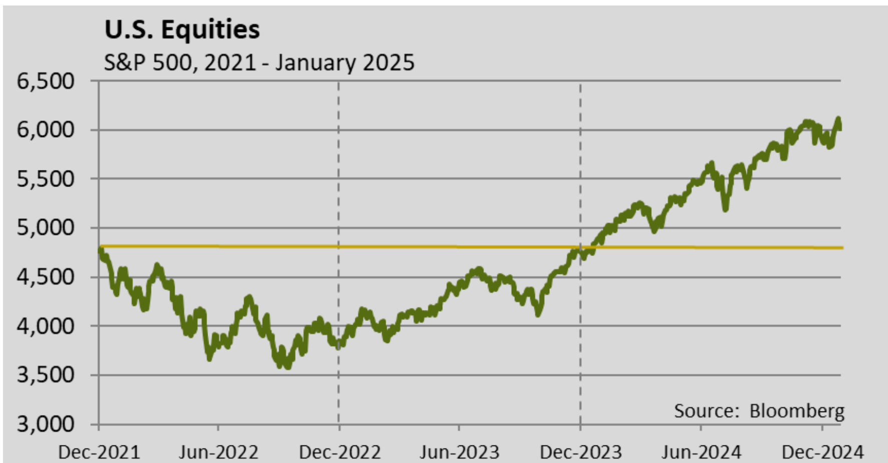
The Times They Are A-Changin'

January 2025

Summary

The economic outlook for 2025 is marked by a delicate balancing act with global economies navigating persistent inflationary pressures, rising interest rates, and shifting labor market dynamics. On one hand, U.S. economic growth continues to be steady, and inflation seems to be stabilizing. Technological innovation in automation, AI and digital infrastructure have largely carried financial markets for two years with the S&P 500 posting back-to-back 20% gains.



Yet, as Bob Dylan's timeless anthem *The Times They Are A-Changin'* reminds us, "Come gather 'round people, wherever you roam, and admit that the waters around you have grown." While the context for Dylan's words was quite different, they resonate in the context of today's financial and political landscape. Just as in the song, rapid change can be disruptive, and financial markets will need to evolve with the times.

Recent economic data has been positive and supportive of positive financial markets:

- **Real GDP growth has been stable for 5 quarters.** After falling to 1.3% at the end of 2022 and rebounding to 3.2% at the end of 2023, economic growth was 2.7% as of September.
- **Inflation was below 3% for most of the year and steadied at 2.9% in December.** After stubborn inflation since 2021, inflation is near the Fed's target rate of 2.5%.
- **There were still 1.1 million more job openings** than unemployed people in November.
- **The Fed has lowered short-term interest rates by 1%** over the last four months of the year.

The steady economy led to strong financial markets, primarily driven by technology stocks. Despite the high longer-term, market-driven interest rates, volatility in the stock market has been low. The last stock market correction (10% drawdown) occurred in 2023.

Many indicators of financial market health are positive, and client portfolios remain at their maximum equity levels. However, it seems likely that volatility will be higher in 2025. Stock market strength has elevated expectations from investors, and those expectations could be difficult to exceed. The returns after two strong years are typically more modest, and markets often realize larger drawdowns. In addition, the increased uncertainty from policy change can be difficult for financial markets to digest.

Changin'

It is difficult to consider 2025 without touching on the changes in the U.S. government. Much remains uncertain about precisely how President Trump will execute his economic agenda, including tariffs, trade, taxes, and energy policy. Financial markets have been up and down trying to keep up with the flurry of executive orders and their associated impacts. During Trump's first term, out of 77 major rules that were challenged, Trump won just 31% of the time, experienced a mixed outcome in 12% of cases and lost the rest of the time (source: JP Morgan).

Tariffs + Tax Cuts + DOGE + Deregulation + Deportations + Crypto + Energy Policy

TARIFFS & TAX CUTS

In his inauguration speech, President Trump stated that 25% tariffs could be imposed on Mexico and Canada beginning February 1 due to border issues, but there were few mentions of explicit tariffs on China or a universal tariff. Trump also threatened 25% tariffs on Mexico and Canada in his first term, but they were never implemented.

Tariffs are concerning as they could add pressure to inflation, and most macro economists who study tariffs believe they would reduce U.S. manufacturing (via higher input costs or retaliation from other countries). It is difficult to tell which aspects are negotiation versus planned policy. However, it seems that the Trump administration plans to target deregulation and tax cuts first and leave the potentially more disruptive tariffs until later in the year.

DOGE & DEREGULATION

Trump's formation of the Department of Government Efficiency (DOGE) is part of a broader effort to make the federal government more efficient through reducing bureaucracy, cutting waste, and streamlining federal agencies. He has prioritized efforts to decrease regulations, aiming to make government processes more business-friendly and reduce what he viewed as unnecessary red tape.

While the pronouncements are symbolic, it is difficult to see DOGE having much of an impact on spending. The Federal employment of 3 million people is at its lowest level as a share of U.S. employment in 85 years (roughly 2%). The largest employer is the Department of Defense followed by the USPS and Veterans Affairs. The areas in the DOGE crosshairs represent a combined 1% of federal workers. (Source: JP Morgan)

OTHER ITEMS

Many other executive orders were issued in the past few weeks. Immigration and deportation policies could impact employment and economic growth, depending on the scale and timing. While Trump did not comment on cryptocurrency in his January 20 speech, his appointment of an "AI & Crypto Czar" and January 18 launch of a meme-coin branded $TRUMP indicate his plans for less regulation in this space.

While the various country acquisition mentions (Canada, Greenland) may just be negotiation, the Panama Canal issue is notable and serious since Chinese firms now operate ports at both ends of the canal and control many projects associated with the canal.

CHANGE

Change can be difficult for financial markets. If optimism is too strong and the economy overheats, inflation could become a problem again. If tariffs and immigration policy weigh too much on economic growth, inflation and/or an economic slowdown could ensue. This is not a statement about the appropriateness of such policies but the potential to create volatility in financial markets. While 2024 did not experience a 10% market decline, the environment is ripe for increased volatility in 2025.

Three-peat???

The S&P 500 posted back-to-back years with gains of 20% or more in 2023 and 2024. While such an environment sounds excellent, expectations for future returns should be more measured, and the risk of a stock market correction is higher. Volatility over the past few years has been mild. In 2023 and 2024, the largest drawdowns of the year were relatively small at 10% and 8%, respectively.

There are only eight periods of back-to-back years with 20%+ gains since 1950, and half of the data are clustered in the 1990s. See table below. Subsequent returns are generally positive (75% of the time) but are more modest and typically encounter some volatility. In fact, seven of eight cases saw a correction of at least 10%. The average drawdown throughout Year 3 was 13%, a meaningfully higher correction than either 2023 or 2024.

Stock Market Returns

S&P 500 After Back-To-Back 20% Gains

Period	Year 1 Return	Year 2 Return	Year 3 Return	Year 3 Drawdown
1950-1952	30.8%	23.7%	18.2%	-7%
1954-1956	52.6%	32.6%	7.4%	-11%
1975-1977	37.0%	23.8%	-7.0%	-16%
1982-1984	20.4%	22.3%	6.2%	-13%
1995-1997	27.6%	23.0%	33.4%	-11%
1996-1998	23.0%	33.4%	28.6%	-19%
1997-1999	33.4%	28.6%	21.0%	-12%
1998-2000	28.6%	21.0%	-9.1%	-17%
2023-2025	26.3%	25.0%	?	?
Average	31.1%	25.9%	12.3%	-13%
Percent positive	100%	100%	75%	

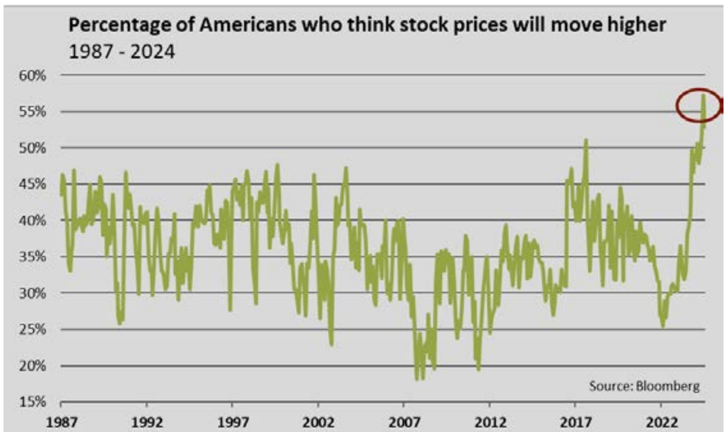
Sources: FactSet, JP Morgan, Franklin Templeton

Although volatility is typically not comfortable, stock market corrections are normal. According to Ned Davis Research, on average, there is a 10% drawdown in the S&P 500 every 172 trading days (roughly nine months). The current market has gone 310 trading days (roughly 15 months) without such a correction. The stock market could clearly continue its unfettered run, but the odds of some sort of corrective activity are increasing.

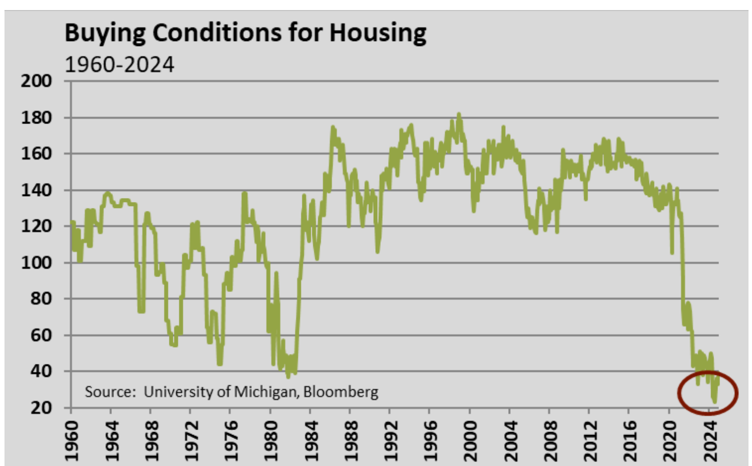
Extremes in Sentiment

Extremes in consumer sentiment are notable since they can indicate a possible trend reversal is nearing, as investors might be overly optimistic or pessimistic, potentially leading to a correction or reversal. In his 1986 shareholder letter, Warren Buffett advances a similar theory:

> *"What we do know... is that occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."*



There are two indicators that are good examples of extreme sentiment. The percentage of Americans who think the stock market will move higher is at the highest level in almost 40 years. See chart above. Confidence in the future is typically positive, and although the economy and unemployment seem strong, such high confidence in financial markets leaves a lot of room for disappointment.



On the other hand, the University of Michigan confidence survey indicates that consumers are very pessimistic about the conditions for buying a house. The ratio of good versus bad conditions provided its lowest reading in 40 years. These sentiment indicators do not illustrate that a crash or surge is imminent. However, it does fit with the expectation that financial markets could see increased volatility throughout the year.

Final Thoughts

Looking ahead at 2025, there is a delicate balance between the confidence stemming from several years of strong stock market performance and the recognition that change can be challenging to navigate. Again, in the words of Bob Dylan,

> *"Come writers and critics who prophesize with your pen*
> *And keep your eyes wide, the chance won't come again*
> *And don't speak too soon, for the wheel's still in spin*
> *And there's no tellin' who that it's namin'*
> *For the loser now will be later to win*
> *For the times, they are a-changin'."*

While it is challenging to see what the future brings, the economy is currently healthy. Changes from the Trump administration are likely to provide both opportunity and risk. As mentioned in the past, making investment decisions based on political expectations is difficult. However, it is important to recognize that the president often receives both undue credit and blame for economic outcomes. The economy is shaped by a complex interplay of factors, including monetary policy, global market dynamics, consumer behavior, and technological advancements, many of which are beyond the control of any single administration. Most data-driven indicators remain positive, and portfolios remain at their maximum equity position, reflecting the strength of underlying fundamentals rather than purely political sentiment. Investors are encouraged to maintain a long-term perspective, focusing on diversification and resilience against potential volatility.

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