Economic and Investment Outlook

January 9, 2025

Equity Market Update

U.S. equity indexes posted strong returns in 2024. The S&P 500 and the NASDAQ indexes led the way up 25% and 30%, respectively. Large technology stocks propelled these indexes due in part to substantial spending on artificial intelligence (AI). Developed international indexes have modest technology weightings and are populated with economically sensitive industries which generally did not perform well, leading to low single-digit returns. Finally, the emerging market index performed poorly in the fourth quarter due to concerns over the prospect of higher tariffs in the upcoming Trump presidency, leading to a still respectable 8% return.

After such a strong run for U.S. equities over the last two years investors are growing more anxious, particularly due to uncertainties surrounding the future direction of interest rates and the impact of possible increased tariffs. We acknowledge that risks are increasing but remain sanguine as we do not want to lose sight of the opportunities. We believe that the market is efficiently pricing in AI opportunities which are likely in the early innings. On the flipside, companies that are not posting strong results have not performed well in 2024. This is evidenced in the wide range of returns across markets in 2024. Navigating markets can be challenging, but over the long-term equities have posted attractive returns as they reflect economic growth.

Total Return Performance for the Major U.S. and International Stock Market Indexes

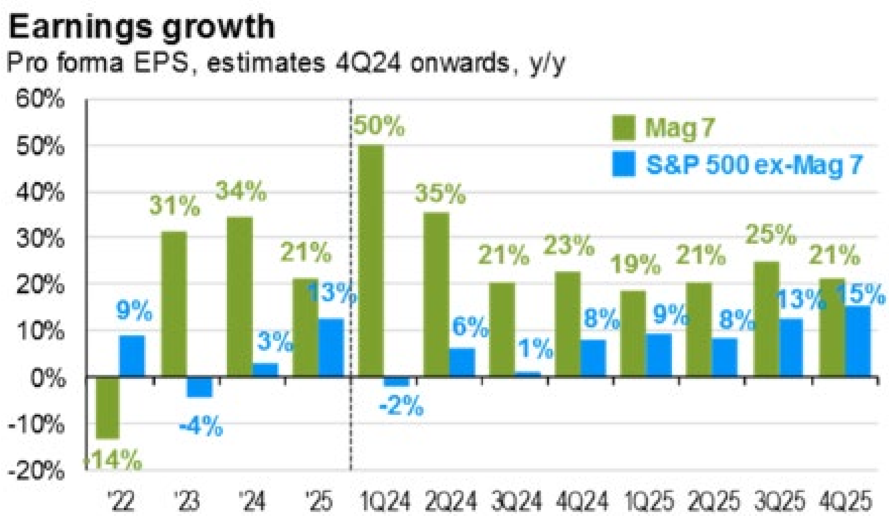
Equity Index	*YTD December 31, 2024*
United States	
Dow Jones Industrial Avg.: 30 Stock Composite	**14.99 %**
S&P 500 Composite: U.S. Large Cap	**25.02 %**
NASDAQ Composite: Technology Heavy	**29.60 %**
S&P 600 Small Cap: U.S. Small Cap	**8.65 %**
International	
MSCI EAFE Large Cap: Europe, Asia & Far East Large Cap	**4.43 %**
MSCI EAFE Small Cap: Europe, Asia & Far East Small Cap	**2.30%**
MSCI EM Emerging Market: Emerging Market Countries	**7.97 %**

Source: Bloomberg, L.P.

U.S. Equity Markets

The "Magnificent Seven" stocks have had an outsized impact on returns the past few years and this is likely due to much higher earnings growth than the rest of the market as highlighted below. The chart shows that this is expected to continue in 2025. We are not concerned over the higher valuations for these companies due to their superior fundamentals. As long as they can maintain above average growth, we believe investors will continue to reward these companies with higher valuations.

Despite a strong year for U.S. large-cap equities, many sectors did not participate including energy and health care which only posted modest gains, despite reasonable fundamentals. Wall Street is a fashion show, and many stocks were out of fashion last year. These and other weak sectors could prove to be the fuel for the next leg up in the market. Small and mid-cap companies performed reasonably well in 2024 despite stubbornly high interest rates and limited exposure to AI themes. These companies are dependent on the health of the U.S. economy and short-term interest rates. If rates don't come down much in 2025 due to a strong economy, we believe that these companies can perform well. The main risk is higher rates coupled with a slowing economy which we view as a lower likelihood scenario.



Source: JPMorgan Guide to the Markets 12/31/2024

International Equity Markets

Developed international equity markets have been challenged for years vs. the U.S. due to more of a focus on cyclical companies and a modest weight to higher growth technology companies that comprise a large portion of U.S. indexes. While valuations are not demanding for international stocks, that alone is not a catalyst for better forward performance. We are seeing a more shareholder-focused movement in Japan which may stimulate that market. European citizens are beginning to push for political change after many years of low economic growth. Change is hard, but if indeed we begin to see some genuine reform, this could be a catalyst for better returns going forward.

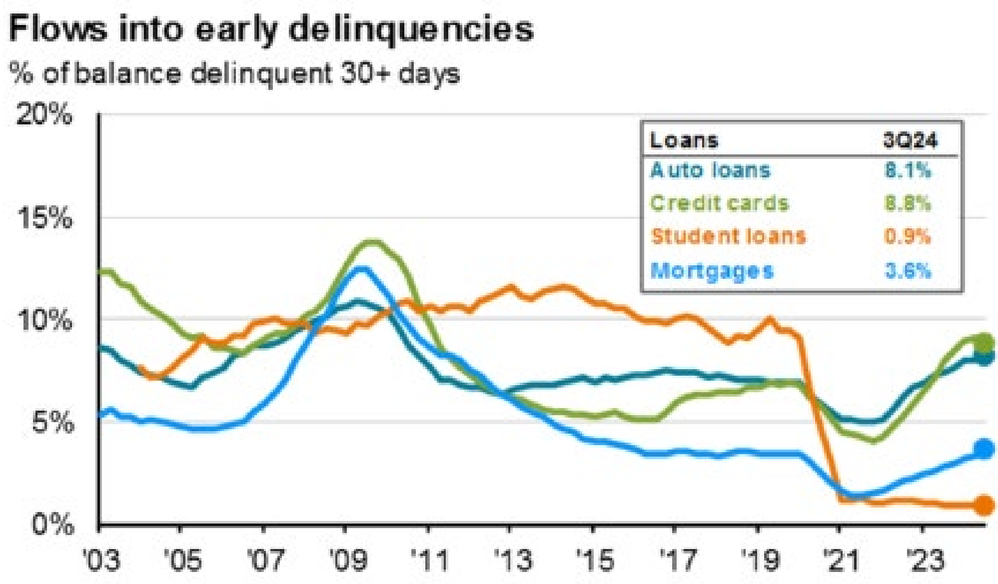
Emerging markets (EM) have posted low-single returns over the last decade despite seemingly high growth prospects. China is a large weight in EM indexes and has been essentially flat over this same period. Investors are not comfortable with the Chinese government's role in markets causing valuations to contract. The Chinese government has taken steps recently to stimulate their moribund equity market, but it remains to be seen how successful this will be. The threat of tariffs hurt EM markets in late 2024, as they are very dependent on the U.S. How the tariff threat plays out will be a large determinant for 2025 performance.

Inflation, Interest Rates & Fixed Income

Inflation has recently picked up modestly as the U.S. consumer price index (CPI) has now risen the last two months and currently sits at 2.7% at the end of November. In response to this, the consensus of the Federal Open Market Committee (FOMC) now forecasts two 0.25% interest rate cuts in 2025, versus four previously. To be clear, this is as of today and events invariably change. Some forecasters expect the labor market to weaken in 2025, necessitating more interest rate cuts. The FOMC is not clairvoyant and is subject to changing their opinion as events dictate. The concern is if inflation remains elevated, and unemployment picks up. This would put the FOMC in a box. We will certainly be monitoring inflation and unemployment closely over the coming months.

It is important to remember that the FOMC has cut interest rates by 1% in 2024 to a current range of 4.25% to 4.5%. Unfortunately, longer-term rates, which are not controlled by the FOMC and are market driven, have risen over the last few months in response to higher inflation readings among other concerns. The graph below highlights that auto loans, credit cards and mortgage delinquencies are rising, which is concerning.

We continue to find interest rates attractive for fixed income investors, as rates are much higher than inflation providing an attractive real return. In the event that the economy slows and the FOMC cuts interest rates, that would be an additional tailwind for fixed income. Even in the event that rates were to rise modestly from current levels, the higher coupons would provide a cushion from falling bond prices.



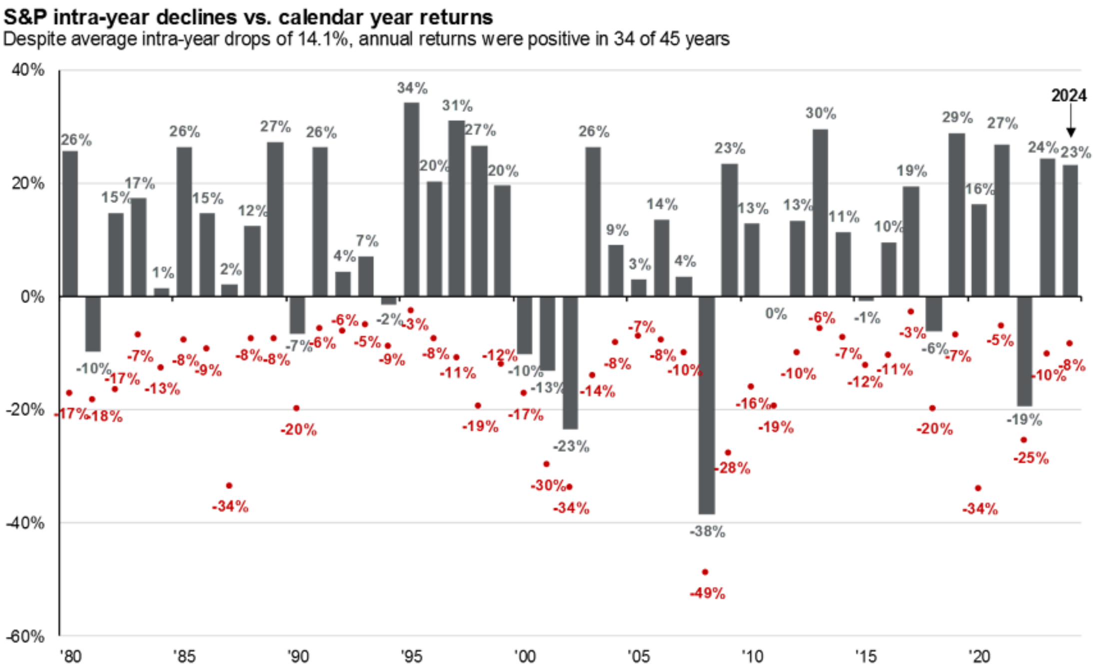
Source: JPMorgan Guide to the Markets 12/31/2024

Election

After a rise in U.S. equity markets post the November election, markets have retreated as investors weigh the implications of future government policy. We have found that it is wise to wait until after a president assumes office and actual legislation is passed before making impulsive investment decisions. Higher tariffs have been suggested and most economists predict only a slight increase in prices as exporters to the U.S. are forced to accept lower margins to offset the increase in tariffs. Typically, the changes that are promised or forecasted do not come to fruition or are watered down. The government is generally a slow-moving wheel despite politicians' promises for change.

Summary

The red numbers in the bar chart below indicate that markets regularly fall intra-year on average 14% while annual returns have been positive in 34 of 45 years. The bar chart highlights that the S&P 500 was relatively tranquil in 2024, with one intra-year period falling 8% before ending up 23% (excluding dividends). This is a nice reminder that markets are volatile despite solid long-term returns.



Source: JPMorgan Guide to the Markets 12/31/2024

We have enjoyed low inflation for an extended period of time until the spike after COVID. Our two concerns entering 2025 remain elevated inflation along with a concern over weakening employment. On the positive side, a large proportion of companies in the S&P 500 have secular growth characteristics which can weather some economic turbulence. If the economy were to slow in the next year or two, it is important to remember that these periods are typically brief, and the U.S. economy comes out the other side stronger.

U.S. markets have been buoyant for much of the past decade demonstrating how economic expansion generates wealth. We have a dynamic disruptive economy which has created a tremendous amount of growth. While no one knows what the next year will bring, we do know that the indomitable spirit of U.S. businesses will remain.