2024 YEAR BEHIND
2025 YEAR AHEAD

"The less prudence with which others conduct their affairs, the greater prudence with which we must conduct our own affairs."

~ Warren Buffett

Many are surprised at what happened in markets and the economy in 2024. When it comes to markets, there wasn't a lot that ended up being all that different from 2023. A 26% S&P 500 return in 2023 was followed with a 23% return in 2024. The "Mag-7" ended up being magnificent again, though at very different levels relative to one another, and the hoopla around artificial intelligence has hardly subsided. It was a big year for almost any risk-taker, and that was hardly contained to those invested in high-flying technology stocks. Indeed, Consumer and Financial stocks posted returns above the market average, and even defensive "laggards" like Consumer Staples and Health Care posted positive returns.

Is it really surprising for markets to have had a big year? History has certainly delivered plenty of other back-to-back robust years (seven other times, to be precise). The economy grew in 2024 below its long-term post-war historical average but well above its post-financial crisis average. Unemployment has stayed low. Corporate profits have stayed high. And the Federal Reserve hasn't increased interest rates since July of 2023, and it began cutting rates the last four months of 2024. Should we really be surprised that markets had such a robust year?

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Yes and no. No, because of all the reasons just stated. Profit growth has been substantial and the old adage that "as profits go, so goes the market" has held up well. The economic backdrop is good enough to support and sustain more profit growth. Markets took solace in 2023 in knowing that the period of monetary tightening they found themselves in would not last forever, and then they took more solace in 2024 when tightening did come to an end. This is the best of all worlds for risk-takers: Markets that price in good news before it happens, and then price it again when it does happen!

For many, there are still reasons to be surprised by how markets behaved in 2024. At the very least, there are questions as we enter 2025. The economy does not seem to have suffered from the impact of significant monetary tightening that began in 2022. Those who believed a "lag effect" would create eventual market distress have waited in vain (so far). Geopolitically, things hardly feel serene, with the Russia/Ukraine war about to go into its third year, a morass of uncertainty in the Middle East, and a perpetual question about what China's intentions are with Taiwan. The promise of artificial intelligence has given hope to some praying for a boon to productivity (and positive returns to those riding the wave of those who power such technology), yet actual application and utility still remains elusive and legitimate questions exist about the delta between measurable usefulness and future aspiration. The U.S. political dynamic remains divided and polarized, with many still anchoring their expectations for capital markets to their like or dislike or political leadership. Some enthused by the results of the U.S. elections are stunned markets are not up more, and others who are grieved by the results cannot believe markets have not revolted. I have seen this movie before, I assure you.

It is no secret that analysts tend the play things safe when making predictions. The vast majority of Wall Street analysts over the last 25 years have forecasted a market return for the S&P 500 in the year ahead between 0% and 10%, in line with average returns. And yet, markets rarely achieve their average return by delivering an average return, but rather by performing well above the average some years, and well below it others. Some analysts prefer to stay in the safe lane of calling averages. Others, and I include myself in this company, prefer to avoid the futile task of predicting what the market will do one year at a time. Should we ever develop an investment plan for a client that requires us to know what the markets may do in the next year, we may take on such a task more seriously (or more likely, find a better career). But as long as our commitment to truth-telling remains, we will continue our habit of looking at themes, risk-reward trade-offs, business fundamentals, and prudent decision-making – and rejecting the opportunity to guess a number out of thin air, safely or otherwise.

But if we are going to stay in our (self-righteous) lane of not making market calls which are unhelpful, impractical, and unreliable, we also owe it to ourselves (and you) to not be surprised at what happens. Surprise should be reserved for those who predicted the opposite. And the corollary to avoiding the foolishness of futile predictions, is also avoiding the foolishness of surprise.

2024 IN REVIEW:

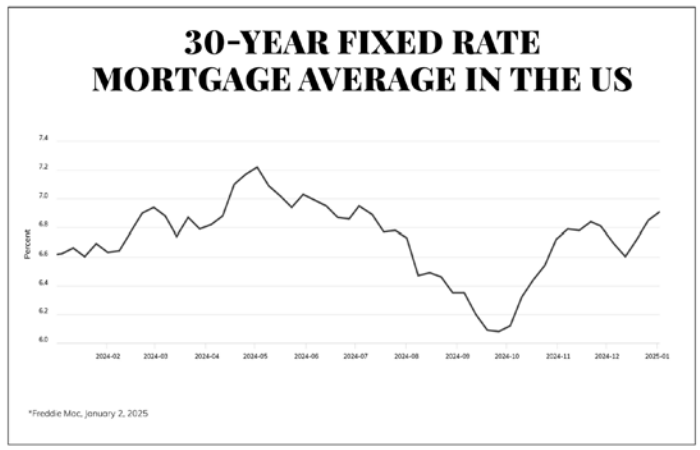
2024 offered very little chance for investors to be disappointed, other than for those investors who (once again) felt they would “time a dip.” The S&P 500 made 57 new all-time highs in the year, which begs the question as to why the 57th one is concerning but the first 56 were not? The Dow Jones Industrial Average (our continued vote for the major market index that best captures the reality of the American market) made 47 new highs on the year, and the Nasdaq made 38. In other words, the three major market averages spent much of the year at an all-time high, and then went higher from there. A little sell-off to close the year put some cushion between the all-time highs reached in early December and where we sit entering 2025. As has always been the case, “all-time highs” are a mere point in history that are eventually referred to as “a number way lower than where we are now” (i.e. 10,000 was once the all-time high; markets are up 4x since then).

The first quarter of 2024 started with a bang, with all three market indices up substantially as quarterly earnings results boosted market optimism, and markets shrugged off the fact that March rate cuts did not materialize. Concerns that inflation may be stickier than Fed aspirations had indicated in late 2023 became a media narrative but not a market narrative, and the 10-year bond yield stayed close to 4% (though off of the low levels at which it started the year). Credit spreads tightened as recessionary concerns completely disappeared, and markets seemed poised for a positive year ahead.

Q2 saw a good setback in markets to start the quarter, a big comeback in the month of May, and then a familiar rally in June in which much of the market did not participate but the AI/tech world did. Small-cap and the Dow each saw a decline in Q2 while the Nasdaq and tech-heavy S&P advanced. The Fed went another quarter holding rates in place, and the summer launched with a bizarre Presidential debate night and solid optimism about corporate profits.

Q3 was really where a lot of the market excitement happened last year. July saw the Nasdaq experience a double-digit correction, a very brief unwinding of a Yen-carry trade, and fundamental concerns about the labor market pushing markets into a sell-off in early August. Markets rebounded in September, buoyed by labor data indicating summer questions were a false alarm and, of course, the Fed beginning to cut the federal funds rate from its 5.5% level. Investors likely remember the recovery from July-August market distress as something related to central bank activity, but a closer analysis reveals that the unemployment rate peaking at 4.3%, moving back towards 4%, with weekly unemployment claims staying between 215,000 and 225,000 (Department of Labor), bolstered confidence that the economy was not unraveling. This did cause bond yields to move higher, but for a good reason, not because of rising inflation expectations.

I would be remiss if I did not point out that Q3 finally saw mortgage rates come down a bit (having held around 7% for most of the year, they moved their way down to 6% in response to the Fed’s plans for rate cuts). However, by Q4 they reverted right back towards the 7% level. The Fed wants (and needs) to bring mortgage rates down. Using the fed funds rate to do so is going to take more effort than previously understood.



Of course, Q4 was dominated by the election, first by anticipation of what was believed to be a very close race, then by the election results themselves, then by the daily excitement around the President-elect’s Cabinet and advisory team, and then in December by the reality of all that was unknown. Markets enjoyed the biggest month of the year in November, with thousand-point positive days to follow the election, yet saw declines in October and December that muted the total quarterly impact.

2024 did little to worry investors that the economy, itself, was a concern for markets. A healthy labor market, the tightest of financial conditions now being in the rearview mirror, and some level of optimism about the incoming administration’s economic agenda, combined with the ongoing hype in the “AI back-kitchen” story (i.e. the belief in infinite growth for those companies powering Artificial Intelligence) all led to a second year in a row of a benign environment for risk assets.

2024 MARKET SUMMARY:

The best two-year period for markets in 25 years did follow a very difficult year for both stock and bond markets in 2022. The 2024 calendar year really did look a lot more like 2023 than 2022, with barely any asset classes negative, as opposed to 2022 where barely any were positive (besides dividend growth equity). The growth side of the market outpaced the value side, large cap outpaced small and mid-cap, and the U.S. and Asia outpaced Europe and South America.

2024 ASSET CLASS PERFORMANCE

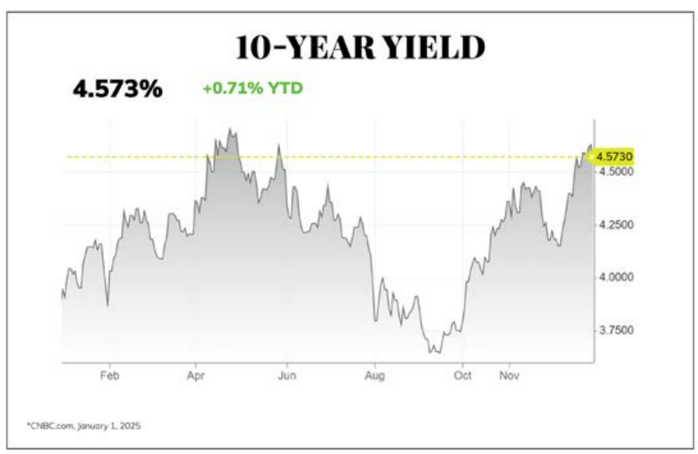
Nasdaq	28.6%
S&P 500	23.3%
Nikkei 225	19.2%
MSCI World	16.9%
Chinese Stocks	12.6%
S&P MidCap 400	12.2%
Russell 2000	10.0%
High Yield Bonds	8.2%
S&P Europe 350	6.1%
Dollar DXY	5.8%
U.S. REIT	4.3%
Emerging Markets	4.1%
Commodities	2.6%
U.S. Bonds	1.9%
U.S. TIPS	1.5%
Global REIT	-0.4%
Brent Crude Oil	-3.0%

*S&P Global, January 1, 2025

The Russell 2000 (small cap index) closed the year up just 10%, giving up over 8% in the final month of the year after having increased 11% in November (a post-election round trip for the small cap space). Over ten-years the small cap index is now only up 7.7% per year versus the 13% annualized return of the S&P 500 (barely half of the return over a full decade). In the shorter term, the small cap space is up just 3.92% per year for the last four years, while the S&P 500 is up 13.4% per year – a massive 10% per year difference between small cap and big cap.

Many argue that small cap is due for a catch-up rally while others argue that large cap is merely ahead of itself. We recognize the data just anecdotally, recognizing that timing any kind of reversion to the mean has led to substantial embarrassment for those who have tried.

Bonds delivered a slightly positive return on the year despite interest rates moving higher. This dynamic was what I described a year ago where rates moving higher from a level already well off the zero-bound provide a cushion against price depreciation, whereas the 2022 rate move not only devalued the price of bonds, but offered no coupon to offset. In 2024 the higher yield Treasuries offered was greater than the price depreciation that took place when rates moved higher, allowing for a positive total return (barely).



Communication Services and Technology were the leaders of the U.S. stock market. The dispersion of returns was heavily skewed to the very largest of names, and less and less names in these sectors participated in the market rally as the year went on. The top three sectors of 2024 were the exact same as 2023's top three, while the bottom three of 2023 all moved into the middle of the pack in 2024. Only Materials ended the year in negative territory (despite entering December up almost 10% on the year).

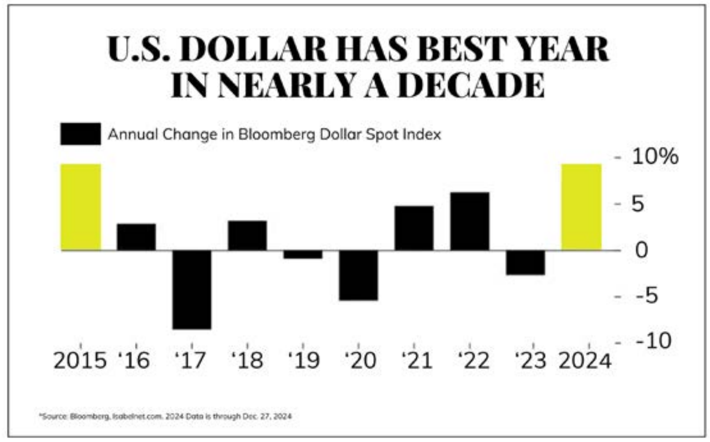
2024 SECTOR PERFORMANCE

Communication Services	38.9%
Technology	35.7%
Consumer Discretionary	29.1%
Financials	28.4%
Utilities	19.6%
Industrials	15.6%
Consumer Staples	11.9%
Energy	2.3%
Real Estate	1.7%
Health Care	0.9%
Materials	-1.8%

*CNBC.com, January 1, 2025

The Energy sector is more nuanced than its 2.3% index return suggests. Midstream energy, focused on the pipelines that transport oil and gas and the terminals that export it, was up well over 40% on the year, despite a modest pullback in the final weeks of the year. Annual returns in excess of 20% for the midstream space have been a huge boost for investors who saw this opportunity after the COVID shutdowns of 2020.

The U.S. dollar rallied substantially, hurting international investments, and shocking those (once again) who believed Gold (and even crypto) were allegedly dollar-hedge investments (both gold and bitcoin were up substantially in 2024). The next move for the U.S. dollar is one of the big questions for 2025, and while many believe the Trump policy portfolio is bullish for the dollar, his historical bias has been for a weaker dollar (to benefit American competitiveness for its own exporters). I am a broken record at how unreliable dollar prognosticators are, but for those concerned about the dollar losing its reserve status, global markets did not get that memo in 2024.



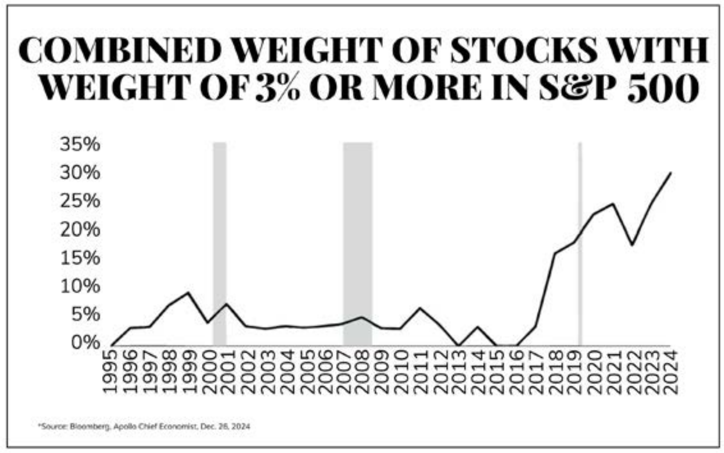
It would not be accurate to refer to the Magnificent Seven as "shiny objects" as they are certainly some of the most profitable and ensconced companies in world history. Whether or not their valuation levels hold is a different subject, but they certainly represent a more credible claim on market positioning than those elements I generally refer to as "shiny objects." That said, when one looks at 2024 returns it is worth noting that right behind the "Mag 7" were huge runs in the "gaming" sector, the "blockchain" space, as well as elements of cloud computing, cyber security, and mobile payments. To say that the price growth here was not exactly synchronized with the real profit growth of these companies would be a pretty substantial under-statement. Some of this doesn't feel like 2023 or 2022 – but more like 2021 … (and I do not mean that as a positive).

The economy appears poised to have grown 2.7% in 2024, net of inflation (Bureau of Economic Analysis). The jobs market has stayed healthy, capital expenditures are strong, the consumer is (always) happy to spend, and business confidence has picked up a lot since the Fed began easing and the new administration took hold. Government spending remains way too high, manufacturing remains subdued, and housing remains (mostly) frozen. It is not an overwhelmingly sanguine environment for the economy, but as far as 2024 goes, it did just fine.

2024 BOTTOM LINE:

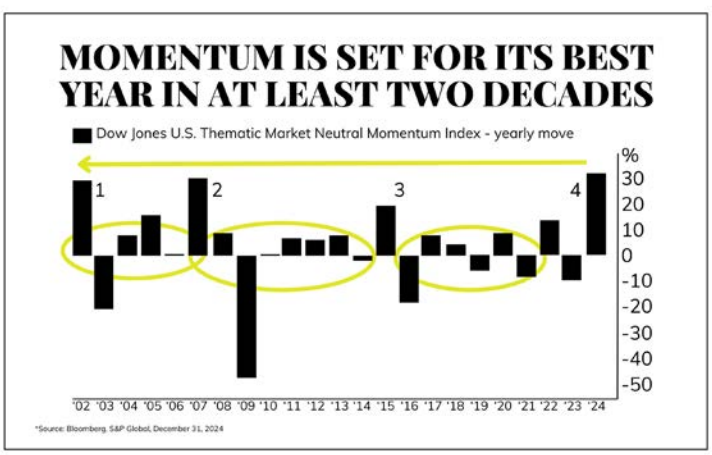
1 TOP-HEAVY
(again, sort of)

While the breadth of the market improved a great deal into the latter half of 2024, it was a year in which Nvidia achieved a market capitalization of $3.3 trillion and rose +171%, Tesla hit $1.3 trillion in market capitalization and rose +62% (all of which happened in the last eight weeks of the year), and Meta achieved a $1.5 trillion market capitalization after rising +66%. Six of the Magnificent Seven rallied more than the broad market (more on this below), and the top ten companies in the S&P 500 now make up 40% of the S&P's market capitalization, a simply unreal level of top-heaviness in the index (math refresher: 10 companies = 40% of the market; 490 companies = 60% of the market).



2 GROWTHY MOMENTUM STRIKES AGAIN

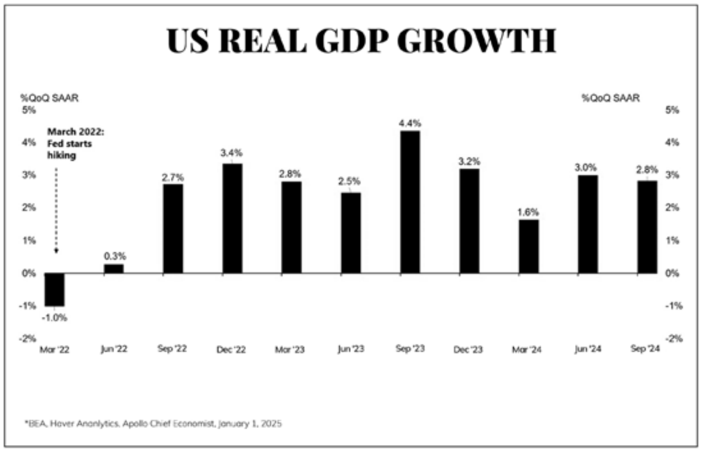
After the pummeling that "shiny objects" and the broader large-cap growth sector took in 2022, the two-year comeback has been impressive. Specifically, momentum has been a great factor in 2024, matching the strong years such a factor had in 2002, 2007, and 2015. The challenge will be to buck the historical trend that past strong "momentum" years have preceded, namely years of significant under-performance (often with large reversals thrown in along the way).



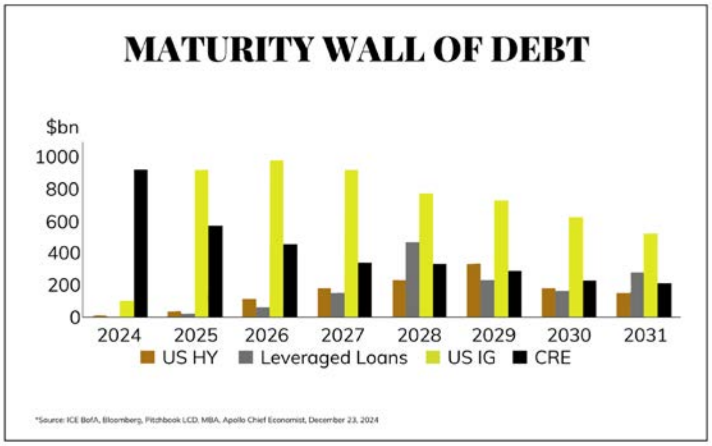
Momentum and Growth are not the same thing, though. Believing that that which has gone higher will continue to go higher has always worked until it stops working, which has historically been 100% of the time. Growth investing, though, wherein one pays a large premium to buy the earnings streams of companies growing at above-average growth rates, has definitely left many investors feeling "this time it's different" as the drawdown of 2022 is long-forgotten and the top-heavy theme in the preceding section overlaps with the "growth, forever, at any price" theme. Managers have no fear of being wrong on expensive growth names, investors feel any exit price is too low, and passive index investors provide a self-reinforcement mechanism to the strategy. 2024 did little to chasten this thinking or behavior.

3 THE ECONOMY DIDN'T GET BAD and the Fed began easing anyways

That the economy continued to grow after the Fed tightened monetary policy so aggressively in 2022 and 2023 will be the story economists talk about for years to come. That economists still believe economic growth and inflation are in tension with one another will be a cause I focus on for the rest of my life (it is a ghastly economic error that has done unspeakable damage to the economics profession, investment decisions, and public policy).



Ultimately, the Fed's decision to cut rates even while still tightening their balance sheet, even as unemployment stayed low, and even as real GDP growth was expanding, either indicates that they have come around to my supple-side way of seeing things (not likely), or that there is something else going on in their rationale. That something else, in my estimation, is the realization that significant debt levels across corporate and real estate categories is set to begin maturing now after a post-COVID lock period of very low rates.

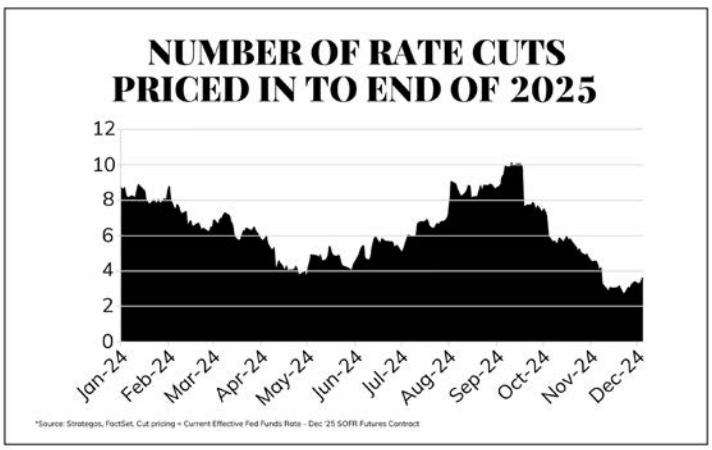


2024 REPORT CARD:

1 FED REALITIES ARE OVERRATED

A+

Market expectations moved all over the place, all year. At the beginning of the year markets expected rate cuts to commence in March, but no rate cut took place until September. Early in the year expectations were for eight rate cuts by the end of 2025; those expectations moved to a whopping ten cuts in the middle of the year; and now the expectation is for only two cuts in 2025. Yet, as each change/adjustment/re-pricing of expected rate cuts took place, markets couldn't have cared less.



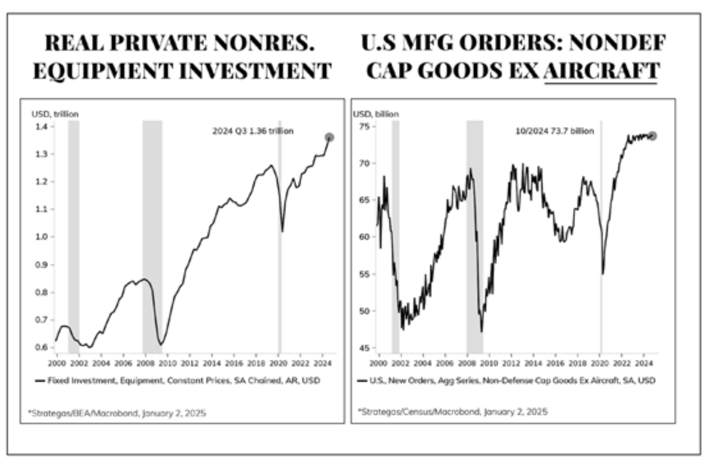
This is not to say that if the Fed had increased rates in 2024, or otherwise surprised markets with an unexpected move towards tightening, markets would not have revolted. The assumption in the theme was a lack of directional surprise; beyond that, the particular realities of how much and when, though entertaining fodder for financial media, were utterly irrelevant to markets, as the entirety of 2024 proved (and for that matter, so did 2023).

2 BIGGEST CONTEST OF 2024: DEGLOBALIZATION VS. CAPEX RENAISSANCE

B

This one is much harder to grade because it is somewhat abstract, it involves not one, but two, macro themes – each of which is hard to empirically measure – and both components are perpetual, and so the adjudication continues not just in how it played out in 2024 but how it will continue in 2025 (and years beyond that). In other words, I am not critical of the specifics of my thematic call here – I think it proved to be dynamic and relevant as forecasted in 2024. Rather, I am critical that I proffered a theme which would end up being so hard to empirically grade. I will take a B out of false humility, but one could justify a higher or lower grade if they so chose.

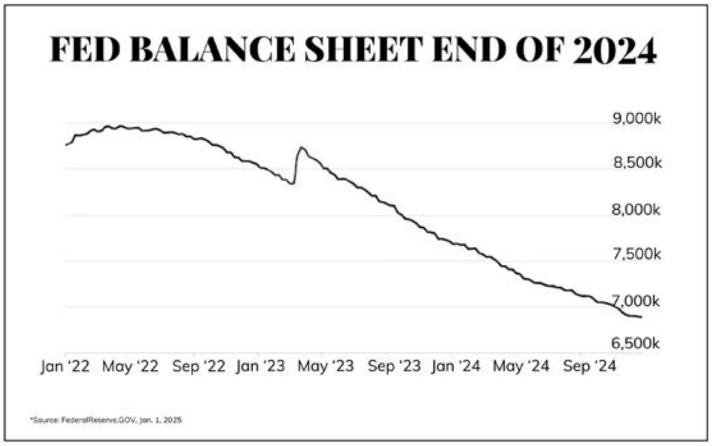
Essentially, the impact of deglobalization is not proving to be sudden, harsh, or violent, and yet despite a slow and measured pace, there is no doubt that many components of deglobalization are taking place. Re-shoring and near-shoring are playing out (more than on-shoring, I should point out), and certainly the global appetite to protect supply chains post-COVID is significant. But what has proven to be the biggest driver of capital expenditures for the U.S. economy continues to be fortifying digital and data investment, and the energy and power needs behind this anticipated digital need. Business investment has been strong and the impact of deglobalization has been muted. Fixed investment in equipment has been robust, and manufacturing orders on capital goods ex-aircraft is a record high.



This story is far from over.

3 QUANTITATIVE TIGHTENING IS THE UNDERRATED STORY, ONE WAY OR THE OTHER

The Fed began 2024 with a balance sheet of $7.7 trillion and ended the year with a balance sheet of $6.88 trillion, so they took off $800 billion in 2024, after reducing the same in 2023. Bottom line: I was early – credit markets did not resist ongoing Fed tightening, and the Fed even became willing to take the intellectually contradictory position of easing monetary policy via rate cuts in the last four months of the year, while tightening via ongoing reduction of the balance sheet.



That said, the pace of tightening substantially came down in the second half of the year, and I have more to say about 2025 expectations below.

4 CHINA TO SPLIT THE BABY ON JAPANIFICATION

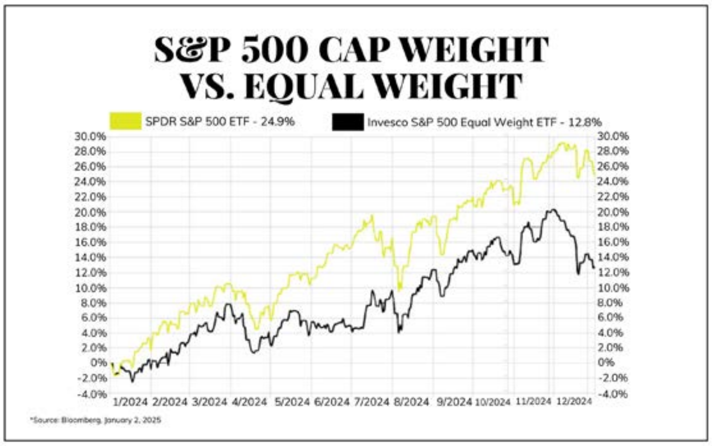
It was a granular call a year ago, on a topic that I think is far more important than many investors realize. As China faces the consequences of a deflationary unwind of what was an inflationary property bubble, the global playbook (Japan, U.S. EU) in such scenarios for a generation has been the two-headed monster of fiscal and monetary intervention. My belief a year ago was that China was far more likely to succumb to the allure of fiscal stimulus than it was to tread the path of monetary experimentation. China has worked very successfully to stabilize their currency, to present a credible bond market, and to compete for trading partners on the basis of monetary credibility. What they have not done, of course, is liberalize. Economic freedom and political tyranny remain in irresolvable tension, and China's means of expanding economic vitality (allowing for mobility of labor and capital) cannot exist within Communist tyranny.

China did ease monetary policy in 2024, but no more than any credible central bank would in these circumstances. They avoided "Japanification" extremes (for now), splitting the baby exactly as discussed a year ago (heavier emphasis on fiscal accommodations with an apparent priority for avoiding extreme monetary experiments). Maybe even Communist countries can learn from the failures of others?

5 BROADER MARKET PARTICIPATION

B

As mentioned previously, the performance of the so-called Mag-7 included a name up +171% (Nvidia), two names up over +60% (Meta and Tesla), and three names up between 30% and 45% (Apple, Google, and Amazon). Only Microsoft was up substantially less than the market, and it was up +13% (the horror). At the end of the day, the “cap-weighted” S&P 500 created double the return of the even-weighted (25% vs. 13%).



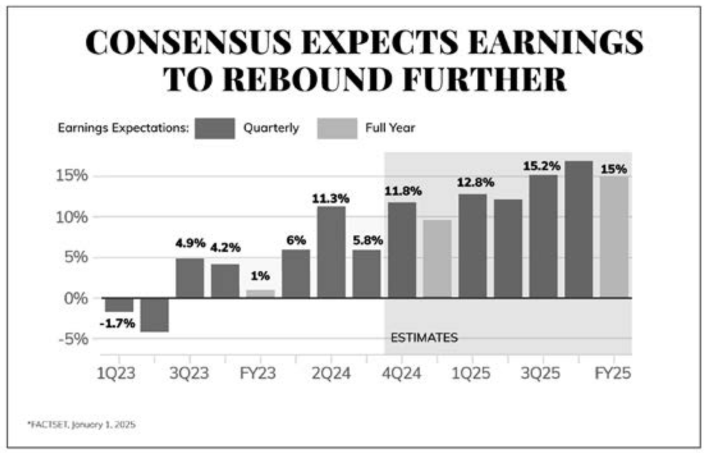
And yet, truth be told, the attribution of returns in the market was much broader than it was last year, with only one sector negative (Materials, down a paltry 2% on the year after a big 11% drop in December), and sectors like Consumer Discretionary (+30%) and Financials (+28%) joining Technology and Communication Services in exceeding broad market returns. Even the defensive sector of Utilities, down 7% as the worst-performing sector in 2023, rebounded to post a return in excess of 19% for the year. Any year in which Utilities are up 19% and ten of eleven sectors are positive can be considered a year of notable breadth, no matter how well some behemoths did at the top.

Also note in the chart above – at one point in the middle of the year the cap-weighted index was up 17% while the even-weighted was up 4% … So while the top-heaviness did result in double the return for the cap-weighted index, that broadening out of the market in the second half of the year narrowed the delta substantially.

6 2025 EARNINGS WILL DICTATE 2024 PERFORMANCE

A

This call never centered around what 2025 earnings projections would be, per se, just that as revisions and earnings guidance for 2025 came through in the second half of 2024, so would go markets (for good or for bad). And indeed, that is exactly how it played out, with earnings growth for 2025 expanding throughout 2024, and holding at around 15% by the end of the year. Whether or not 2025 will achieve these expectations remains to be seen, but 2024 did not see downward pressure on 2025 earnings expectations, and 2024 markets responded accordingly.



7 PRESIDENTIAL ELECTION A MAJOR NEWS STORY, NOT A MARKET ONE

B+

The 2024 calendar year saw a complete non-event come and go with a Republican primary in which no Republican challenger to Donald Trump achieved any momentum whatsoever, let alone viable delegate votes, at the same time that the runaway winner for the nomination faced a plethora of convictions, arrests, indictments, civil suits, and other such legal excitement. At no point did markets ever so much as shrug at the results of the Republican nomination or the legal drama being thrown at candidate Trump. The summer launched with a highly-viewed debate between the two [presumptive] nominees, Donald Trump and incumbent President Biden, the result of which was a substantial effort inside the Democratic Party to ask President Biden to step down as the 2024 nominee (an effort that would eventually succeed). Again, with the unprecedented drama of an incumbent President removing himself from running due to obvious physical and mental decline, markets never shrugged. An assassin's bullet came within a half-inch of ending the life of candidate Trump live on national television, and markets never moved. The Democrats took the daring step of skipping a primary entirely, selecting Vice President Kamala Harris to be their party's nominee without any opposition, debate, or campaign. Market response? Crickets. All of the summer's drama ended with a mundane fall campaign that featured only one debate, polls that suggested the race would be a nailbiter, and ultimately, a decisive win for President Trump. At no point throughout the year can anyone plausibly state that markets were moving in tandem with the political news.

Now, some may object to my conclusion based on the substantial rally that took place in markets after the election results were known (the Dow moved 2,500 points in the weeks following the election), but once again, the counter-factual is irrefutable. The Dow closed the year at 42,544 after all was said and done, eight weeks after the election. Where was the Dow two weeks before the election? 42,544. Small Cap, Energy, Financials and Bonds all rallied after the election results – and then they all gave back every bit of that rally.

8 ENHANCED VOLATILITY

D+

If I could have scored this theme in early August it was looking like things might play out well. On July 17 the Dow was at 41,200 and on August 6 it hit 38,638, so the Dow Jones Industrial Average dropped 6.2% in three weeks. The Nasdaq was at 18,650 on July 10, and hit 16,137 on August 6, so that represented a 13.4% drop in four weeks. This seems like pretty heightened volatility, right? Well, actually, it is child's play. The reality of volatility is that when a drawdown is happening, the trauma is not usually about what has happened, but fear over what will happen. A 6% drawdown, when it is happening, cannot possibly be thought of a 6% drawdown, because no one yet knows what the final level will be. We get to refer to drawdowns with the benefit of finality – of closure – and that makes it all feel and sound a lot different. History, though, tells us, that a double-digit drop intra-year is the normal event for markets, and while the Dow drew down 6% twice, it never got close to even a 10% drawdown. The S&P 500 got very close for about one hour in early August, but it never even drew down 10%, and the Nasdaq's 13% drop was real, but short-lived.

My view is that 2024 was actually a year of slightly below-average volatility, so while there were a couple drawdown incidents, they were not "elevated," hence the D grade here. But volatility as laid out in this theme is more than just "drawdowns" (i.e. magnitude of up/down movements). My forecast was for a market "prone to unproductive zigging and zagging." And yes, there was some of that – though much less around the political and geopolitical categories than expected. The minimal zigs and zags we saw generally followed a Fed press conference or some report of the possibility of a slowdown in AI-chip orders, but these event-driven zigs and zags underwhelmed my expectation. The market went up or down more than 1% on just 18% of days in 2024, and this is not a lot. Markets have moved up or down more than 1% in a day 23% of the time since 2013, and in more recent history these > 1% up/down days took place 25% of the time in 2023, a stunning 49% of the time in 2022, 21% of the time in 2021, and 45% of the time in the COVID year of 2020. In other words, day-to-day volatility was significantly down in 2024 relative to recent and extended history.

Another reason for the low grade here, which many may feel is me being too hard on myself: The so-called MOVE index which measures volatility in the Treasury Bond market was also reasonably subdued in 2024. There were moments of spikes around inflation data and yield rallies, but all things being equal, despite long bond rates moving up and down 50 basis points a couple times, the volatility of rate moves (which I very clearly included in this theme – the language said "stock and bond volatility") was relatively stable and below levels seen in recent years.

Summary: Three A's, three B's, two D's

2025 THEMES:

1 TARIFF VOLATILITY UNDER-APPRECIATED & TARIFF PANDEMONIUM OVER-THOUGHT

We do not expect a global catastrophe or Smoot-Hawley debacle from what Trump 2.0 will end up doing with tariffs, nor do we expect this to all transpire without some chaos.

The Dividend Café in November of 2024 offered several extensive downloads of the election results and particular policy ramifications for markets around a Trump 2.0 administration. The nexus of policy and markets is a passion of mine, and something I believe we analyze well at The Bahnsen Group. It will be no surprise to you that several themes for 2025 center around elements of public policy, particularly as it pertains to the Trump 2.0 administration.

Tariffs represent the single-hardest element of policy to handicap going into 2025 because they contain the most complexity and uncertainty around what may happen. My view has been that there are two schools of thought here. I will over-simplify their views to make my point around this binary assessment. On one hand, some believe that massive tariffs are coming, they will spike prices worldwide, they will spark retaliatory tariffs that will erode appetite for trade, and they will serve as a catalyst to depress economic activity domestically and globally. While I believe this far-left tail risk is highly unlikely to happen, there is certainly truth to the idea that a glut of poorly-constructed tariffs would be highly problematic for trade and market functioning. My resistance to this view is not theoretical, but practical. In short, it is based on the low likelihood of the Trump administration actually going through with such.

The other view, though, a sort of inverse of that same extreme perspective, is that there will be no market impact for Trump 2.0 tariff plans, that they will be entirely used as negotiating tactics that extract better cooperation from allies around domestic policy priorities (i.e. securing more help from Mexico and Canada with crime, drugs, and border security), and that getting better deals with China and other trading partners will be the end result, without much noise along the way. I also see this "right tail" outlook as possible, but unlikely.

The middle ground view is that there is likely to be unexpected market disruption from the manner in which the Trump 2.0 administration pursues its trade and adjacent policy objectives, and yet that the various "worst case scenarios" are all highly unlikely to materialize (the market ramifications of those scenarios being one of the key reasons President Trump, himself, is so unlikely to allow those things to happen). There may very well be a better currency understanding that comes out of our discussions with China (that could go into 2026, by the way, and that would be a good thing as any deal that takes less than a year to do will likely not be as substantive and meaningful of a deal as one that takes more time). There may be some economic cost to be borne by some tariff increases that do happen. If the cost of new tariffs sets around $40-50 billion, we do not see such as having profound market impact. If the cost reaches a $200 billion level, the impact will be severe.

But at the end of the day, despite noise along the way (exacerbated by unconventional messaging tactics and some members of the team who favor "shock and awe" negotiating to statesmanship), we expect the final tally to be muted in its cost to the economy, with some potential for a very positive result if the cards are all played well.

A Dividend Café is coming in early 2025 that will lay out a fuller perspective on tariffs, focusing on economic reality and not politics. The politics of the topic right now are completely diverged from the economics, as the nationalistic and populist impulses of the moment have sentimentalized the idea that a higher cost on imports will benefit domestic manufacturing. While my own economic analysis strongly disagrees with that conclusion, I also do not necessarily believe that such an objective is even front and center for the new administration, economically. It is certainly useful politically, but the major policy objectives appear to me to be less protectionist, and more related to matters of national security, border control, and immigration. Hence my earlier description of "complexity" in analyzing this topic

2 2025 TAX BILL(S) ARE THE MOST IMPORTANT POLICY REALITY FOR MARKETS

More than even tariffs, deregulation, and DOGE, nothing will matter for markets quite like taxes.

President Trump has left himself a tall order entering the new year. He campaigned on making permanent the tax cuts he successfully passed in his first term, but then upped the ante quite a bit from there on the campaign trail. No promise was more electorally significant (see: Clark County) and rhetorically memorable than “no tax on tips” – and failure to deliver there has “read my lips” risk all over it. Other promises linger, but perhaps with less political seriousness attached. No taxes on overtime wages may prove difficult, and no federal income tax on social security payments almost certainly cannot be achieved in budget reconciliation. He succeeded in lowering the ghastly 35% corporate income rate to 21% in 2017, but now has teased a 15% rate for those companies who commit to producing in America (a dubious idea, but one added to the list of campaign promises).

The reality of tax legislation in 2025 is that it will require use of the budget reconciliation process to avoid the filibuster and 60-vote threshold in the Senate. The White House has the votes they need (and then some) in the new Republican Senate if the vote only requires a simple majority, and so a strictly partisan plan for tax reform is required to see this come to fruition. What remains to be seen is whether or not there will be a willingness to use the budget reconciliation process twice (Karl Rove is predicting that this will happen, with the first package used to pass an immigration bill and the second to pass a tax bill – meaning a longer timeline to get tax reform done).

If for any reason a comprehensive tax bill is not passed mid-year (I believe it will be), a one-year extension of the sunsetting provisions of the 2017 tax bill is extremely likely. Other opportunistic components exist that are, ironically, less sensitive to the politics of the moment but far more relevant to markets. Is 100% business expensing back on the table? The state and local tax deduction (SALT) could see its cap increased from $10,000 to something higher ($20,000 is likely a lay-up, but there is talk of $30,000 or higher, a sizable, albeit backdoor, tax cut to millions of middle class and upper middle class taxpayers).

The downside risk to markets is in (a) Timing (later versus earlier), and (b) Magnitude (less versus more), in terms of 2025 tax reductions. The upside opportunity for markets is in non-campaign focuses becoming a bigger reality than expected, from business deductions, to corporate rates, to the size of total tax relief. Size (magnitude) depends on deficit implications, and there is no more important variable in what assumed deficit implications will be than the policy baseline used in the budget process. A huge bandwidth exists in the possible level of tax cuts that can be implemented in reconciliation if the assumed baseline is current tax law, versus one assuming extension of the 2017 tax cuts. That determination will drive much of the outcome than can be expected in 2025 tax law changes. It may seem procedural and even tedious, but it is ultimately math, and law. Many smart people are working to optimize conditions for this reconciliation process.

3 CHINA RELATIONSHIP TO IMPROVE, NOT WORSEN

A lot of opportunity exists to cut a grand bargain with China in 2025, not spend the year in escalated tension.

This is perhaps one of the riskier themes being offered for 2025, and one that is ripe for misunderstanding (and error). President Trump has surrounded himself with many China hawks since famously coming down the escalator in 2015, and a large part of his national platform has been built around “tough talk” regarding China. The 2018 negotiations around a trade deal after the early innings of a trade war reflected policy intentions to move the needle in the way the U.S. trades and interacts with China.

That said, I see the possibility for certain things changing that may lead to a less acrimonious 2025 in U.S.-China relations than many are expecting. At the heart of this theme is not what rhetoric or language in social media posts may surface from time to time, but rather, real policy activity. I base this on the following::

- President-elect Trump has reversed course on a national Tik-Tok ban and is actively soliciting the Supreme Court to allow his administration to cut a new deal with China versus implementing an outright ban.

- The new administration did not bring back China adversary, Robert Lighthizer, and it named other high-profile China foe, Peter Navarro, to a token, symbolic position.

- There is serious talk of China playing a role in how the Russia/Ukraine matter comes to an end, something China did not do (quite the opposite) the last three years.

- Ample opportunity exists to bring the trade deficit down with Chinese commitments to purchase U.S. liquefied natural gas, agricultural products, and aviation goods.

- A currency accord may not happen in 2025 but the idea gives both sides bandwidth to accomplish certain trade and economic objectives without sensationalistic headlines about tariffs. In other words, currency exchange rates allow someone to lose weight by just changing the scale.

- The U.S. is diminishing its supply chain dependency on China around matters of key national interest whether there is a grand agreement with China, or not. There may as well be some part of a deal that benefits China, since these are other changes are inevitably happening regardless.

- A key advisor to President Trump and significant player in the campaign, in new efforts around government efficiency, and in broad counsel to the President, Elon Musk, has significant interests in China and has presented multiple ways to meet U.S. objectives without further antagonism.

I know all of the things that can go wrong here, but I believe this theme is an out-of-consensus call that carries profound implications for markets (i.e. bullish for emerging markets, bearish for the dollar, and likely bearish for crude oil prices).

4 FINANCIAL DEREGULATION WILL PROVE TO BE AN UNDERRATED CATALYST FOR GROWTH

As much as we will talk about energy, trade, and taxes with Trump 2.0, the opportunity in the financial sector from deregulation is substantial.

If Elon Musk and Vivek Ramaswamy asked me for my opinion on government inefficiency, I would suggest they make a list of the governmental entities, bureaus, and agencies that are all tasked with doing some of the same things when it comes to financial services. The duplication of oversight across the FDIC, CFPB, OCC, NCUA, SEC, FTC, comptroller, Treasury Department (and I could go on and on if I wanted to) is not merely an embarrassing indication of inefficiency; it comes at a massive cost to the taxpayers, and worse, it impedes economic growth.

The financial sector had essentially traded somewhere between 2x and 3x book value in the 10-15 years before the financial crisis. It has regularly held between 1x and 2x book value in the 10-15 years since the crisis. That number has more recently creeped up to the higher end of the range (2x) - higher than post-crisis averages but still well below pre-crisis levels. Return on Equity lingered between 5% and 10% for years after the crisis (I remember this malaise at Morgan Stanley quite well), and has now gotten up to 12% (and rising). Many names routinely had a ROE of 15-18% well before the financial crisis. Regulatory relief (of the sensible and prudent variety) is one lever (a big lever) for an expanded Return on Equity, which drives a higher multiple to Book Value.

As you will see in theme #6, we are already anticipating a healthy amount of corporate activity in 2025 that will unlock value for investors and catalyze economic growth. Financial deregulation is a needed step towards promoting risk-taking, reinforcing the systemic safety of the financial system, and ridding ourselves of antiquated measures that have grown bureaucracy, but not achieved their desired aims.

5 EARNINGS DISAPPOINTMENT A BIGGER RISK THAN EARNINGS SURPRISES

No one is predicting that earnings will disappoint their expectations of 15% growth, but failing to reach that level is more likely than exceeding it.

This is an especially lame theme for those who want to treat these themes as predictions, forecasts, or market calls. By definition, there is no way to measure or verify my assertion that falling short of 15% profit growth has more implications than if we somehow exceed it. But perhaps a little extra context will illuminate the wisdom of the point I am making … Let's say the market was going to go up a certain amount (you pick what that amount is) if profits end up growing exactly 15% as is current consensus forecast. Now let's say actual profits are 10% less than that growth estimate, or that they are 10% more than that growth estimate. Does anyone believe that the market return will be proportionately up or down around that number? When 15% profit growth is attached to a 22x market multiple, a failure to reach expectations is punished far more than an excess of expectations is rewarded. This is the point I am making, and I do not believe it is fully appreciated by index investors.

For years concerns about profit expectations were linked to concerns about revenue growth. For the first time in many years skepticism about earnings is tied to the feasibility of profit margin expectations. Embedded in forecasts for 15% profit growth in 2025 is the assumption that operating margins will expand once again. Betting against margin expansion has been a losing bet for a long time, but extremely optimistic projections needed to pull all of this off lead me to believe the risk-reward trade-off is skewed towards the downside.

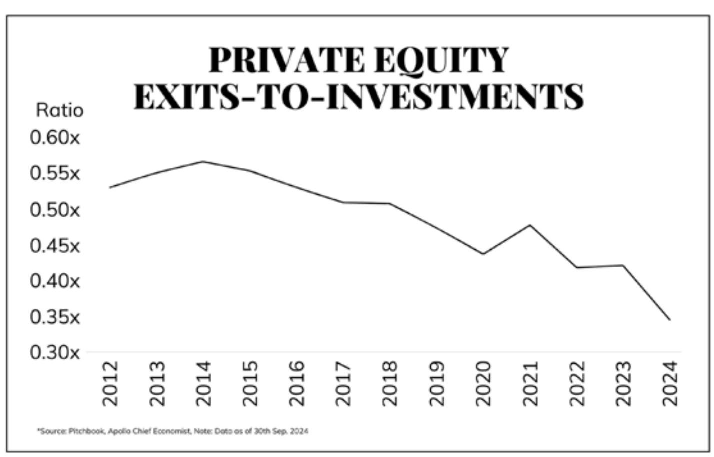
6 CORPORATE ACTIVITY TO SKYROCKET

From M&A to IPO to private markets activity, three factors point to a coming boom in corporate activity.

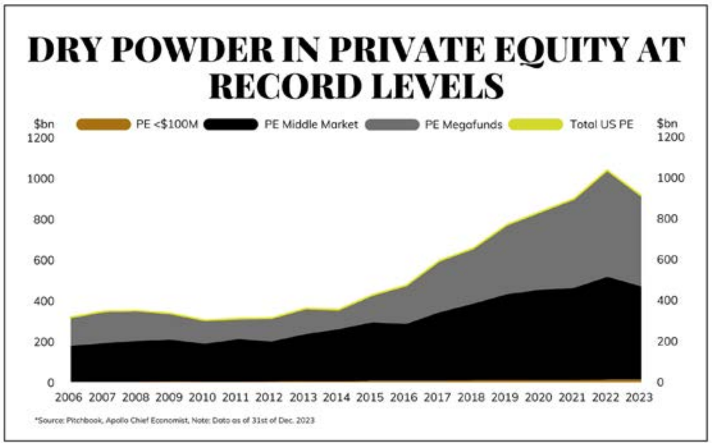
There are multiple factors behind this particular theme. First, the regulatory apparatus is widely expected to be more accommodative of mergers and acquisitions under the new administration. Former FTC commissioner, Lina Kahn, was an outspoken opponent of many proposed corporate transactions and operated from a definition of antitrust that was broad, aggressive, and if I am being honest, legally dubious. New FTC commissioner, Andrew Ferguson, is perceived to be more friendly to innovation, growth, and private markets autonomy. The friendly regulatory conditions go beyond the obvious consideration of federal approval. More reasonable capital requirements in the banking system frees up more opportunity for balance sheet investment from large and medium-sized banks, and the massive growth of private credit has provided substantial sources for deal-funding outside of commercial banks.

Second, the interest rate environment is more conducive to corporate activity. Not only are interest rates lower than they were a year ago, but indications are that they are headed lower, still. The environment for the last three years was not only one of higher rates, but directionally facing the possibility of higher, still. As so much of the borrowing behind corporate activity is floating rate, the cost of capital at transaction matters, but so does the cost of capital going forward.

Finally, and perhaps most importantly, corporate America faces a significant need for activity in our private markets. The ratio of exits-to-new investments has been cut in half, leaving a substantial inventory of high-performing companies waiting to be profitably sold. We have seen $100-150 billion of exits each quarter the last two years, well below the $150-250 billion average of the two years prior.



Private Equity funds are sitting at record levels of dry powder. There is ample liquidity to fund purchases, a better regulatory, interest rate, and liquidity environment to do such, and public markets that ought to have much more appetite for larger deals in the year ahead.



7 THE DEFICIT IS COMING DOWN

Coming down from $1.8 trillion in peacetime and economic expansion is nothing to celebrate, but projections are too pessimistic about next year's deficit.

Let's start with some simple math: Strategas Research estimates that U.S. shareholder wealth increased in 2024 by $11 trillion. The exact amount of increased tax revenue that will come from that is not certain as dividends and realized capital gains become taxable, but unrealized gains are not taxable (until, of course, they become realized). What we do know is that increases in shareholder wealth increase the tax base substantially, and my friends at Strategas Research believe that current expectations for tax revenue are under-stated by $255 billion for the next fiscal year. If my preceding point (#6) is correct, expect even more outsized capital gain tax revenue behind increased M&A activity and Initial Public Offerings in capital markets. Expect the revenue side of the equation to generate less deficits than expected as the tax base outperforms expectations.

But on the expense side, expect further deficit relief (with an important caveat). What I am not predicting is actual fiscal discipline – spending will be massive, and no matter what good may come from the so-called Department of Government Efficiency (fingers are crossed), I am not expecting the spending side to improve the real reality of what plagues excessive government spending. However, there has been much talk about the $882 billion the federal government spent on interest expense in fiscal year 2024, but not much talk about the impact of 100-175 basis points coming out of short-term federal borrowing costs in the year ahead. While this ought to be a great moment to bemoan the minimal amount of term structure work that was done in the period of 1-3% long-term borrowing costs that our federal government could have taken advantage of, the fact of the matter is that a substantial amount of government borrowing is presently on the short end of the curve, which for the first time in thirty months is coming down.

It is no secret that the Biden administration has spent nearly $200 billion in various forms of student loan cancellation. Suffice it to say, those actions are not likely to continue with the new administration. The general assumption is that various funding levels to support Ukraine from the Russian attack are likely to come down, as well. Apart from any low-hanging fruit that may be forthcoming from DOGE, there are certain budget expenditures that are just not likely to repeat in the next fiscal year.

I would love to tell you that I am forecasting a collapse of the budget deficit to something closer to balance, or even $500 billion. Let's not get carried away. What I am suggesting is that projections for something between $1.5 trillion and $2 trillion are likely to be over-stated by hundreds of billions of dollars due to the reasons cited here, and hopefully, for other reasons not yet forthcoming..

8 QUANTITATIVE TIGHTENING IS ENDING

The Fed will stop the reduction of their balance sheet as added tool of monetary easing.

I did make this same call last year, and as mentioned in the 2024 report card, the Fed pushed their tightening measures further and longer than I expected. This theme is simply a repeat of the same call – that the $2 billion of balance sheet reduction they have effected over the last thirty months (without incident) has been a surprise, and that their goals for the shape of the yield curve and liquidity conditions in financial markets are not likely to allow for another year of tightening. The “roll-off” the Fed has used to effect balance sheet reduction (i.e. the selective allowance of bonds held on their balance sheet to mature without proceeds being reinvested) has worked without disruption to credit markets for some time. Unlike the policy objectives of 2017-18 and 2022-23, the Fed’s primary posture is towards accommodation and removing the tightening characteristics previously used. Reducing the balance sheet while cutting interest rates is a monetary policy of running in place, and I believe 2025 will be the year that all policy levers line up in the same direction.

It is worth noting that conflict between the Federal Reserve and the Trump administration is more likely avoided this way, as well. I do not believe the FOMC should set monetary policy around the wishes of the White House, and I do not believe the President-elect is correct that that executive branch should be involved in monetary policy decisions. That said, I do believe that Chairman Powell knows his term ends in May of 2026, he knows of the past tensions with President Trump, and he knows of the whisper plans to appoint a “shadow Fed chair” to essentially critique current Fed policies in advance of the change. It is not my desire that any of this plays out, and it is not my belief that Chairman Powell will allow the White House to take over Fed decision-making. It is my belief, though, that ending quantitative tightening both achieves Fed policy aims and better satisfies the incoming administration.

CONCLUDING THOUGHTS

If you think predicting what will happen in stock prices is a tricky business (and I assure you, it is not our business), you would not believe the trickiness of forecasting the 10-year bond yield. That society's gaze is always and forever on stock prices, and barely ever on something that seems so esoteric as the 10-year bond yield does not change the fact that the 10-year bond yield is perhaps the most important metric in all of finance. Aside from the fact that the borrowing rate of the world's largest borrower, whose currency is the world's reserve currency, has significant implications for lenders, borrowers, savers, and investors all over the world, the 10-year bond yield is a powerful economic metric, too. With some nuance around this, it reflects expectations for nominal GDP growth in a way that few other metrics can. And it is this reason that I bring up the 10-year bond yield in this paper, despite knowing that most readers are focused on risk assets, not government bonds or interest rates.

I would suggest to you that one year from now, the 10-year at something well over 5% indicates a pummeling of risk assets on a valuation basis, but a 10-year right around 5% might indicate tremendous economic growth boosting stock market expectations. Paradoxically, I would suggest that a 10-year around 3% might indicate sluggish growth that hurts stock prices, whereas a 10-year around 3.8% might indicate a valuation boost on the other side of the implied economic malaise.

If you aren't confused yet you might not be paying attention. I am suggesting that the 10-year being higher, or lower, could really hurt risk assets, and I am suggesting that a 10-year being higher, or lower, could really boost risk assets. A brave call, don't you think? But I am actually saying this with more specificity than the typical two-handed economist speaks. The magnitude of a change in the 10-year bond yield matters, up or down, and the reason matters. A lower bond yield could be good for valuations, and if the magnitude is not too much, could indicate softening inflation and status quo real growth. A higher bond yield could crush valuations, but if the magnitude is not too much it could indicate expanding growth that makes up for the valuation impact with improved fundamentals.

This is the story of the market as we enter 2025. Will growth be strong enough that the bond yield holds up above 4%? For stock investors, there are two vulnerabilities to the good times that have been rolling: (1) Valuation, and (2) Economic fundamentals. If #2 goes well enough, #1 could become a problem. If #1 is not becoming a problem, is something breaking down in #2? This tension is the story for investors in 2025. It is perfectly possible that a "goldilocks" scenario plays out – economic growth doesn't disappoint, but bond yields don't undermine high valuations. What is not possible, though, is that this tension will not be highly worthy of our watch as the year progresses. Risk investors have enjoyed scenarios for some time where most things lined up in their favor. A strong economy in 2018 despite monetary tightening … Some monetary accommodation in 2019 despite a crack in the economy … A kitchen sink of fiscal and monetary stimulus in 2020 despite a global pandemic … A quicker and better than expected recovery in 2021 with ongoing monetary stimulus to boot … It all lined up well for risk assets.

In 2022 this "heads I win, tails I also win" scenario came to an end for many investors. But in 2023 and 2024, instead of entering a Fed-induced recession, the dice came up with the right combinations again, as valuations increased on expectations of easier monetary policy to come, and fundamentals behaved well as corporate profits grew and the economy outperformed concerns many had.

We do not enter 2025 with room for expansion of valuations, and we do not enter 2025 with a lot of pessimism about the economy. Upside risks surface when pessimism is too prevalent. The opposite issue may be at play now. But does anyone want to bet that the economy will under-perform expectations, or that possible tax reform, deregulation, and other commitments of the new administration will not complement strong corporate profitability to create another year of solid fundamentals? It may not happen, but it certainly doesn't feel like something I want to bet against in 2025.

Valuation is the concern investors ought to have – the risk that good news either doesn't materialize, or that it does materialize, but was already over-reflected in the price. It is impossible to motivate a lot of people about valuation when the dice have come up how the player wanted time and time and time again (whether it be fundamentals, or valuation, or policy impact, or all of the above). I have not predicted that the dice will come up seven in any annual white paper I have written, and I am not about to start now.

As 2025 progresses for investors, holding the aforementioned tension around fundamentals and valuation ever so tightly, the 10-year yield will be a valuable piece of information and will warrant much reflection. Our investment strategy will not be to root for something "higher, but not too high," or "lower, but not too low." That strategy may pay off just fine – never bet against a hot roller – but it isn't what we do at The Bahnsen Group.

Rather, investing in great companies that are growing their profits and executing on a business strategy, all the while returning cash to their minority owners (us!) via dividends, strikes us as eminently smarter than praying for higher valuations and an economy that cooperates. I happen to think those people who have made hope their strategy may get one of the two things they need in 2025 (no guarantees), but it is the other one I wouldn't bet on.

But we are not betting at The Bahnsen Group. We are all in on an investment philosophy that cares not how the dice come up. We are invested only in the really important things. To this end, we work.

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