

Entertaining Imperfection

**“Disappointment is the bridge between expectations and reality.
Learn to cross it gracefully...”**

~ The Dalai Lama

After two exceptional years, the U.S. equity market seems priced for perfection. This backdrop has been amplified by high expectations that Trump administration policies will “stick the landing,” stimulating growth without stoking inflation or triggering higher interest rates – a near-perfect outcome.

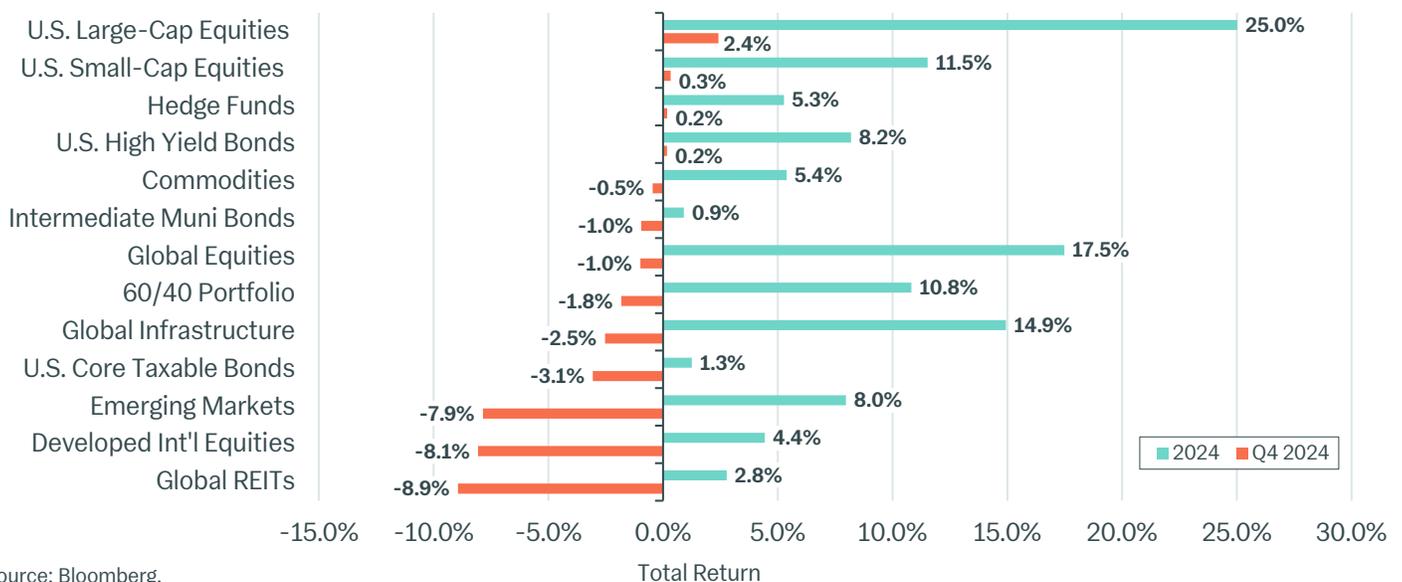
Any deviation from these optimistic assumptions could introduce significant volatility. We saw this manifest at the end of last year and at the start of 2025. Financial markets ended 2024 on a mostly disappointing note given an apparent pivot in Fed policy (away from consistent easing). While the Fed did meet market expectations in December by cutting the Fed funds rate to 4.25%-4.50%, Chair Jerome Powell underscored that additional rate cuts will be heavily data dependent and that the Fed can be more cautious with further adjustments to its policy rate.

Moreover, the closely monitored Fed “dot plot,” which asks members of the Federal Open Market Committee (FOMC) to project where the Fed funds rate will be in the future, suggests two important things:

- (1) The “neutral” rate that the FOMC sees as likely (roughly the end point for rate cuts) has risen over the last few months. This supports our “higher for longer” thesis for interest rates and inflation, which we put forth back in January 2022.
- (2) There is a wide swath in Fed governor opinions regarding the next few years (i.e. a wide spread between high and low estimates). This highlights an elevated level of policy uncertainty for financial markets to digest, thus setting the stage for higher volatility, something that also forms part of our thesis.

Amidst all the uncertainty, there are arguments for optimism, particularly in areas where growth and transformation are underway. Balancing this outlook, we explore both what could go right and what could go wrong in 2025.

2024 Asset Class Performance



Source: Bloomberg.





2024 in Review

Despite the December selloff, 2024 was another robust year for most asset classes. Here is a closer look:

Global Equities: Magnificent 7 ruled the roost. U.S. equities enjoyed a second consecutive strong year, with large-caps, especially big tech, continuing to lead the way. In the fourth quarter, big tech took back the mantle of leadership after signs of broadening dissipated with a seemingly more hawkish Fed. Small-cap stocks lagged, continuing to face challenges from higher interest rates, inflation and a tight labor market post-Covid. Overseas, the standout was China, where stocks closed the year with a 19% gain on improving economic data and aggressive government stimulus measures rolled out over the course of 2024.

Fixed Income: Rate rebound. The realization that interest rates might not head much lower was bolstered by the potential for higher budget deficits and inflation under a second Trump Presidency. The nomination of deficit hawk Scott Bessent as Treasury Secretary initially salved investor concerns, but rhetoric around the implementation of tariffs, tax cuts and the Congressional debt ceiling debate pushed U.S. interest rates higher. Whereas core bonds gave back most of their 2024 gains in the fourth quarter, high-yielding corporate bonds (+8%) were the clear leaders on improving economic data.

Real Assets: All that glistened was not gold. The potential for deregulation, domestic investment, attractive valuations and continued strength in the U.S. dollar supported the outlook for both public and private infrastructure equities, which were among the leading real assets performers in 2024. However, outside of gold and oil, each of which benefited from an uptick in geopolitical uncertainty to post year-to-date returns above 20%, much of the rest of the real assets space, such as real estate, struggled due to expensive financing and limited transaction activity given renewed pessimism over interest rates.

Private Equity: Slow-motion recovery. Private equity returns have been less robust recently, although final 2024 numbers have yet to be reported. That said, we would expect that year-end performance would get a lift from public market comparisons. Investment activity continues to slowly gain traction, but high interest rates and a lack of M&A activity have been headwinds. Whereas those factors have buffeted some private equity managers, others have found ways to step in and provide liquidity in creative ways including via secondary funds and continuation vehicles. This phenomenon will likely benefit secondary managers as markets continue to thaw.

Diversifiers (hedge funds and private credit): Credit-driven. Credit strategies were the strongest performers within the diversifiers category, although many equity long-short managers also benefited from net long public equity positions. Occasional bouts of volatility and subsequent performance of the asset class have helped underscore the fundamental value the space can provide in the form of returns from differentiated sources. Private credit continues to offer an opportunity to establish strategic positions with limited downside with a particular nod to activity in Europe: High new issue volume and refinancing activity have kept credit spreads wide, suggesting opportunity in European CLOs (collateralized loan obligations) has not diminished.

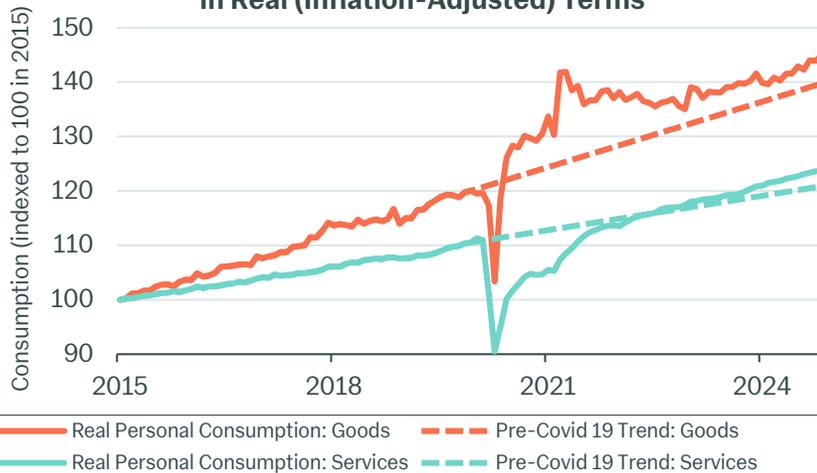


What Could Go Right in 2025

Multiple factors could contribute to ongoing economic and market strength in 2025:

- 1. Expansionary fiscal policy:** Expansionary measures such as targeted deregulation, infrastructure investment and lower corporate taxes could provide meaningful tailwinds, particularly in regions with low baseline expectations. These fiscal initiatives would likely bolster corporate profits and economic momentum. With that said, Republicans' inability to demonstrate unity during the December 2024 budget negotiations could be a harbinger of difficulties pursuing their bold agenda in 2025.
- 2. Above-potential U.S. economic growth:** Similar to 2024, the U.S. economy could grow at an above-potential rate, outperforming consensus expectations. While the labor market could continue to weaken, aggregate wage growth could remain historically solid, driving healthy consumer spending and economic activity. There is also room for upside surprises in non-U.S. economies, where expectations remain very low.

**U.S. Consumer Spending Relative to 2015
in Real (Inflation-Adjusted) Terms**



Source: U.S. Bureau of Economic Analysis.

- 3. Global trade recovery and reshoring:** Pessimism regarding global trade may be overstated. President Trump's policies, though unpredictable, are unlikely to escalate into a full-blown trade war due to potential backlash from U.S. investors, U.S. consumers and the Treasury bond market. During President Trump's first term, it became clear he will back off from policies when the capital markets, especially the stock market (his favorite "poll"), start showing disapproval. Additionally, the new Administration may surprise markets by striking trade deals with China and others.

The Year After Momentous Elections

Our January 2024 Commentary was titled "The Year of Momentous Elections" and, boy, was it ever! As the global elections super year progressed, voters driven by economic grievances expelled incumbent leaders and/or weakened their parties, with inflation and worsening inequality top of mind.

Social and political divisions and perceptions of an unresponsive political class only increased voters' disdain for the status quo, and lent support to populist figures, such as Donald Trump who recaptured the U.S. Presidency. This phenomenon held around the globe with results in Mexico, India, France and more recently the resignation of Prime Minister Trudeau in Canada.

Looking forward, the "momentous election year" has ended with a somewhat cloudier vision for the future, although one marked by continued retreat from globalization and a likely increase in nationalism. The foreign policy relationships of the Trump administration will be important to monitor as allies seek to curry favor transactionally to avoid tariffs or secure continued support in military conflicts.

The U.S. relationship with China has a broad set of potential outcomes: It could devolve from a tit-for-tat trade dispute into a full-blown cold war, or oppositely, a landmark trade agreement could be achieved. With so much uncertainty leading to a wide range of potential positive and negative outcomes, the most obvious consequence of political change is an increase in financial market volatility as campaign promises evolve into actual policies.



Tariff uncertainties may also encourage U.S. companies to reshore manufacturing, boosting domestic investment and growth. As such, the global trade cycle could strengthen, especially if it is coupled with more stimulus measures in China and deregulation in Europe (As in the Reagan era, Europeans may become inspired by the benefits of deregulation in the U.S. manifesting themselves). Additionally, we have seen a number of announcements from foreign companies pledging to invest billions in the U.S., seemingly as a way of currying favor with the new Administration.

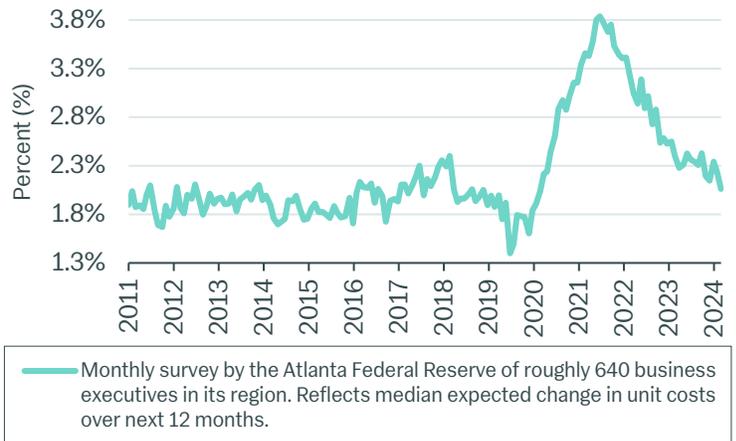
4. Stabilized inflation: Inflation in core consumer prices could level off, providing clarity for financial markets. If long-term inflation expectations remain anchored and the Federal Reserve maintains a measured approach to policy easing, this stability could support risk assets and economic growth.

5. Transformative impact of AI: Markets have increasingly priced in the transformative potential of artificial intelligence. While still in its early stages, AI holds the promise of significant productivity gains, driving economic efficiency and supporting long-term corporate profitability. Companies outside the technology sector demonstrating tangible AI-driven advancements (and/or software companies leveraging their AI capabilities to those industries) could generate continued optimism and bullishness for the equity markets. In many ways, the fact that most investors do not expect another year of outsized gains in the S&P 500 could be reassuring. It implies that average returns, driven by improved fundamentals like AI-led productivity, may foster sustainable growth and temper fears of market exuberance.

6. Wealth as an economic driver: The underappreciated role of wealth in supporting consumption and economic resilience continues to play a pivotal role. U.S. household net worth hit \$160 trillion in Q3 2024 compared to U.S. GDP of approximately \$30 trillion translating into a ratio of 575% of GDP, which is 75% higher than a generation ago. Household net worth (for the top 60% of households that drive 80% of spending) at record levels relative to GDP could continue to provide a foundation for growth.

7. Leadership and U.S. exceptionalism: Despite global uncertainties, what's being called "U.S. exceptionalism" could continue to manifest relative to other developed economies. The Trump administration's pro-business stance could enhance America's competitive position, while the country's robust innovation ecosystem and geopolitical advantages reinforce its exceptionalism.

Survey of U.S. Firms' Inflation Expectations
(Median for Next 12 Months)



Source: Renaissance Macro Research, Macrobond.

Relative Strength of S&P 500 vs. Foreign Equities
(MSCI ACWI ex US*): 2004-2024



*Morgan Stanley Capital Int'l All Country World Index (MSCI ACWI) minus U.S. equities. Source: www.bespokepremium.com.



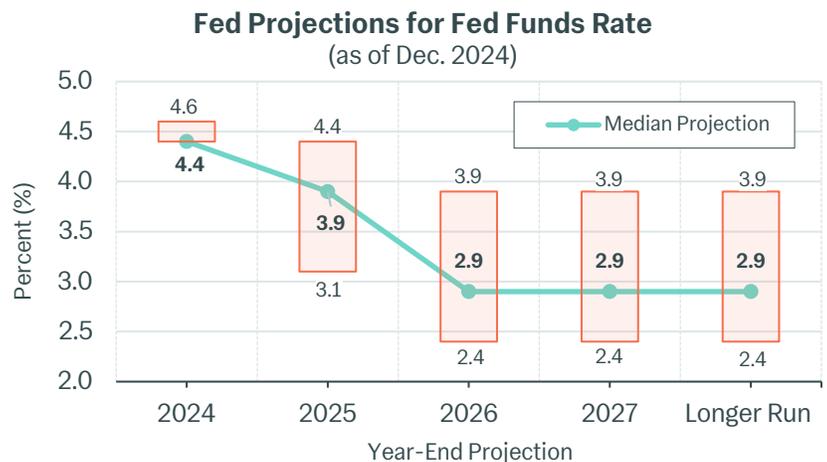
- 8. Peace dividends from geopolitical resolutions:** The resolution of conflicts in key regions such as the Middle East and Ukraine could generate a significant peace dividend. Reduced geopolitical tensions would lower risk premiums and create a more stable environment for global trade, investment and market growth.
- 9. Municipal strength.** Most U.S. municipalities, especially at the state level, are in relatively good fiscal shape, presenting the possibility of strong regional economies and tax cuts to support economic growth. With that said, the potential for the new Administration to pursue a major shifting of fiscal responsibility from the federal government to the states could counterbalance those benefits.

What Could Go Wrong in 2025

Conversely, a variety of risks could disrupt the optimistic outlook:

1. The Fed pivots away from easing plus lack of fiscal restraint:

The Federal Reserve is likely to halt its easing campaign earlier than anticipated, as it continues to revise upward its long-term neutral policy rate. This shift, as well as the prospect for multi-trillion dollar federal deficits, may catalyze a “bear” steepening of the U.S. Treasury curve (i.e. all yields rise, with long yields rising faster than short yields), elevating long-term yields and creating turbulence for risk assets.

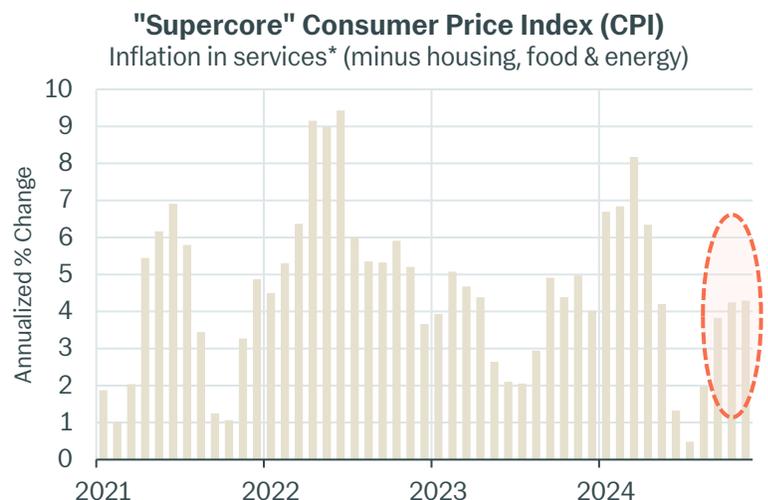


Source: LSEG Datastream and Yardeni Research; Federal Reserve Board FOMC Summary of Economic Projection.

We maintain that Treasury bond yields and the steepness of the yield curve will likely be the dominant factor dictating whether the bull market in equities continues. As such, we are keeping a close eye on the 10-year Treasury. It appears 5% is the level at which equity markets may become spooked.

Additionally, higher Treasury yields could reduce demand for corporate bonds leading to increased spreads between corporates and Treasury yields, another yellow flag we will be watching closely.

- 2. Sticky inflation:** U.S. core consumer price inflation could remain above the Fed’s 2% target, forcing investors to rethink and revise upward their longer-term inflation expectations, especially if we experience policy shocks – including extreme tariffs or supply side disruptions – which could further accelerate inflation, forcing the Fed to reverse course and tighten monetary policy prematurely. Ongoing solid economic growth and a lack of slack in the economy could amplify inflationary pressures. All this could increase the term premium, potentially triggering higher U.S. Treasury yields and dampening equity market valuations.



*Services include medical care, utilities, hotels, airline travel, insurance, etc. Source: US Bureau of Labor Statistics.



3. Global trade and geopolitical uncertainties: While a full-blown trade war seems unlikely, elevated political tension and tariff-related uncertainties could intermittently disrupt global supply chains, investor sentiment and economic growth. Tariffs targeting China or other key trade partners such as Mexico and Canada may introduce new inflationary pressures. Persistent conflicts in key regions such as the Middle East, Ukraine, heightened U.S.-China tensions and possibly new uncertainty related to Greenland and Panama pose risks to global economic stability and market performance.

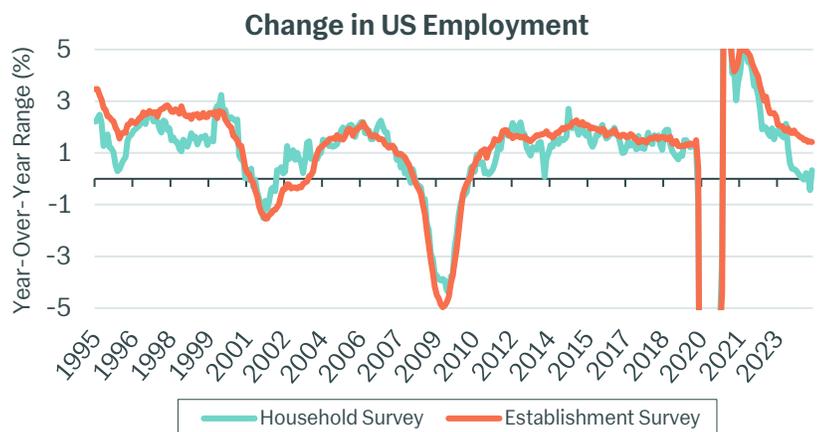
Type of Policy	Potential Economic Impact				U.S. Financial Market Implications		
	Growth	Inflation	Debt/Deficits	Uncertainty	Treasuries	Equities	Dollar
Fiscal (lower taxes; higher deficits)	↑	↑	↑	—	—	+	—
Deregulation	↑	↑	—	—	—	+	+
Trade (more tariffs)	↓	↑	↑	↑	—	—	—
Deportations & Anti-Immigration	↓	↑	↑	↑	—	—	—

Source: LNW.

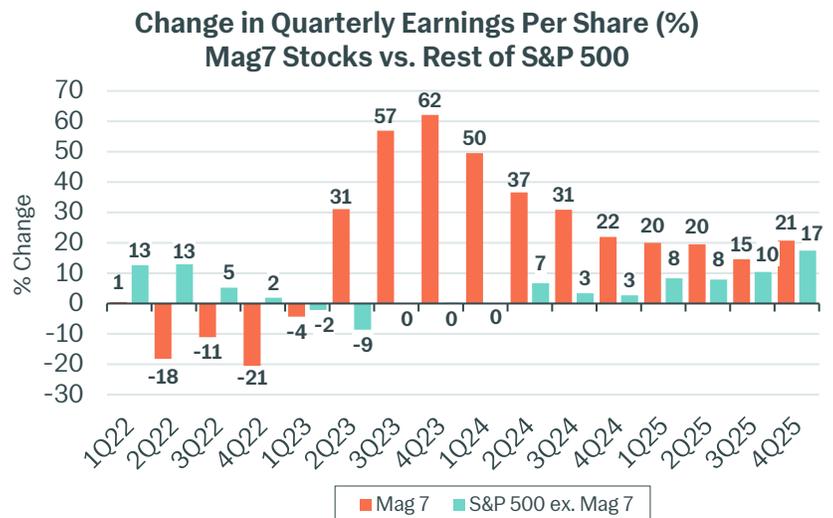
4. Labor market pressures: Changes to U.S. immigration policy, particularly those impacting industries reliant on immigrant labor such as agriculture and food processing, could exacerbate labor shortages. Higher costs and inflation in food prices could ripple through the broader economy.

5. Volatility in risk assets: Elevated equity valuations and high, potentially rising bond yields may constrain equity market performance, fostering an environment prone to periodic risk-off episodes.

6. AI disappointments: Despite significant investment and enthusiasm surrounding AI's transformative potential, the market has priced in rapid and substantial productivity gains. Should companies fail to deliver tangible financial benefits from AI infrastructure and software investments, investor sentiment could shift, derailing the broader bull market. A reassessment of AI-driven valuations could disproportionately impact the technology sector and/or sectors heavily reliant on technology.



Vertical axis truncated for legibility. Household survey asks individuals about their employment status, while the establishment survey counts jobs at businesses. Source: Bureau of Labor Statistics.



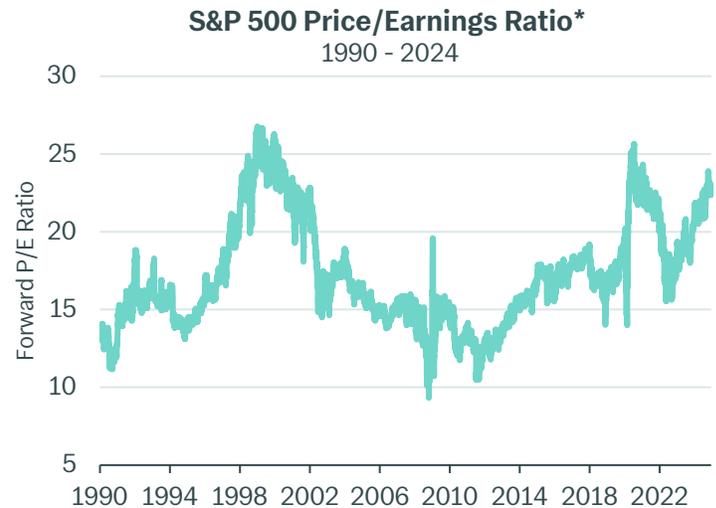
Source: S&P Capital IQ Compustat, Ned Davis Research, Inc.



7. Erosion of U.S. exceptionalism:

The narrative of U.S. exceptionalism faces challenges. A potential devaluation of the dollar due to fiscal irresponsibility, U.S. political dysfunction, the potential for declining innovation, or shifting geopolitical dynamics could erode America's relative advantage (or at least perceived advantages) in global markets.

8. **Policy volatility:** If the expected policies of the Trump administration do not come to fruition, or if they are less impactful than anticipated (or more in regard to tariffs), investor optimism could unravel. This would likely lead to repricing in equity markets, particularly for sectors that had previously rallied in response to policy expectations.



*Forward price/earnings ratio is based on current price divided by earnings forecast for next 12 months. Source: Bloomberg.

Implications for the Markets and Economy

The interplay of the above positive and negative factors could have far-reaching implications for both markets and the broader economy:

- **Equities:** U.S. large cap valuations appear to be stretched, with the S&P 500 trading at 22 times forward earnings compared to a 10-year average of 18. While earnings growth projections are strong, any downward revisions or policy disappointments could trigger corrections. With that said, small-cap and cyclical stocks, including industrials and materials, may benefit from pro-growth policies and infrastructure investment.
- **Fixed income:** The bond market offers renewed relevance as a source of cash flow in portfolios. However, elevated yields on Treasury and corporate bonds may limit equity market upside by attracting risk-averse capital.
- **Private markets:** Private assets such as real estate and infrastructure offer resilience against geopolitical and market volatility. These assets provide steady cash flows, can mitigate inflationary risks and are less correlated with traditional equities. Additionally, deregulation may lead to increased transactions within private equity (PE) thereby generating distributions for investors. We would frame broad PE market outlook as cautiously optimistic, with most expecting increased deal activity and consensus on the importance of post-close value creation. The secondary market is expected to play a crucial role in providing liquidity while we all wait for an M&A thaw to actually materialize and bear fruit.
- **Technology and innovation:** Sectors benefiting from AI and new technologies will remain in focus. Companies capable of demonstrating tangible AI-driven productivity gains could lead the market, while speculative tech stocks may face heightened scrutiny. There is some risk that companies have been taking a shotgun approach experimenting with many different types of AI software solutions and demand could drop off as they either don't see the benefits or start narrowing their use cases. With that said, the Department of Government Efficiency ("DOGE") could reallocate human capital dollars to technology solutions to improve efficiency.



Concluding Remarks

Navigating 2025 will require a balanced and resilient approach to portfolio construction. Portfolio resilience will be 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.

Investors should also prepare for the possibility of higher interest rates driven by rising U.S. deficits and debt levels, which could spook bond markets. Growth in U.S. government debt has outpaced the economy by 50% over the past two decades, underscoring fiscal risks that could influence market dynamics. A focus on quality—both in equities and fixed income—will remain essential as markets grapple with these structural headwinds.

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



ABOUT THE AUTHOR



Ronald G. Albahary, CFA® is Chief Investment Officer at LNW. As head of the investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with client advisory teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNW, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The LNW investment team is comprised of 12 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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