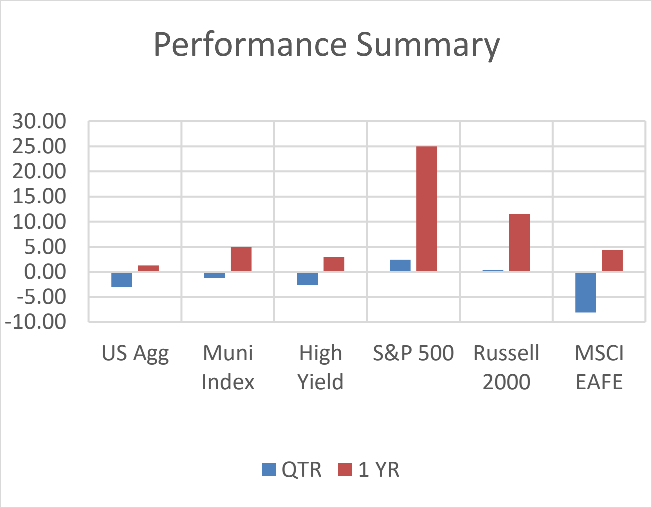
Global financial market returns were mixed for the quarter. The results of the US election sent stocks soaring in November. However, the party ended abruptly in December, when the Federal Reserve reduced its forecast for more interest rate cuts amid slower progress on inflation and an uncertain policy outlook. The bond market had a tough quarter, with yields steadily climbing throughout October and again after the election.



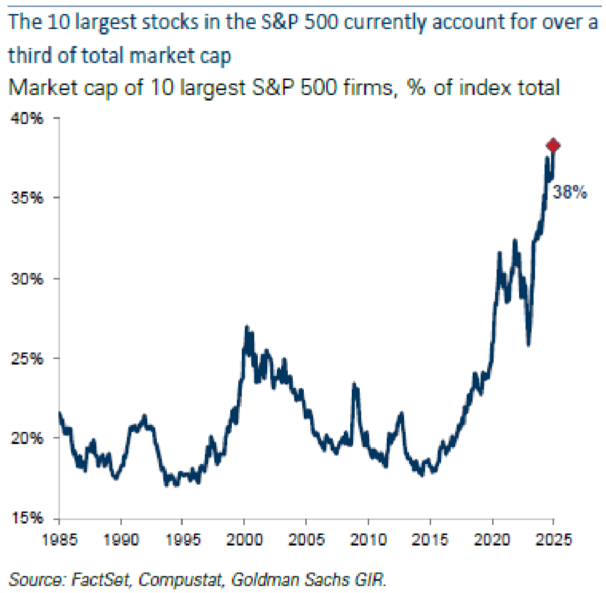

- The S&P 500 recovered from an October sell-off and generated solid returns. before stumbling at the end of December. For the quarter it was up 2.41%.
- Returns were very narrow for the quarter, led by a handful of technology stocks. Growth stocks finished the quarter up over 6% while value stocks were down 2%.
- After outperforming in the third quarter, dividend stocks had a negative performance in the fourth, down 1.8%.
- Foreign stocks underperformed as fears of slower growth and potential weighed on their performance. For the quarter the MSCI EAFE index was down 8.06%.
- The Federal Reserve cut interest rates twice in the quarter and the target federal funds range ended 2024 at 4.25-4.50%.
- U.S. bonds were down 3.06% for the quarter but finished the year up 1.25%.

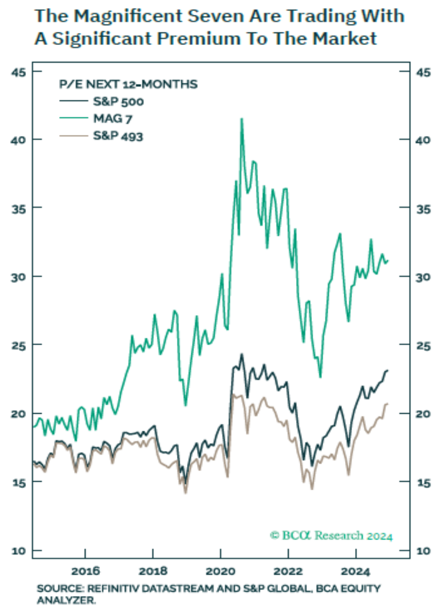
## Market Fears in 2025

It is the time of year when Wall Street strategists make their predictions for the coming year, which always include a list of the biggest risks facing the financial markets. We try not to get too caught up in the "noise" of short-term predictions but do think there are some risks worth monitoring as we head into 2025. Below is a list of some of the risks we will be watching.

**Interest rate surprises.** The consensus of investors is that the Federal Reserve will make several more interest rate cuts in 2025. Should economic growth and inflation reaccelerate under President Trump, forcing the Fed to cut short or reverse the current easing cycle, risk assets will face headwinds. Investors will be watching President Trump's tariff, tax, and economic policies closely to gauge their impact on fiscal deficits, the economy, and inflation. Higher interest rates would be a clear headwind for the financial markets.

**High valuations and earnings disappointments.** It can be argued the stock market in the U.S. is priced for perfection. In the past two years, more than half of the return in the S&P 500 has simply come from higher valuations being put on stocks. With the market highly concentrated and trading around 23x future earnings, any earnings disappointments, especially from the top 10 stocks, could easily take stock valuations and the market lower. The charts below show the current concentration and valuation of different components in the S&P 500.




**Housing and commercial real estate.** In early 2022, less than 4% of US residential mortgages had an interest rate above 6%, whereas one-third had a rate below 3%. By mid-2024, 16% of mortgages had a rate above 6% and one-quarter had a rate below 3%. The interest payments on mortgage rate debt will naturally continue to increase as time goes on and may start weighing on consumers in 2025 and beyond. Commercial real estate vacancies continue to be historically high and will pressure regional banks if they continue to grow.

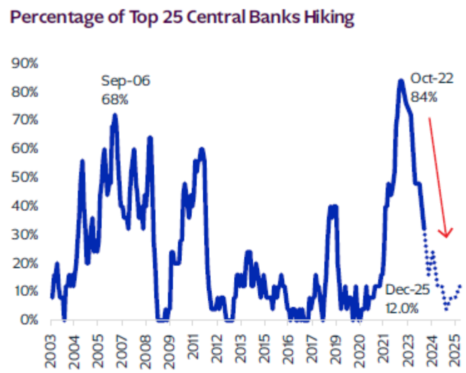
**Tariff and immigration policies backfire.** The consensus view is there is a low probability of a recession in the next year. However, we are starting to see some early warning signs such as credit card and auto loan defaults reaching their highest levels since 2011 and the economy is starting to feel stress. Should upcoming tariff and immigration policies lead to global trade wars and slower economic growth, the odds of a recession may start to increase. A recession would be a significant negative for risk assets.

**Other risks** that cannot be predicted but may emerge include geopolitical risks, cyber-attacks, supply shocks, etc.

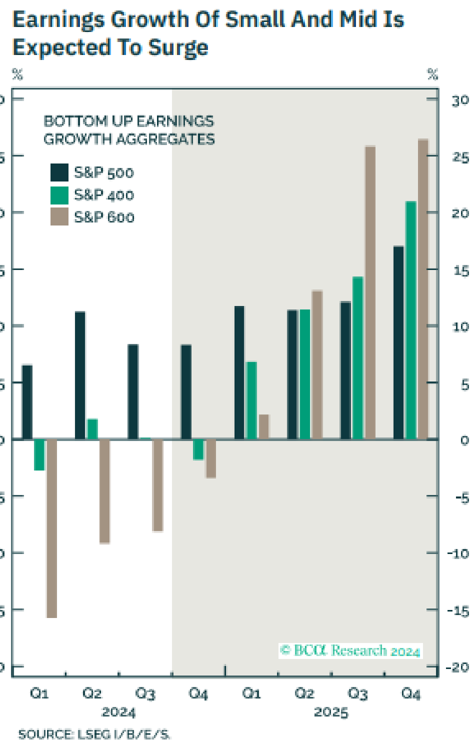
## Glass Half-Full?

The list of potential risks is lengthy as we head into 2025. However, we cannot lose sight that financial markets tend to go higher more frequently than they sell-off, and usually do not experience a sharp sell-off unless a recession occurs. Below are a handful of reasons to believe the 'glass may still be half-full' for risk assets in 2025.

**Central bank easing is usually positive for financial markets (assuming there is no recession).** The chart below shows the global central bank hiking cycle peaked in late 2022 and has dropped significantly since. Even though the U.S. easing cycle may not be as robust as originally thought, the global easing cycle looks to be intact, especially in China and Europe. A backdrop of a global easing cycle is usually quite positive for risk assets, as long as a recession can be avoided.




Hiking/cutting rates defined as a change in rates over the past three months. Data for U.S., JP, CN, AU, CA, EZ, NZ, NO, SE, GB, JP, CH, IN, ID, KR, PH, TW, TH, VN, BR, CL, ZA, TR, IL, CZ, HU, PL. Data as at September 30, 2024; Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.




**U.S. earnings growth is projected to increase by roughly 13% in 2025**. Assuming the S&P 500 can maintain its current valuation (not a given) this should bode well for positive returns in the coming year. Earnings growth for small and mid-cap stocks are expected to get the biggest bump in 2025, their earnings growth is represented by the S&P 400 and S&P 600 in the bar chart (below left). Given the lower starting valuations for small and mid-cap stocks, should the forecasted earnings materialize in 2025 it could bode well for solid returns. Again, the economy is key as earnings typically turn down should a recession occur.

**Productivity has been increasing at a decent clip for the first time in a while.** U.S. labor productivity has fluctuated between periods of boom and bust since the 1960's. Emerging from COVID, we have seen a greater reliance on automation and digitalization which has led to an upturn in productivity, after a decade-long slump. Should this trend continue, it would be a real positive for the economy and earnings. The chart (below right) highlights the boom/bust nature of the productivity numbers.

## Putting it all together… themes to consider

Putting it all together, we believe 2025 may be a year where the economy and financial markets walk a tightrope. If the new Trump administration is able to thoughtfully implement policies to benefit the economy and global trade, there is a good chance the bull market will continue into 2025 and possibly beyond. However, if policy changes are chaotic and lead to economic uncertainty, we think the odds of a recession will increase and there may be substantial downside for risk assets, especially given the level of valuation and concentration risk in the markets. There is a good chance that volatility in the financial markets will increase this year until market participants gain confidence in the policies to come. Below are some of the key themes we will be watching closely in the new year.


Chart refers to real output/hours worked. 1960s refers to 1959-68; 1990s-00s refers to 1995-05; 1970s refers to 1973-79; 2010s refer to 2010-19; 1980s refers to 1980-88. Data as at September 30, 2024. Source: Bloomberg, Federal Reserve Bank of San Francisco.

**Cybersecurity.** In an environment of rising geopolitical tensions, cyberattacks, and shifting global supply chains we expect this theme to stay in place for years to come. CEOs and governments around the world are optimizing corporate security to have resiliency in all facets of their businesses and services. Which should bode well for cybersecurity-related assets in the foreseeable future.

**Artificial Intelligence.** We expect the artificial intelligence investing theme to be robust in 2025 and beyond. That said, we believe it will start to shift from the infrastructure companies to more of the application and platform companies. Investors will start to focus on who can monetize the technology and who will the long-term winners be.

**Broadening Markets.** The Trump administration is expected to be pro-growth, anti-regulation, and somewhat inflationary in its first year. Should President Trump's policies have a positive impact in these areas and avoid triggering a recession we expect the following areas to benefit: domestic-oriented companies; heavily regulated industries; smaller-cap and value-oriented stocks.

**Tariff Bluffs.** If the Trump administration has been using the threat of global tariffs as a negotiating tactic and trade deals can be reached without triggering major trade wars, it will be a positive for global risk assets. Should this occur, it would be a boon for foreign stocks that are trading at much lower valuations than U.S. stocks. Investors should get a good read on this in the first six months of the new administration.

**M&A and IPOs.** We expect the Trump administration to take a 'light' position on anti-trust issues. This may lead to an increase in mergers and acquisitions and initial public offerings (firms going public) compared to the last few years. This should benefit financial service companies, some areas of technology and healthcare, and small-cap stocks in general.

**Inflation Hedges.** Until we have a better sense of the economic policies to come, we think it makes sense to maintain some inflation hedges in portfolios. This may include keeping bond portfolios with below-market duration (interest rate risk) and potentially include assets like precious metals, short-term Treasury inflation protection securities, and even commodities if the global economy picks up.

This will be an important year for investors to remain disciplined and watch closely how trends unfold in the months ahead. If you have any questions regarding this commentary or your investment strategy, please let us know and we would be happy to schedule a time to review.

Best regards,

Steve Giacobbe, CFA, CFP®