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2024 Q4 REVIEW

Wrapping Up a Good Year for Stocks and Looking Forward Into 2025

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2024 Fourth Quarter Review

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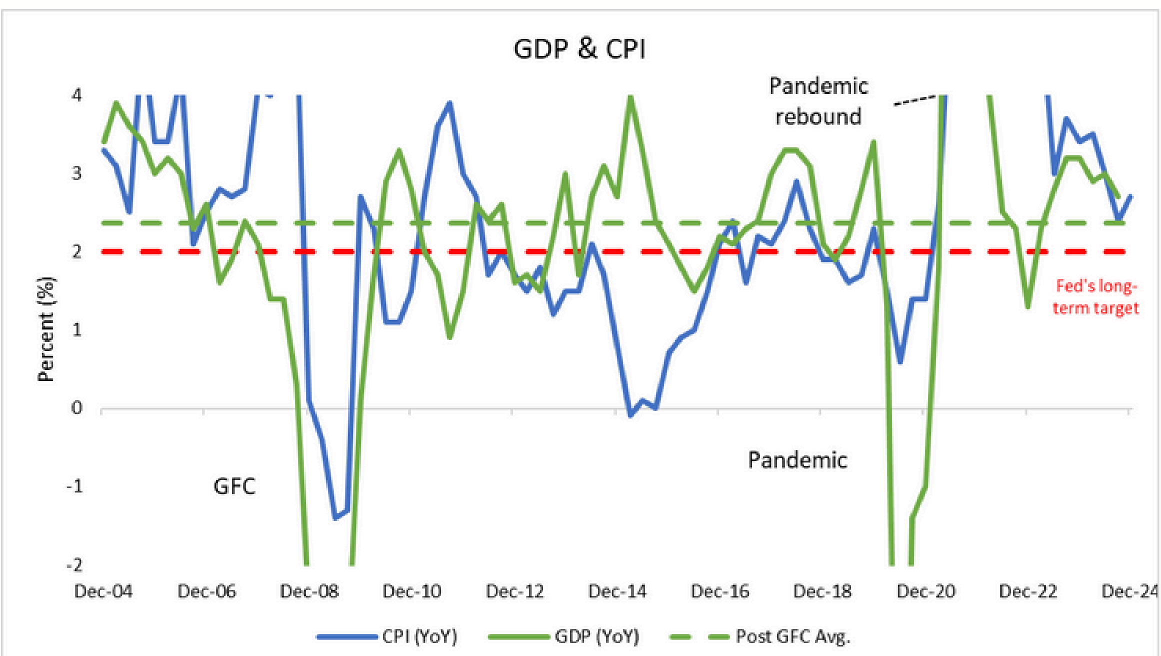
2024 was a very good year for stocks, as earnings growth broadened beyond the largest technology companies and the Federal Reserve pivoted to lowering interest rates. The MSCI All Country World Index rose 18% and the S&P 500 Index increased by 25%. Mega Cap stocks continued to drive returns as the equally-weighted S&P Index was up only 12.5%. The Bloomberg Aggregate Index finished up 1.3% for the year, but after the Trump election victory, higher fixed income yields sent bond prices lower as investors factored in fewer interest rate cuts by the Federal Reserve.

Donald Trump began his second presidency with a rapid series of executive actions that demonstrate how the balance of Federal power may be shifting toward the executive branch. 2025 is likely to be dominated by the Trump administration's initiatives and reactions to them. Post election, markets rallied as investors chose to focus on the potential upsides to a Trump victory, namely the prospects of tax cuts and deregulation. However, Trump's election also poses some potential for concerns due to the potential for trade tariffs, unpredictable actions, and possible disruptions from immigration restrictions and deportations. In this update, we will analyze various scenarios for 2025.

Prior to looking into our murky crystal ball, let's review where markets and the economy stand at year end. 2024 saw a benign economic environment with Real GDP growth above post 2008 averages and a moderation in inflationary pressures. This created room for the Federal Reserve to begin cutting interest rates.

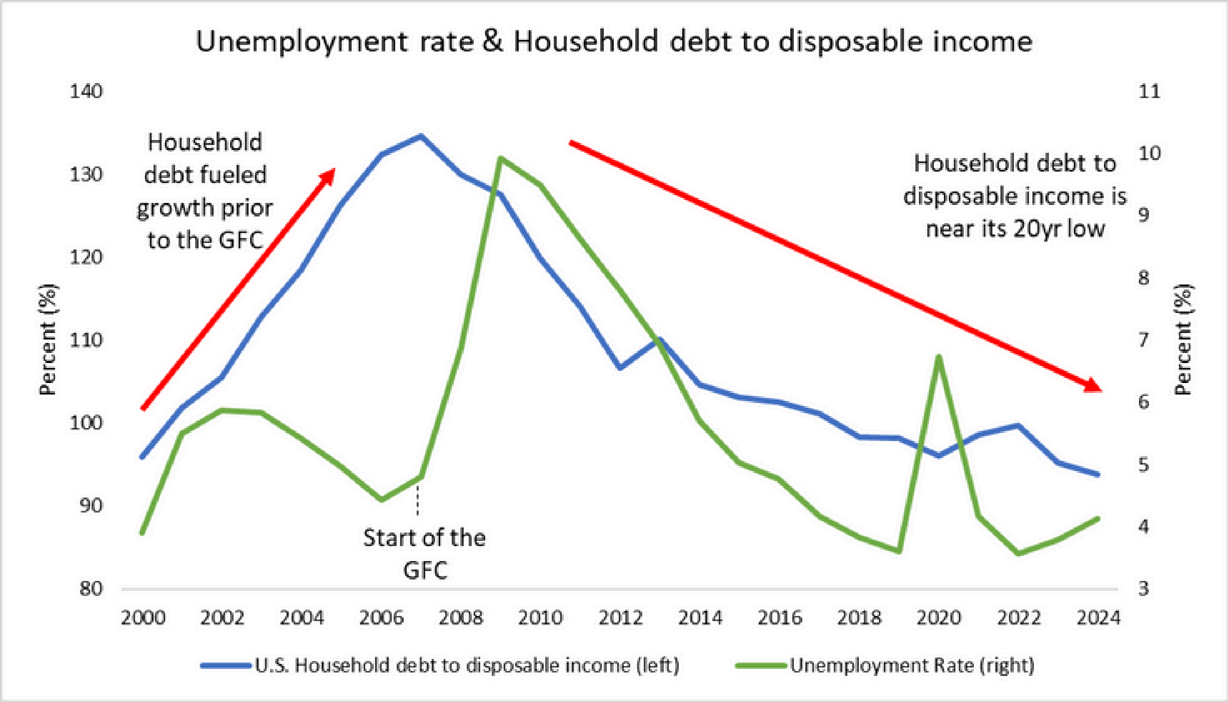
Chart 1: GDP Growth Remains Above Post-2008 Global Financial Crisis Average and Inflation is Near Target



Source: Bloomberg as of 12/31/24

In addition, US households are in relatively good financial shape in the aggregate, with full employment and stronger balance sheets. Recent economic growth came with households reducing their financial leverage. This is unlike the period leading up to the Global Financial Crisis (GFC) of 2007-2008, when growth was sustained through increased household debt. As shown in the chart below, the lower household debt levels today provide a healthier economic foundation than the housing debt burden prior to the GFC.

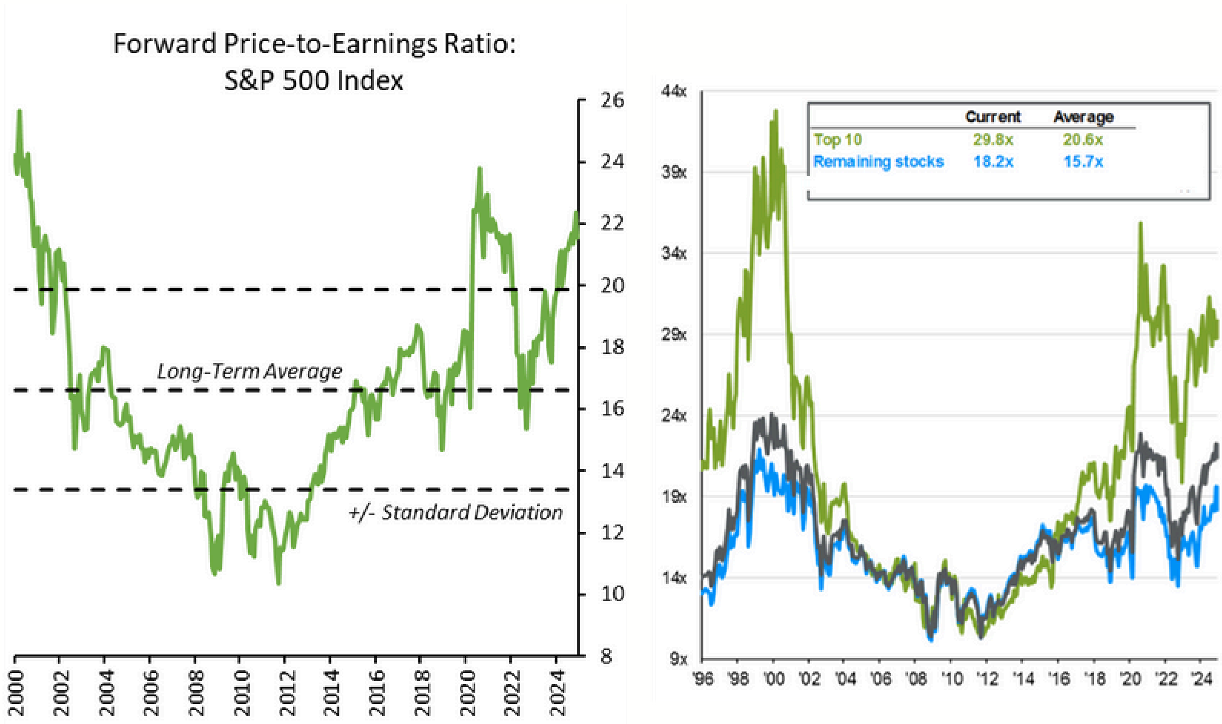
Chart 2: Unlike the Pre-GFC Period, Household Debt is Not Growing Today



Source: Bloomberg as of 12/31/24

Looking forward, investors are optimistic for 2025 - forecasting above average sales and earnings growth, continued margin expansion and elevated stock multiples. These sentiments are opposite to the recession fears of 2023. We caution that these expectations -- for mid-teens earnings growth -- are well above the 20-year historical average of 7.6%.

Chart 3: Stock Valuations are Above Average <u>Even if One Assumes</u> Strong Earnings Growth



Source: Factset as of 12/31/2024, JP Morgan

Stock valuations are very high. The 10 largest companies (Apple, Microsoft, Nvidia, Amazon, Meta, Broadcom etc...) in the S&P 500 Index trade at a significant premium. The premium may be justified in light of their competitive position and the fact that their recent earnings growth is substantially higher than other firms. The remaining 490 Index companies trade at a more moderate premium to long term historical averages. This valuation divergence may partially reflect that these high growth, high margin mega-cap companies may warrant a higher valuation multiple. Still, we worry that high valuations and high growth expectations often lead to investor disappointment.

With a new Administration promising dramatic changes, there is little question that 2025 will be affected by new fiscal, trade, regulatory and geopolitical steps from President Trump and Congress, as well as monetary policy from the Federal Reserve. We will aim to assess both the potential short-term impact, as well as longer term policy implications for fundamental economic factors such as unemployment, inflation, interest rates, and corporate earnings.

Trade & Regulation

We expect massive change in the structure of trade and regulation policy, but the shape of these initiatives will not be clear for several months. On the one hand, deregulation can promote more competition and improve supply and demand. On the other hand, too little regulation can create poor corporate behavior, supply imbalances, and lower societal trust. For example, large construction and infrastructure projects would benefit from more streamlined environmental and safety reviews while too little oversight can lead to corruption and serious safety hazards.

The impact of tariffs is likely to be more straightforward. Tariffs are intended to protect jobs and strategic industries, but these import taxes are likely to raise prices and add to inflation. Tariffs often reduce investment spending due to elevated trade policy uncertainty. By increasing prices of imported goods, tariffs will generally reduce demand for those goods. Tariffs are likely to reduce global trade and increase tensions and retaliation by other countries, which will impact currencies and monetary policies. Revenue raised by tariffs usually makes little contribution to the federal budget.

Fiscal Policy

The Trump administration is looking to reduce the corporate tax rate from 21% to 15% and extend the 2017 Trump personal tax cuts. Corporate tax cuts will provide a one-time boost to earnings growth, and Trump has proposed other tax cuts. However, the US is already running a much larger structural deficit today than 2017, when the last tax cuts were enacted, making passage of legislation more difficult.

Fiscal spending is high and tax receipts are low, as the combined impact of the Bush and Trump tax cuts reduced tax receipts by around 4% of GDP. Meanwhile, fiscal spending is mostly driven by Defense and non-discretionary (interest payments, Social Security and Medicare) programs. As a prominent economist has noted, the US government is like "an insurance company with an army." Social Security, Medicare and Defense expenses are set to rise because the population is aging, and we face an increasingly tense geopolitical landscape. At the same time, discretionary fiscal spending -- excluding Defense -- accounts for only 3% of GDP.

The present funding gap (spending minus receipts) of over 6% of GDP is above the 3% level that economists believe is sustainable, and the deficit will continue to grow as federal interest expense continues to rise. Longer term, we believe that the nation's rising fiscal imbalance and debt burden will eventually require painful tax increases and spending cuts. The U.S. is fortunate, for now, that foreign and institutional investors continue to fund the growing federal Treasury debt with low real interest rates.

International Policy

Trump is likely to be more isolationist than any President in the last fifty years. This may strain existing alliances and lead to increased global frictions. We expect more volatility in 2025, since foreign policy and the timing of crises are impossible to predict.

Monetary Policy

Trump has also attacked the independence of the Federal Reserve, which might lead to more accommodative monetary policy and higher inflation, negatively impacting bond prices. In addition, the potential economic benefit of the proposed tax cuts may be partially offset by a higher "term premium" for longer term bonds as investors demand higher yields to offset inflation and the rising cost of future deficit funding.

Summary Table of Proposed Changes

In the chart below we have tried our hand at summarizing the potential large changes.

Policy Category	Proposed Actions	Likelihood	Fiscal Impact
Fiscal	• Extend 2017 tax cuts • Lower corporate tax rate to 15% • Restore state & local deductibility • End income taxes on social security benefits	Likely Unlikely Very Unlikely Very Unlikely	Neutral Positive
Trade & Regulation	• Reciprocal tariffs on trading partners • 10-20% universal baseline tariff on imports • 25% tariffs on all imports from Canada & Mexico • Repeal IRA subsidies for Green • Expand LNG exports	Likely Unlikely Unlikely Likely Likely	Small Negative Large Negative Negative Neutral Neutral
International Policy	• Consider pulling out of NATO if the NATO members “don’t pay their bills” • End War in Ukraine through a negotiated settlement	Unlikely TBD	Large Negative

Given positive sentiment and elevated valuations, we believe stock returns may be muted and unlikely to repeat the stellar returns in 2023 and 2024.

We continued to release podcasts – on topics such as Cybersecurity and Charitable giving in late 2024 -- and we will assess the evolving Streaming Entertainment landscape in February. Our podcast series permits us to go into greater depth on relevant topics, and we hope you enjoy the opportunity to listen and give us feedback.

2025 may signal the most dramatic governance changes of the last quarter century. We remain cautious optimists and believe owning a balance of stocks and bonds is an appropriate baseline. However, we will be monitoring unemployment, inflation, corporate earnings, and key leading economic indicators, while assessing the progress of the new US administration and the wider world.

We look forward to hearing from you, and updating you on your portfolio and on our outlook for the next year. Please reach out with any questions.

Best regards,
The ChoateIA Investment Team

For More Information

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The Bloomberg US Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.