Financial Markets Perspective

January 2025

A Look Back; a Look Ahead

As most of our readers know, we offer a forecast of the economy and financial markets for the coming year and evaluate our prior year's prognostication. This year is no different, so let's see how our forecasts for 2024 turned out (note italics for the predictions) and what we see in our crystal ball for this year.

"The good news is that there are many positives both from an economic and financial markets perspective."

From an economic viewpoint, growth was just about average, running around the 3% level for the year, which is not bad considering all the calls for a recession. Equity markets finished well ahead of expectations, with the S&P 500 returning 23% on the back of a 26% return in 2023. Conversely, fixed-income markets experienced more volatility than normal, and the 30-year government bond declined 8%. Earlier in the year, bond markets rallied on the expectation of an easier Federal Reserve monetary policy. However, once the Fed began to lower interest rates, long-term rates rose, surprising many bond market professionals who expected more interest rate declines.

"From a financial markets perspective, companies recognize how artificial intelligence (AI) could positively impact the way we live, and work will come out on top."

By drawing together and analyzing data from internal and third-party data sources, AI can help decision-makers in various tasks, such as predicting their costs, identifying and reacting to potential supply chain disruptions, and more accurately predicting product demand. Last year's equity markets were characterized by the domination of the "Magnificent Seven," a group of the largest capitalization technology companies enjoying unusual growth due to the application of artificial intelligence.

"So, what is the potential bad news? Mostly, expected market volatility relating to our national presidential election."

Equity markets were less concerned about the election, even though the withdrawal of President Biden was a big surprise. The president's replacement, Kamala Harris, never gained the broad acceptance necessary to win the presidency. The election's outcome did not lead to any violent responses and markets generally applauded the election but still experienced some retracement in December after outsized gains during the rest of the year.

"The implementation of AI across industries is the next step in significantly improving our lives."

AI can positively augment work by replacing and automating repetitive tasks or assisting with routine decisions, which may reduce the burden on workers and allow them to perform other responsibilities better. Some top companies using AI include Amazon, Apple, Google, Microsoft, and NVIDIA. For example, few companies are involved in as many industries as

Amazon, including e-commerce, cloud computing, logistics, voice-activated technology, and even autonomous vehicles. Personal assistants like Siri and Alexa have made AI a part of our daily lives, and other companies have been infusing their products with AI to develop intelligent technology and services like self-driving cars, automated robots, content generators, cybersecurity threat detection, and customer experience analytics.

"In an easier Fed policy environment and lower inflation, long-term bonds should experience further gains along with a traditional stock market return in a 9-12% range with obvious divergencies brought about by circumstances."

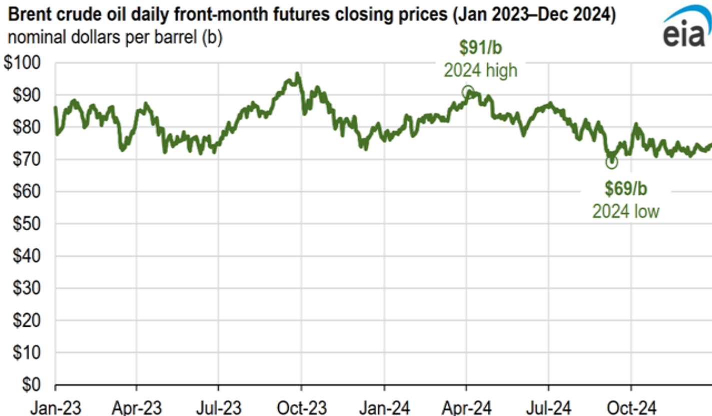
We got the Fed policy expectation correct, but we erred in our forecast of the direction for long-term bonds where prices fell, resulting in losses, and we were too conservative in estimating how well the stock market would do after a 26% rise in the S&P 500 in 2023.

"Corporate profits will likely continue in a positive trajectory given falling interest rates and mildly positive fiscal policy. However, changes in future tax laws could impact that expectation and in an election year, such changes are unlikely. Also, the generation of profits could be skewed by the outsized gains expected in artificial intelligence and biotechnology."

According to FactSet, earnings for companies within the S&P 500 are expected to have grown by about 9.4% in 2024. Companies will start reporting their final quarterly financial results for that year in the next few weeks. It will mark a sharp gain from the 1.4% growth recorded in 2023. Corporate profits rose for the first three quarters, primarily due to the AI story. There was no action on the tax front where such decisions were left to a new Administration.

A Look Ahead to 2025

Our theme for 2025 is a bumpy road ahead in the near term. Historically, a major driver of financial markets has been wide swings in the price of oil. In 2024, the price of a barrel of oil was $69 to $91, not a wide range in contrast with the price swings during the Seventies and Eighties. For the year's second half, oil prices stabilized at the lower end of the annual range.



For 2025, we expect to see relative stability in oil prices. While the U.S. remains in a growth uptrend, the rest of the world's economies are having problems. China, a major oil consumer, is having continued struggles, and Europe's economic growth is nil. The continued conversion to electric automobiles and the shift in utility power sources to natural gas undermines the ability to

drive oil prices higher. The incoming U.S. president is committed to increasing domestic oil output -- another factor likely to produce lower, not higher, prices. We expect oil prices to remain between $70 and $80, with a possible break below $70.

Economic growth is expected to continue to run at a rate between 2% and 3%, not unlike the experience of 2024. Policies implemented by the new president are not likely to have any major impact on economic growth this year but could affect future years depending on the shape and scope of such programs.

Interest rates fluctuated during 2024, with the Federal Reserve implementing three reductions in the Fed funds rate, with further reductions planned for 2025. These planned reductions should lead to declines in other long-term interest rates, but last year's surprise was that long rates began to rise rather than fall in the aftermath of the change in Fed policy. The divergence could play havoc with fixed-income markets as well as mortgage rates.

The exhibit above reflects the wide swings in the interest rate on the 10-year government bond during 2024. Given the continued economic improvement, we expect interest rates as measured by the 10-year. Government bond yield will fluctuate between 4% to 4.5%. In other words, rates should continue to move within a range but are not expected to move out of this range, given the tradeoff between economic growth and a Fed that seems committed to further short-term reductions in the Fed funds rate.

The New Administration

For equity investors, most of the announced programs will benefit the economy. First, reductions in tax rates or the commitment not to raise taxes are important components to stimulate further economic growth. History tells us that lower tax rates increase economic activity.

Second, a commitment to lower regulations and curb the regulatory power of the administrative state will also contribute to greater economic growth. Limiting government agency's ability to create laws and regulations will be a major component of contributing to a favorable economy.

The new Administration's decision to increase fossil fuel production will help control inflation by lowering oil prices. At the same time, the freedom to export liquified natural gas will keep the

dollar strong. Commitments to alternative power sources, such as nuclear, are experiencing a renaissance due to new plant construction methods, and progress in the commercialization of nuclear fusion will further lower oil prices. In other words, energy should not be the problem that has been periodically pushing inflation higher.

The stock market should be a beneficiary of these planned changes. The threat of using tariffs to level the playing field of international trade has caused the most tumult regarding inflation. From our point of view, we see more smoke than fire. Tariffs can also be used to get other countries to cooperate by lowering, not increasing, tariffs and investing in the United States. Tariffs may monopolize the headlines this year, but we do not see the potential for a global trade war.

While the U.S. government will lean toward freer markets and lower taxes, other countries seem to be going in the opposite direction. As a result, we see more turmoil in Europe and Asia because of their policies. We are on the cusp of another fiscal policy change that should mirror the policies of an earlier Trump Administration. We have been here before, and the economic and market performance was very good for investors. The new President has some foibles that will cause some near-term dyspepsia as new policies roil both the status quo and, in turn, sectors of financial markets. Interest rates should remain stable, and equity markets should have another better-than-average year. There could always be an unidentifiable event that could upset this prediction, but a new "Golden Age of America" has arrived.

Keep the Faith. Faith is the Spirit!

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