Fourth Quarter 2024 – Investment Commentary

In the fourth quarter 2024, domestic stock markets moved higher although performance was muted with the sharp sell-off in late December due to lowered Fed rate cut expectations in 2025. Small and mid-caps were hit particularly hard in December. For 2024, it was another solid year across the board with large-cap stocks leading the way, especially big-tech names while international markets lagged. This is the second consecutive year of +20% gains in the S&P 500.

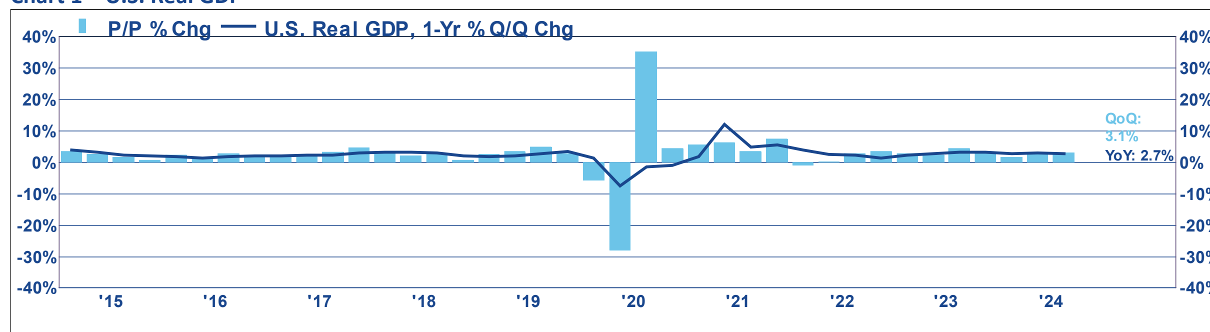
Table 1 – Stock Index Total Returns – as of December 31, 2024

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	0.55	6.35	29.57	29.57	8.13	17.49	16.20
S&P 500	-2.38	2.41	25.02	25.02	8.94	14.53	13.10
Dow Jones Industrial	-5.13	0.93	14.99	14.99	7.56	10.55	11.57
S&P 400	-7.12	0.34	13.93	13.93	4.87	10.34	9.68
Russell 2000	-8.26	0.33	11.54	11.54	1.24	7.40	7.82
MSCI Emerging	-0.14	-8.01	7.50	7.50	-1.92	1.70	3.64
MSCI Developed	-2.27	-8.11	3.82	3.82	1.65	4.73	5.20
Fixed Income	**1-Month**	**3-Month**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**

At the S&P 500 sector level for 2024, Communication Services (+40.2%), Information Technology (+36.6%), Financial Services (+30.6%), and Consumer Discretionary (+30.1%) led the way while Energy (+5.7), Real Estate (+5.2%), Health Care (+2.6%), and Materials (-0.04%) lagged. Ten of the eleven sectors within the S&P 500 posted positive returns. In the first half of 2024, much of the S&P 500's returns were concentrated in a few stocks known as the Magnificent Seven. However, the depth and breadth of market advancement greatly improved in the second half of the year as more sectors, industries, and companies contributed.

Many of the narratives that drove healthy economic growth and robust stock market gains over the past couple of years are expected to continue in 2025, although at a slower pace. Solid consumer spending and business investment were a major driver of higher-than-expected economic growth in 2024 supported by rising household wealth, easing inflation, continued monthly job gains, and rising confidence levels. The U.S. economy is forecasted to advance +2.0% in 2025, down from +2.7% in 2024 and +2.9% in 2023.

Chart 1 – U.S. Real GDP



These fundamentals have also been supportive of corporate earnings growth which is vital to sustain and expand market valuations. The consensus estimate for S&P 500 earnings growth is +14.8%. With the upcoming fourth quarter earnings season, 2025 earnings guidance will be closely watched for any meaningful deterioration. As 2025 unfolds, economic fundamentals remain solid but there is much scrutiny concerning Federal Reserve (Fed) monetary policy and that of the incoming Trump Administration, which has recently heightened market uncertainty and volatility.

At the conclusion of the Fed's final Federal Open Market Committee (FOMC) meeting in December, the Fed released their latest FOMC Statement and Summary of Economic Projections (SEP). As expected, the Statement cut the federal funds rate by 25 basis points to 4.50% bringing the target rate down a full percentage point for the year from 5.50% to 4.50%.

What wasn't expected were the revisions from the SEP. For 2025, the Fed raised the projected fed funds rate to 3.9% from 3.4% and also raised the projected rate of inflation to +2.5% from +2.1%. The Fed signaled a shift towards a more cautious approach to future rate cut adjustments. They projected only two rate cuts for 2025, down from an earlier expectation of four cuts, indicating a more hawkish stance than previously expected. The Fed cited several reasons for the higher revisions, namely, stronger than expected economic growth in 2024, higher than expected inflation readings, and projected inflation estimates for 2025.

The Fed has a dual mandate of maximum employment and stable prices. While they see these risks as fairly balanced and strongly feel they are "well positioned to deal with the risks and uncertainties that we face in pursuing both sides of our dual mandate," the bond market did not react well to the aforementioned revisions as bond yields moved higher and bond prices lower. Bond yields and prices are inversely related.

Table 2 – Fixed Income Total Returns – as of December 31, 2024

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	-0.43	0.17	8.19	8.19	2.92	4.21	5.17
Bloomberg Inter Gov't/Credit	-0.62	-1.60	3.00	3.00	-0.18	0.86	1.71
Bloomberg U.S. Aggregate	-1.64	-3.06	1.25	1.25	-2.41	-0.33	1.35
Barclays Michigan Muni	-1.47	-1.24	1.25	1.25	-0.63	1.03	2.40
Bloomberg Municipal	-1.46	-1.22	1.05	1.05	-0.55	0.99	2.25

Since September 2024, the Fed has cut the target rate 1.0% to 4.50% from 5.50% while the yield on the 10-year treasury has increased from 3.64% to 4.60%, almost 100 basis points or 1.0%. This divergence is historically very uncommon if not unprecedented. Long-term yields typically either moved lower or stayed in line with the Fed policy cuts. While unusual, this development isn't that surprising as the yield curve:

- Had been inverted for over two years and is now positively sloped as 2/10s is at 32 basis points
- The Fed's neutral rate is rising ≥3% - This is the theoretical rate to meet the Fed's mandate
- Inflation expectations are rising again due to Fed projections and expected Trump policies
- The historical spread between the 2-year and 10-year treasury is +1.25% - now 32 basis points

Essentially, the yield curve is just normalizing at higher interest rate levels and don't be surprised if the 10-year moves well north of +5.0%.

The 10-year treasury yield began moving higher shortly after the Fed's first rate cut in September as inflation readings in September and October came in higher than expected. After the presidential election in November, it moved higher because of expected tariff policies which historically have been inflationary. Even some members of the Fed incorporated anticipated tariff policy in their December inflation projections. There has been much speculation on how Trump's policies will impact fiscal and monetary policy, the economy, and the markets.

Since the election, we've had numerous inquiries on how the Trump Administration policies will impact portfolios, both in support of and in fear of these expected policies, which has prompted us to conduct extensive and comprehensive research. Research analysis was taken from various partisan think tanks, buy-side firms, sell-sides firms, and from legal and industry expert opinions.

There is no doubt there will be a lot of moving parts to decipher as Trump policy develops. The Trump Administration will be focusing on four major policy initiatives which are the extension of the Tax Cut and Jobs Act of 2017, execution of their deportation policy, implementation of their tariff policy, and the formation of the Department of Government Efficiency or DOGE.

While all will hit the ground running, the extension of the Tax Cut and Jobs Act of 2017 and deportation policy are most likely to be the main focus in the first half of 2025 followed by tariff policy and DOGE later in 2025 and the first half of 2026. From research, below are some summary observations and highlights of each major policy initiative.

Extension of Tax Cut and Jobs Act of 2017

- This tax bill expires at the end of 2025 and is a top priority of the incoming administration
- Extension of individual and business tax provisions
- Elimination of taxes on social security benefits, tips, and overtime pay
- Repeal of the Inflation Reduction Act of 2022 is top priority – excludes health care related
- Lower corporate tax rate from 21% to 15%
- Tariff policy may try to be incorporated within tax bill extension with income tax offset

Deportation Policy

- Immigration has greatly benefited the tight labor market but also put significant burdens on local communities from health care, education, housing, and fiscal budget perspectives
- If policy is aggressive, could quickly cause a significant tightening of the labor market
- Most likely to affect agriculture, construction, leisure, hospitality, and retail industries
- Wage and price pressures are likely which could lead to higher business costs and inflation
- Consensus is that inflation may rise +0.50% to +1.0% due to this policy

Tariff Policy

- Trump used tariffs as a negotiating tactic in first administration but has wavered on upcoming policy between using tariffs as a negotiating tactic or as an across-the-board 10% increase
- Imports comprise 13% of U.S. GDP, tariffs are a one-time increase, and it only affects product upon arrival at dock side
- A 10% tariff does not equate to an across-the-board 10% price increase as it does not affect post dockside costs such as shipping, transportation, warehousing, advertising etc.
- Tariffs could weigh on global supply chain by disrupting trade flows of parts, goods, & deliveries
- Retaliation by other countries will likely vary due to specific country circumstances – Canada 2025 election, level of energy supplied by U.S. to Eurozone etc.
- When challenged legally, courts have historically given deference to the Executive Branch – especially if law(s) enacted or delegated by Congress to the Executive Branch
- Across-the-board tariffs of 10% are estimated to raise inflation 1.0% to 1.5% and interest rates as well, while targeted tariffs should have much less impact

DOGE - Department of Government Efficiency –

- This advisory body was formed to enact three major kinds of reforms: regulatory reductions, administrative reductions, and cost savings. It will provide guidance and recommendations.
- A similar task force has been tried before via the Grace Commission in 1982 by Ronald Reagan with limited success because it lacked authority, and critics argue the same will be true with DOGE
- Overturning of the 1984 Chevron case will be the perceived primary factor that will allow for regulatory and administrative change via executive order, congressional action, or administrative rulemaking. Success of DOGE will heavily depend on its ability to influence Congress. A tall task!
- For four decades, courts have relied upon Chevron to give deference to an agency to interpret laws enacted by Congress which is why the administrative state has swelled so much over 40 years
- In July, the Supreme Court rescinded this deference giving this power back to the courts for interpretation of laws passed by Congress
- The overturning of Chevron opens the door for regulatory cuts, which means less regulations, less workers needed, the downsizing of Fed Government, and hopefully less outstanding debt
- Actions taken to reduce government will likely be challenged in court
- The goal is for DOGE to be unwound by July 2026.

Most of the research and analysis of these policy initiatives point to a limited overall macroeconomic impact in 2025 (+-0.50%) as many of the expected Trump policies are offsetting over time. However, inflation expectations are likely to move somewhat higher due to the effect of deportation and tariff policies.

We have been overweight stocks and underweight bonds now for the better part of two years. The uncertainty associated with the shift to a more cautious Federal Reserve monetary policy and the incoming policies of Trump administration have tested the resolve of these strategies, but we remain cautiously optimistic in 2025 and expect limited economic impact and for earnings growth to continue to be supportive of market valuations.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – January 6, 2025

Sources: FactSet, Federal Reserve, UBS, Allianz, WSJ, Pillsbury Law, Goldman Sachs, S&P Global, Penn Wharton, Moody's, American Enterprise Institute, and Brookings Institution

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