Innovative Thinking + Smart Strategies

2025: The Year Ahead

Annual Market Outlook

MV Financial Research & Strategy Group

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The Year Ahead: 2025 Annual Outlook

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Note to our readers: On page 12 you can find our investment thesis presenting the key themes of our outlook for markets and the economy 2025. Of course, we invite you to read the full document for an understanding of the economic, capital market and other forces shaping our thought process.

I. The World In Transition

It is never easy to predict what is going to happen in the next twelve months, and very rarely do the best efforts of economists, sociologists and market pundits of all stripes get it all right (you can generally toss away all those specific numbers the big banks and securities firms come up with about where the S&P 500 or Nikkei 225 will be come New Year's Eve 2025, and they will all be revised multiple times anyway between now and then).

It is especially hard this year, because the world is in a profound state of transition. What we have more or less accepted as the norms of what is still quaintly called the "postwar order" – the war in question having ended eighty years ago in 1945 – no longer seem to be the permanent backdrop for the shorter-term cycles of economic, social and political ebbs and flows. Nor is there anything like a clear-cut "new order" in anyone's line of sight; what we are going through instead is a transition on many levels.

To be perfectly honest, this transition may or may not have a meaningful impact on the progress of financial markets in 2025. Markets are very good at ignoring whatever they cannot price directly into a numerical valuation model, and they are entirely amoral as to fuzzy, qualitative notions like the rule of law or the rights of out-of-favor minority populations. But we know that the uncertainty of this transitional period is something of concern to many of our clients. We are going to address it up front, in this first section of our outlook. Then, as usual, we will go through our specific investment thesis for the economy and financial markets in the second section, explaining the thinking behind our portfolio allocation decisions and noting the many variables that will probably require more rethinking as the year goes on.

In this first section we will consider three aspects of the transition. The first concerns the challenges we see to our weakened national and international institutions. The second addresses head-on the exceedingly high level of variability around possible economic outcomes that is making life hard for central banks to effectively manage monetary policy. The third aspect concerns artificial intelligence, both from the standpoint of where the equity market's AI narrative may go from here, and how profoundly the dramatic advancements in this technology may impact this transitional period either for better or for worse.

A. The Institutional Challenge

In 1989, as the Cold War was coming to an end, the political scientist Francis Fukuyama famously predicted the "end of history." He described this as the twin victories of Western-style liberal democracy and economic globalization over all former recipes for the organization of nations, from nineteenth-century mercantilism and imperialism to the twentieth-century disasters of communism and fascism. Fukuyama saw world history in terms of progression – not in a linear sense from one era to the next, necessarily, but with a directional arc over time and, per the argument in his 1989 essay, with an endpoint.

Events have played out differently. Neither liberal democracy nor globalization seem to represent any kind of evolutionary terminus. Rather than a Fukuyama-style directional arc, one could argue that the course of world history today looks a bit more like the "eternal recurrence" model of Friedrich Nietzsche, where the more or less unchangeable essence of human nature keeps us going back and forth between alternative models, with any change from one era to the next being little more than the result of circumstantial accident. That sentiment is perhaps a bit too pessimistic for our liking, but we can see the logic to it.

They Threw Them Out, Bums and Good Ones Alike

In 2024, citizens in more than seventy countries around the world went to the polls to vote in national elections. It was the biggest exercise of making one's voice heard in recent memory, in what could have appeared to be a triumphal moment for democracy. And it was, in one sense. By and large, these elections proceeded fairly with outcomes reflecting the popular voice as measured by ballots received and counted by duly appointed election officials (we do not include here the farcical play-acting of elections conducted

in Russia, Iran and Venezuela in the past year). The people spoke – over half the world's entire population was eligible to cast a ballot in 2024.

And while each election had its own particular set of issues at stake, there was a common thread woven through them. That thread was anti-incumbency, a profound and often visceral reaction against whoever happened to be in power. If you were a governing party in 2024 trying to get re-elected, your chances of doing so were poor. The Conservatives of the United Kingdom were shown the door in July by Keir Starmer's Labour Party, returning to power for the first time since 2010 (though Labour PM Starmer himself now appears to be wildly unpopular after just six months on the job). A couple months before that, in India, Prime Minster Narendra Modi hung onto power but lost the parliamentary majority that almost everyone thought was a sure thing. Japan's Liberal Democrats, the ruling party of that country for all but two of the years since the end of the Second World War, also lost their parliamentary majority. South Africa's African National Congress, the party once led by global icon Nelson Mandela, got the boot.

Here in the US, a hastily put together yet spirited campaign by Kamala Harris failed, in the end, to overcome voters' widespread dissatisfaction with the past four years under Joe Biden, putting Donald Trump back in the White House a mere four years after voters tossed *him* out. Germany's fragile governing coalition collapsed in November and set the stage for snap elections in February, which will likely mean the end for Chancellor Olaf Scholz. His Social Democratic Party, a center-left institution created in the nineteenth century that outlived the Kaiser's monarchy, the tumultuous Weimar Republic and the horrors of the Third Reich, is currently in a distant third place in the polls (worryingly, the party in second place is the most far-right ethno-nationalist party to hold regional power in Germany since 1945, and more worrying still is that this party appears to be beloved by certain ascendant oligarchs here in the US). Meanwhile, in France, an unruly coalition including representatives of both the far right and the far left gave Michel Barnier the shortest tenure as prime minister since the beginning of the Fifth Republic, leaving President Macron's ability to effectively govern this restive country before his own term runs out in 2027 in serious doubt.

Oh, and within a matter of days, South Korea's president declared martial law, then maintained he was just kidding, then got impeached, and is currently doing his best to evade the police while an arrest warrant hangs over his head. Just another day in 2024 global politics. And the story continues as 2025 gets underway, with Canada's prime minister Justin Trudeau announcing that he, too, will be joining the ranks of ex-PMs, resigning his post before the voters can do it for him. Canadian elections will happen sometime between now and October 20, and polls currently show a decisive advantage for an opposition conservative party with a strong flavor of the kind of showmanship and faux-populism that has proven to be durably popular elsewhere, including Canada's immediate neighbor to the south.

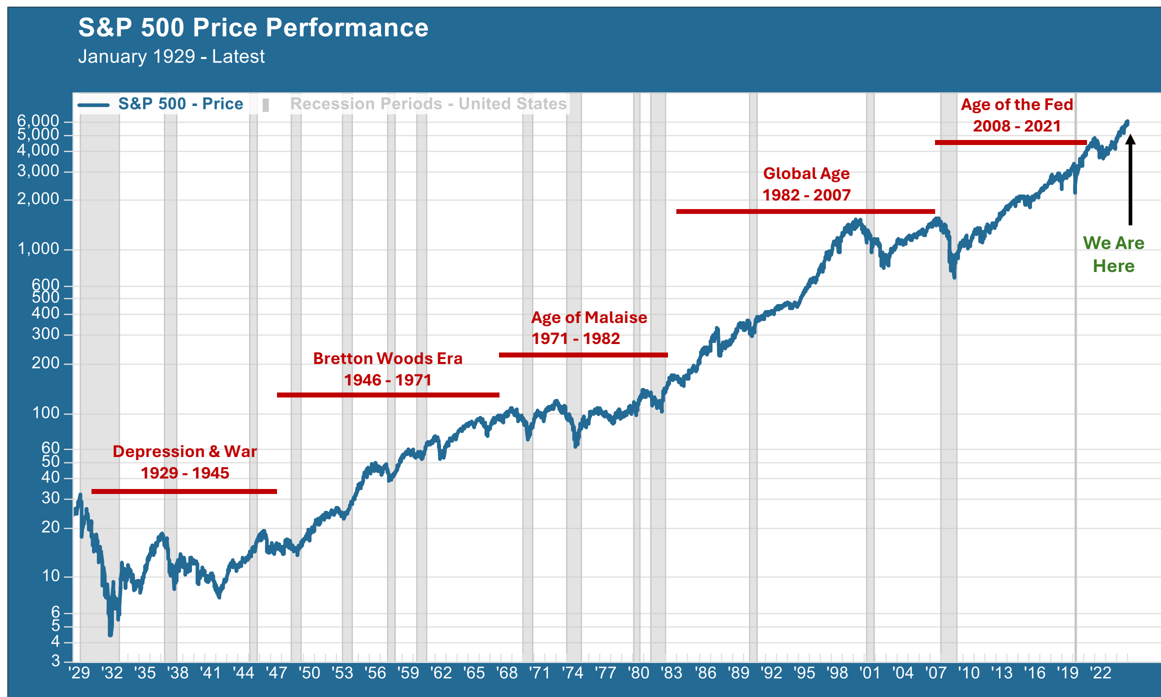
Why Now?

The vehemence with which citizens are lashing out against their elected officials is a topic of endless debate among observers of the political scene. Why now? Why everywhere? Yes, we all know that most of the world experienced the highest inflation since the 1970s between 2021 and 2023. Nobody likes it when everything, from monthly rent to grocery store staples to ski vacations, is so much more expensive than before. But we didn't have even a mild cyclical recession, let alone a cataclysm like the 2008 Great Recession, as the economy stumbled out of the coronavirus pandemic in 2021 and began to regain its footing. Unemployment since then has hovered between 3.4 and 4.2 percent – very low by historical standards. The stock market – with the exception of a protracted downturn in 2022 – has continued to set record high after record high. And even inflation is less than a third of what it was at the June 2022 peak of more than nine percent. War has been devastating for the unfortunate citizens of Ukraine, Gaza and Sudan, among other places, but most of the world's population continues to live in relatively peaceful circumstances. The world today, for all its problems, is a far cry from the economic and social misery of the early 1930s, when fragile democracies in the grasp of the Great Depression buckled under the violent forces of reaction and paved the way for the conflagration of the Second World War.

So, why now? And – because after all, this is an economic outlook, not a political science dissertation – what might it mean for the economy and financial markets this year? To try and answer this question, we think it would be helpful to start by taking a top-level view of where we find ourselves today relative to secular

periods gone by (by secular, we mean an overarching structural period usually containing more than one shorter-term economic cycle). According to the view shaped by our own research, we have had five such secular eras going back to the stock market crash of 1929 and the ensuing Great Depression. In the chart below, we have mapped out these eras with the reference points of (a) the performance of US equities represented by the S&P 500, and (b) recorded economic recessions.

Chart #1: Long-term US Stock Market Performance and Economic Recessions



Source: MVF Research, FactSet

Ageing and Tired Institutions

The above chart will not necessarily help us understand the answer to the question "why now?" Indeed, "why now, when the stock market is at or close to an all-time high?" one might ask. But it will give us one important perspective, which is the old age of most of our national institutions. And when we try to weave a common thread through the many different political contests in 2024 where anti-incumbency was the driving sentiment, that connecting thread is antipathy towards these institutions. We are talking about a broad swath of organizational umbrellas here, including government (both national and local), academia, big business, entertainment, media, organized religion and even the military. Politicians who identified with "the system" as it pertained to any of these institutions did badly at the ballot box. Those who advocated change – even if by "change" they meant nothing more than "burn it all down" – on the whole did better.

As we said above, there are not a whole lot of impartial data points out there to explain why 2024 was the year when this antipathy towards institutions boiled over. But Chart #1 above helps us to understand how even the most robust creations of progressive human intentions can become fragile with old age.

The end of the Second World War marked a significant break with past norms for many US institutions, brought about by the first time in the country's history when it actively took upon itself the role of world superpower (the country's response to the end of the First World War in 1918, by contrast, was a retreat into the kind of isolationism that had long been a character trait of the young America in the nineteenth century). Post-1945, the US was the dominant figure in multilateral institutions such as the World Bank, International Monetary Fund, United Nations and GATT (General Agreement on Tariffs and Trade).

In the realm of education, elite universities became an aspirational goal for the brightest members of a growing middle class, rather than a finishing school for old money. Hollywood studios exported American

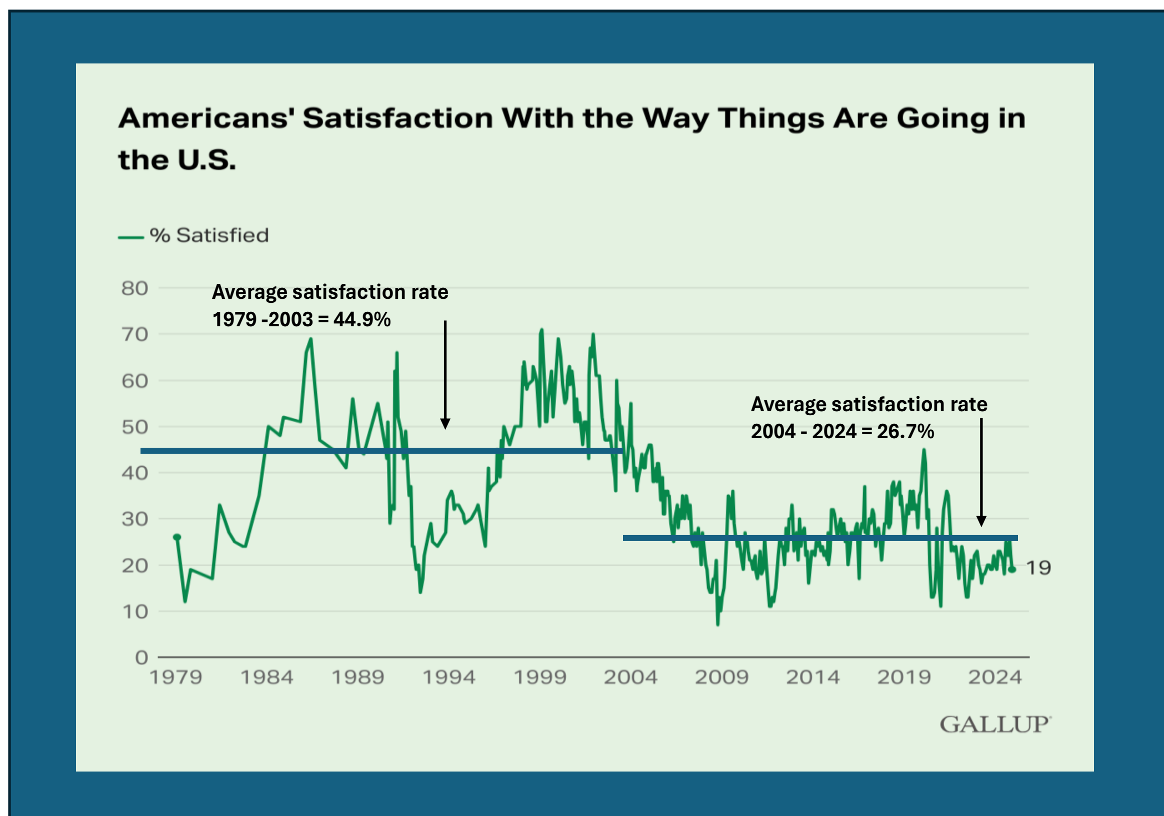
culture to a world clamoring to be a part of it. The organizational structure of the modern corporation, with its management tiers and human resources departments and cafeteria of benefits including health care, paid leave and retirement plans, took shape. And in politics, the two major political parties were defined mostly by differences at the margins on issues such as taxes, labor unions, social and welfare spending and the like, while coming together in large enough numbers to oppose Soviet communism and to spread US-style democracy overseas.

These institutions persevered through the very different secular ages shown in Chart #1, from the American dominance of the immediate postwar era (the Bretton Woods era) through the social unrest of the late 1960s and the chronic economic woes and social malaise of the 1970s, and then the Global Age during the 1980s and 1990s when America's inherent strengths in the fields of finance and technology positioned it to dominate an era of free trade and the unrestricted, nearly frictionless movement of money and information around the world. But all the while, the institutions were doing what comes naturally with ageing: becoming set in their ways, hoarding monetary and cultural advantage wherever possible, and closing themselves off from the lives of ordinary citizens. The path for aspiring so-called "elites" narrowed as acceptance rates for top-tier universities plunged into single digits (and university education itself became a prerequisite for many types of employment previously open to those whose education stopped at high school).

Right Track, Wrong Track

Throughout this time, sentiment among American households waxed and waned more or less in line with economic cycles. Between the late 1970s and the early 2000s, as you can see in Chart #2 below, there was a great deal of variance in sentiment, with the negative periods closely tracking the recessions of 1981-82 and 1990, and conversely a sustained level of optimism during the growth cycle of the 1990s.

Chart #2: Americans' Satisfaction Levels With US Trends, 1979-2024



Source: Gallup, Inc.; MVF Research

Note what happens after the early 2000s, though. Sentiment fell even during the economic recovery after the (relatively mild) 2001 recession. Unsurprisingly, the indicator fell to its worst levels during the Great

Recession of 2008 – but then it stayed at relatively low levels for pretty much the duration of the next decade and a half to the present. The absence of a recession for all but two months of this period (the Covid recession of March – May 2020) did nothing to improve sentiment. The difference is stark. The average satisfaction level for the 1979 – 2003 period was 44.9 percent, while that for the 2004 – 2024 period was 26.7 percent. The explanation that "it's the economy, stupid" may have been true when uttered by Democratic Party strategist James Carville during Bill Clinton's first campaign in 1992. It no longer appears to be true. "It's all the things, stupid" may be how folks today are expressing it. The pejorative epithet "elite" is less a precise definition of a job description or resume of personal accomplishments, and more a catch-all term for the widespread sense that the institutions, wrapped up in their own bubbles, are no longer capable of serving the greater good for which they were originally intended, all those decades ago.

And the negativity the public feels towards American institutions is by no means limited to the usual suspects of Congress, the media and the like. In another Gallup poll, respondents were asked to rate the honesty and ethical values of 23 different professions. Over 24 years from 2000 to 2024, 22 out of the 23 professions saw their ratings on "honesty and ethical values" fall. The fallen included the clergy (26 percent decline from 2000 to 2024), judges (21 percent), grade school teachers (13 percent) military officers (eight percent) and even day care providers (the percentage of people rating them as possessing honesty and ethical values fell five percent from 2000 to 2024). The rot is everywhere, it would seem.

There are many circumstantial events over the past twenty years that likely contributed to what we might be tempted to call the "new malaise" (in contrast to the Carter-era "old malaise"). The global financial crisis, the inescapable clutches of divisive social media, post-traumatic stress from the pandemic – these all arguably played a part. For whatever combination of reasons, a sizable percentage of citizens here in the US and elsewhere in the world appear to be ready to go along with the incendiary rhetoric of the influential provocateurs who say "burn it all down." Globalization, free trade, liberal democracy itself. And there are people in power, or coming into power, who are in the position to do just that, should they want to.

We don't know how much of the rhetoric will ever become actual policy. But the transition away from a backdrop that lasted, more or less, for eighty years to something as yet unclear adds a new dimension of difficulty to the job of planning for the next twelve months.

B. What To Expect When You Expect the Unexpected

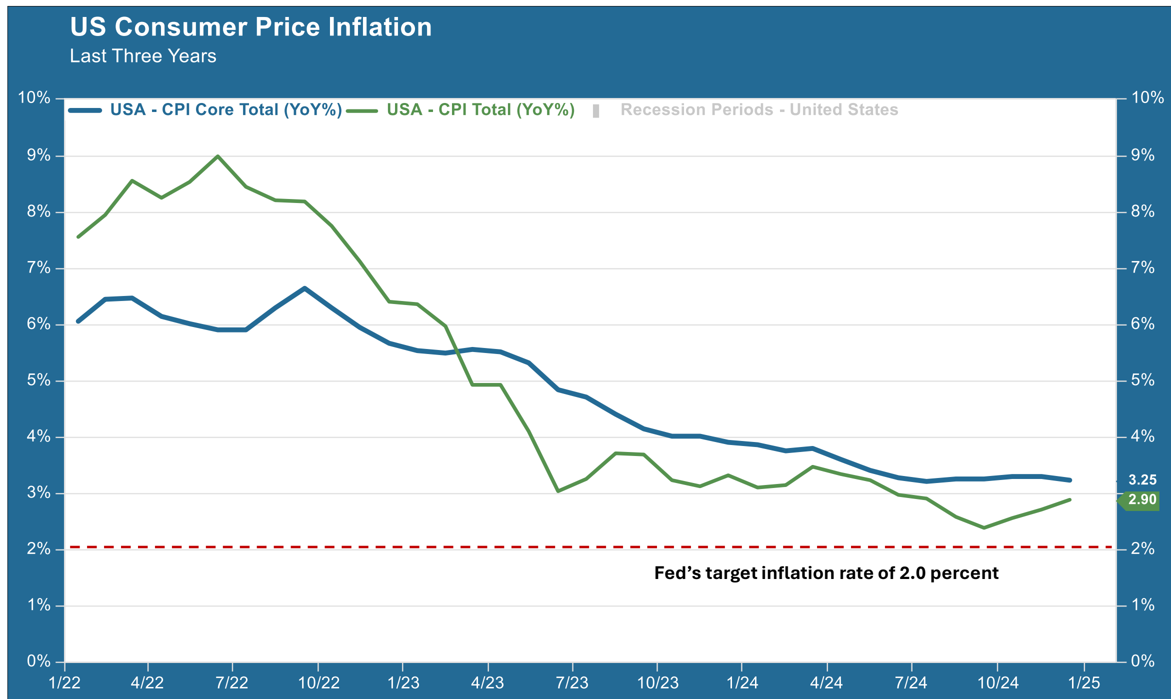
The Fed's Conundrum

Spare a thought, if you will, for the men and women of the Eccles Building, the home of the Federal Reserve, as they try to chart a course for monetary policy in a year with so many unknowns at the outset. Perhaps the clearest example of the fog of uncertainty we described in the opening sentences of this report is that the voting members of the Federal Open Market Committee (FOMC), who set interest rate policy, don't know any better than we do what the actual plans of the incoming administration are with regard to the two crucial subjects of tariffs and immigration. And they may not get much clarity even after Inauguration Day on January 20. Trump has a predilection for keeping people (and the media, in particular) off balance, never knowing what to take seriously and what to ignore. Here is why that matters.

Let's start with a baseline for inflation. The overall trend is down, as Chart #3 below shows. Core inflation, which excludes food and energy prices, is the number the Fed pays attention to, while the headline number matters more to households for whom food and energy loom large in the monthly budget. A year ago, the downward trend was robust enough that the FOMC, in its December 2023 meeting, projected confidence in a steady pace of interest rate cuts for 2024.

But as Chart 3 shows, that trend has leveled off recently. Both core and headline CPI have been trending flat or even slightly elevated since the middle of the summer. The stickiness of the so-called "last mile" to the Fed's target inflation rate of 2.0 percent – sticky in part due to the persistence of housing-related expenses (rent, owner's equivalent and the like) – has caused the Fed to scale back its assumptions for further rate cuts. And this is without even taking into account the inflationary impact of new tariffs.

Chart #3: Inflation Trends: Core and Headline CPI for Last Three Years



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, MVF Research, FactSet

So our baseline (using the Fed's preferred metric of core inflation) is somewhere around 3.3 percent. The problem the Fed has is that, in the event of a sizable increase in tariffs on products imported from our three main trading partners (20-25 percent from Canada and Mexico, and 60 percent or even more from China), that baseline starts to look like it has nowhere to go but up.

To be fair, there are many intangible factors that determine the actual impact of tariffs, including fungibility (i.e., replacing goods imported from high-tariff counties with either domestic production or similar goods obtained from elsewhere), currency manipulation (reducing the value of a currency, all else being equal, makes that country's exports less expensive) or shifts in demand preferences (though any of these would probably take time to develop). But in essence, a tariff is a tax on imports, which increases the cost of the goods in question, which puts upward pressure on consumer prices in general.

Ghosts of Smoot-Hawley

During the US presidential campaign there was some upbeat chatter from pundits on the right about the US economy of the late 1800s, a period during which tariffs were a major source of government revenue (one reason for that being, of course, that the US didn't have an income tax to speak of until 1913). That was always a strained analogy, given the profound differences between late-nineteenth century America, which was then considered to be an emerging market, and the world-leading economy of today. But in their enthusiasm for learning from past models, these pundits might have been better off contemplating the disastrous effects of another tariff regime – the Smoot-Hawley tariffs signed into law by President Herbert Hoover in June 1930, just as the Great Depression was getting under way. The punitive nature of Smoot-Hawley produced a set of retaliatory measures from the countries affected, including the struggling nations of Europe trying to forestall the rapid deterioration of their economies and societies.

The issue here is not whether a full-throated tariff program along the lines of campaign promises (and some post-election comments as well) would by itself produce a Smoot-Hawley level disaster. That is extremely unlikely. But tariffs do have a negative impact on growth, in addition to inflation. The Peterson Institute for International Economics, an economic think tank, argues that a 10 percent universal tariff would take one

percent off Gross Domestic Product (GDP) growth for the first two years after implementation. One percent is not insignificant. Economists' projections for real GDP growth in 2025 hover around two percent (the projection from the Summary Economic Projections at the Fed's December FOMC meeting was two percent exactly).

This matters, because a lower GDP growth rate also implies a worsening of conditions in the jobs market. The Fed, remember, has a dual mandate of maintaining stable prices (i.e., keeping a lid on inflation) and full employment. So far the labor market has cooperated, despite a collective freak-out by financial markets last summer when a couple jobs reports came in below expectations. The US unemployment rate is currently 4.1 percent, which is solid by historical standards. But changes in economic conditions can quickly alter the jobs calculus. Macroeconomic data points feed off each other – higher prices, lower consumer spending and weakness in overall growth would almost certainly push unemployment higher and threaten to accelerate the next recession.

Then there is the question of immigration and deportations. Consider one data point – one that is painfully close to us on a personal level and to many people we know with loved ones and friends in Southern California. The wildfires that devastated Los Angeles this month are likely, when all is said and done, to become the most expensive natural disaster the US has experienced in modern history. It will require billions of dollars and a tremendous amount of rebuilding to restore Pacific Palisades, Altadena and other affected neighborhoods.

Now consider the fact that approximately 25 percent of the labor force for building and construction in California is comprised of undocumented immigrants. What is going to happen to the rebuilding equation – in terms of time and money – if that labor force, along with so many others around the country, is targeted for widespread deportations? And how does the math in this equation feed back into that of the overall economy? Again – we don't know today – nobody knows today, probably even within the closest inner circles of the incoming administration – what the actual policies are going to be versus the often highly incendiary campaign rhetoric. But the practical outcome of a draconian policy combining sharp restrictions on immigration with mass deportations, should such a policy come to pass, is a high level of upward pressure on wages in general. Higher wages and higher prices when combined can lead to the kind of stagflation last seen in the late 1970s.

And there is not much the Fed can do through its monetary policy tools to anticipate and head off weakness in the economy without knowing what the incoming administration is actually going to do. We think that means at least several months of pauses in monetary policy, holding the Fed funds target rate at the current level of 4.25 – 4.50 percent. For us as portfolio managers, that has important implications for our fixed income allocations, particularly with regard to target average durations. When you don't know what to expect, the most important thing you can do is not overextend your convictions too far in any one direction. If the rhetoric about tariffs and immigration turns out to be little more than that, then we can expect a return to an orderly monetary easing policy commensurate with a slowing, but still growing, economy. If it turns out to be more than just noise and shiny objects for the MAGA base, that will require a different set of considerations.

C. AI, Robot

A Narrative In Transition

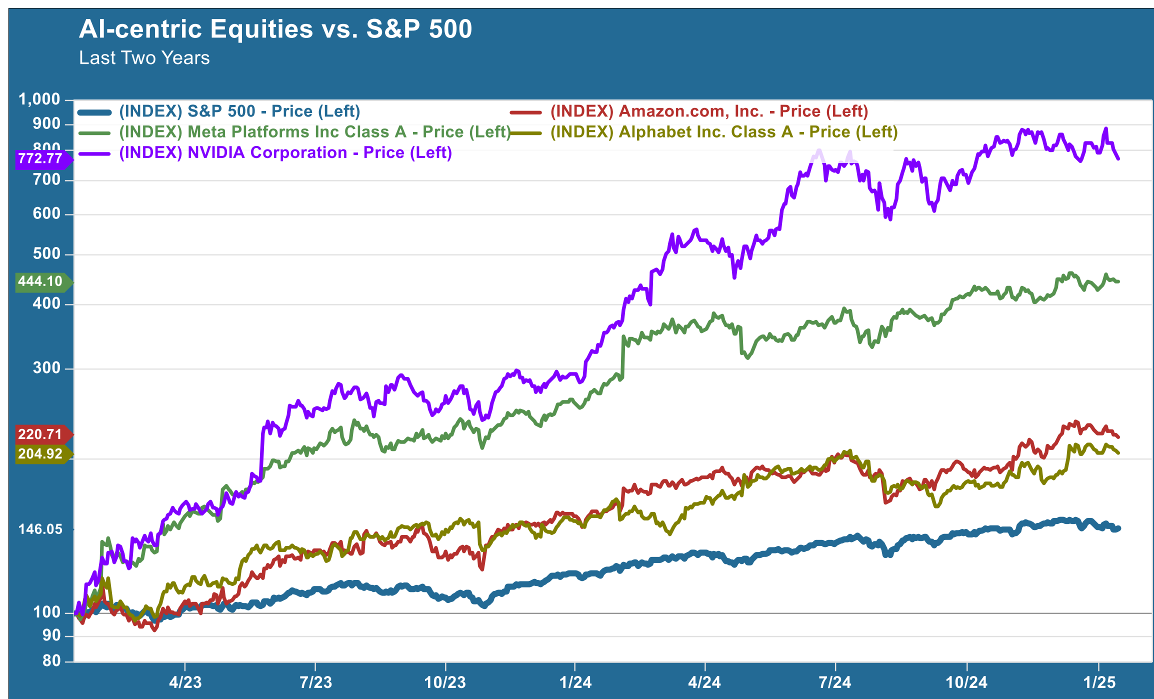
The third element of our "World In Transition" thesis is how the artificial intelligence story will evolve this year. Evolve it will, in one direction or another, if only because so much money is being put into the infrastructure to make it run. Two years have now elapsed since the wonders of ChatGPT, a generative AI application, caught the world's attention and set financial markets on fire with the "AI narrative." For a not inconsiderable amount of time since then, in fact, a small number of companies at the center of AI infrastructure has anchored overall stock market performance. The S&P 500 returned more than 20 percent two years in a row, in 2023 and 2024, largely thanks to AI.

More recently, it has not just been those high fliers at the center of the AI growth story, like Nvidia, Alphabet and Microsoft, but also a number of areas downstream such as utilities. It takes a massive amount of energy to power the large language learning modules at the heart of AI applications, and that power has to come from the grid. Currently, data centers worldwide consume around one to two percent of total global power consumption, and observers expect that will increase to three to four percent by the end of the decade. According to a Goldman, Sachs research report in May of last year, power demand related to AI by data centers is expected to grow by 160 percent between now and 2030.

It is sometimes hard to visualize how data points like this translate into real-world activities, so here is an example. If you are a user of ChatGPT, a query you make to the application will require, on average, ten times as much electricity to process as a Google search query (think about that the next time you ask ChatGPT to compose a Shakespearian sonnet for your beloved on your anniversary!).

In short, developing AI isn't cheap. And in 2024, an increasing number of voices in the investment community made themselves heard expressing doubts about whether all the costs would ever be worth it. "What problem, exactly, is all this massive expenditure on AI going to solve?" Skeptics pointed to evidence that fewer than five percent of all businesses are actively using AI solutions in their core business activities. Those instant essays in the style of your favorite Romantic poet or Victorian novelist might be fun for cocktail party conversations, they argued, but are they worth the massive premium the market has put on them over the past two years? Chart #4, below, shows just how impressive this premium has been. Don't forget, when contemplating the outperformance of these stocks over the benchmark index, that the index itself gained more than 20 percent annually for each of the past two years.

Chart #4: AI-centric Equities versus S&P 500 for the Last Two Years



Source: MVF Research, FactSet

Productivity, Promise and Peril

The skeptics have a point – many companies have been slow on the uptake and many managers will admit, when asked, that they don't really understand how this or that AI application will make them work better. Some will say that trying to work with AI tools is like having a young intern you have to manage and explain things to when all you really want to do is be left alone to finish the job efficiently.

But we think they miss a larger point. Even since that first ChatGPT launch a couple years ago, the capabilities of AI language learning modules has grown tremendously and is moving ever closer to the science's holy grail of artificial general intelligence (AGI). In a world of AGI, robots with AI capabilities can perform almost any imaginable task as well as or better than a person. Jensen Huang, the CEO of leading AI chipmaker Nvidia, speaks directly to the AI skeptics in saying that robotics is the next major frontier for development, the emergence of which will put to good use all that capital expenditure being put into data centers, language learning modules and the like. And that is a development which transcends a frothy stock market narrative. It speaks directly to productivity, which is the most important ingredient for long-term economic growth. With that opportunity comes both promise and peril.

The promise manifests itself in one of the more recent buzzwords in AI spaces: agentics. As developers get ever closer to AGI, the potential grows for "AI agents" – basically, robots with highly advanced AI capabilities – taking over the vast expanses of the economy populated by human agents, from customer service call centers to real estate to producers of textbooks and technical documents. You will likely hear a great deal more about agentics this year if you pay attention to the chatter in AI circles. The services sector, which makes up around 70 percent of total US Gross Domestic Product, is full of agents performing go-between activities often in unproductive ways. AI agentics has the potential to deliver a real productivity boost, which in turn could position the economy for long-term growth at higher levels than are currently achievable.

It could also, of course, have unsavory consequences as well, not the least of which is what happens to all those human agents when they lose their jobs. There is no current consensus about what the long-term consequences of advanced AI might be on work and employment. One argument, which would seem to have merit, is that demographic trends are working in favor of job seekers. The dependency ratio, which relates the number of retired people needing assistance to the number of working-age people able to provide the help, is increasing as the numerous baby boomer generation moves further into its retirement years while, on the other side, population growth in the US and much of the world falls below the replacement rate of 2.1 births per family. Given this trend, some say, the impact of AI agentics would be a net positive, as it would help offset the labor shortage that demographic trends would otherwise predict.

Maybe, and maybe not. There is much else, of course, that we have to think about when it comes to AI. A citizenry that has spent the past quarter-century immersed in reality TV, social media and emergent virtual reality has already lost some amount of ability to discern reality from fiction. AI could magnify this problem far beyond where it currently stands. Or, perhaps, when all is said and done it will turn out to be a development with net-positive benefits. As with so much else in this world of transition, we don't know. But we are ready to take on both the opportunities and the challenges that lie around the next bend in the river. Show us what you've got, 2025.

II. 2025 Investment Thesis

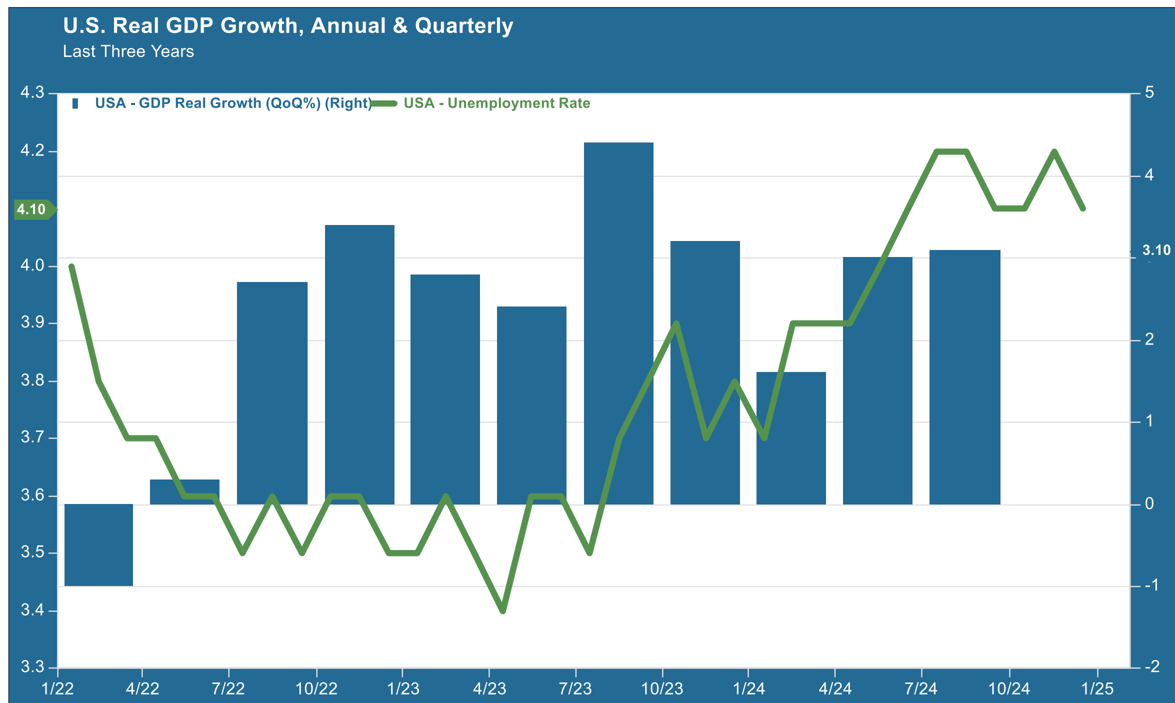
A. US Economic Outlook

So, we just spent multiple pages talking about a world in transition, with so many unknown variables of high importance that even the Fed could not say with complete conviction today whether their next interest rate move will be a cut or a hike. And now we're going to give our investment thesis outlining our base-case scenario. Needless to say, the magnitude of variability is higher than usual. But here we go.

Steady Growth From Consumption and Investment

Our base case assumption for the direction of the overall economy is the continuation of the moderate growth we have seen for the past couple years, driven primarily by continued strength in consumer spending (though probably at a slower pace than in 2024), and ongoing private sector business investment, much of which will be directly related to the continued build-out of AI infrastructure (data centers, improvements in energy efficiency, large language modules and the like). Gross Domestic Product grew at an annualized rate of 3.1 percent in the third quarter last year and is projected to grow at 2.2 percent for the fourth quarter (the Q4 report will come out on January 30, subsequent to the publishing of this paper). Employment has been relatively stable since the end of the Covid pandemic, which is quite remarkable given that for much of this period the economy experienced a dramatic monetary tightening regime.

Chart #5: US Real GPD Growth and Unemployment Rate, Last Three Years



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, MVF Research, FactSet

We do have some concerns about the staying power of consumer spending, mostly due to the fact that consumer credit card delinquencies are currently at their highest level since 2010, in the immediate aftermath of the Great Recession. For the first nine months of 2024, credit card lenders wrote off $46 billion in delinquent balances. The savings buffer households built up during the pandemic has largely dissipated, and much of what has kept consumption bubbling along for the past year has come on the back of more debt. At some point, and potentially within the time frame of the coming year, the constraint of debt

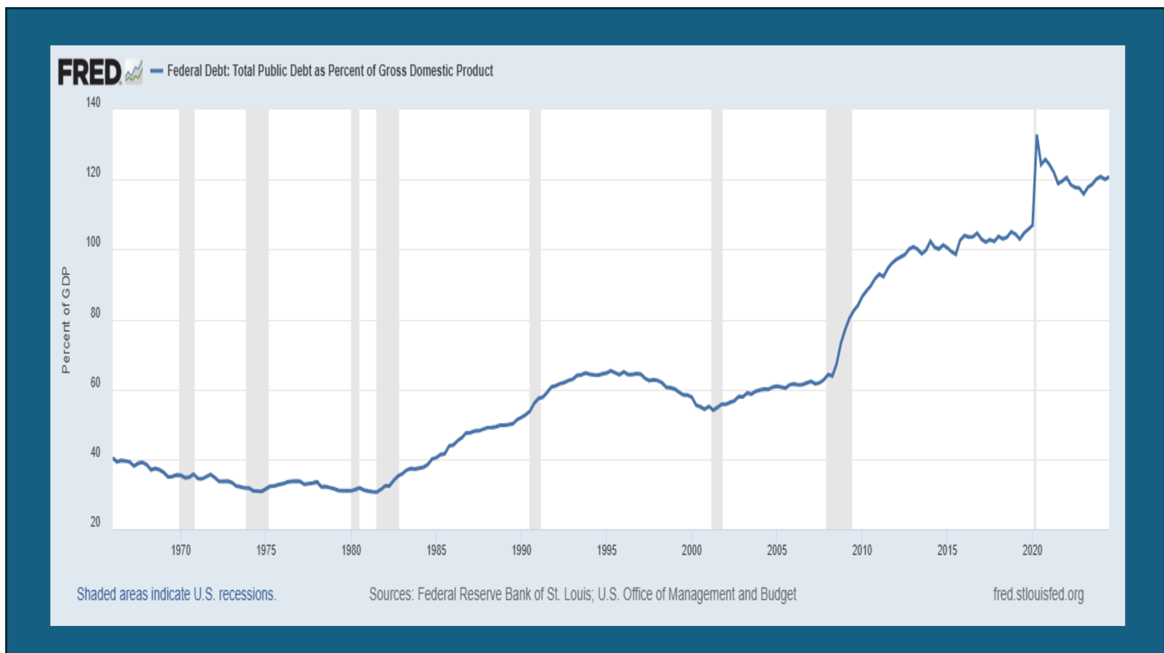
limits is likely to put a brake on spending trends. But we do not expect those trends to turn negative. As long as employment trends remain favorable, and wage growth doesn't fall too far below inflation (wage growth has outpaced inflation for the better part of the past two years), there should not be a precipitous decline in the spending capacity of the average US household. But we will have to keep watching that delinquency trend – and how that trend may fare in a world where interest rates are not coming down as fast or as far as had previously been imagined.

In Section One of this report, we took note of the many uncertainties surrounding artificial intelligence. Regardless of whether AI-related equities continue their outperformance or, conversely, get popped by investors wary of their stratospheric valuations, the outlays by companies investing in AI infrastructure will likely continue as the use cases expand to a larger number of industry sectors including consumer-facing services and manufacturing. In summary, the combination of continued consumer spending and a steady pace of private sector business investment should be sufficient to keep overall US economic growth moving in a positive direction. Our base case scenario does not contemplate a recession in the next twelve months.

Bond Vigilantes Will Be Noisy, But Cautious

The term "bond vigilante" was popular in the 1980s and early 1990s, and referred to the collective antipathy of fixed income investors to inflation, out of control government spending and other acts of malfeasance against the stable money world of their fantasies. Public debt as a percentage of total US Gross Domestic Product rose from around 30 percent in 1980 to 65 percent in 1995, so there was plenty for the bond vigilantes to complain about. That seems quaint, though, compared to where total public debt is today. As chart #6 below shows, that figure now is around 121 percent of GDP. As of November 2024, the total public debt of $36 trillion was the highest in US peacetime history (as a percentage of GDP, as the chart below shows, the figure was higher in 2020 due to the sharp (but brief) fall in GDP brought about by the pandemic).

Chart #6: US Total Public Debt as Percentage of GDP, 1966 – 2024

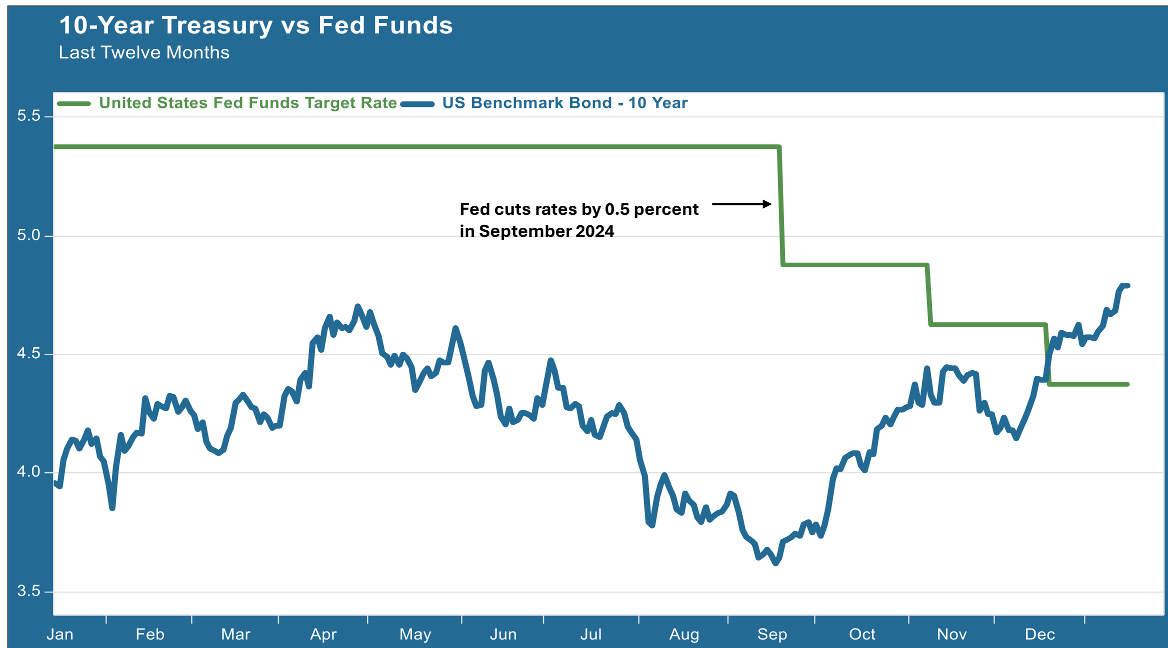


Source: Federal Reserve Bank of St. Louis, MVF Research

Bond vigilantes make themselves heard by selling large quantities of public debt – i.e., Treasury securities – and thus driving up interest rates. There has been a little bit of that going on over the past several months. Recall that the Fed began its monetary easing program in September with a jumbo-size cut of 0.5 percent to the Fed funds target rate. Investors at the time widely expected rates to come down across the yield curve. "Move into longer durations" was the advice most often heard. But longer term rates actually went

up after the September cut. The benchmark 10-year Treasury yield, which had been inverted to short-term yields continually since the summer of 2022, rose in a dramatic fashion, as shown below in Chart #7.

Chart #7: 10-Year Treasury Yield and Fed Funds Target Rate, Last Twelve Months



Source: MVF Research, FactSet

So there has been some talk of the bond vigilantes dusting off their 1980s-era power ties and double-breasted suits and posing further threats to intermediate-term rates. It is possible, and the probability would likely increase if the incoming government manifests a blatant disregard for any form of fiscal prudence in pushing for new tax cuts on top of the existing tax cuts (which are almost certain to be extended when they expire this year) and risking higher inflation with aggressive tariffs (though, technically, there should be some net benefit to fiscal coffers from tariffs – but the math gets tied up with all the unknown variables).

And let's not forget that the biggest bond vigilante of all, should it ever decide to act as such, would be China with its $780 billion-odd's worth of US Treasuries held as part of its foreign exchange reserves. That's a scenario, to be sure, but it is not in our base case. In fact, we would expect there to be some intermittent noise from the bond vigilantes in 2025, enough to keep anyone invested in fixed income on their toes, but not enough of a mass movement to push intermediate-term interest rates into dangerous territory. "Dangerous" in our view would be a sustained push above five percent for the 10-year yield.

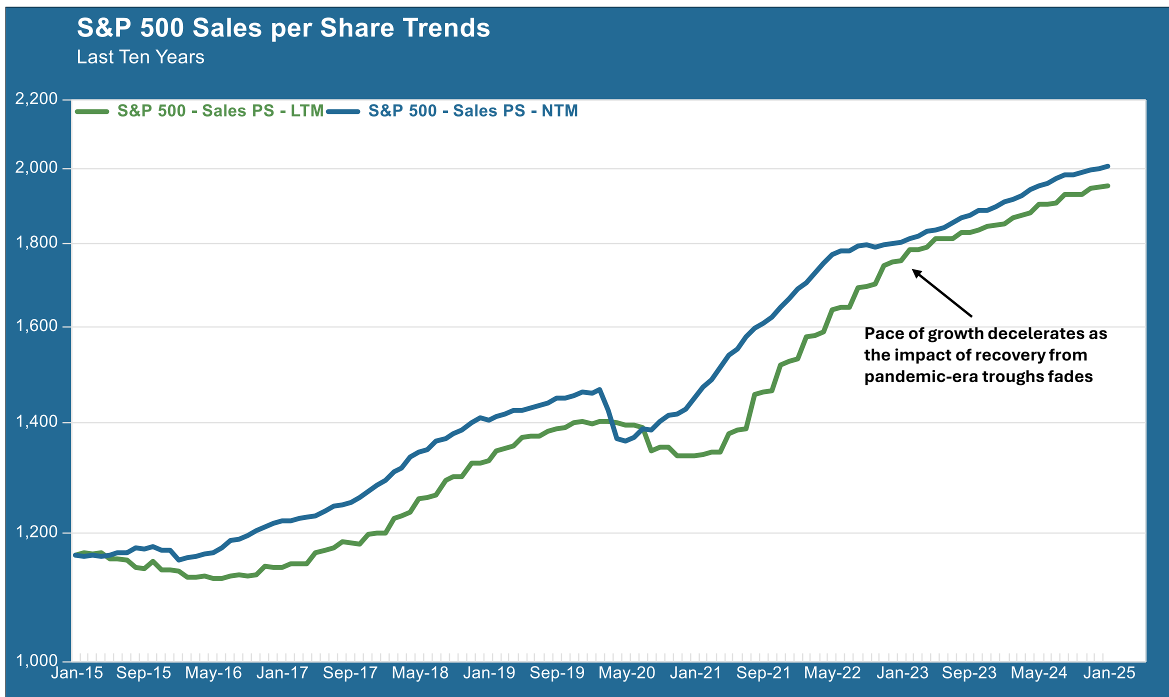
And while we are on the subject of bonds, this would be a good time to put down in writing our base case assumption for the Fed and monetary policy. As we noted in Section One of this report, there are a lot of uncertainties at play. But we're going to stick with what the Federal Open Market Committee itself thinks at present, which is two rate cuts at some point in the year, but probably not before late spring at the earliest. This assumption could change – indeed, all our assumptions about the bond market are going to be subject to data inputs on a continual basis and may change accordingly.

Sales and Earnings Should See Healthy Growth

Fourth quarter earnings season is just getting under way, but when all is said and done in a few weeks, analysts expect that S&P 500 total sales will have growth by about five percent year-on-year, while the same analysts are looking at earning per share growth (EPS) in the neighborhood of 10 percent. Looking ahead, the prognosis is even brighter, with current estimates for 2025 sales at 5.7 percent alongside EPS growth of 14.5 percent. According to composite estimates by FactSet, a financial data research company,

six out of the ten major S&P 500 industry sectors should register double digit growth in 2025: communication services, consumer discretionary, healthcare, industrials, information technology and materials. This would represent a continuation of a steady, though somewhat decelerating, trend since early 2023. The deceleration, which you can see in Chart #8 below, is relative to the faster pace of growth in 2021 and 2022 off the declines experienced during the pandemic months.

Chart #8: S&P 500 Sales per Share Trends, Last Ten Years



Source: MVF Research, FactSet

As with just about everything else in this report, current expectations can change considerably with new information about consumer trends, interest rates and the like. We still hear quite a bit of commentary about "uncertain macro outlook" from corporate management teams on earnings calls. But at the same time we have seen more cases of forward guidance being raised rather than lowered by those management teams, so on balance they, too, are not yet seeing clear signs of a meaningful slowdown in consumer activity. This is important, because after two years of 20 percent-plus gains in share prices on the S&P 500, US large cap equities in particular are not cheap. We will have more to say about valuation concerns in the next section below.

B. Global Market Outlook

Valuation Comparisons Have Limited Use

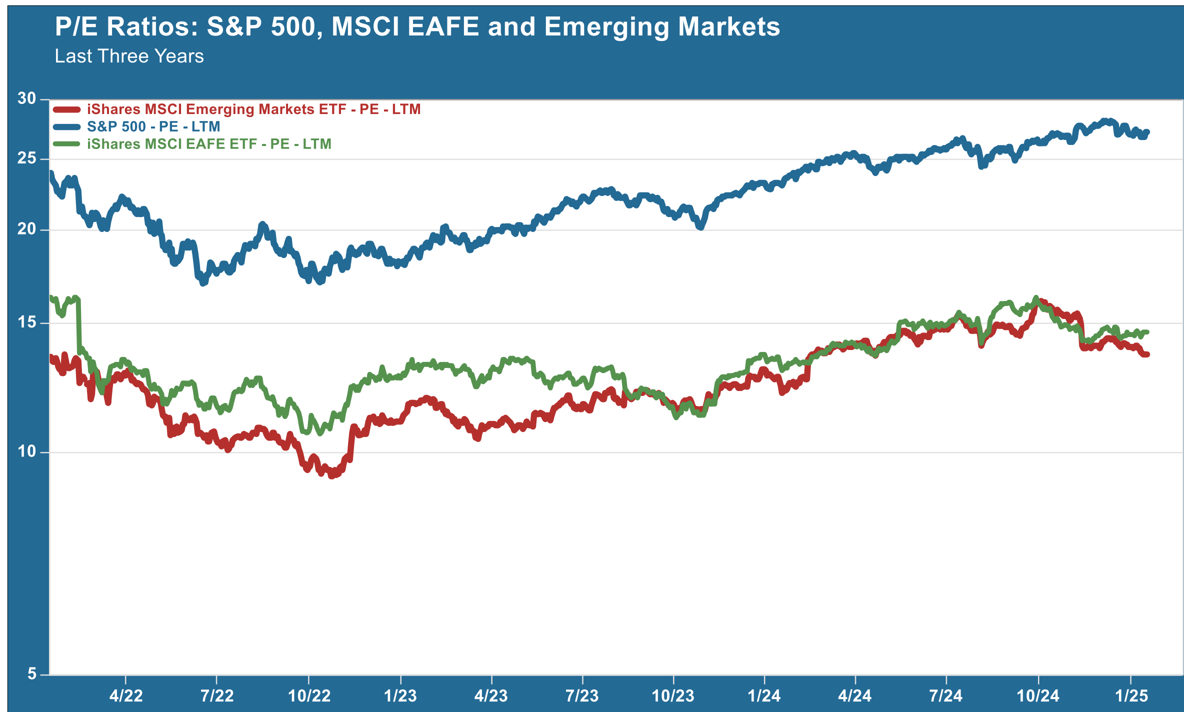
Valuations. Bargain-hunting. If only it were that simple.

For many years now, non-US equities, including both developed and emerging markets, have underperformed their counterparts in the US. For many years, the raw numbers alone have been a siren song for value-conscious bargain hunters. The logic of portfolio diversification also weighs in when it comes to decision-making time for portfolio construction. You want to put some of your eggs in other baskets so that they don't all break at the same time when something goes wrong.

But in the real world, it is not as simple as that. In the short-term, asset classes may go up and down for any number of reasons both rational and wildly irrational. In the long run, though, markets will tend to perform

according to their respective underlying fundamental strengths. Try as we might, we have not been able to convince ourselves that there is a strong fundamental case to make for increasing our portfolio weights to non-US assets. Even when the valuation opportunities are as attractive as they are now – and have been for some time. Chart #9 below shows a comparison between the price-to-earnings (P/E) ratios for the S&P 500 versus two key international benchmarks; the MSCI EAFE index of developed countries, and the emerging markets (EM) index.

Chart #9: S&P 500 LTM P/E Ratio versus MSCI EAFE and Emerging Markets, Last Three Years



Source: MVF Research, FactSet

The theory of rational financial markets says that any anomaly this pronounced is long overdue for mean reversion. After all, we're talking about securities with essentially the same basic characteristics. A share of stock, whether it pertains to a company headquartered in Fort Worth, Texas or Shenzhen, China or Rotterdam, The Netherlands, is the same thing – a claim of ownership on a portion of the company's earnings with (usually) voting rights attached. But mean reversion hasn't happened, not in the three years shown in Chart #9, nor in fact at any time since 2011 for either the EAFE or EM indexes.

Finance and Technology Still Rule the Global Economy

Back in Section One of this report we made brief note of the role finance and technology had in propelling the US economy back to an enduring position of strength starting in the 1980s, after the prolonged bout of malaise in the 1970s. The 1980s was the decade of financialization, with groundbreaking innovations in both the high finance of capital markets – think of innovations like interest rate swaps, liquid yield option notes, and currency futures – and the Main Street consumer finance of everyday households. These innovations would not have been possible without concurrent advances in information technology. In the 1990s, the enabling technology went into hyperdrive with enhanced mobile telephony and the commercial Internet. Here's the key point for purposes of our argument: the vast majority of the intellectual property facilitating these advances in finance and technology resides in the US, the property of the companies that have been the bellwethers for the continued outperformance, from year to year and through multiple economic cycles. This intellectual property now permeates almost every corner of the economy, from consumer-facing enterprises to industrial manufacturing, energy and communication services. Although there are pockets of technology-based excellence elsewhere in the world, such as the Nordic countries and

China, from a global perspective this remains the province of the United States, and will probably continue to serve as a resilient competitive advantage from some time to come.

The Ailing Giants: Germany and China

The other part of the non-US story is a particular one: the prolonged weakness of the second- and third-most important economies in the world; China and Germany. Their problems are both different and interrelated. For its part, China has not successfully managed a transition from the end of its supercycle era in the mid-2010s, resulting in years of tepid and declining growth, the collapse of its most important industry sector (property development) and a weak consumer sector tipping into deflation. Germany, the engine of the Eurozone, faces the specter of flat or negative growth with weakening global demand for its high-end manufacturing exports, and chronic political dysfunction at home.

Chart #10: Germany and China Year-on-Year GDP Growth, Last Fifteen Years

Source: MVF Research, FactSet

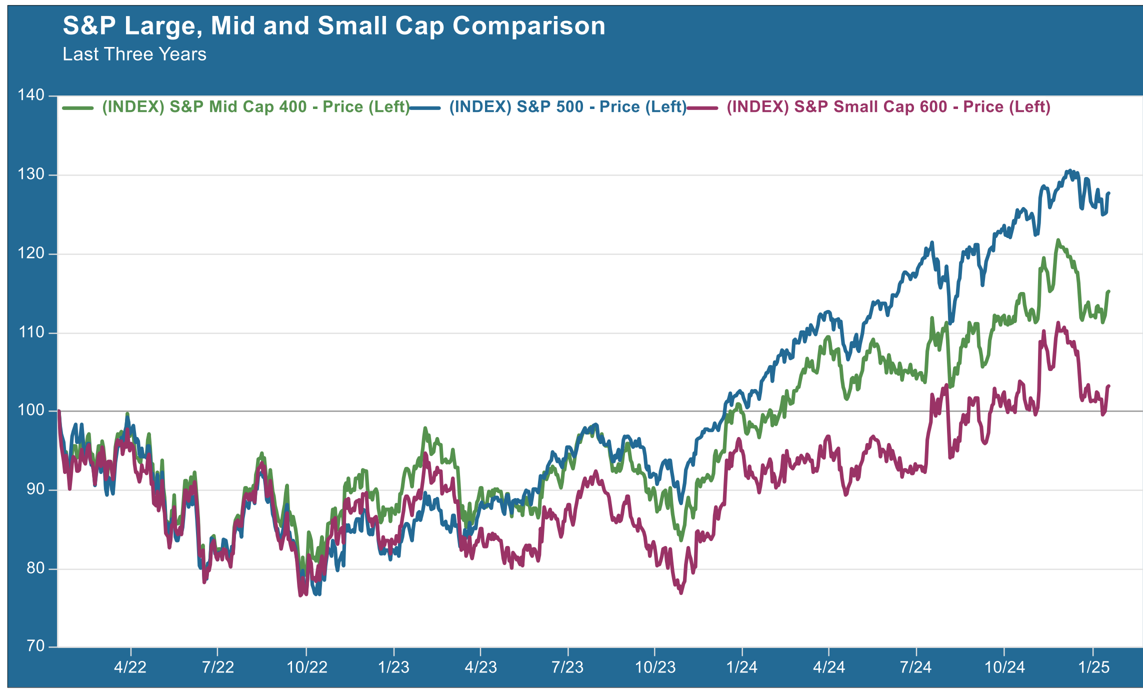
The global economy needs a strong Germany to shore up growth in the Eurozone and add strength to the economic influence of the community of liberal-democratic nations. And for all the geopolitical concerns that surround China – and there are many of those – a strong domestic Chinese economy is preferable from the standpoint of global stability than a weakened one. The fates of these two countries in 2025 will be extremely important for the world at large.

Don't Overlook US Midcaps as a Potential Diversification Source

If the rest of the world doesn't offer attractive opportunities for equity portfolio diversification, where might investors find refuge from dependence on US large cap stocks? One idea we think has some merit is the US midcap sector. Let's first understand what this area of the market is. If you take the top 100 stocks in the S&P 500 (ranked by market capitalization) out of the equation, then what you are left with is 400 stocks including none of the big names like Apple, Nvidia and Microsoft. Among these 400 stocks are some names you have probably heard of, like the high-end culinary retailer Williams-Sonoma, and others with which you are likely unfamiliar, like Expand Energy Corporation. Interestingly, once you take those top 100 S&P 500 stocks out of the equation, the contribution of Information Technology drops from 32 percent of the total market cap to just nine percent for the S&P 400 Mid Cap index.

Why mid caps? We see a couple good reasons. First, while we continue to believe that the large cap tech companies have sustainable long-term value, there is no denying that they comprise the most expensive part of the market. It probably would not take much in the way of a short-term catalyst to spark a meaningful pullback. In that event, exposure to the mid-cap sector would provide something of a cushion.

Chart #11: S&P 500 (Large Cap), 400 (Mid Cap) and 600 (Small Cap) Comparison, Last Three Years



Source: MVF Research, FactSet

2025 may also be a year in which US stocks with a higher component of domestic sales and less exposure to potential risks in places like China could outperform their multinational counterparts. Both mid cap and small cap stocks could plausibly fill this position, but we think that mid caps could do so with fewer of the downside risks that small caps face. Small caps, in particular, may be more susceptible to the adverse effects of higher-for-longer interest rates and attendant problems in areas like the leveraged loan market than mid caps. For these reasons, we see positive diversification benefits to a mid cap allocation.

C. Final Thoughts: Navigating Uncertainty in 2025

When we think about portfolio allocation in times of uncertainty (which is most of the time, but this year in particular), we start by asking a simple question. Can we fulfill the needs of our clients with regard to their specific objectives of growth, income and capital protection through exposure to traditional equity and fixed income asset classes, or are there gaps that require something with a different set of attributes? Every day, we are barraged by the sales arms of various investment houses hawking all manner of "alternative" strategies – private credit, structured products, options, illiquid REITS – you name it. But if we cannot make a convincing case for how any of these offerings will fill an obvious gap with regard to one of those three goals – growth, income and safety – then we do not see the point of paying for them (and they generally do not come cheap). This is the principle of Ockham's razor: the solution that is as simple as possible (but no simpler) to accomplish all requisites of the task at hand.

This year, we believe, will be subject to more variability than usual, for reasons we have attempted to explain in this report. We are starting from what is essentially a neutral position where growth, income and safety are more or less in balance for each portfolio strategy. This may require changes as we obtain more data as the year develops. We are ready to act as necessary to protect the integrity of each client's long term goals, in this year and every year henceforth.

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