Executive Summary

Q1 2025 Economic Commentary

We are entering 2025 with higher potential for disappointment (after two stellar years for U.S. equities), as well as for optimism, particularly in areas where growth and transformation are underway. 2025 could be a higher risk/higher opportunity environment that will require a balanced and resilient approach to portfolio management as the policies of the Trump administration unfold.

Since year-end 2024, market volatility has increased, driven by a change in the interest rate outlook and policy uncertainty. Markets are acclimating to a new outlook for U.S. interest rates and inflation likely staying higher than the pre-Covid experience. What the Fed considers the neutral rate, roughly the end point for its interest rate cuts, has risen in the last few months as inflation has remained above the Fed's 2% target.

"Higher for longer" is a thesis we have propounded since the start of 2022, and it has major implications this year given likely changes to fiscal and trade policy under the new Trump administration. For one, there is potential for longer-term interest rates to keep rising due to higher U.S. deficits and debt levels, which could spook bond markets. The government's growth (i.e. growth in federal budgeted expenses), outpacing the economy by 50% over the past two decades, underscores fiscal risks that could influence market dynamics.

U.S. Treasury bond yields and the steepness of the yield curve are likely to be a dominant factor dictating whether the bull market in equities continues. As such, we are keeping a close eye on the 10-year T-bond yield. It appears 5% is the level at which markets may become rattled. Higher T-bond yields could reduce demand for corporate bonds and increase the yield spread between corporates and Treasuries, another yellow flag we will be watching closely.

In 2025, we see reasons for optimism as well as potential drivers of a correction. Potential positives include:

- Growing U.S. economy with stable interest rates and inflation coupled with record household wealth
- Potential for expansionary U.S. fiscal policy (lower taxes) and deregulation
- Rebound in global trade and investment amid beneficial trade deals and war resolutions
- AI-enhanced productivity and the continuation of what some are calling "U.S. exceptionalism"
- China's stimulus efforts succeeding and helping the world's 2nd largest economy boost domestic demand
- Europe initiating more market friendly policies to revive regional economic growth

Among the major potential challenges:

- Stubborn inflation amid sizable federal deficits, prompting rising interest rates
- Potential trade wars or new geopolitical conflicts
- Volatility due to the rollout of new Trump policies
- Disappointment in AI, manifested by earnings shortfalls among the highest profile AI companies (i.e. the Mag 7)

A focus on discipline will remain essential as markets grapple with structural headwinds in 2025. Positioning is key, with an emphasis on diversification, including diversifiers such as hedge funds and private credit, exposures designed to mitigate the risk of inflation, and income-generating assets. Additionally, allocations to private markets can also provide exposures to areas that could benefit from deregulation.

While challenges abound, opportunities exist for those willing to embrace imperfection and adapt to an evolving economic landscape. By remaining disciplined, investors can weather volatility to capture long-term growth in an increasingly dynamic market environment.

Please read our full *Q1 2025 Commentary* for more detail.