MARKET SIGHT LINES

Year-End Reflections

By Michael O'Keeffe, *Chief Investment Officer*

My team and I continue to develop our formal outlook for 2025, which we will publish in the first full week of January. Given this work, December is a good time to reflect on this past year and consider some important issues as we look to start the new year. In this Sight|Lines, we offer some year-end reflections about 2024 with a look to 2025.

THE TAKEAWAY: A GOOD YEAR BRINGS KEY ITEMS INTO FOCUS

2024 has been a very positive year for the economy and markets, bringing several key issues into focus as we head into 2025. In summary:

- The U.S. economy grew more than expected this year, with more growth forecasted.
- Fiscal spending was elevated this year, good for the economy but adding to debt.
- The Federal Reserve (Fed) maintained a restrictive monetary policy but began rate cuts in September.
- Interest rates remain elevated, and the bond market posted a modestly positive return.
- Earnings growth has been positive in 2024, with more expected next year.
- Equity markets have posted strong returns, elevating valuations.
- Looking forward, inflation will be in focus: Will it fall closer to 2%, the Fed's target?
- Assuming we're on that inflation path, the Fed will cut rates further.
- But higher inflation could mean higher rates for longer, shaking market confidence.
- The incoming administration may cut spending, and austerity could be a positive.
- Geopolitical risks are in focus, with the potential for associated market volatility.
- The power shift in Washington, D.C. may or may not go smoothly.
- Expectations for both the economy and earnings are high, so any "miss" may disappoint.

IN-DEPTH: AS A GOOD YEAR FINISHES, CERTAIN KEY ISSUES COME INTO FOCUS

2024 has ended up being a very positive year for both the economy and markets, bringing several key items into focus as we prepare for 2025. Going deeper:

- The U.S. economy grew more than expected in 2024, with forecasts for more growth:
  - U.S. GDP is forecast to grow 2.7% this year, above the forecast of 1.3% as we started the year.
  - The consensus GDP forecast for 2025 is 2.1%, with little talk of recession.
- Fiscal spending was elevated this year, good for the economy, but adding to debt.
  - The $1.8 trillion deficit added to the debt, which now totals $36 trillion.
  - Our debt service – the interest on our debt – represents 35% of our discretionary spending.
- The Fed maintained a restrictive monetary policy but began rate cuts in September.
  - Officials cut the fed funds rate a half point in September and a quarter point in November.
  - Fed funds futures are pricing in cuts of a quarter point in December and a half point next year.
- Interest rates remained elevated, and bond markets posted modestly positive returns.
  - The 10-year Treasury yield began the year at 3.88% and now sits at 4.28%.
  - The Bloomberg U.S. Aggregate Bond Index has returned 2.8% year to date.
- Earnings growth has been positive in 2024, with more expected next year.
  - The S&P 500 earnings growth is expected to be 9.6% in 2024 and 14.8% in 2025.
- Equity markets have posted very positive returns year to date, elevating valuations.
  - The S&P 500 is up 29.2%, with its price/earnings ratio 27% above the 10-year average.
- Key issues are in focus, each with the potential to influence markets and increase volatility:
  - Inflation is expected to move toward the Fed's target, so a move higher could disappoint, especially if the Fed slows rate cuts further or considers a hike.
  - The power shift in Washington, D.C. brings changes investors have viewed positively, so any meaningful resistance to change, or gridlock, could spell trouble in the markets.
  - The incoming administration will be focused on spending:
    - The new Department of Government Efficiency (DOGE) will look for ways to cut spending.
    - Austerity can be a positive as an important step toward reining in the deficit and debt.
  - Geopolitical risks are in focus as a potential catalyst for market volatility:
    - Escalation of the many military hotspots can shake investor confidence.
    - The new administration must manage well the use of tariffs to improve foreign relations.
  - Markets trade on expectations about the economy and earnings, so an economic slowdown or erosion in earnings growth could easily trigger market weakness from these elevated levels.

CONCLUSION

2024 is ending, and my team and I continue to develop our outlook for 2025. Of course, December is a good time to reflect, looking back on the last year and considering important issues as we start the new year. We look forward to publishing our full outlook report in the first full week of January.

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