Review & Outlook

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Review and Outlook

Over the past year, the U.S. economy has been surprising and impressive. Economic growth, driven largely by consumer spending, has outpaced the rest of the world, while inflation has fallen faster, and unemployment has stayed lower than in other countries. Repeated calls for a recession in 2023 or early 2024 were beaten back by continued economic strength, and the financial markets followed suit, handily beating expected returns. Although those strong returns were driven by a small number of mega-sized companies.

Interest rates for mid- and longer-term bonds (5-20+ years) decreased nicely in the first half of 2024, giving broad bond returns the best period they've seen in several years. However, interest rates increased again from late summer through fall when the Federal Reserve made it clear that they would lower interest rates more slowly than expected. Inflation has proven to be a bit sticky, and the potential economic policies of the incoming administration could also be inflationary, further putting upward pressure on interest rates, hurting prices for those same mid- and long-term bonds.

The surprising climb in stock prices invites questions about valuations. Stocks, especially recent technology and AI darlings Nvidia, Amazon, Tesla, and others, are now quite expensive relative to historical valuations and realistic expected growth.

Index Performance Data
Total Return as of 12/31/2024

Indices[1]	Q4 2024	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	2.63%	23.77%
iShares MSCI ACWI EX-US Total Return	-8.84%	2.19%
Bloomberg U.S. Aggregate Bond Index	-3.06%	1.25%

Financial markets moved up in the immediate wake of the election, but have wavered since that initial bump. It seems that investors are weighing the potential benefits of additional tax cuts and the chance for regulatory reform against the chance of higher inflation due to tariffs and workers shortages in key industries, should deportations take place. There is also concern about continued increases to U.S. debt, as significant annual deficits continue. We focus on the economic and financial impacts of possible tariffs in the "In Focus" section below.

There was a surge in worker productivity from 2020 through 2022, which helps explain some of the numbers, like stronger than expected economic growth and corporate earnings, but productivity has returned to its pre-pandemic trend of relatively low growth.[2] Something new and surprising needs to happen in 2025 for us to enjoy the sort of economic activity and stock returns that we saw in 2023 and 2024.

Given that interest rates remain higher than previously forecast, investors are starting to ask what truly supports these high prices. Can earnings increase fast enough to make prices reasonable? Or will prices correct themselves, either by increasing modestly over a period of time, or by dropping somewhat?

According to The Conference Board, "The US economy is set to end 2024 on strong footing after a year of surprisingly robust growth. However, myriad uncertainties loom over 2025, suggesting somewhat slower economic activity next year and material two-sided risks. The economy should expand at an upwardly revised pace of 2.7% year-over-year in 2024 (from 2.6%) and 2.0% in 2025 (from 1.7%). US real GDP growth in 2026 should settle at its potential rate of 1.8%. Inflation is expected to stabilize at the Fed's 2% target in Q4 2025, later than the original Q2 2025 estimate. Consequently, the Fed may achieve the

neutral Fed Funds rate target range of 3.00-3.25 in October 2025, also several months later than originally anticipated."[3]

The Conference Board's "myriad uncertainties" include not knowing which policies the incoming administration will successfully put into place. Deportations could cause labor shortages and price spikes in industries such as agriculture, meat packing, and construction.[4] Tariffs could also cause prices to increase and spending to slow. However, we believe President Trump will look at financial metrics, like bond yields and stock market returns, as a measure of success. As such, it isn't clear how hard his administration will push the policies promised during the campaign. Any outlook depends on what you assume regarding tariffs, deportations, and other policy topics. Right now, there is so much uncertainty that a wide range of forecasts are plausible, from continued economic growth to significant slowing of activity and a correction in the financial markets.

In Focus

In part, the outlook for the U.S. economy depends on what you assume about tariffs. The incoming administration has promised to impose tariffs on all imports, and to set them as high as 60% on Chinese imports. Such tariffs would push the country into uncharted territory. Many economists, including a recent report by Oxford Economics, believe that the impact would be significant and negative.[5]

Tariffs are essentially taxes on imported goods that are applied at the border. Their purpose is two-fold: to make imported goods more expensive, thereby encouraging consumers to purchase domestically made products rather than imported goods, and to generate revenue for the government. One thing to note is that only U.S. importers pay tariffs. The importers then have a choice between raising the price of the goods they've imported, or reducing their own margins (profits) to keep prices lower for consumers. Their first choice is almost always to raise prices. Hence, tariffs tend to move money from consumers to domestic producers through higher prices, and to the government through the tax collected. Higher prices and higher taxes mean less overall consumption and less economic activity.[6] Roughly 70% of U.S. GDP comes from consumption. So, slower consumption means a slowing of economic activity and growth.

In general, the companies that benefit from tariff protection are not the most efficient or competitive to begin with. Tariffs benefit higher-cost domestic producers who have trouble competing with low-cost, foreign producers; for example, textiles, and the manufacture of low-cost furniture and electronics. As such, tariffs largely protect inefficient businesses. At their worst, they make raw materials for U.S. manufacturers and consumers more expensive in the absence of any competitive substitutes.[7] For example, the largest imports from Canada are raw materials like lumber, oil, and potash. If we impose a 25% tariff on all Canadian goods, as proposed, the likely outcome would be higher prices for those goods with little to no offsetting benefit to U.S. consumers, as it isn't likely the tariffs would result in new lumber or potash production facilities in the U.S.

There are reasons for tariffs to support infant industries: in response to dumping (exporting goods at a price below the actual cost of the good), or to protect national interests (such as not wanting to be dependent on a foreign country for specific intelligence or defense items). But broad tariffs like those that the incoming administration has promised go far beyond such meaningful uses, which ultimately leads to inefficiencies and slower growth.

In addition, we foresee problems if select companies are granted exemptions from tariffs, or if tariffs are applied unevenly due to political favoritism. Problems emerge when companies are rewarded for political actions rather than economic efficiency, innovation, or other traditional measures of economic success. This point may prove to be important, as at least one recent analysis of tariffs applied during Mr. Trump's first term in office found that firms who made political donations to Republican candidates were more likely to receive exemptions than firms that made donations to Democrats. Requiring businesses to "pay to play" has never been considered good policy for fostering long term economic growth.[8]

As previously noted, new tariffs would generate revenue, with the tradeoff being slower economic growth. According

to groups like the Tax Foundation, most studies show that the impact of slower growth far outweighs the benefits of any additional tax revenue.[9] The reverse has also been true, where tax cuts, especially the "Tax Cut and Jobs Act of 2017", did not generate enough new economic activity to offset the lost tax revenue.[10] The point is that politicians often promise that new policies will generate benefits that more than offset any costs. Yet, we can observe that those net benefits often fail to materialize.

Another problem with the promised tariffs is that taxing goods imported from other countries invites, and almost demands, a response from those countries. Tariffs can lead to trade wars. While the U.S. does not export as much as it imports, countries can respond to the tariffs in different ways. Trade wars are not just about the price of imports and exports, and the U.S. would likely not benefit. Indeed, several peer reviewed studies show the promised tariffs would increase inflation and slow economic growth, even to the point of having the economy shrink.[3]

Further, the uncertainty around the tariffs presents problems for forecasting. Many businesses are purchasing items now (driving up inventories) out of concern for tariff-driven price increases in 2025. Other businesses are simply waiting to see what happens; not making any new decisions or investments. The uncertainty around what will happen is hard on businesses as they struggle to know what investments they should make. Delays or making the wrong choice could hurt profits and growth.

All this uncertainty presents a great challenge for investors. If the administration ultimately does very little with tariffs, then the economy could do well in 2025, and the stock market could move up. However, the administration may also choose to impose significant tariffs. And if that happens, the resulting inflation could create significant headwinds for both U.S. economic growth and the stock market in the coming months, and perhaps even years.

Our current investment posture is cautious, keeping in mind that a risk-free return of over four percent in short term bonds and money market funds is still possible. We see little evidence of future growth at a reasonable price in any particular sector, and have tilted our bond holdings towards the shorter term with a view that longer term rates may continue to increase. And while the Federal Reserve might continue to lower short term yields into early 2025, the risk appears to be fewer rate cuts than expected, and a 10-year rate marching up to 5 percent, or possibly higher.

While we do not see large problems on the near horizon (such as another financial crisis) we do worry that the economic consequences of policies such as tariffs and deportations may outweigh any potential benefits from cuts to taxes and regulations. As we move forward, we will continuously need to weigh these concerns against a pragmatic belief that the incoming administration will be sensitive to any policies that could harm two of the prime metrics held up as signs of success: sustained lower inflation, and a rising stock market.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
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