1Q | 2025

Red Light, Green Light

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TK Viewpoint

2024 provided a second consecutive year of double-digit gains for large capitalized domestic companies. The breadth of the 2024 rally included every major US style and size equity index. Earnings for the S&P met consensus expectations and have risen for 2025. Inflation declined throughout the year, closer to the Federal Reserve's desired ~2% target rate and the unemployment rate was able to remain below 4.5%, achieving their dual mandate of low and stable inflation and full employment. "Goldilocks" economic data, as it is called for being not too hot or cold, as well as strong earnings and higher Price to Earnings ratio contributed to performance for investors who own risk assets.

We are pleased with the performance of accounts over the last two years, but the nature of our work is that it is never finished. We must constantly assess risk and reward for the next year. 2025 has projected ~11% earnings growth YOY and directionally we are looking for ~7% earnings growth for 2026. With inflation seemingly tamed below ~3% and the unemployment rate constructive at ~4.5%, the Federal Reserve would ostensibly be warranted in lowering the "Fed Funds Rate" to ~3%. All of these data points support a pro-growth environment.

So…What could possibly go wrong?!? Among the many obstacles for us to navigate in managing your hard-earned dollars are the ever-present geo-political risks of war, weather, and whims of political leaders. The dysfunction in the housing market is a worry. How will the low inventory of homes in the US and high prices be reconciled when almost ~85% of mortgages are lower than current 30-year mortgage rate of ~6.9%? Ironically, China has the reverse problem with an oversupply of houses weighing down their economy and banking sector. How will proposed tariffs on China further exacerbate the economic woes of the second largest economy in the world, and will those problems bleed into global GDP expectations and a re-assertion of inflation?

The most important data point we are monitoring is the US Ten-year Treasury Yield. After two years of yielding less than a two-year bond (Inverted yield curve) it has begun to normalize, providing a higher yield than shorter duration bonds. If the 10-year US Treasury remains below ~4.5% it will be neutral to the stock market. Yields above ~4.5% will signal inflation and become a headwind to stocks. Another important factor we are monitoring is the dollar. The dollar above $1.07 to a basket of foreign currencies is a headwind for the US economy. Both data points are linked to the deficit. The US debt is a growing obstacle to our prosperity. The size and cost of financing it are issues that monetary policy (The Federal Reserve controls monetary policy) cannot fix. Fiscal policy (The legislative and Executive branch control) must be employed to both tax rates and spending priorities in order to bring the deficit back into ratios that support financial health for the American economy. Over the last decade, US Government revenue has increased ~14%, but US Government spending has increased ~38%. The net interest expense as a percentage of tax revenue is now ~17%, almost as high as the defense budget.

Our base case is for profitability in 2025. Proposed deregulation in the next administration may increase earnings for affected segments of the economy, like the financial sector. The likely extension of the TCJA (Tax Cuts and Jobs Act) would also benefit risk assets in 2025. The prospect of increased tariffs warrant leaning into domestic small and mid-size companies that would benefit at the expense of emerging market imports.

The risk of inflation re-asserting itself next year is high based on current fiscal policy and proposed tariffs. If that occurs, we could see the Fed's hands tied in lowering interest rates. If interest rates are higher for longer than current expectations, there are negative implications on the housing market, deficits and ultimately risk assets in general. For these reasons and many more not touched on here, we will be focused on balanced portfolios that employ discipline in both position size and valuations. We will be adding to fixed income to both mitigate risk and capture absolute return in the form of interest income. The universal optimism for performance in 2025 is actually our biggest concern. So, while we see a path forward for positive performance in 2025, we will be proceeding with caution as the potential for the light to change from green to red is not only possible but likely.

Happy and Prosperous New Year!

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