New Administration in Washington Leads to a Foggy 2025 Outlook:

Federal Reserve Chairman Jerome Powell stated on December 18th regarding further rate cuts: "And, you know, the point about uncertainty is it's kind of common sense thinking that when the path is uncertain you go a little bit slower. It's not unlike driving on a foggy night or walking into a dark room full of furniture. You just slow down." Powell's assessment of our current economic environment was even more appropriate when the December payroll numbers were released on January 10th 2025. Results were far in excess of expectations, with the unemployment rate a tenth lower than expected and down to 4.1%. We will review this topic as well as provide our comprehensive economic outlook for 2025 in this quarter's commentary.

Our 2025 Economic and Fixed Income Outlook

During 2024 we were frequently asked by clients why we were not extending duration in the higher interest rate environment, opting instead to remain at or near benchmark durations for portfolios. In the end, we feel our 2024 composite performance results speak for themselves. We believe that our national annual budget deficits and total debt are starting to take their toll on the long end of the yield curve, both in terms of a heightened real cost of capital for risk free U.S. Treasuries and also on an increasing term premium. The inflationary impacts of potential tariffs, tax cuts, and persistent budget deficits are causing investors to demand a greater term premium to hold long-term bonds. Exacerbating the issue, it is increasingly clear that neither Democrats nor Republicans are taking the topic seriously. At least not yet.

We are a team of rational thinking long-term fixed income investors. The folly of thinking that there are $2 trillion of spending cuts to be made to the budget (recently reduced to a still irrational $1 trillion) is an illusion. There are no easy solutions and no silver bullets. Frankly, a balanced budget is not a rational expectation. What is rational is perhaps a near-term deficit of a trillion dollars (from the current approximate three trillion), closer to the pre-tax cut 2017 deficits of approximately $500 billion. To bond vigilantes, this display of seriousness would be a huge step in a favorable direction and be rewarded with a decline in the term premium. Alas, enough with our likely client-shared aggravation with Washington and on to our 2025 forecast.

Corporate Earnings and Capital Expenditures: We are forecasting improvement in S&P 500 corporate earnings from the 9.4% estimated growth for 2024 to a more robust 12-14% growth for 2025. We expect solid improvement in business investment during 2025 driven by further developments in projects like CHIPS Act factories and artificial intelligence, but also due to tax incentives, rising confidence and lower short-term interest rates. On the other side of the ledger, the new administration's expected tariffs could raise input costs and would partially offset these tailwinds.

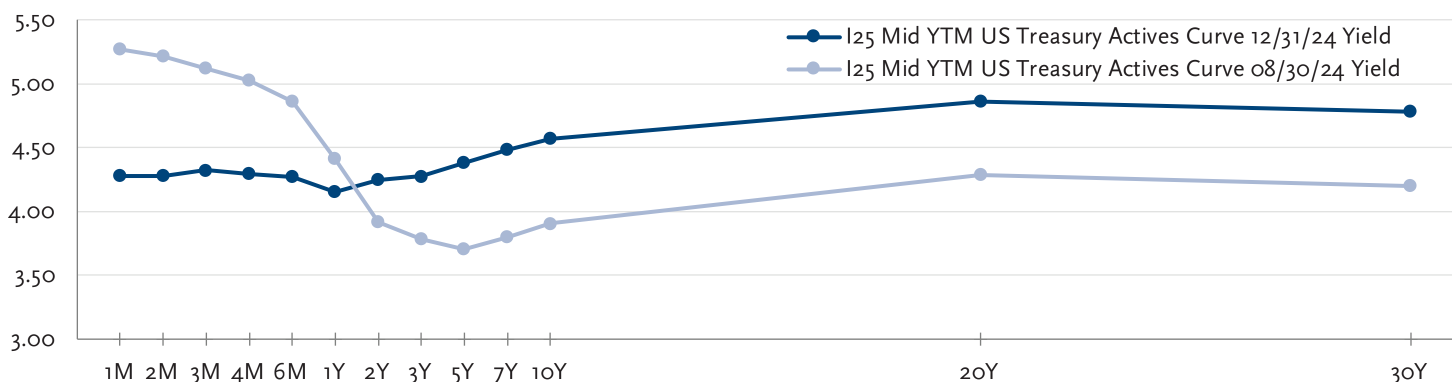
The ISM Manufacturing Index: In 2024, we saw the persistence of flat to modestly negative real growth in the manufacturing sector. The survey-based ISM Manufacturing Index has signaled contraction, with readings significantly below 50 throughout most of 2024. Manufacturing activity in Europe and China has been weak in 2024. The U.S. ISM Non-Manufacturing Index was relatively strong throughout most of 2024 and actually strengthened in the second half of the year. For 2025, we expect a repeat of 2024, with a bias toward modest growth.

The ISM Manufacturing Index is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

Gross Domestic Product: For 2025, we believe the U.S. economy will continue to grow but at a slower pace, in the 2.0-2.5% range. The Bloomberg consensus for 2025 GDP is 2.1%. The Fed began to cut rates during 2024 in response to a cooling labor market, but further cuts in 2025 are uncertain given persistent inflation modestly above the Fed's 2.0% target. Any additional cuts would be mainly defensive in nature, preserving the recovery and allowing the economy to continue to grow around its long-run potential of 1.8-2.0%.

Unemployment: We anticipate the unemployment rate will be more or less stable in 2025, in the low 4% area. We expect the labor force participation rate to be stable and that adequate job growth rate will be sustained in 2024. Wage growth, currently around 4%, will trend modestly lower as is typical in the later part of an economic cycle.

Inflation: We expect inflation to continue to trend modestly lower during 2025. Core PCE (Personal Consumption Expenditures excluding food & energy), the Fed's preferred measuring gauge, will finish 2024 at approximately 2.8%. We believe the Fed will remain focused on attaining their 2% Core PCE target, but during 2025, they will patiently allow the rate to decelerate.



Monetary Policy: The Fed has now cut the overnight rate by 100 basis points (bps) and has signaled that it expects to cut this rate by another 50 bps in 2025. However, a lack of progress on inflation over the second half of the year and some stronger than expected payrolls numbers have the markets second guessing this forecast. In fact, in a highly unusual move, longer-term interest rates have risen while the Fed has cut short-term rates. See the chart above. This is contrary to the historical experience.

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We can think of four reasons for this unusual development, all of which point to a higher terminal rate when the Fed is done cutting:

1. The election, and Trump's policies, which traders worry will be inflationary.
2. Recent lack of progress against inflation. Year-on-year rates are going sideways.
3. The Fed cutting rates against this backdrop of an inflation threat.
4. Increased Treasury supply.

Why would market interest rates rise when the Fed cuts rates? There's an assumption the Fed cuts only when it is appropriate. That policy is always optimized to achieve results. But to the extent the Fed is cutting rates when inflation is too high and stuck, or worse, when inflation is too high and may rise again, long yields will drift upwards.

As for supply, the U.S. budget deficit remains historically elevated and the Treasury has increased the proportion of debt funded in T-bills from the usual 15-20% range to 22.1% (10/31/2024) due to insufficient demand for duration. Funding the Treasury with a greater proportion of short-term bills results in higher cash flow volatility. Ultimately, the Treasury Department will want to term out bills into longer-term coupon securities adding duration supply, potentially leading tohigher long-term rates. The market may be already pricing this additional supply into long-term interest rates.

Interest Rates: It is our view that the Fed will likely cut rates twice in 2025 and the front end of the curve will decline. Regardless of the significant move higher in longer term rates during the waning months of 2024, we maintain a bias for interest rates across the curve to drift lower in 2025, resulting in a modest steepening of the curve. We expect the 10-year Treasury yield to end the year between 4.25-4.50%.

Investment Grade Corporate Bond Outlook: Corporate securities produced a total return of 2.13% in 2024 with tighter credit spreads offset by higher Treasury rates. In 2025, we expect corporate spreads versus Treasury bonds to widen only modestly. Given strong balance sheets, corporate credit fundamentals and rating trends that remain strong, we will continue to stay up-in-quality. We believe credit selection will be paramount in both investment grade and high yield, as the focus will shift toward fundamentals and the ability of corporates to navigate this macro uncertainty with U.S. economic growth slowing modestly.

High Yield Bond Outlook: The default rate for cash paying bonds during 2024 was 1.25%. The 30-year average high yield bond default rate is 3.2%. We expect an increase in both defaults and spreads during 2025 versus the record setting lows of 2024. Given our consistent tilt to quality, higher rated high yield bonds, we anticipate our total return in this asset class to be less favorable in 2025 relative to the past year.

Investment Grade Corporate Bond Fourth Quarter Performance

U.S. investment-grade bonds returned -3.1% during the quarter as a hawkish Fed and inflationary fears combined to put upward pressure on the yield curve. Per the Bloomberg U.S. Credit Index, investment grade corporate credit tightened by 9 bps versus comparable U.S. Treasury yields in the fourth quarter. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. Despite the challenging interest rate environment, corporate credit continued to be the best performer for fixed income markets in 2024. In our opinion, there are no positions in the portfolios with any credit or sustainability concerns through the market cycle.

High Yield Bond Sector Fourth Quarter Performance

High yield fixed income bonds eked out a positive return of 0.15% in the fourth quarter. High yield spreads started the quarter at 307 bps and ended at 290 bps, as limited issuance and a strong economy created a favorable environment for high yield credit. For the full year 2024, high yield returned 8.2%, comprised of 6.8% from coupon and 1.4% price return. From a quality perspective, all ratings categories performed well, with BBs underperforming the others at 6.3% given their greater interest rate sensitivity, single-Bs returning 7.6% and CCCs having an extremely strong year at 18.2%. High yield bond data is representative of the U.S. High Yield Corporate Bond Index which is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Thank You

Our fixed income team in Carmel, IN will celebrate 20 years with Oppenheimer & Co. Inc. on June 17th, 2025. Many of you have been clients of ours this entire time. We want to thank you and all of our clients for your business and introductions to new relationships during the past decades. We look forward to serving you in 2025 and helping to successfully navigate the ever-changing fixed income landscape. Please remember our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can occur, we believe our long-only style of investing has delivered positive results with reduced volatility over the long term.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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* **Past performance is not a guarantee of future results.** AdTrax 7541292.1