CROSSMARK GLOBAL INVESTMENTS

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10 Predictions for 2025

Fewer Tailwinds, More Tail Risks

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2024 Review – Theme: Goldilocks Remains a Fairytale

2024 was more favorable to equities than we thought. U.S. consumer spending held up, the labor market improved early in the year, and U.S. economic data surprised to the upside. Labor demand weakened after the first quarter, to the point that the Fed felt it needed to cut interest rates by 50 basis points in mid-September to prevent a recessionary rise in the unemployment rate. History shows that the Fed has not been successful at preventing a recession when unemployment increases. In our view, the trend in the labor market still shows that the Fed has not yet definitively secured a soft landing. Outsized equity returns in 2024 have occurred not just because of positive earnings growth, but also because of significant multiple expansion and the ongoing concentration effects of mega cap tech companies.

While the Fed began to cut interest rates—though less than anticipated at the start of the year—interest rates along the yield curve rose marginally. Inflation declined a bit, but the Fed's 2% target remained elusive. Quality spreads tightened even further. Earnings growth was good but failed to meet the beginning of the year double-digit consensus growth expectations. About one-third of the stock market gain came from earnings; two-thirds from valuation improvement. Big stocks handily beat small ones (again!), and growth stocks far outdistanced value stocks. Sectoral performance was mixed with communication services, technology, consumer discretionary, and financial stocks leading the way (the home of all the Magnificent Seven); healthcare, materials, energy, and real estate were "only" up a single-digit percentage. U.S. stocks bested non-U.S. stocks yet again.

The financial and geopolitical world changed on Nov. 5 with Trump's election victory and Republican sweep in Congress. The outlook is now far from business as usual, opening up a wide range of outcomes for the global economy and financial markets. President-elect Trump has campaigned on policies that are both pro-growth (tax cuts and deregulation) and disruptive/anti-growth (widespread tariffs and deportation/anti-immigration).

It is with this backdrop that we proceed as usual with fear and trepidation (and hopefully some good, educated guesses) to unveil our prognostications for 2025 in the form of 10 Predictions.

10 Predictions for 2024: Scorecard

We achieved seven correct predictions for 2024, in line with our long-term average. Here is a brief rundown of the 2024 predictions.

Score / Prediction		Explanation
	The U.S. economy experiences a mild recession as the unemployment rate rises above 4.5%.	Needless to say, the much-anticipated recession failed to materialize. While we are late in the economic cycle, excess COVID savings and then excessive government spending carried the economy higher. And while the labor market is weakening slowly, job growth in government, education, and healthcare kept the unemployment rate from rising much.
	The 2-3% inflation ceiling of the 2010s becomes the 2-3% inflation floor of the 2020s.	While technically we won't know the accuracy of this prediction until the end of the decade, it is clear that inflation remains above the Fed's target of 2%. (Trailing 12-month headline inflation is +2.7%, with core at +3.3%.) Our view continues to be that the Fed's 2% target will remain elusive absent a recession.
	The Fed cuts rates fewer than the six times suggested by the Fed funds futures curve.	When the year is complete, the Fed will have cut rates three times (100 basis points), much less than was anticipated by the consensus at the beginning of the year. A decent economy and somewhat stubborn inflation have kept the number of cuts to less than expected.
	Credit spreads widen as interest rates decline.	We entered 2024 with spreads fairly tight already. Anticipating an economic slowdown, we expected those spreads to widen. Needless to say, that didn't happen, and credit spreads are very tight/record tight.
	Earnings growth falls short of the double-digit percentage consensus expectation.	Coming into 2024, the consensus expectation was for earnings growth of 12%. In the last couple of months, consensus expectations have moved down to high single digits. While profit margins have increased and top-line growth has been good, the combination was just not robust enough to get another double-digit earnings growth year.

10 Predictions for 2024: Scorecard (Continued)

Score / Prediction		Explanation
	Stocks record a new all-time high early in the year, but then experience a fade.	Without a recession (Prediction 1) and continued earnings gains, not to mention increased valuation levels, stocks motored high virtually all year long.
	Energy, financials, and consumer staples outperform utilities, healthcare, and real estate.	As we write, the three predicted outperformers are up on average 19%, while the three predicted laggards are up only 11%. Financials were one of the best sectors, while healthcare was indeed the worst sector. Thankfully, our sector predictions have been among our best over the years.
	Faith-based share of industry AUM rises for the eighth year in a row.	The measurement of this one comes with a lag, but trends suggest a favorable outcome as more and more individuals, advisors, and institutions are attempting to align their investments with their values.
	Geopolitical crosscurrents multiply but have little impact on markets.	Wow! The world has been a mess this year—Russia/Ukraine, the Middle East, the Russia-China-North Korea-Iran alliance. Thankfully, there has been little, if any, impact on markets.
	The White House, Senate, and House all switch parties in November.	Much has been said about the Republican sweep and much more will be said in 2025 as policy proposals become reality. So far, markets are mainly euphoric about policy prospects for 2025.

Key Questions

1. Will the Trump administration focus primarily on tax cuts and deregulation, or tariffs and deportation?
2. How will tariffs impact the global economy?
3. Will inflation become quieter or become entrenched?
4. How will the Fed balance labor market weakness and sticky inflation?
5. Can high valuation levels be sustained?
6. Can profit margins continue to rise to meet earnings expectations?
7. Will the higher than usual uncertainty level cause increased volatility?
8. Is U.S. debt on an unsustainable trajectory?
9. Will China's stimulus manage to boost the economy?
10. What is the trajectory for Russia-Ukraine, the Middle East, and other hot spots?

2025 Outlook

Investors continue to enjoy the bull market, but remain somewhat nervous about valuation. Policy uncertainty is higher than usual, in part because there are so many policy changes at the same time. Donald Trump campaigned on a mix of policies that are both economy supportive (tax cuts and deregulation) and disruptive or negative (tariffs and deportation). As a result, the election outcome has created fatter tails for the U.S. economy. It is possible that a mix of pro-growth and disruption policies will occur simultaneously and/or the administration will toggle back and forth, thereby heightening uncertainty as well as economic and financial market volatility. The main policy downside risks are related to trade and immigration policies. This could be negative for growth and push up inflation. That could lead to the Fed ceasing the cutting cycle and potentially even restarting rate increases, putting upward pressure on bond yields and negative pressure on stock valuation.

Trump 2.0 may drive higher uncertainty around inflation and deficit risks. Immigration and tariffs may be inflationary, but corporate tax cuts are disinflationary as benefits get passed onto the consumer. Lower oil prices from increased energy production could also help. Lighter regulations will be positive for financials (especially banks), which now have relatively strong balance sheets and are focused on cash returns and potential loan growth. A pickup in merger-and-acquisition activity may occur with lessened regulatory scrutiny.

U.S. equities should remain supported by continued economic expansion and earnings growth, ongoing easing by global central banks, and a likely 1Q wind down of the Fed's quantitative tightening. Consumers are largely flush with cash and record wealth, although there is evidence of fraying at the low end amid some mid-level consumers. The Fed is in easing mode but will likely dial its dovish intent down in 2025 due to sticky inflation, with potential upside risks due to continued economic growth and trade/tariff issues.

The stock market is already pricing in an optimistic backdrop and carries high valuations, creating risks as we enter 2025. An early-in-the-new-year 5-10% pullback is possible (if not probable) given the sharp gains, froth in sentiment, and stretched valuations, leaving the market vulnerable to bad news or simply in need of consolidation. Note that stocks tend to be strong in November/December, but weaker in January/February.

10 Predictions for 2025

Theme: Fewer Tailwinds, More Tail Risks

	Prediction	Explanation
1	**Economic growth slows as the unemployment rate rises past 4.5 %.**	Expectations for an economic slowdown (or even a recession) have been on the worry list for quite some time. So why are we concerned? Clearly, the pandemic excess savings created more spending power than we anticipated. And that was followed by enormous federal government spending. The first is gone; the second is likely to continue. Evidence that low end and increasingly middle-income consumers are struggling has us concerned. Lower/middle-income consumers have less wealth built up in housing and financial markets than high-end consumers and are turning to credit cards to sustain consumption. Coupled with a slowing labor market, we think economic growth will slow somewhat in 2025 and unemployment will move up, but to still historically low levels (4.5%).
2	**Inflation remains sticky, fails to reach the Fed's 2% target, and causes Fed funds rate to fall less than expected again.**	The Fed's target of 2% so far has been elusive. Unless/until we have a recession, the probability the Fed achieves their target is not high. Current inflation is running closer to 3% than 2%, and is likely to stay there. With tariffs and deportation lurking, the risk could be higher inflation, not lower. Recent union wage settlements are troublesome as well. All of this is likely to result in the second year in a row where the Fed lowers rates less than expected. We repeat our inflation prediction from 2024: "The 2-3% inflation ceiling of the 2010s becomes the 2-3% inflation floor of the 2020s."
3	**Treasury 10-year yields trade primarily between 4% and 5% as credit spreads widen.**	We anticipate a trading range of 4% to 5% for the 10-year Treasury in 2025 and perhaps some volatility within that range. Sticky inflation, aggravated by tariffs, could cause upward pressure on rates. Conversely, labor market weakness, the end of quantitative tightening and the whiff improvement in the deficit would act to move yields lower. As a result, we are recommending a reasonably neutral policy in fixed income with a bias toward quality. Very/historic tight credit spreads seem impossible to remain if there is any hint of economic slowdown or credit problems.
4	**Earnings fail to achieve consensus a) 14% growth and b) every sector has up earnings.**	Earnings growth failed to achieve consensus targets in 2024, and we expect a repeat in 2025. To realize the 14% gains in earnings forecasts by the consensus requires more margin improvement than we expect to witness. Earnings growth is likely to stay above average, but the risks are to the downside, not the upside. Further productivity gains could make our prediction incorrect. The average company should see some acceleration in earnings growth as the Magnificent Seven see some slowing. It is rare that all 11 sectors have up earnings as forecasted by the consensus. Energy, consumer staples, and real estate are candidates for negative comparisons.
5	**Equity volatility rises (VIX average approaches 20 for only the third year in 14).**	2024 equity volatility as measured by the VIX was the lowest since the last decade. With all the policy uncertainties, a Fed likely slowing rate cuts, and high valuation levels, we expect volatility to pick up. There are so many new policy crosscurrents that are likely to confuse investors and accelerate the volatility. The unknown regarding the question of the Trump administration's focus could also raise volatility levels. (Is the primary focus on tax cuts and deregulation or tariffs and deportation?)

10 Predictions for 2025 (Continued)

Theme: Fewer Tailwinds, More Tail Risks

	Prediction	Explanation
6	**Stocks experience a 10% correction as stocks fail to keep up with earnings (i.e., P/Es contract).**	Stock market corrections are not easily predicted. Historically, 10% corrections average almost once a year. We have not seen one in three years. With equities up more than 50% in the last two years and valuation levels at near all-time highs, a 10% decline should not surprise anyone, correcting an overshoot to the upside. When stocks are up 20% two years in a row, the third year almost always witnesses a P/E ratio decline, hence our view that stocks do not keep up with earnings in 2025. It is possible that some sort of pullback occurs early in the new year as election euphoria is replaced by the reality that while good things are likely to be legislated, it will take longer than expected.
7	**Equal-weighted portfolios beat cap-weighted portfolios (average manager beats index), and value beats growth.**	The average large cap mutual fund has beaten the averages only once (2022) in the last 15 years. The inordinate dominance of mega cap stocks, especially in technology and technology-related areas, has perhaps been overdone. The slowdown in earnings growth of the mega cap stocks and the increased earnings growth in the average stock raises the probability of a change in leadership and the ability of the average manager to beat the benchmarks. The average active manager has a higher probability of beating the benchmark in sloppy, sidewise (or even declining) markets than in the straight-up markets we've seen recently. The improvement in the average company's earnings prospects coupled with the valuation disparity between growth and value causes us to believe that value can beat growth in 2025.
8	**Financials, energy, and consumer staples outperform healthcare, technology, and industrials.**	Sector calls are never easy, but we have had above-average success with this prediction. With all the policy (and therefore economic) uncertainties, it seems extra treacherous this year. Nevertheless, we believe the relative winners will include financials (the biggest beneficiary of deregulation, continued upside earnings revisions, and relatively good balance sheets), energy (with decent yield and cash flow characteristics, a slowing in non-OPEC production, and the fact that these stocks are under-owned), and consumer staples (cheap stocks with good cash flows that are under-owned and out of favor). Conversely, we believe the relative laggards will include healthcare (still a policy risk sector with, at best, mediocre fundamentals), technology (expensive and with a regulatory overhang), and industrials (risks from tariffs and trade, as well as weak PMIs).
9	**Congress passes the Trump tax cut extension, reduces regulation, but tariffs and deportation are less than expected.**	Significant legislative and executive branch policy changes are likely in 2025. Positive for the economy, earnings, and markets would be tax cuts and reduced regulation. Operating in the other direction would be tariffs and anti-immigration policies. We expect some of both, but more of the former than the latter. As 2024 ends, positive sentiment regarding new directions is very high—only time will tell if the euphoria is misplaced.
10	**DOGE efforts make progress but fall woefully short of $2 trillion per year of savings.**	We applaud the efforts of the newly created Department of Government Efficiency (DOGE) to cut costs, change personnel, and introduce new technology in the Federal government. Much will be attempted in the first 100 days and the first two years, after which Trump becomes a lame duck and Congress could switch parties. A significant problem is that the "sacred cows" of Social Security, Medicare, Medicaid, veterans affairs, defense (which Trump wants to increase), and net interest make up the vast majority of government spending. "Only" $800 billion of spending remains versus DOGE's goal of reducing spending by $2 trillion per year. The ONLY way to fix the problem (growing Federal debt and interest expense) is to tackle the entitlement programs.

Focus Five: 2025 Factors

Factor	Key Points	Portfolio Response
1. Economy/ Earnings	• Expect some economic slowing • Inflation sticky (2% unlikely) • Earnings estimates too high	• Be flexible • Don't chase returns—take some profits • Invest if big downdraft • Consider alternatives
2. Fixed income	• Maintain neutral policy • Expect some quality spread widening • Munis relatively attractive	• Recommend neutral duration • Focus on quality • Munis attractive (if tax circumstances appropriate)
3. Equities	• Valuations near all-time high • Earnings risk • Valuations not cheap • Margin improvement in consensus estimates difficult to achieve • Expect pullback	• Focus on earnings • Tough year to make money • Buy dips/trim rallies
4. Sectors	• Generally high quality preferred • Focus on earnings and cash flow, not P/E expansion	• Overweight financials, energy, and consumer staples • Underweight healthcare, technology, and industrials • Own value with a catalyst and inexpensive growth
5. International	• Markets significantly cheaper than U.S. • Central banks generally behind U.S. • U.S. dollar strength makes international outperformance difficult	• Slowly increase international weighting

What to do?

1. Expect choppy (choppier) markets (buy dips/trim rallies).
2. Expect lower returns.
3. Focus on earnings growth and free cash flow (not P/E expansion).
4. Diversify across asset classes, styles, and geographies.
5. Own high-quality value and less expensive growth.
6. Consider an absolute return strategy (and alternatives in general) to complement market exposure.
7. Step up to significant weakness.

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