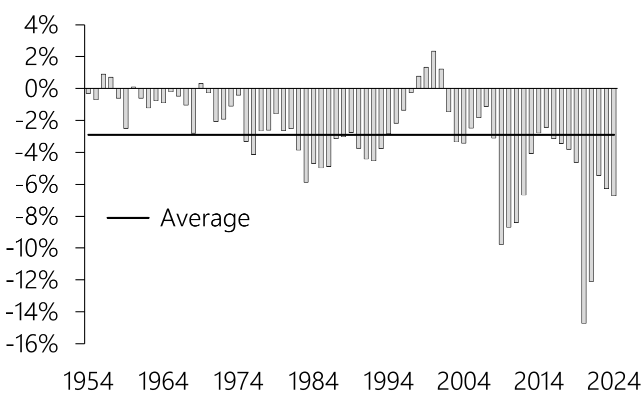
Act (TCJA) begin to expire at year-end. The TCJA was enacted using budget reconciliation, a legislative process that requires a simple majority vote, and many of its provisions were made temporary so as not to increase the deficit beyond the 10-year budget window. The Committee for a Responsible Federal Budget estimates that extending the expiring provisions will add $4 to $5 trillion to the federal budget deficit over 10 years. Failure to do so would effectively result in the biggest tax increase in U.S. history. Since the corporate tax cut is permanent, individuals and pass-through entities will bear the brunt. The budget deficit has grown to over 6.5 percent of GDP, and the federal debt of over $36 trillion exceeds GDP by 1.2 times (Exhibits 7 and 8). Given the narrow majority in both chambers, the GOP must placate deficit hawks and will need to pare its tax and spending plans (and bank on tariffs) to make the reconciliation math work.

Euro Area Caught Between Meager Growth and Inflation, Limiting Policy Support

The Euro Area's two largest economies, Germany and France, continue to drag down the bloc's overall growth (Exhibit 9). The composite PMIs of both nations are contracting, and economic woes have amplified internal political strife. Spain, on the other hand, continues to outperform appreciably, with real GDP expanding at a +2.5 percent annualized pace over the last two years versus just +0.3 percent for the rest of the Euro Area. While the European Central Bank (ECB) has gradually slashed rates by -135 basis points since last June to spur growth, "sticky" services inflation prevents it from easing more forcefully (Exhibit 10). The Euro Area is set to post real GDP growth of about +0.8 percent in 2024 and will likely eke out positive, but sub-one percent, growth again in 2025. Yet, potential U.S. tariffs are a key downside risk and could dent exports, which have helped keep growth in the black in recent quarters. The upshot is that tariffs may be disinflationary (via lower demand) and motivate the ECB to ease much more aggressively.

Exhibit 7: U.S. Federal Budget Deficit

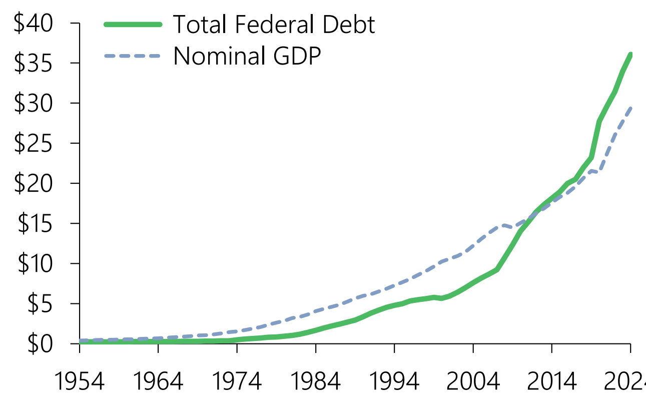
Percent of GDP



Source: Congressional Budget Office, 12/31/24

Exhibit 8: U.S. Federal Debt vs. Nominal GDP

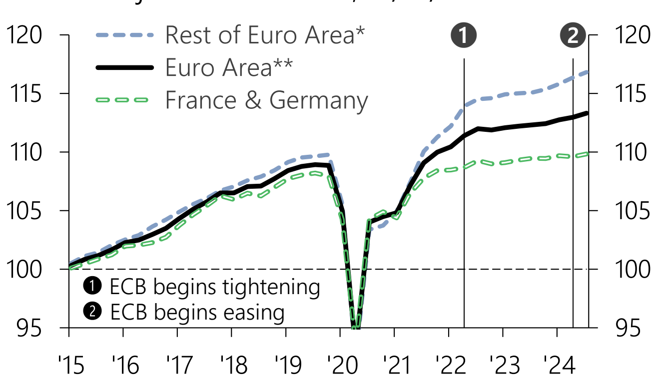
$ Trillion



Source: U.S. Treasury, Bureau of Economic Analysis, 1/7/25

Exhibit 9: Euro Area Gross Domestic Product

Inflation-Adjusted and Indexed, 12/31/2014= 100

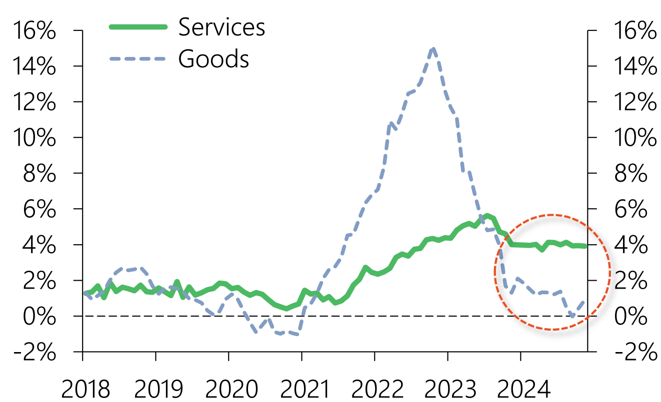


**Euro Area excluding France, Germany, & Ireland* ***Excluding Ireland*

Source: Eurostat, 10/30/24

Exhibit 10: Euro Area Consumer Price Index

Y/Y Percent



Source: Eurostat, 12/18/24

Bank of Japan Pauses Interest Rate Hikes Amid Increased Uncertainties

The Japanese economy made significant strides in 2024, but deflationary pressures lie in wait. Real GDP grew at an annualized rate of +1.5 percent in the last nine months of calendar 2024, while the Bank of Japan (BoJ) hiked rates twice since March 2024 to start policy normalization. These accomplishments are no small feat for a country exiting a three-decade deflationary funk. Unemployment of 2.5 percent, wage growth at a 30-year high, and upbeat corporate sentiment warrant guarded optimism. Nonetheless, the handoff from healthier wage growth to sustained consumption growth faces challenges as consumer confidence stalls. A key growth source until now, the services sector has wobbled recently. In addition, the manufacturing sector continues to contract, and waning Chinese growth prospects and increased U.S. trade policy uncertainty cloud the outlook. The BoJ also punted on a December rate hike and indicated caution ahead, which is a sensible move as we expect real GDP growth to slow to +0.5 to +1.0 percent in 2025.

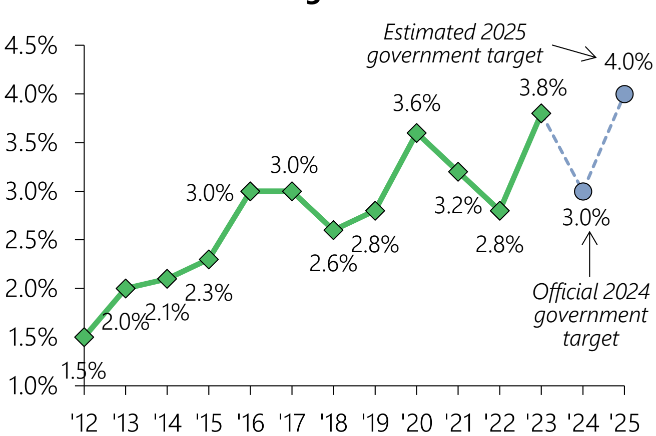
China's Economy Continues to Muddle Through; U.S. Tariff Risk Looms Large

Chinese policymakers' jawboning and measured stimulus efforts have yet to turn the economic tide and stem deflationary pressures, at least not materially. The "official" Manufacturing PMI fell marginally to 50.1 (below 50 contractionary) in December, and the Services PMI increased to 52.0 from 50.1 in November. While exports remain a source of economic growth, domestic demand is very weak. Retail sales are growing well below trend, and consumer confidence and willingness to spend remain depressed. Policymakers are set to raise policy support in reaction to a looming trade conflict with the U.S. and will probably need to finally bring out the bazooka. At a bare minimum, they are apt to ease monetary policy further and lift the budget deficit to 4 percent of GDP from 3 percent in 2024 (Exhibit 11). While China will likely report real GDP growth close to its target of "around 5.0 percent" in 2024, the outlook is biased to the downside. We project GDP growth of about +4.5 percent in 2025. Yet, some analysts estimate that a 60 percent U.S. tariff, albeit remote, could reduce China's GDP growth by over 200 basis points.

Tit-For-Tat Tariffs and Stronger U.S. Dollar Potential Global Growth Headwinds

On the campaign trail, President Trump vowed to initiate a 60 percent tariff on imported goods from China and a 10 percent tariff on imports from elsewhere. After the election, he pivoted to a 25 percent tariff on imports from Mexico and Canada and 10 percent on those from China. Unsurprisingly, U.S. trade policy uncertainty has spiked (Exhibit 12). A coming reconciliation bill will probably depend on tariff-generated revenues to offset the costs. Therefore, the Trump administration is primed to slap tariffs on some (or all) countries or target specific sectors. An inevitable tit-for-tat response may exacerbate geopolitical strains and depress global economic growth. The strengthening trade-weighted U.S. dollar, driven by GDP growth and interest rate differentials, will mitigate the inflation impact of tariffs in the U.S. but will lessen the translated earnings of U.S. multinationals and weigh on emerging markets, especially those with sizable dollar-denominated debt. While domestic-oriented U.S. firms, in general, should benefit from tariffs and a stronger dollar, there will be winners and losers (and possible supply disruptions).

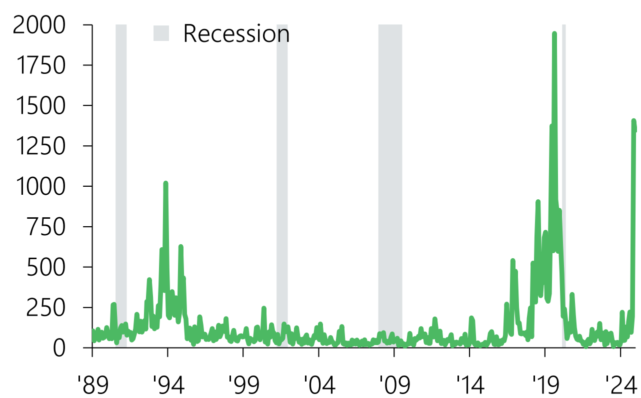
Exhibit 11: China's Target Deficit-to-GDP Ratio



Source: CEIC, 12/31/24

Exhibit 12: U.S. Trade Policy Uncertainty Index

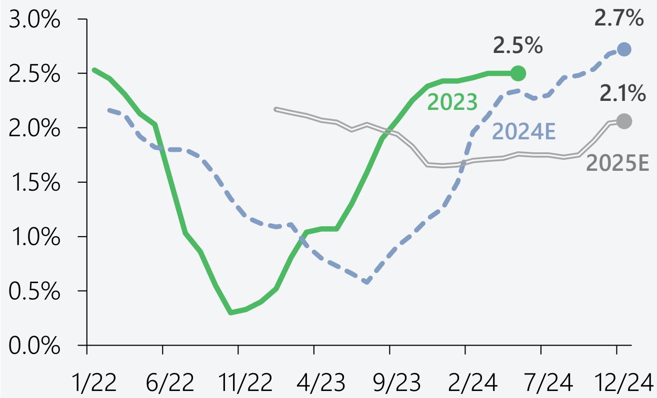
1985 = 100



Source: Baker, Bloom, & Davis, 12/31/24

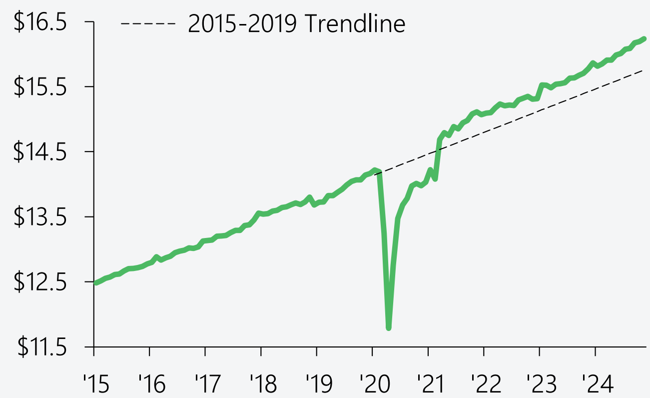
United States: Other Notable Data Points

Upward Revisions to Growth Outlook Continue
U.S. Real GDP Growth Estimates
Bloomberg Weighted Average, Y/Y Percent



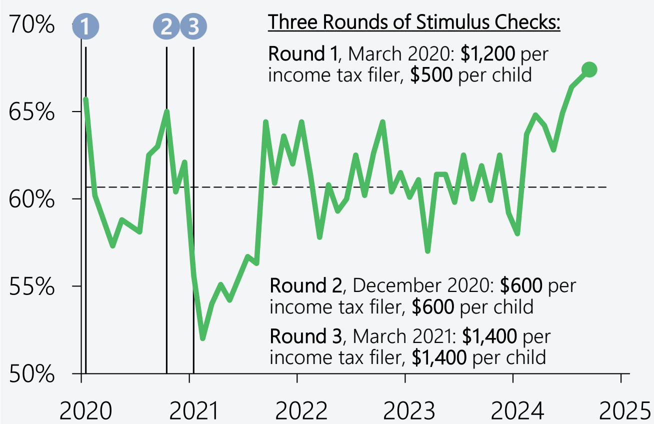
Source: Bloomberg, 12/31/24

PCE Growing Above Pre-Pandemic Trendline
U.S. Real Personal Consumption Expenditures
SAAR, Trillions of Chained 2017 U.S. Dollars



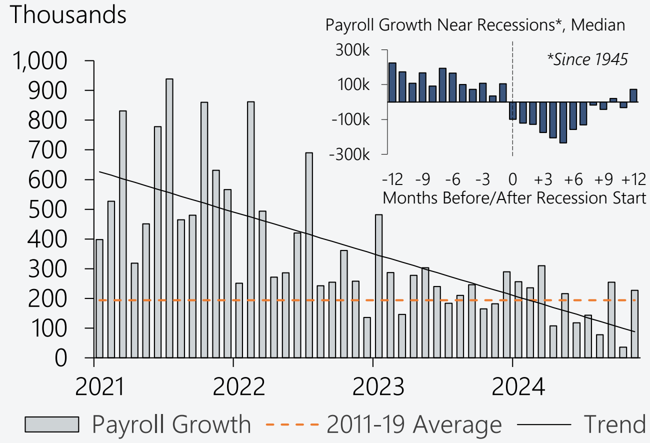
Source: Bureau of Economic Analysis, 12/20/24

Increasing Share of U.S. Consumers Fatigued
Share of U.S. Consumers Living Paycheck to Paycheck



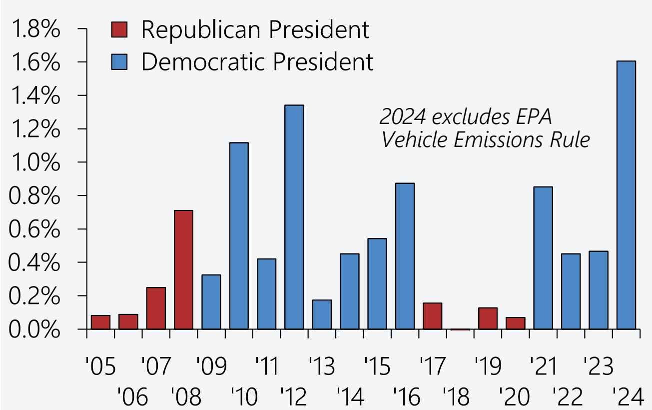
Source: PYMNTS Intelligence, 12/27/24

U.S. Payroll Growth Continues to Downshift
Monthly Change in U.S. Nonfarm Payrolls
Thousands



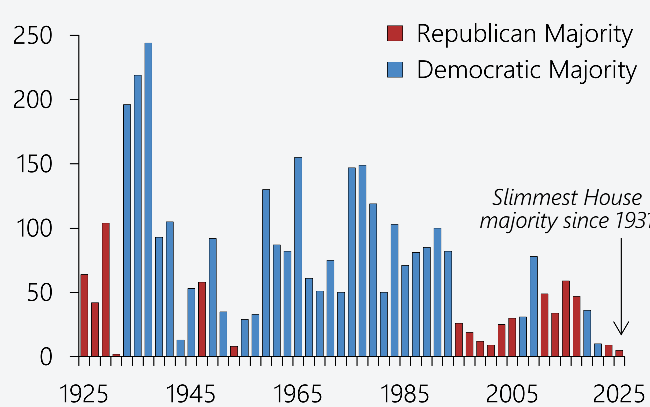
Source: Bureau of Labor Statistics, 12/6/24

Deregulation Should Provide Vital GDP Boost
Total Cost of U.S. Regulations, by Year
Percent of Nominal GDP



Source: American Action Forum, BEA, FactSet, 12/31/24

Slim House Majority May Impede GOP Agenda
Party Majority in House of Representatives
Number of Seats

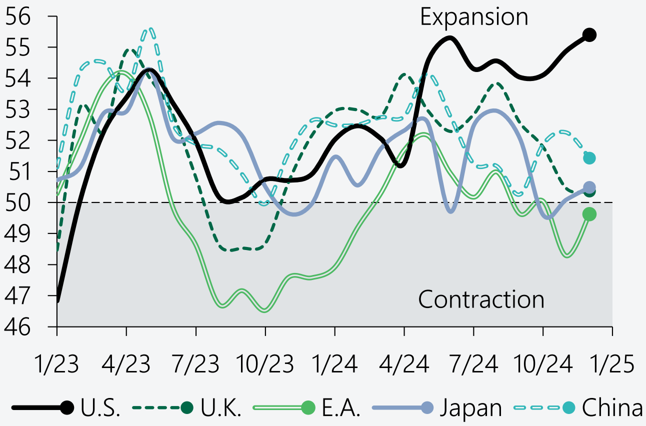


Source: U.S. House of Representatives, 12/31/24

International: Other Notable Data Points

U.S. PMI Continues to Pull Away From Pack

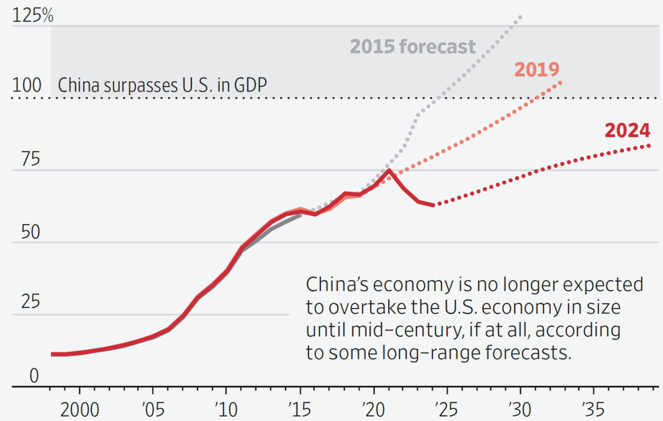
Composite Purchasing Managers' Indices



Source: S&P Global, 1/6/25

China No Longer an Economic Juggernaut

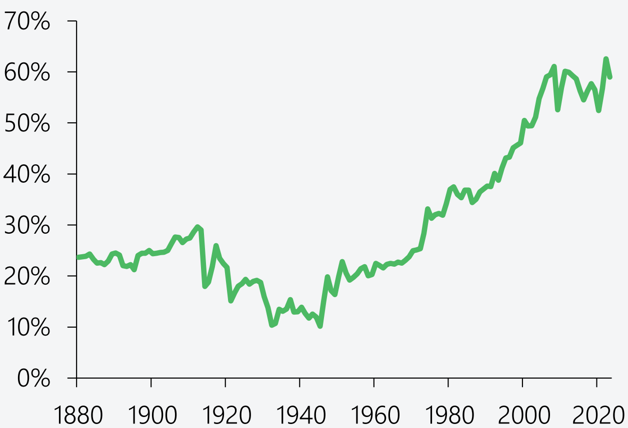
China's GDP as a Percentage of U.S. GDP



Source: Wall Street Journal, 1/1/25

Unwinding Globalization Will Prove Disruptive

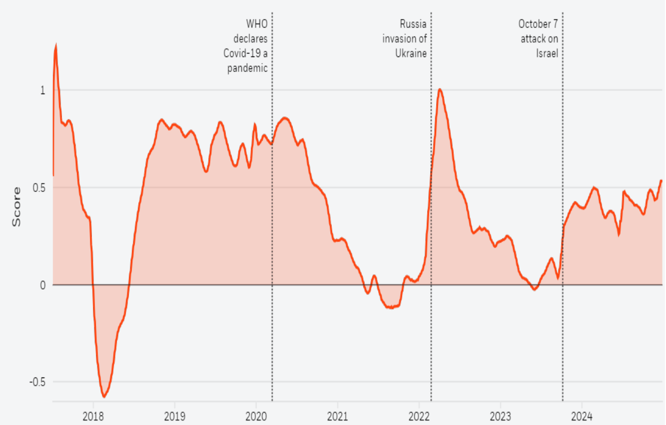
World Trade as a Percent of GDP



Source: Our World in Data, 12/31/24

Global Geopolitical Risk Continues to Increase

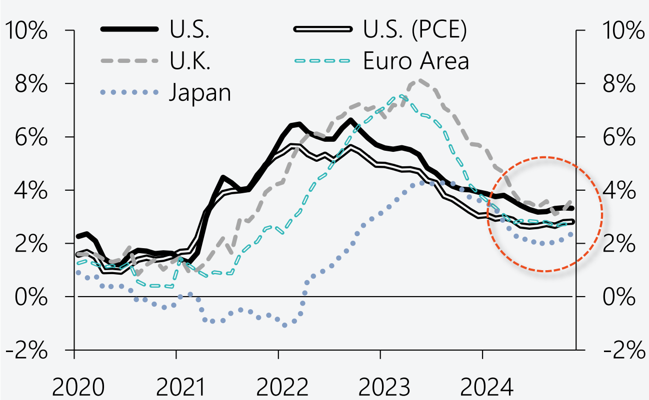
BlackRock Geopolitical Risk Indicator



Source: Blackrock, 12/13/24

Disinflation Stalled in Key Developed Markets

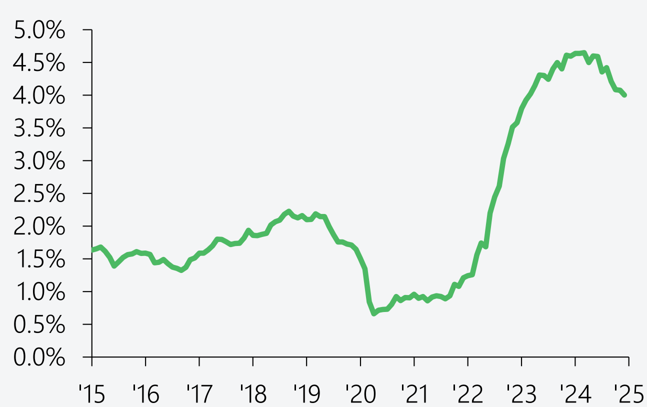
Consumer Price Index
Excluding Food and Energy, Y/Y Percent



Source: FactSet, 12/31/24

And May Temper Global Rate-Cutting Tailwind

Global Short-Term Interest Rates
Weighted by Share of World GDP



Source: FactSet, 12/31/24

Fixed Income: Environment and Strategy

Fed's Recent Messaging Perplexing But Still Abundant Room to Cut Rates

The Federal Reserve (Fed) cut the fed funds rate by another 25 basis points at its final meeting of 2024, bringing the cumulative rate reduction to 100 basis points. The Fed also increased its median forecast for core PCE inflation in 2025 to +2.5 percent from +2.2 percent, with the "dot plot" implying just two 25 basis point rate cuts in 2025 versus the four projected in September. Notably, the number of meeting members reporting upside risk to inflation jumped to 15 from 3, as they likely speculated about the next administration's impact. While the Fed's messaging puzzled investors, the "dot plot" change was not completely unexpected. The fed funds futures curve began shifting upward shortly after September's 50 basis point cut on positive economic surprises and "sticky" supercore inflation. Even so, the Fed's forecasts (and the futures market) have been fickle and must be eyed with some skepticism. The presumed neutral rate aside, the real fed funds rate, or the rate minus PCE inflation, is still restrictive enough to let the Fed ease further. It will be more reluctant to cut as the gap, close to 200 basis points at year-end, closes.

Worsening Federal Budget Deficit Exerting Upward Pressure on Treasury Yields

The Treasury yield curve steepened in the fourth quarter, with the 10-year yield rising to +4.57 percent at year-end from its September low of +3.62 percent, as the economic growth outlook improved and disinflation estimates moderated. Yet, concern over increasing Treasury supply due to the mounting federal deficit was also a factor. The deficit grew 19 percent to $2.1 trillion for the rolling twelve months ending November 2024, on top of the 28 percent in the year-ago period. The pro-cyclical fiscal stimulus lifted economic growth. But, it also stymied the Fed's inflation battle and put the country deeper into debt. Total debt of over $36 trillion ($29 trillion in marketable securities) at year-end equates to 124 percent of GDP and 744 percent of receipts – the respective percentages were 62 and 355 in 2007. Net interest of $893 billion for the past twelve months is a whopping 12 percent of outlays, up from 5 percent in 2020. On top of it all, the Committee for a Responsible Federal Budget estimates that the Trump Campaign tax and spending proposals will lift debt by $7.8 trillion (range of $1.7 to $15.6 trillion) over ten years.

Soaring National Debt Threatens Economic Growth and Fed's Independence

The large and expanding federal debt burden will negatively impact economic growth and limit fiscal policy options. The Fed will also likely face even more political pressure to keep rates low as interest payments gobble up an increasing share of outlays. Still, swelling issuance has put upward pressure on longer-dated yields, as has rising term premia. Treasury issuance climbed 29 percent versus a year ago and tripled over the past decade. The Congressional Budget Office also estimates that a one-percentage-point rise in the debt-to-GDP ratio lifts 10-year Treasury yields by 2.5 basis points (all else equal). Some academics contend that the figure is as high as 5.0 basis points. So, instead of its typical downward path in easing cycles, the 10-year Treasury yield rose 86 basis points from when the Fed started cutting rates through year-end, partly on renewed debt concerns. While there is a growing effort to curb wasteful federal spending, it is highly uncertain if it will have a consequential impact on the debt trajectory, as these initiatives often prove unpalatable given short-term political and economic considerations.

Taxable Fixed Income Strategy

Due to a looming slowdown in consumer spending, we believe the Fed will reduce rates in 2025 more than its members expect. To capitalize on a shift to lower rates and a steeper yield curve, portfolios are overweight bonds in the 3- to 6-year maturity range, which, we believe, offer the greatest price return potential. Portfolios are underweight longer-maturity bonds, and we are reducing exposure to lower-quality assets. Also, as corporate bond spreads remain historically tight, we remain underweight but expect better investment opportunities as economic growth slows. Both mortgages and taxable municipal bonds offer attractive valuations, prompting us to raise allocations – we expect mortgage spreads will narrow as rates decline. To conclude, portfolios have a sizable income advantage, a key driver of outperformance. We have extended durations where appropriate, believing the recent bond selloff is overdone given our near-term inflation outlook. However, the 3- to 6-year segment is expected to drive price outperformance, maintaining an income advantage of about 100 basis points relative to benchmarks.

High-Grade Tax-Exempt Yield Increases Lessen Total Returns

Tax-exempt yields increased sharply in the fourth quarter, although generally to a lesser extent than comparable maturity U.S. Treasuries. Long-term high-grade municipal bond yields rose by 40-50 basis points, while short-term high-grade municipal bond yields increased by 50-55. For the year, high-grade municipal bond yields climbed 30-80 basis points, with the most significant increases in the five-to-ten-year portion of the yield curve. Credit spreads tightened modestly during the quarter and substantially for the year. The sharp rise in yields resulted in a negative total return of -1.2 percent for the Bloomberg Municipal Bond Index in the fourth quarter and a slightly positive return of +1.1 percent in 2024 (Exhibit 13). During the quarter, shorter-duration bonds tended to outperform longer-duration bonds. For the year, the best performance was in the short and long end, with the weakest performance in intermediate bonds. In general, short bonds had less principal erosion from the increase in yields, while longer bonds had more income to offset the principal erosion from rate increases.

Investors Absorb Record New Issue Supply

Municipal bond issuers priced over $120 billion in bonds during the fourth quarter, the most fourth-quarter issuance since 2020. The total supply for 2024 of $507 billion is the highest annual total on record, versus the previous high of $485 billion in 2020. Fund flows into tax-exempt mutual funds were strong for most of the fourth quarter but ended the year with a few weeks of outflows. Fund flows were strong for the year, with over $40 billion inflows into all muni funds, including over $15 billion into high-yield funds. Trading volume rose in the fourth quarter, after a relatively quiet third quarter, due to the increased volume of new issues and the higher yields. Interestingly, new issues continued to be in demand throughout the quarter.

Tax-Exempt Fixed Income Outlook

The overall rate environment for U.S. Treasuries will continue influencing the tax-exempt yield curve in 2025. The Republican sweep of the 2024 elections has made the extension of the Tax Cuts and Jobs Act our base case, although the small majorities in the House and Senate perhaps increase the potential for incremental changes to gain the concurrence of individual legislators. Some market strategists believe that the municipal tax exemption may be a topic of negotiation, but ultimately, we think this is a headline risk versus a likelihood. This backdrop should sustain the demand for tax-exempt income from individuals but is unlikely to stimulate corporate demand meaningfully due to the low probability of a significant corporate tax change.

Tax-Exempt Fixed Income Strategy

We remain focused on income as the primary driver of return and emphasize higher-yielding areas of the municipal bond market. Portfolios remain primarily invested in revenue bonds, especially housing, which has both attractive yields and a secular resurgence in issuance over the last several years. Transportation has also been a growing focus area in many portfolios, which we think will continue due to attractive yield characteristics and ongoing capital plans from issuers. Also, bonds with a degree of optionality, such as short or current-call provisions, remain attractive when available. All strategies benefitted from their income advantage in 2024, while a barbelled approach to managing duration also aided intermediate and long portfolios. This income advantage, the higher absolute yields, and modestly longer than benchmark durations have portfolios positioned well for the environment we expect in 2025.

Exhibit 13: Bloomberg Municipal Bond Index Percent Returns

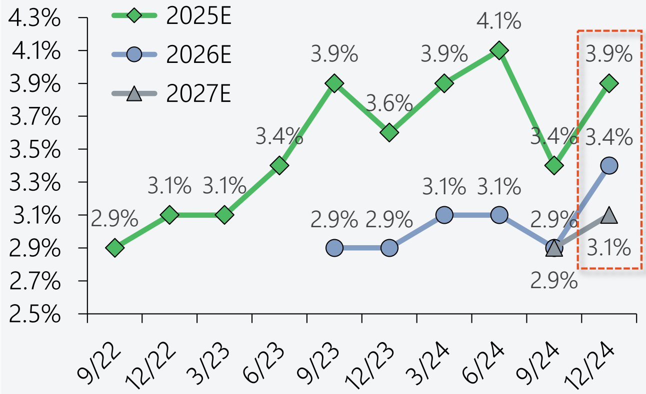
	4Q24	2024		4Q24	2024		4Q24	2024		4Q24	2024
Muni Bond Index	-1.22	1.05	AAA	-1.32	0.33	GO Bond Index	-1.18	0.55			
3-Year	-0.42	2.04	AA	-1.18	0.79	Revenue Bond Index	-1.25	1.22	Education	-1.30	0.72
5-Year	-1.04	1.17	A	-1.19	1.78	Electric	-1.10	0.94	Water & Sewer	-1.28	0.61
7-Year	-1.30	0.51	BBB	-1.32	2.87	Hospital	-1.26	1.93	Resource Recovery	-1.20	0.20
10-Year	-1.34	-0.33				Housing	-1.65	1.55	Leasing	-1.32	0.67
Long	-1.65	1.40				IDR/PCR	-1.25	3.17	Special Tax	-1.15	0.64
						Transportation	-1.17	1.31	Tobacco Index	-0.94	1.98

Source: Bloomberg, 12/31/24

Fixed Income: Other Notable Data Points

Fed Funds Rate Projections Drifting Higher

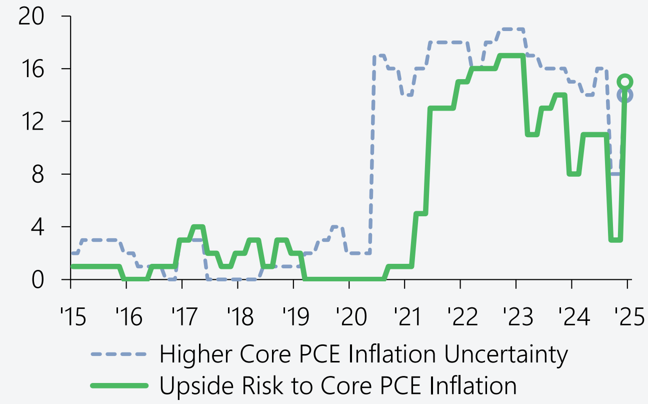
FOMC Median Fed Funds Rate Projections
Year End, Percent



Source: Federal Reserve, 12/18/24

Policy Uncertainty Increasing Inflation Risks

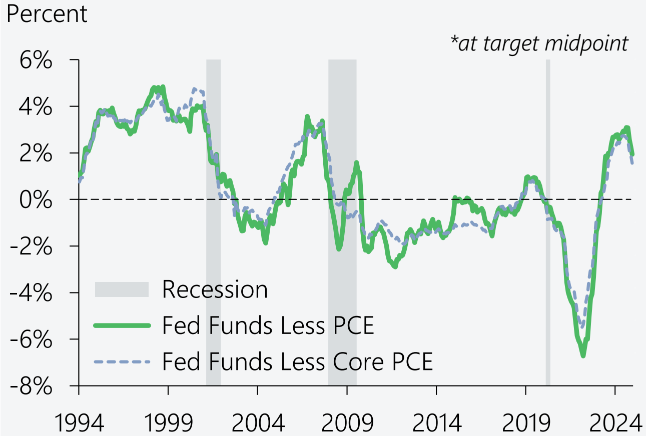
FOMC Assessments of Inflation Uncertainity and Risks
Number of Participants Reporting



Source: Federal Reserve, 12/18/24

Real Fed Funds Rate Still Highly Restrictive

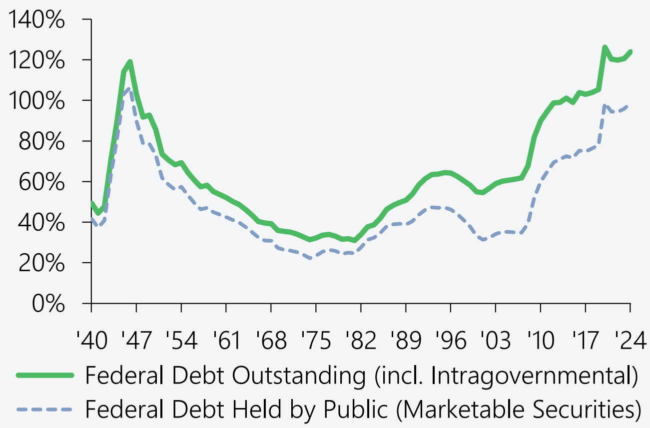
Real Fed Funds Rate*
Percent



Source: Federal Reserve, BEA, NBER, 12/31/24

U.S. Federal Debt Trajectory Unsustainable

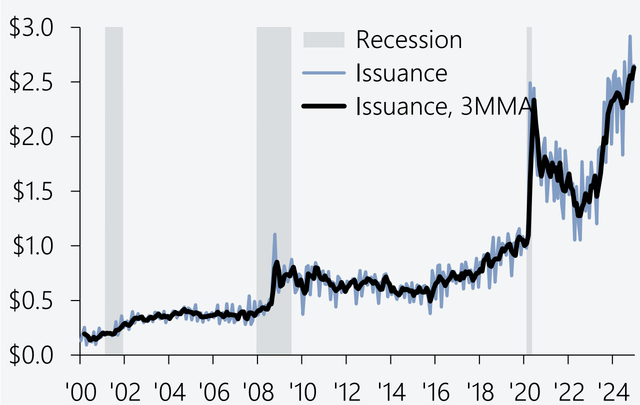
U.S. Federal Debt as Percentage of Nominal GDP



Source: U.S. Treasury, Bureau of Economic Analysis, 12/31/24

Issuance Exerting Upward Pressure on Yields

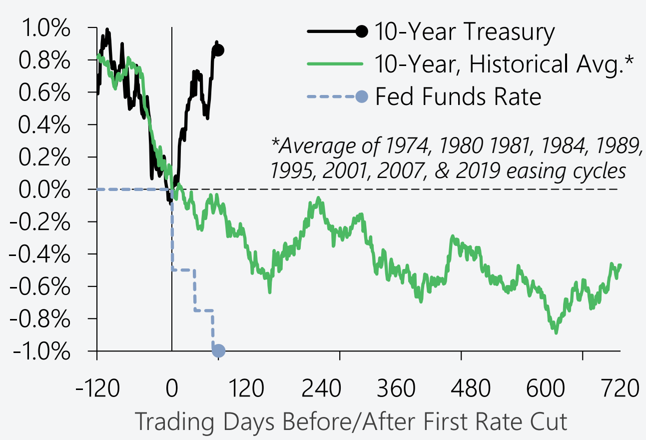
U.S. Treasury Gross Issuance
Trillions



Source: SIFMA, 12/31/24

Yields Buck Historical Trend This Easing Cycle

Yield Change Since Day of First Fed Funds Rate Cut



Source: FactSet, 12/31/24

Global Equities: Environment and Strategy

Global Equity Strategy

After two consecutive years of outstanding stock market returns, investors should temper their expectations for 2025, as somewhat elevated valuations may limit return potential. With that said, stocks are well-supported by healthy GDP growth, moderating inflation, and monetary loosening. The Trump administration's success in reducing tax and regulatory burdens also provides potential upside (although there are also risks to consider). Notably, higher expected volatility will likely offer compelling opportunities for stock pickers, especially since the market has not had a "typical" correction in over two years.

Technology stocks, led by the so-called "Magnificent Seven," have dominated the equity market over the past two years, and for good reasons. Several growth drivers, most notably artificial intelligence, along with digital transformation, cloud adoption, automation, data analytics, and cybersecurity, have sustained robust fundamentals. Even though these trends will continue to drive earnings growth and investor sentiment in the sector, valuations are starting to discount the strong outlook more fully. For the market's momentum to continue, broader participation across sectors may be necessary.

The industrials and healthcare sectors have lagged but show strong potential for a rebound in 2025. For industrials, the slowdown coincided with the Federal Reserve's launch of monetary tightening over two years ago. The Manufacturing PMI has been below 50, or in contraction, for 25 out of the past 26 months, signaling prolonged weakness. We expect a rebound in 2025, supported by a more accommodative Federal Reserve. We favor companies exposed to cyclical and secular growth markets, including aerospace, electrification, power, and automation.

Investor sentiment in healthcare stocks has been persistently negative over the past year and, more recently, due to concerns over the increased government scrutiny of managed care and pharmacy benefit managers. Yet, the earnings outlook for many healthcare companies remains solid, and investors should not overlook influential demographic trends that will continue to drive growth. We see attractive risk-reward opportunities across various industry groups, including medical devices, drug distributors, managed care, biotech, and select pharmaceutical stocks. While the sector's attractive earnings stability (i.e., "low beta") has not been a key focus in a market driven by risk-on sentiment, this quality will become more valuable if volatility increases, as we expect.

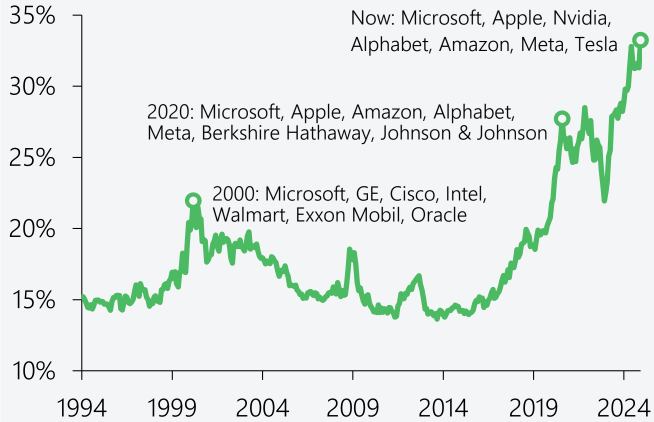
We emphasize China, Singapore, and India equities in international portfolios. Our positive stance on China is a shorter-term view, as we believe the government's stimulative measures will be enough to counter the new U.S. administration's potential actions that will undoubtedly spark continued market gyrations. Despite the volatility, the MSCI China Index gained +19.7 percent in 2024, following three years of losses. Valuation remains attractive from a historical and global perspective, with the MSCI China Index trading at approximately 10 times forward consensus earnings, which improved further following third quarter 2024 results. We prefer industries with positive secular trends and domestic-driven sectors, including insurance, the internet, consumer, and utilities.

Our bullish stance on India is predicated on strong economic growth- likely exceeding +6% in fiscal year 2025- with consumer spending leading the way. Mexico also remains attractive, although we recognize trade policy risk as the U.S. accounts for about 80 percent of Mexico's exports. The country may face higher U.S. tariffs and possible renegotiation of the USMCA trade agreement, but we expect Mexico to reach a satisfactory deal. We have turned more cautious about Brazil because of its weak currency, high inflation, and significant fiscal policy challenges amid elevated debt levels. Overall, portfolios remain well diversified among sectors, with our preference for financials, e-commerce, consumer staples, industrials, renewable energy, technology, and basic materials.

Global Equities: Other Notable Data Points

S&P 500 Index Concentration at All-time High

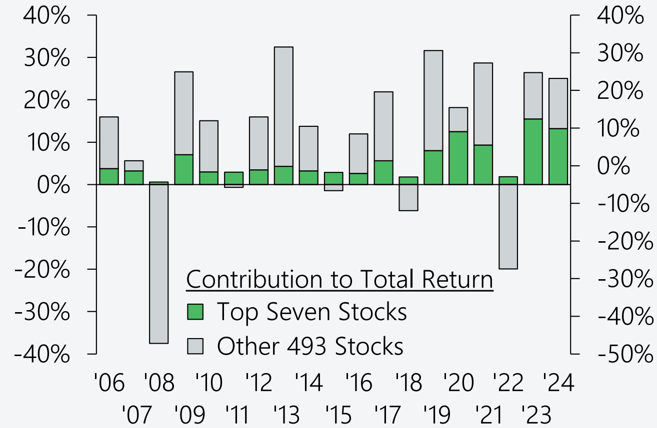
Top Seven Constituents as a % of S&P 500 Market Cap



Source: FactSet, 12/31/24

Handful of Stocks Drove Robust Market Returns

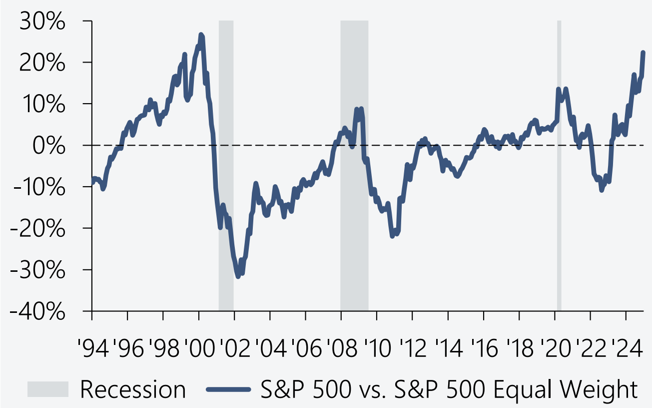
S&P 500 Total Returns



Source: FactSet, 12/31/24

Equal-Weighted Return Gap Close to Past High

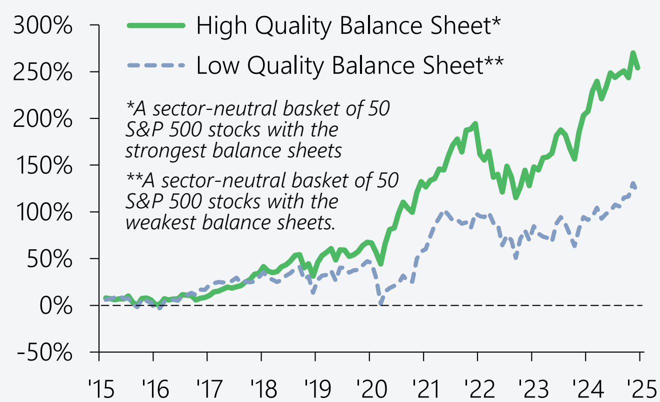
S&P 500 (Cap-Weighted) vs. S&P 500 Equal Weight
Rolling Two-Year Relative Price Returns



Source: FactSet, 12/31/24

High- & Low-Quality Return Gap Also Widening

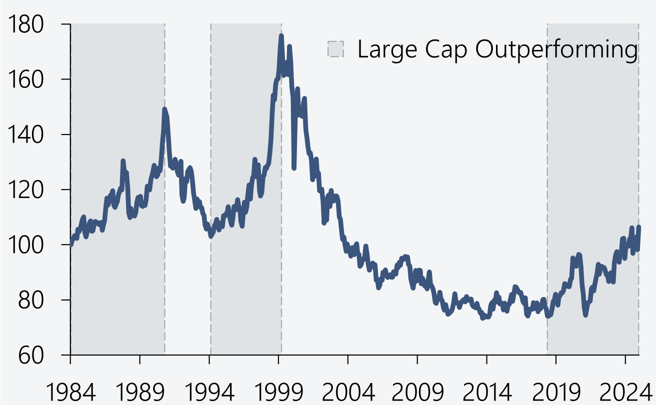
Stock Performance by Balance Sheet Quality
Cumulative Return



Source: Goldman Sachs, Bloomberg, 12/31/24

Large- & Small-Cap Tug-of-War More Recently

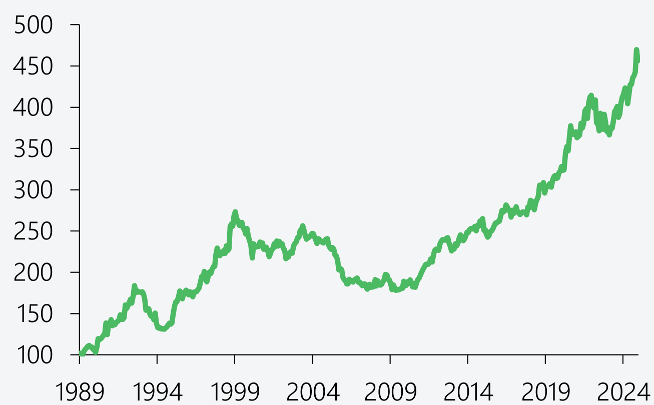
Large Cap and Small Cap Investment Cycles
Russell 1000 Index Relative to Russell 2000 Index



Source: Goldman Sachs, Bloomberg, 12/31/24

U.S. Equities Continue to Outperform Massively

MSCI USA Index Relative to AC World Index (ex. USA)
In U.S. Dollars, 12/31/88 = 100

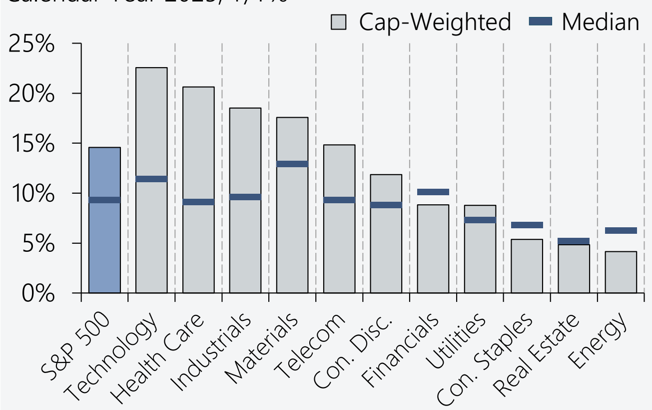


Source: FactSet, 12/31/24

Global Equities: Other Notable Data Points

Sector EPS Growth Portends Market Broadening

S&P 500 Bottom-Up EPS Estimates
Calendar Year 2025, Y/Y%

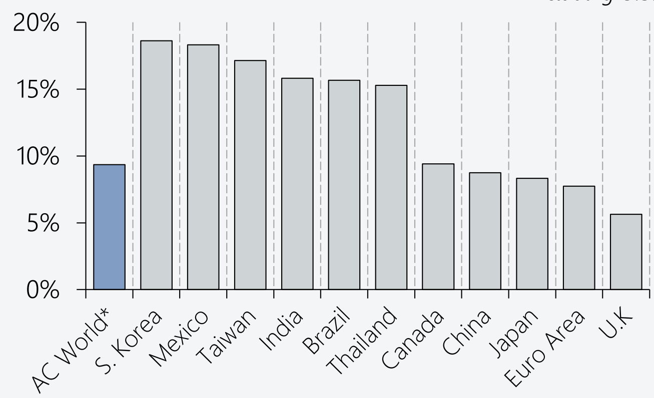


Source: FactSet, 12/31/24

Same Argument for International EPS Growth

MSCI Bottom-Up EPS Estimates
Calendar Year 2025, Y/Y%

**Excluding U.S.*



Source: FactSet, 12/31/24

Trump's Policies Have Varying Sector Impacts

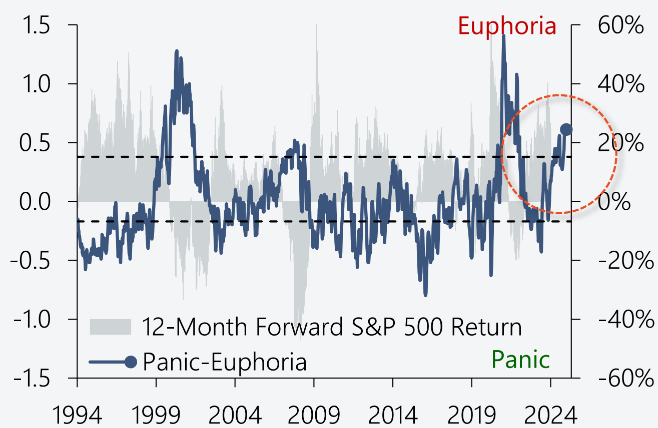
Stylized Relative Sector First-Order Impact by Policy

S&P 500 Sectors	Trade/ Tariff	Border	Dom. Mfg. Tax Cut	Regu- lation	Govt. Efficiency
Energy	–	–	↑	↑↑↑	–
Materials	–	–	↑	↑↑	–
Industrials	↓↓	↓↓	↑↑↑	↑↑	↓↓
Discretionary	↓↓↓	↓↓↓	↑	–	↑
Financials	-	–	–	↑↑↑	–
Technology	↓↓↓	–	↑	↑	↑↑
Telecom	↓↓	–	–	–	↑
Healthcare	↓	↓	–	–	↓
Staples	↓↓↓	↓↓	–	↓	–
Utilities	↑	–	–	↑	↑
Real Estate	↓	↓	↑	↑↑	↑↑
SMID	↓↓	↓	↑↑	↑↑↑	↑↑

Source: JP Morgan, 12/13/24

Citi's Model Warns of Negative Market Returns

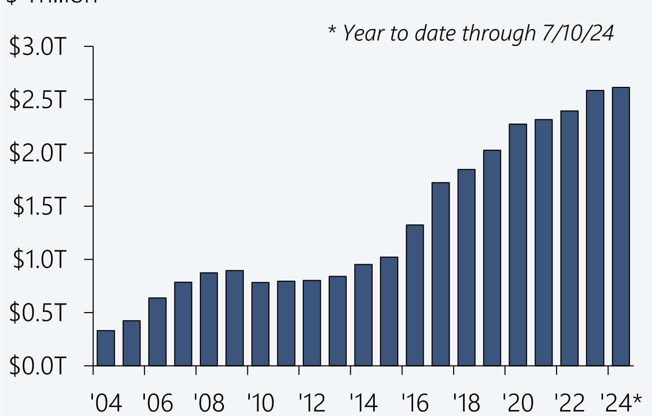
Levkovich Index (a.k.a., Citi Panic-Euphoria Model)



Source: Citi Research, 1/3/24

PE Firms Have Heaps of Dry Powder to Deploy

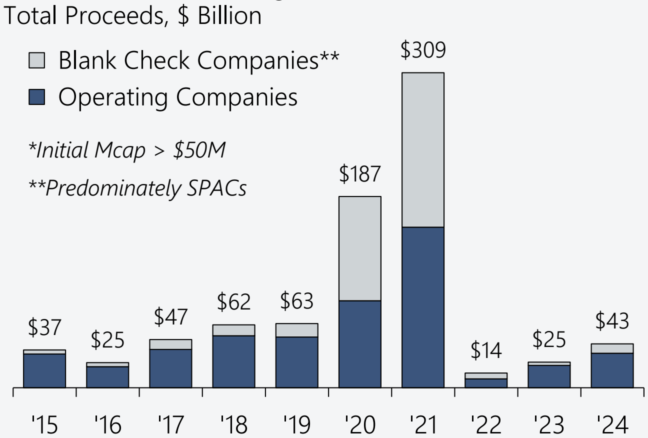
Global Private Equity Dry Powder
$ Trillion



Source: S&P Global, 7/12/24

Initial Public Offerings Poised to Rise in 2025

U.S. Initial Public Offerings*
Total Proceeds, $ Billion



Source: FactSet, 12/31/24