CROSSMARK GLOBAL INVESTMENTS

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10 Predictions for 2025

Theme: 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.

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1. Economic growth slows as the unemployment rate rises past 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.
3. Treasury 10-year yields trade primarily between 4% and 5% as credit spreads widen.
4. Earnings fail to achieve consensus a) 14% growth and b) every sector has up earnings.
5. Equity volatility rises (VIX average approaches 20 for only the third year in 14).
6. Stocks experience a 10% correction as stocks fail to keep up with earnings (i.e., P/Es contract).
7. Equal-weighted portfolios beat cap-weighted portfolios (average manager beats index), and value beats growth.
8. Financials, energy, and consumer staples outperform healthcare, technology, and industrials.
9. Congress passes the Trump tax cut extension, reduces regulation, but tariffs and deportation are less than expected.
10. DOGE efforts make progress but fall woefully short of $2 trillion per year of savings.

Conclusion

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 and with 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.

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