December 2024 Capital Markets Commentary

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"You cannot spend your way out of recession or borrow your way out of debt." **Daniel Hannan**

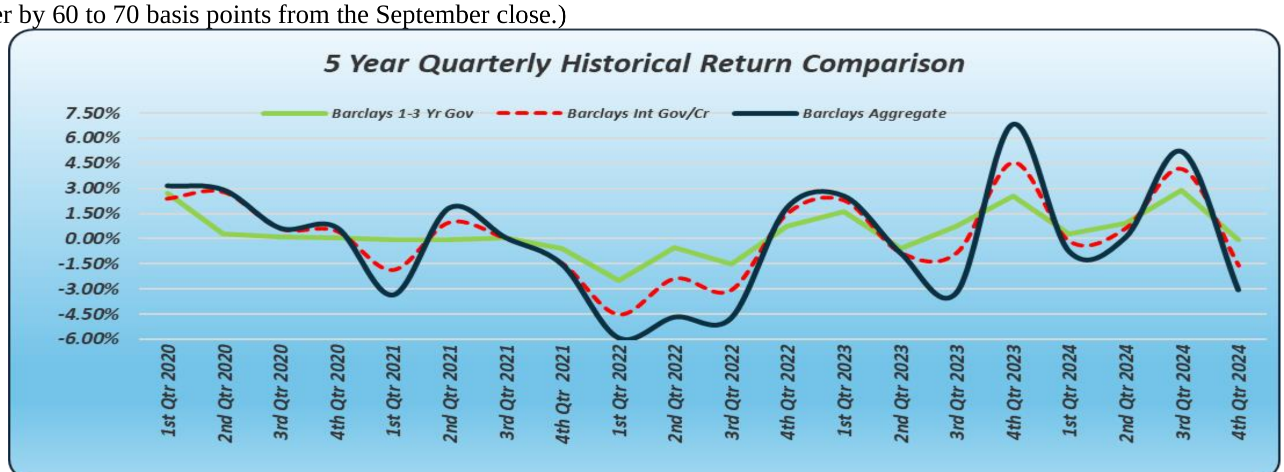
Fixed Income

The 4th quarter of 2024 ended on a sour note for the bond market. With a return of -3.06% for the quarter (On the Barclays U.S. Aggregate), this proved to a tough quarter for the bond markets and led to uninspiring results for the whole year, which was made worse when adjusted for inflation.

The yield on the benchmark U.S. 10-year Treasury note held below the 4.55% mark on the final trading day of 2024. For the year, the 10-year note's yield rose 60 basis points on the back of slowing disinflation and concerns about the inflationary risk from the incoming Administration's stated policies.

During the quarter, the FOMC cut rates twice, and moved the target Fed Funds to a range of 4.25% to 4.50%. Inflation is still higher than the Fed's target, but most Fed governors are still leaning towards lowering rates in 2025, albeit a little less than they thought only a few months ago. This change in policy stance seems to be reason the bond market faltered in the 4th quarter.

As mentioned, returns were negative across almost all parts of the curve during the quarter. The Barclays U.S. Aggregate posted a -3.06% return for the quarter, and the Barclays Intermediate Index was at -1.60%. The short end of the yield curve also saw a negative return, with the 1-3 Year Government Index at -0.08%. Only at the truly short end of the yield curve did you see positive returns. The 1 Year T-Bill returned +1.1% for the quarter. As for yields, the 10-year Treasury yield ended the quarter at 4.58%, the 5-year Treasury yield ended at 4.38%, and the 2-year Treasury yield ended at 4.25%. (As of the end of December, yields were higher by 60 to 70 basis points from the September close.)



Fixed Income Markets - Looking Ahead

At the November and December FOMC meeting, there was a change in policy and the FOMC lowered rates twice by 25 basis points. The markets were looking for more.

Although inflation has slowed enough to levels that allowed the Federal Reserve to cut interest rates, they also tempered their future interest rate policy, from four cuts in 2025 to possibly only two.

Even though the fixed income markets are looking for continued downward rate cuts, which are still priced into the market currently, we continue to believe that there will probably be additional Fed cuts in 2025; however, the easing may be muted. With the recent rise in yields, investors still should not miss the opportunity to lock in attractive yields and potentially benefit from the price appreciation that will occur when yields continue to decline in 2025.

The Fed's top priority of inflation reduction and containment remains. However, the Fed could pause rate cuts sooner rather than later. There is an expectation that the Fed's bias is to remain toward further rate reductions through the 1st quarter of 2025, as questions about the true health of the labor market linger and possible pro-growth policies risk overheating the U.S. economy and fueling inflationary concerns.

Equity

The equity market, as measured by the S&P 500 Index, closed out 2024 with an impressive gain of 24.99%, marking the second consecutive year of strong performance following a 24.23% increase in 2023. Even though back-to-back gains of this scale are significant, they are not historically unusual.

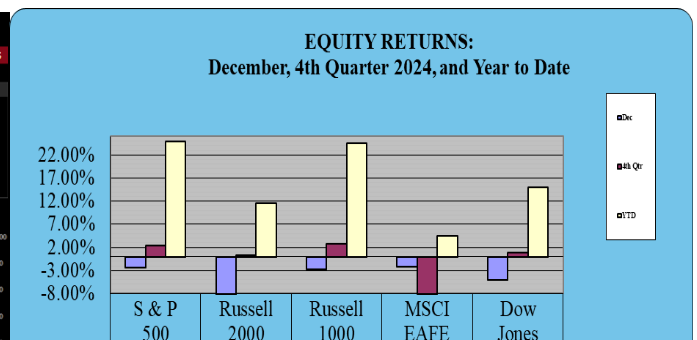
While the U.S. equity markets had a very good year, the 4th quarter, although positive, was tempered by a weak December. There was no shortage of market-moving events in 4th quarter. The stock market opened the quarter with a slow start in October, but the outcome of the presidential election triggered a broad rally in November. And as usual, following election euphoria, the rally faded as the year ended, although as mentioned, the S&P 500 still traded only a few percentage points below its all-time high.

Small cap stocks led the way during the broad market rally, with the Russell 2000 rising +11% in November to set a record high. Bank stocks also did well post-election, as investors priced in expectations for financial deregulation and strong economic growth. Industrial stocks also saw broad-based strength in anticipation of the Trump administration's pro-growth and protectionist policies, which could spark an industrial rebirth in the U.S.

While the stock market saw intermittent selloffs during the quarter, it continued marching higher as corporate earnings still hold out hopes that the economy can avoid a recession. As mentioned above, the S&P 500 index rose 25% during the 2024.

With inflation falling faster than expected, below 3%, moving closer to the Fed's 2% target, the 4th quarter of 2024 saw only two more 25-basis point rate cuts in November and December.

All indexes were positive for the quarter, with the exception of the EAFE Index. On the U.S. side, the S&P 500 ended with positive +2.4% return for the quarter, and the Russell 1000 index returned +2.7%. Other indices did equally well. The Russell 2000 index returned a meager +0.3%, and the Dow returned +0.9%. The international markets posted the only negative returns of-8.06% for the quarter.



	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
Dec	-2.39%	-8.26%	-2.79%	-2.25%	-5.13%
4th Qtr	2.39%	0.32%	2.73%	-8.06%	0.92%
YTD	24.99%	11.52%	24.49%	4.43%	14.98%

Equity Markets - Looking Ahead

2025. Will we have a roller coaster year in stocks?

As we move into 2025, conditions still remain good for U.S. equities.

The current bull market, which started in October 2022 is now in its third year. This bull market has performed in line with historical norms, but bull market returns often moderate as the markets mature. This suggests that the market's focus could shift to fundamentals and earnings as the next catalyst to push markets higher. 2025 may be shaping up to be a year where companies will need to deliver on investors' expectations to justify their current high valuations.

As mentioned in the last quarterly commentary, stock markets have historically experienced volatility in the few months prior to U.S. Election Day. However, markets typically recover in the weeks following the election. Given the election outcome, what is certain is that 2025 will contain plenty of twists and turns. Optimism about the economy and Trump's accommodative government have pushed stocks to record highs. They're also trading with historically high valuations, which many analysts note, "typically increase the magnitude of market drawdown during a shock."

As we move forward, there are always risks for markets and investors. Inflation seems to be in check but remains above Fed targets. The timing and amount of future interest rate cuts by the U.S. Federal Reserve is murky for the markets, and with that everyone needs to be wary. Although 2025 looks to be a positive year for equities, hold on to your hats.

The Economy

The Economy. Stronger is Better.

After five years of uncertainty and turmoil, the U.S. economy ended 2024 in arguably its most stable condition since the start of the coronavirus pandemic. Inflation has cooled. Unemployment is low. The Federal Reserve cut interest rates.

By most measures, the US economy is in good shape. Employers added about 2 million jobs this year. Unemployment is low. In much of the country, gasoline is now selling for less than $3 a gallon.

Change is in the air. Trump won the election. He campaigned on a platform of lower taxes and less-stringent regulations, which seen as growth-positive, but also higher tariffs on imported goods and mass deportations of illegal immigrants, which is seen generally as bad, at least initially. These crosscurrents and the fears they are raising make it difficult (both domestically and internationally) to plan for the future; potentially creating an environment of concern across policy areas. Add to this a Federal Reserve operating in data-dependency mode, and we have a backdrop of reactionary market behavior and policy decisions.

The FOMC reduced their overnight rate by 50 basis points during the quarter. While markets expected cuts after the September reduction of 50 basis points, the debate was how much would the next cuts be. During the December press conference, Federal Reserve Chairman Jerome Powell indicated that recent data released shows the economy is stronger and there are inflation worries. Add to that, recently announced plans by Trump that he intends to introduce a 25% tariff on all goods imported from Mexico and Canada, plus a 10% additional duty on goods from China. Economists expect those tariffs, plus other parts of Trump's economic agenda, like mass deportations that could make it harder for employers to find workers, will push up inflation.

The Economy - Looking Ahead

Economic Growth? Jobs? Inflation? Global problems? – At least the election is off the table.

It seems that Fed policies have done a pretty good job at controlling inflation while they tried to balance their mandate of maximum employment and stable prices.

In looking forward, the economic forecast for 2025 shows growth, but at a slower pace than 2024. Inflation will remain above the Federal Reserve's target, with President-elect Trump's policies limiting production while stimulating spending. The greatest risk is not a recession but limited production capability as immigration falls and inflation starts to rise again.

The broad economic picture is murky. While the manufacturing sector continues to show signs of weakness, other economic indicators show a more optimistic picture. Economic growth projections remain strong, which is one of the reasons why inflation is expected to remain above target. Furthermore, positive feelings regarding the incoming Trump administration could push economic growth even higher, depending on whether the new administration is serious about the fiscal deficit or not. Add to that a strong but choosier consumer, coupled with a better-valued, more productive workforce can land the economy in a good place.

As we look to the future, the economic model is best described as cautiously optimistic.Markets remain unconvinced that the fight against inflation is over. Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) data suggest that inflation remains somewhat "sticky" at around 2.7%, still above the Federal Reserve's long-term target of 2%. And as mentioned throughout the commentary, there are concerns that the new administration's policie, such as tariffs and changes to immigration policy, could impede inflation's march back to target levels.

While the markets during 2024 showed concerns about the Fed's "restrictive" monetary policy increasing the risks of a recession, it seems that the recession talk is off the table. The estimate of real gross domestic product growth in the 4th quarter is continuing at the above-average trend. And although that figure will drop by the end of 2025 and probably further by the end of 2026, the slower growth shouldn't constitute a recession. After all, the economy still can grow, but the pace of growth will be weaker.

The economy appears to be in good shape for now. With the election over and inflation largely under control, the Federal Reserve's transparency of its monetary policy decisions, pairing clear communication with measured actions, has contributed to a fairly stable economy and stronger-than-expected equity market performance. Unfortunately, it is tough to predict what happens as the year progresses given possible outcomes of new policies by the incoming administration.
