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Rebalance & Diversify: Staying Strategic in an Evolving Market Environment

December 21, 2024

Born out of a rebound from pandemic-associated weakness, the current bull market in U.S. equities hit a two-year milestone through December. Our investment team will dive deeply into the factors we believe will drive economic growth and markets next year on the following pages.

Investors are watching closely to see how proposed policies from the new administration will be enacted and the related impact on the market. We recognize that each economic period is unique and believe 2025 could be vulnerable to volatility given policy uncertainties and lofty U.S. equity valuations. We recommend starting the year with portfolios rebalanced to strategic asset allocations and maintaining a diversified, flexible approach in navigating what's ahead. Regarding overall portfolio strategy, we maintain a neutral stance on stocks, bonds, and alternatives, with slight tilts toward U.S. equities, mid- and small-cap stocks, and high-quality bonds. Recent adjustments to our alternative allocation reflect a more cautious risk management stance after two years of strong equity market performance.

U.S. Macro Outlook: Resilient Growth Continues

The U.S. economy enters 2025 on solid footing, with steady growth, moderating inflation, and evolving macroeconomic dynamics. Our base case forecasts GDP growth of just over 2 percent, driven by resilient consumer spending, solid productivity gains, and easing monetary policy. Our outlook reflects a continuation of post-pandemic themes: steady growth, declining inflation, and an accommodative Federal Reserve.

Higher-income households remain the cornerstone of U.S. growth, with the top 20 percent of earners contributing 39 percent of consumer expenditures and just under half of total income[1]. We expect this group's spending power to sustain economic momentum, given that tighter credit conditions and slower labor force growth less impact them. Elevated personal savings rates further bolster resilience, supporting steady, albeit moderating, consumption growth.

Productivity rose 2.2 percent in the third quarter of 2024[2], reflecting advancements in technology, particularly the integration of artificial intelligence across industries. Additionally, a post-pandemic surge in small business formation has supported innovation and growth. U.S. Census Bureau data show about 5.5 million business applications filed in 2023[3]. Millennials, now in their mid-to-late thirties, are entering a prime age for entrepreneurship. While not our base case, potential policy shifts to foster small business growth could further enhance innovation and productivity.

Anticipated policy changes under the new administration introduce both opportunities and risks. Extending the 2017 personal income tax cuts and modest new reductions could lift consumer spending and business investment, though the impacts usually take time to materialize. Tariff increases and reduced immigration flows may create near-term frictions but are unlikely to significantly disrupt the macroeconomic trajectory. A lighter regulatory approach could spur capital market activity, benefiting sectors like financials and private equity.

In summary, the U.S. economy is currently set to deliver what we would call "persistently positive" growth in 2025, supported by consumer spending, technological advancements, and a favorable policy environment.

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[1] U.S. Bureau of Labor Statistics, https://www.bls.gov/news.release/cesan.nr0.htm

[2] U.S. Bureau of Labor Statistics, https://www.bls.gov/news.release/prod2.nr0.htm?utm

[3] U.S. Census Bureau, https://www.census.gov/econ/currentdata/?programCode=BFS&startYear=2004&endYear=2024&categories[]=TOTAL&dataType=BA_BA&geoLevel=US&adjusted=1¬Adjusted=0&errorData=0#bar055

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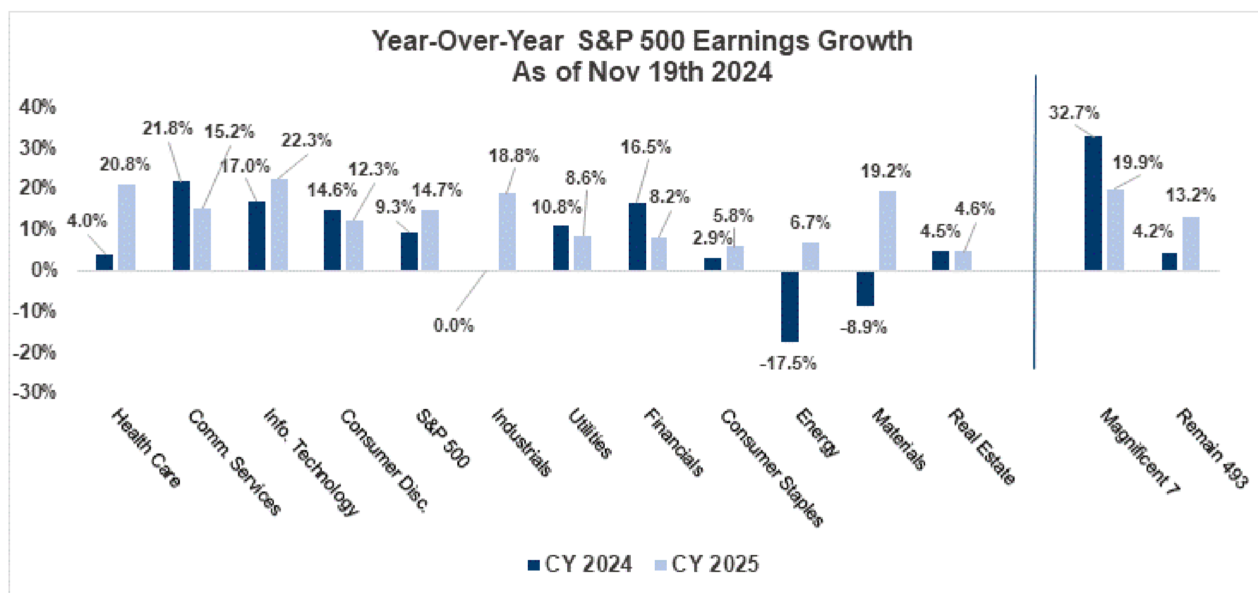
Global Equities: Strength, Caution, and Global Divergence

The remarkable performance of U.S. stocks in 2024 has set the bar high as we enter a new year. The S&P 500's forward price-to-earnings ratio currently stands at 22 times, above its long-term average of roughly 19 times. Adding to the challenge, Wall Street's consensus estimate for S&P 500 earnings growth next year currently sits at 14 percent, also substantially above the long-term average of 6 percent. With stocks trading at premium multiples and considerable growth expected, is the market priced for perfection?

Even as we heed the caution signs, expectations are supported by the solid macroeconomic backdrop outlined earlier. In addition, corporate fundamentals remain robust, with the expectation that leadership will broaden after a period of extreme domination by a small group of mega-cap technology and consumer-related companies. Should this occur, we expect small- and mid-sized businesses to attract greater attention. As the balance between narrow leadership and the rest of the market shifts, we forecast a high single-digit earnings return profile for the broad market, below the current consensus.

Not Just About AI: The Broader Market Shows Strength



Source: FactSet Analytics

International markets present a complex landscape of prospects and obstacles. Recent global election outcomes heighten attention on these economies and local markets. Trade policy is now a central focus for incoming administrations. Given the uncertainty surrounding the timing and specific details, a measured approach to responding to policies as they unfold seems prudent. Investors have favored the U.S. equity market over international markets for an extended period. While international markets present a relative valuation discount, it's important to understand the underlying reasons for this disparity. This approach allows for a balanced consideration of the risks and potential rewards in the international investment landscape.

Interest rate cutting and other stimulus measures remain on the table globally. The European Central Bank (ECB) has addressed sluggish growth by cutting its main deposit rate, most recently to 3.25 percent in October, marking its third reduction of the year. China has made substantial efforts to inject capital and stimulate its economy. The initiatives

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attempt to reassure direct investment, alleviate certain leverage concerns within the county's regional economic structure, and potentially thwart any negative impact a tariff hike may have on its considerable exports.

Conversely, Japan is grappling with wage growth and sustained currency weakness. Expectations suggest the Bank of Japan may normalize policy by raising rates over the next few quarters, diverging from the ECB's approach. Lastly, while there has been a recent slowing, India continues to be the fastest-growing major economy in the world. Structural drivers such as urbanization and infrastructure investments are expected to support elevated levels of growth for the foreseeable future.

While analysts are tempted to revisit the playbook from President Trump's first term, we hesitate to adopt this approach given the markedly different conditions today, including a higher general interest rate level and a distinct monetary policy environment. We anticipate political policies will yield a net benefit for the U.S. economy, likely at the expense of growth in select international markets. These challenges seem to be reflected in current market valuations, some of which we believe offer attractive entry points for long-term investors.

New and Emerging U.S. Equity Trends Remain Our Friends

It's a well-known adage that upward stock-market cycles don't die of old age – they typically need a catalyst to reverse direction. While equities have the potential to move forward, elevated valuations and expectations for growth also suggest increased periods of turbulence. Our focus remains on individual companies with competitive advantages, pricing power, high returns on capital, and reasonable valuations. Within that framework, we also look for businesses exposed to strong secular trends with lasting implications.

A handful of companies tied to artificial intelligence continue to dominate investor mindshare and propel the indexes in 2024. We anticipate this trend will broaden going forward. For example, with AI evolving at a dizzying pace, tech giants are pouring billions into data center construction, betting that these facilities will underpin the next wave of technological innovation. There are several key themes playing out in this initial infrastructure build, with power requirements, on-site labor availability, and cost-effective cooling being among our key areas of focus. As large language models improve and use cases develop, we believe the future beneficiaries will become companies that can harness AI to improve end-user efficiency, customer interaction, and drive returns on investments.

Consumer spending is expected to remain a kingpin in the economy moving forward. This is supported by rising real income, the solid labor market, a wealth effect from the bull market, and a rise in housing equity. Over half of the spending is concentrated in the aging baby boomer population. This demographic trend contributes to the demand for entertainment and travel as consumers prioritize the value of experiences and connections over physical things. Millennials share this affinity for experiences. While a much smaller cohort, the median millennials' net worth is 46 percent higher than that of baby boomers when they were at a comparable age in 1989, adjusted for inflation.

Of course, new trends may emerge as well. Unforeseen policy changes are at the top of the investor mindset. What these policies and priorities mean for the economy, consumer prices, and sectors is unclear. We remain vigilant, knowing that uncertainty creates opportunity at the individual-company level, given each business is unique in its ability to navigate change effectively. For example, tariffs are likely to disproportionately impact companies without the value-add differentiation to command pricing power or those without a nimble supply chain that provides sourcing options. Consider software makers, which offer a value-added service insulated from tariffs, as opposed to commoditized hardware components.

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Policy uncertainty can present an opportunity to accumulate strong franchises at reasonable prices. For example, in healthcare—a lightning rod for policy—the key drivers on demand remain an aging population, new therapies, personalized medicine, and diagnostic testing, all areas highly unlikely to abate. While the market takes a short-term look at potentially disruptive views on vaccines and other health oversight guidelines, we believe longer-term investment opportunities remain solidly in place in a sector that looks attractive on various valuation metrics. Additionally, nuanced names in the sector exposed to areas like new treatments and therapies for companion animals should be immune from politics.

Similar opposing dynamics are likely in other areas of the market. A harder stance on immigration, for example, may lead to less household formation, freeing up housing supply while at the same time driving up costs given immigrant laborers' contribution to the construction industry. Despite weakness in office space, other commercial real estate market areas continue to see solid supply and demand metrics. For example, mixed-use shopping centers with grocery stores anchors are seeing the strongest occupancy rates in decades, driven by a five-year low in vacated properties and a 10-year high in new leasing volumes.

We believe changes to overall returns will be more linked to individual-company fundamentals as broadening market leadership encourages investors to migrate toward growth that isn't yet reflected in stock prices. We're encouraged by our ability to identify companies where we see unique opportunities for growth going forward. Businesses with strong balance sheets, competitive advantages, durable pricing power, and resilient profitability should attract attention in 2025 regardless of policy changes.

Bonds: Fixed Income Streams Keep Flowing

U.S. Treasury yields were volatile in 2024, with the yield curve between the 2- and 10-year maturity reverting to its normal upward-sloping shape last September. As we write this, the Federal Reserve Board (Fed) cut rates twice in 2024, pressuring short-term rates while resilient economic growth supported higher, longer-term yields. The entire curve is above 4 percent as we enter the final month of 2024. Tight credit spreads reflect investor growth optimism as inflation expectations increased modestly following the U.S. election.

We believe that the Fed will continue to cut rates in 2025. The Board's dual mandate of price stability and maximum employment appears in balance, providing the flexibility to take a cautious approach. In our view, today's policy range of 4.50 to 4.75 percent is restrictive and will weigh on economic growth and support additional easing. The path and magnitude of rate cuts will continue to be "data dependent" - a now familiar Fed Chair Powell maxim.

We expect the U.S. Treasury curve to shift lower and steepen in 2025, driven by the front end. Anticipated Fed cuts will weigh on short-term maturity yields, the most responsive part of the U.S. Treasury yield curve to Fed policy decisions. We'd think longer-term yields could also move lower over time but at a slower pace. Economic growth and uncertainty surrounding the incoming administration's policy initiatives may add a yield premium to longer-dated bonds.

Corporate issuers' balance sheets have benefited from robust economic activity, and fundamentals remain healthy. Valuations appear stretched with the additional yield compensation over U.S. Treasury securities near historically tight levels. While credit spreads can certainly grind tighter on the heels of positive economic growth and robust investor demand, we believe there may be a better entry point to add additional credit exposure down the road.

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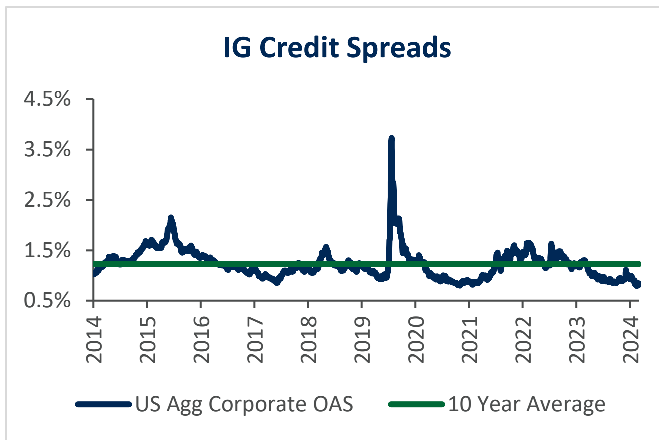
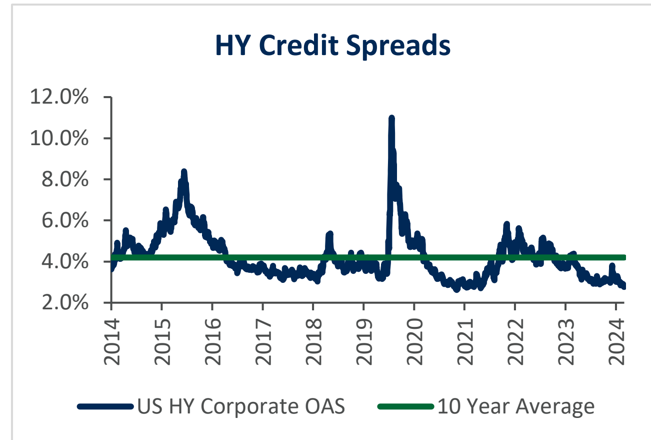
No Reason to Be Greedy; Highest Quality Yields Are Compelling





Source: Bloomberg Finance LP, data as of 10/31/2024

Emerging market debt was a strong performer in 2024. Lower global inflation combined with rate cuts among developed markets could further support the asset class. However, headwinds around the incoming administration's trade and tariff policies have increased. In the municipal bond market, issuer fundamentals continue to benefit from COVID-related policies and tax revenues bolstered by a stable U.S. economy. Reserve balances have strengthened and provide an extra layer of cushion. Absolute yield levels look attractive, while valuations relative to U.S. Treasuries are near last year's level.

We reiterate the importance of balancing reinvestment and price risk within bond portfolios. Across our taxable fixed-income strategies, we have positioned for lower yields and a steeper yield curve. Duration is currently managed close to the benchmark, with longer duration strategies having a shorter bias given uncertainties around U.S. government policies and their impact on Treasury issuance. While cautious optimism supports our current risk asset positioning, should valuations become more compelling, we have the flexibility to become more aggressive.

Alternatives: Diversify and Avoid Complacency

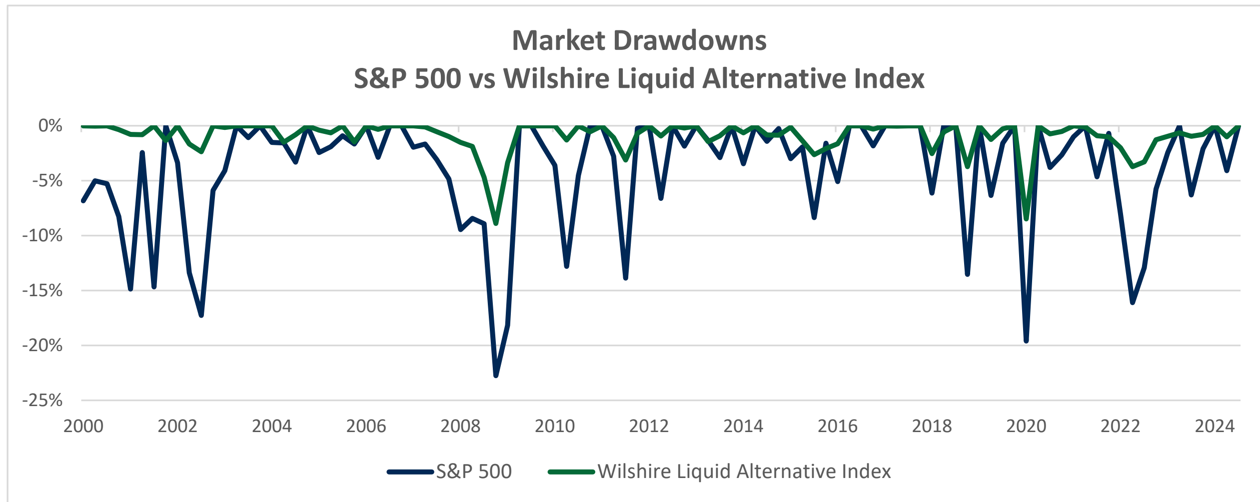
A rising economic tide will lift all boats, but long-term focused investors know the water eventually recedes. Alternative investments, including private markets, have lagged due to high interest rates and a weak exit environment, but their core benefits, including uncorrelated returns and protection against drawdowns, remain intact. Liquid alternatives can also play a similar role in diversifying portfolios. While these investment vehicles can be overlooked in strong markets, we believe they play a key role in risk-adjusted returns, especially when volatility returns.

As noted above, while we have a generally constructive view on traditional asset classes in 2025, we also see a fair amount of optimism reflected in valuations. Investor sentiment has dramatically shifted since the fall of 2022. At the time, recession alarms were ringing in reaction to the dramatic spike in inflation and the efforts of global central banks to rein in prices with rapid and sustained increases in interest rates. Nonetheless, memories of how alternative investments prevailed over traditional asset classes in 2022 were still fresh.

In previous publications, we mentioned that we have exposure to a select group of asset managers that have differentiated investment approaches and portfolios with low correlation to traditional equity and fixed-income markets. These

diversifying strategies aim to reduce portfolio volatility while generating returns within reasonable proximity to the broad equity market, thus augmenting risk-adjusted performance. Mitigating downside risk can be quite useful within the context of a diversified portfolio.

Playing Defense While Staying on Course



Source: Morningstar, as of 9/30/2024

Last year, we recommended an underweight position to this cohort of strategies as the probability of a "hard landing" diminished with signs of a reacceleration in earnings growth across the broad market. As we enter 2025, we are recommending an equal-weight allocation. Our alternative offerings have the potential to be an effective hedge against business cycles, interest rates, and inflation risks. We will continue recommending high-quality private markets investments in client portfolios, benefiting from our vast network and access to high-caliber investment managers.

In Summary:

Crosscurrents from multiple avenues within the economic and investing landscape support a disciplined yet flexible approach to navigating 2025. Our process focuses on high-quality investments, diversification, and other risk mitigation, with tactical positioning to take advantage of dislocations. Successful investments in any environment require blending optimism and caution with a long-term perspective.

Our strength lies in the discipline of our investment process. We diligently project annual capital markets assumptions, adjust our policy portfolios, and layer on top a small tactical positioning when we have conviction. Our in-house macroeconomic research, fundamental security analysis, rigorous manager selection and ongoing monitoring, and seamless trade execution together bring institutional-quality investing to our clients.

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