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FINANCIAL ADVISORY GROUP LLC

Fourth Quarter 2024 Economic and Market Outlook

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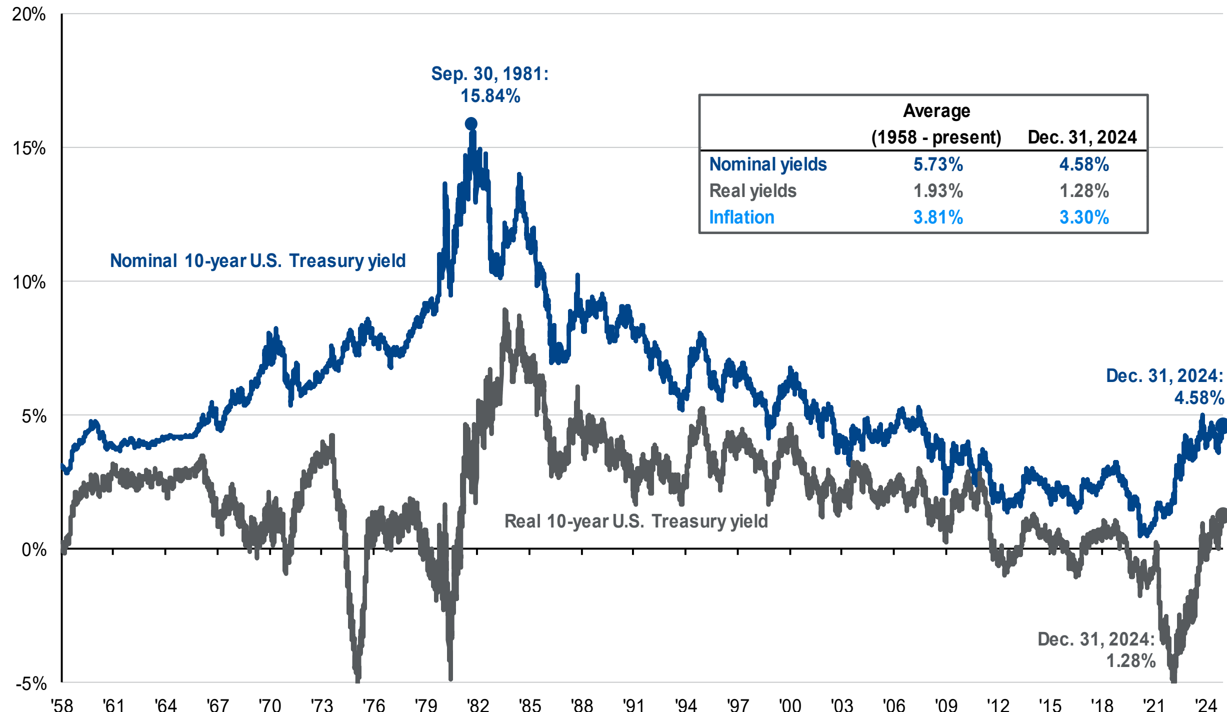
First Quarter 2025 Economic Outlook

As we look ahead to 2025, the question still remains as to whether the Fed will be able to achieve a rare soft landing, particularly given the potential shift in fiscal policy that will likely accompany Trump's second presidential term. Many view the next administration's economic policies as inflationary, given the stated objectives of higher tariffs and lower taxes. In addition, the uncertainties surrounding the impact of tariffs may lead to market volatility, too. An escalating trade-war has the potential to disrupt activity, slow growth, and increase prices.

Figure 1: Outlook for Inflation is Key Metric for Markets in 2025



	Average (1958 - present)	Dec. 31, 2024
Nominal yields	5.73%	4.58%
Real yields	1.93%	1.28%
Inflation	3.81%	3.30%

Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management. Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month. For the current month, we use the prior month's core CPI figures until the latest data are available.
Guide to the Markets – U.S. Data are as of December 31, 2024.

In **Figure 1,** we show the historical relationship between the nominal and real yield for the 10-year treasury. The difference between the two is inflation, as measured by the Consumer Price Index or CPI. As of December 31, 2024, real yields were in positive territory and the difference between nominal (unadjusted for inflation) and real yields (adjusted to reflect inflation) was 3.3%. For comparison purposes, the graph also includes the period in the early 1980s, where inflation expectations were approaching 15.0% and the nominal U.S. Treasury Yield reached 15.8%. While the situation today is not at the same extreme, we are expecting modest inflation to be with us for a bit longer. From a portfolio strategy standpoint, we emphasize bonds with less interest rate sensitivity than the market in the event that 10-year bond yields move higher, while maintaining intermediate exposure as well, in the event that economic conditions deteriorate.

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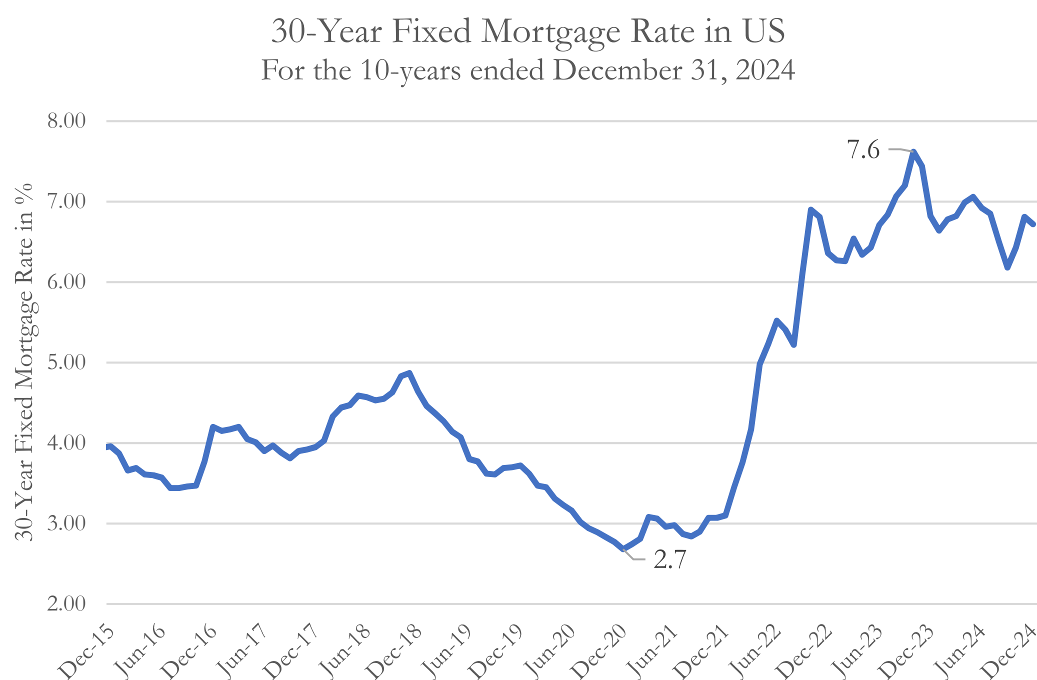
RISKS AND OPPORTUNITIES AHEAD

If inflation does remain higher than expected, the Federal Reserve may have to reverse course and raise rates again at a time when economic conditions are weakening. This would put more pressure on the consumer given the fact that pandemic-era stimulus has effectively been depleted. In turn, recent spending has relied more on credit cards, personal loans, and auto loans, which all have higher rates today than at any time in the last decade. Furthermore, new homeowners are finding it harder to afford homes given the level of mortgage rates and house prices, which are both well above pre-pandemic levels (See **Figure 2**). Since consumer spending accounts for over two-thirds of GDP growth, a slow-down in credit-fueled spending or weakness in the housing market have the potential to tip the global economy into a recession.

Figure 2: Mortgage Rates Remain at Highest Levels of the Last 10 Years



Source: Freddie Mac, 30-Year Fixed Rate Mortgage Average in the United States [MORTGAGE30US], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MORTGAGE30US, January 6, 2025.

Despite these risks, the U.S. is in relatively good shape when compared against the rest of the world. Economic growth was recently revised higher, inflation is well off of its high, and the unemployment rate remains steady at 4.1%. While the U.S. stock market looks expensive at a headline level, it is less so once one accounts for the impact of the seven largest stocks. Although forward earnings-per-share estimates for the S&P 500 (ex- magnificent 7) are more modest than the high expectation technology names, this segment of the market is also trading at lower valuation multiples, making them a compelling complement from a portfolio context.

Outside the U.S., the outlook is less clear. Despite a relative value advantage for non-U.S. markets, the uncertain impact of a potential trade war would have a negative impact on certain global

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manufacturers traded in the U.K., Europe, Japan, and Chinese markets. In the event of a trade war, the U.S. dollar is likely to strengthen against major foreign currencies, and returns in non-U.S. markets are lower in U.S. dollar terms. Of course, the opposite could occur. If inflation in the U.S. rises, this could erode the value of the currency and lead to dollar weakness in the future. However, this is not likely in the near term.

In addition to economic and market risks, rising geopolitical risks may pose challenges to the new U.S. administration and have the potential to increase market volatility as a result. Surprisingly, the ongoing conflicts in the Middle East have not had much of an impact on energy markets thus far. In fact, oil prices declined for most of 2024, even as risks of a renewed conflict with Iran began to increase. However, we did see gold prices rise dramatically over the course of last year and this may be a sign of a rising geopolitical risk premium, since gold is often considered a hedge against financial instability and inflation. Bitcoin (sometimes referred to as digital gold) and other cryptocurrencies soared after the U.S. election given the market's expectations of a more lenient regulatory oversight of the new asset class. However, we see Bitcoin more as a speculative asset. Given its volatility, we would not consider it to have the same hedging properties as gold.

OUR OUTLOOK

Wescott does not try to predict market outcomes, but rather seeks to build portfolios that are well positioned in the event of market shifts and rotations. As we enter a new year, there are high expectations for pro-growth fiscal policies from the new administration. However, today's economy is in a very different place than it was during the first Trump term. Due to the fact that the U.S. budget deficit is now at 7.0% and bond yields are over 4.0%, future fiscal policy may be more restrained than many hope.

Finally, earnings expectations remain aggressive for leading A.I. technology companies and, as a result, valuations are near historical highs. Any shift in investor sentiment can change market leadership very quickly, whether driven by economic factors, such as interest rates or inflation, or by changes in fiscal or monetary policies. Factors such as these are why we manage portfolios in a balanced way.

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Past Performance is No Guarantee of Future Performance.

Reminder: The returns for your accounts are affected by the timing of new investments, cash flow patterns (deposits, withdrawals and transfers), client-specific asset allocation policies and retained individual securities. All of these variables may cause dispersion among returns, as compared to our Models.

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