REGIONS ASSET MANAGEMENT

Investment Strategy Outlook

JANUARY 2025

THE ECONOMY

Does Anyone Really Know Anything?

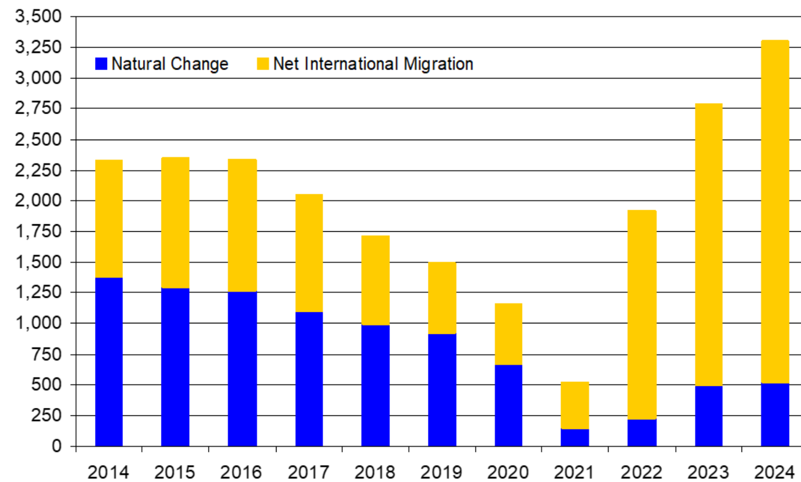
Okay, sure, there are no doubt lots of people who know lots about lots of stuff. But, when it comes to making a detailed forecast of the path of the U.S. economy in 2025, "nobody knows anything" seems a more appropriate theme. After all, even if the broad contours of changes in fiscal, regulatory, trade, and immigration policy to be seen over coming months are taking shape, the range of potential outcomes around the specific details in each of those areas is so wide that it is hard to have much, if any, confidence in any economic forecast for 2025 made before those details emerge. This being our January edition, however, we are bound, we're pretty sure by law, to offer an outlook for the economy in the year ahead. To that end, we'll offer a brief summary of our 2025 forecast, based on the current policy mix, and, along the way, report on how some of our 2024 forecasts fared. Our January 2025 baseline forecast, however, may be better seen as a point of reference as to how we'll see the impacts of policy changes as the details of those changes emerge in the months ahead. We'll also discuss some of the key factors we think will more fully shape the path of the U.S. economy in 2025.

As in 2023, real GDP growth surprised us to the upside in 2024, and for the same reasons. The combination of rapid growth in the supply of and productivity of labor allowed for above-trend real GDP growth while allowing for further deceleration in inflation, though progress on that front stalled as 2024 came to a close. Though the Q4 data are not yet available, full-year 2024 real GDP growth was tracking at 2.8 percent, handily beating our forecast of 2.1 percent growth, and even further outpacing the Blue Chip consensus forecast of 1.6 percent growth. We do not, however, expect another year of above-trend growth in 2025; our baseline forecast anticipates real GDP growth of 2.2 percent in 2025, with a marked slowdown in labor supply growth and a "higher for longer" interest rate profile weighing on growth.

While the pace of job growth slowed as we anticipated in 2024, the labor force grew faster than we anticipated, putting upward pressure on the unemployment rate. For full-year 2024, the unemployment rate averaged 4.0 percent, just above our forecast of 3.9 percent. While we expect job growth to slow further in 2025, we expect slower labor supply growth to blunt upward pressure on the unemployment rate, which we expect to average 4.1 percent for full-year 2025. Despite slowing job growth, aggregate labor earnings – the largest block of personal income – continue to grow at a rate faster than inflation, which has been a support for consumer spending. We expect growth in consumer spending to realign with growth in after-tax income in 2025 after what has been a wide gap over the past few years.

While we expected headline and core inflation as measured by the PCE Deflator to remain above the FOMC's 2.0 percent target through 2024, we also expected a more pronounced slowdown than proved to be the case, as inflation began to reaccelerate over the final months of 2024. Our January baseline forecast has both headline and core PCE inflation averaging 2.4 percent for full-year 2025. Though not precluding further cuts in the Fed funds rate, particularly with many FOMC members nervously eyeing softer labor market conditions, that inflation is proving to be so persistent does limit the scope for further funds rate cuts. After 100 basis points of cuts to the Fed funds rate in 2024, as our forecast anticipated, we anticipate two twenty-five basis point cuts in 2025. Even should that prove to be the case, it may bring little relief from elevated long-term interest rates, as concerns over persistent inflation and the gaping federal government budget deficits figure to put a floor under yields on longer-term U.S. Treasury securities. To the extent that mortgage interest rates are influenced by yields on 10-year U.S. Treasury notes, this does not bode well for the housing market in 2025, and we expect starts and sales of new single family homes to be lower than in 2024.

Components Of Population Change: U.S.2014-2024, thousands of people



Source: U.S. Census Bureau; Regions Economics Division

As we discussed last month, potential changes to immigration and trade policy are sources of uncertainty around the 2025 outlook. We think it important to note that subsequent to last month's edition the U.S. Census Bureau released their latest estimates of U.S. population. The updated data incorporate revised methodology for estimating international migration, which we and others have argued Census was significantly undercounting over recent years. Indeed, the latest estimates show far greater international in-migration since 2022 than had previously been estimated, which the Census data now show to have accounted for roughly eighty-five percent of total U.S. population growth from 2022 through 2024. This highlights the extent to which foreign born labor has been the catalyst for the faster growth in the supply of labor over this span, but also highlights the potential for there to be an adverse labor supply shock – resulting in growth being lower and inflation being higher than our baseline forecast anticipates – should there be a

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significant slowdown in the inflow of foreign born labor. Indeed, by year-end 2024, there were already signs of such a slowdown, and this is clearly something to monitor in the months ahead.

As we see it, the potential effects on wages, output, and inflation stemming from changes to immigration policy would be felt much more acutely, and more immediately, than the effects of expanded tariffs. After all, between timing, exemptions, workarounds, and fluctuating currency values, there are several factors which could blunt the inflationary impact of expanded tariffs, but there would be no offsets for an adverse labor supply shock. That said, to the extent expanded tariffs do push up prices of imported consumer goods, that would exacerbate the financial stress stemming from the cumulative increases in prices over the past few years already being felt amongst many lower-to-middle income households.

In terms of consumer spending, there is already a clear divide across income/wealth lines. Many lower-to-middle income households, far less likely to have reaped the benefits of rising asset prices over recent years, have sharply curtailed discretionary spending, while higher-income households and/or those having seen significant increases in net worth continue to engage in such spending. A sharp correction in equity prices and/or a meaningful decline in house prices, however, could easily trigger negative wealth effects which, in turn, would curb discretionary spending. At the same time, to the extent interest rates remain elevated, spending on consumer durable goods will be impaired while those households with variable rate debt obligations, including credit card debt, will get little, if any, relief from debt service burdens. These factors all pose downside risks to our forecast for growth in consumer spending in 2025.

Perhaps one of the most underappreciated stories of the recent past is the marked acceleration in labor productivity growth, which averaged 2.4 percent over the eight quarters ending with Q3 2024. Whether, or to what extent, this can be sustained is another key question in 2025. The rate at which any economy can grow on a sustained basis over time without sparking inflation pressures is a function of the rates of growth of total labor input and labor productivity. Productivity growth not only allows for wages to grow over time without impinging on profit margins or igniting inflation pressures, but is also the ally of firms facing labor supply constraints. If we are correct in expecting much slower labor supply growth 2025 than has been the case over recent years, sustaining the recent acceleration in productivity growth will be critical in supporting real GDP growth and tamping down inflation pressures.

Though the U.S. economy ended 2024 on firm footing, there is considerable uncertainty looming over the outlook for the year ahead. As such, it seems fitting to wrap our 2025 outlook by repeating a call we clearly got right in both our 2023 and 2024 outlooks, which is that at the end of the year, the economy is unlikely to look as we, at the start of the year, expect it to, even if we do not now know why that will be the case.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; U.S. Census Bureau.

STOCKS

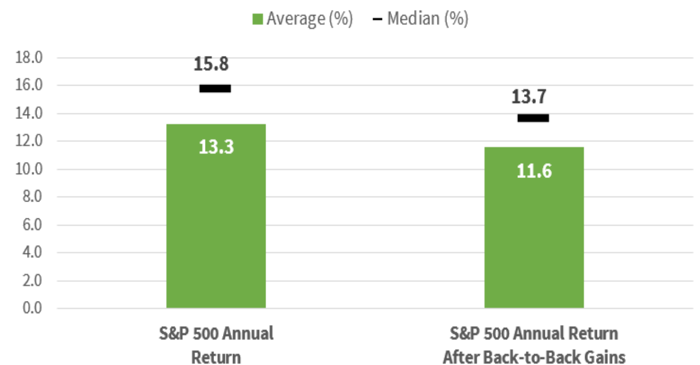
Tougher Sledding Ahead As Policy 'Fog' Sets In

2024 ended with a whimper as the S&P 500 fell 2.5% in December as a Santa Claus rally failed to materialize, but the broader index still managed to close out the year with a 25% annual total return. That makes it back-to-back calendar years with a 25%-plus gain for the S&P 500, which has led to concerns on the part of investors that some give-back must be in the cards after such a sizable two-year rally. While we share some of this healthy skepticism and expect more modest returns from U.S. stocks in the coming year, partially due to our view that the 2023-2024 market rally has left us with lofty valuations that stocks will need to grow and/or reprice into, we believe it premature to turn bearish on U.S. stocks as the S&P 500 is still expected to grow earnings by a respectable 12% year over year in 2025.

Much has been made of the current market backdrop sharing similarities with the 1996 through 1999 time frame. Most notably, both environments either were or have been characterized by powerful tailwinds for secular growth stocks, as the dawn of the internet kicked off the rally in the mid-1990's, and the onset of the artificial intelligence (AI) revolution has acted as a catalyst for upside in recent years. From a performance perspective, the S&P 500 generated an annualized total return of more than 26% from 1996 through 1999 as the Index strung together four consecutive calendar years in which it generated a total return north of 20%. While we don't expect another two years of 20%-plus gains for U.S. large-cap stocks given lofty starting valuations, valuation is a poor timing tool and indicator of when to expect a near-term market reversal, and we are aware that strong secular drivers like AI have a history of propelling stocks for longer and taking them to heights and valuations well above what most market participants believed possible.

This knowledge leaves us open to the possibility that returns could surprise to the upside in the coming year, but our base case calls for the S&P 500 to rise in-line with year over year earnings growth as policy 'fog' contributes to elevated volatility and a choppier backdrop for stocks along the way. Investors could spend much of the first half of this year recalibrating their expectations for economic growth, inflation, and the outlook for monetary policy due largely to potentially meaningful policy shifts out of Washington D.C. It's also worth noting that, on average, the first quarter of a U.S. President's term has generated the lowest S&P 500 return of any quarter in the four-year presidential cycle. Markets crave the certainty that often comes from gridlock in our nation's capital amid divided government as this dynamic ensures that little in the way of sweeping policy changes are enacted. With one party set to control the White House, House of Representatives, and the Senate in the coming year(s), impactful policy changes could come fast with volatility in equity prices – both to the upside and downside – remaining elevated relative to recent years as a result.

Since 1975, Average Annual S&P 500 Return Lower Than Normal After Back-To-Back Annual Gains



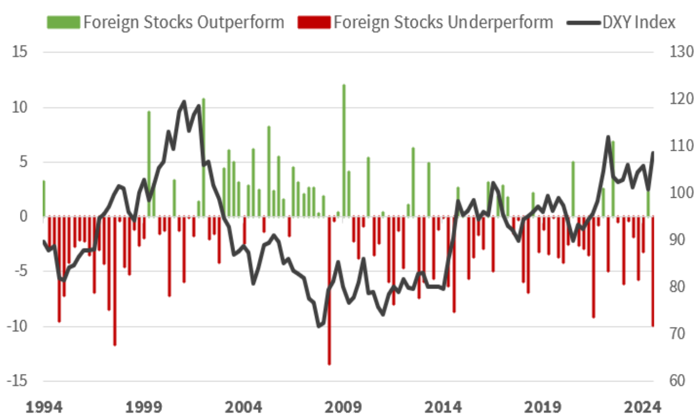
Small And Mid-Cap U.S. Stocks To Benefit As M&A Outlook Improves, But Near-Term Rate Headwinds Remain. The fourth quarter was a winding road to nowhere for small- and mid-cap stocks as the S&P 1000 SMID index returned an unremarkable 0.1% even after posting a 9.5% return in November, as the Index gave back the bulk of those gains by falling 7.4% in December. The December drawdown started with a drift lower that accelerated around the FOMC meeting mid-month, as the Committee raised its near-term inflation forecast and signaled a near-term pause and a slower and shallower trajectory for rate cuts, forcing markets to recalibrate rate cut expectations. Futures are now pricing in just 25-basis points of cuts in '25, down from 75 at the start December. A dose of reality on the rate front has served as a setback for more cyclical sectors, particularly those farther down the market cap spectrum but, notably, earnings expectations for smaller companies flattened out last month, one early sign SMid could be close to finding a near-term bottom.

After downward revisions to earnings estimates last year, expectations for SMid have been lowered drastically, which may set up potential upside surprises in the coming quarters. A pronounced uptick in mergers and acquisition (M&A) activity should provide a tailwind for small- and mid-cap sentiment as potential targets of acquisitions, but harsher immigration policies could disproportionately impact smaller companies and lead to downward revisions to the outlook for earnings growth. Given uncertainty surrounding smaller capitalization stocks, it's no surprise market participants continue to trade these names rather than take long-term positions. At present, there is little to move us off our strategic neutral position as relative cheapness and oversold conditions are some of the only potential near-term catalysts we can point to for this segment of the U.S. equity market.

Some Stability Or Weakness In The U.S. Dollar Would Be Most Welcomed By Foreign Stocks. The U.S. dollar's ascent throughout the 4th quarter and into the new year has put significant strain on international equities. The MSCI EAFE index and MSCI EM index fell by 8.3% and 8.1%, respectively, in the 4th quarter of 2024, with most of those losses coming from local currency, and losses have continued in the new year. To begin the year, the U.S. Dollar Index (DXY) has traded in the 109/110 range for the first time since late 2022, leading market participants to question how much stronger the greenback can get and if the currency has too much good news priced into it already and may be set to reverse course.

There appears to be room for mean reversion and a modest drop in the U.S. dollar given the magnitude and speed of the recent runup, much of which appears centered on uncertainty surrounding immigration and trade policies. A rapidly appreciating dollar will be a headache for the President-elect at some point as it lowers demand for U.S. goods from abroad, so policy changes that are announced could look quite different when implemented based on market reactions to them. International developed and emerging market stocks could get a reprieve in the coming months if the U.S. dollar has discounted policy shifts that either don't materialize or are watered down to varying degrees. The case could be made that U.S. exceptionalism providing a boost to U.S. stocks relative to the rest of the world could still be in its infancy, which could imply persistent dollar strength in the coming years. We enter the new year comfortable with our international exposure as a play on mean reversion and potential dollar weakness, but should the dollar stabilize or move lower and international equities outperform on a relative basis, this would likely present opportunities to rebalance and shift more heavily into the U.S.

Dollar Strength Has Been A Tailwind For U.S. Stocks



BONDS

Diversification Key As Interest Rate Volatility Likely To Persist

The 10-year Treasury yield continued to rise early in early January as trade/tariff rhetoric, U.S. government deficit and spending concerns, and additional signs of sticky inflation joined forces to put downward pressure on prices of higher quality, longer duration bonds. We believe the 10-year U.S. Treasury, specifically, is in the process of carving out a new trading range with a floor of support likely in the 4.40%/4.45% area, but with the upper end of the new range still to be determined and the topic of debate at the start of the year. At the time of this writing, the 10-year yield hovered around 4.75%, a level that provided resistance back in April of 2024 and proved to be the high for the year. But that was before immigration and trade uncertainty, as well as concerns surrounding the U.S. government's budget deficit took center stage and entered the equation for investors, so a break above that level and potential test of the 5% level could be in the cards this time around.

After the back-up in yields over the balance of 2024 and into the new year, long-dated Treasuries now more appropriately or adequately compensate investors for taking interest rate risk. However, investors still face a dilemma regarding when and to what degree to extend portfolio duration given a lack of clarity surrounding immigration and trade policies and, in turn, inflation over the coming quarters. With the 10-year yield again running up into last year's resistance, we would expect those seeking to lock-in these higher yields for longer to begin shifting capital farther out on the Treasury curve as yields creep higher and approach the October 2023 intra-day high yield of 5%.

In this environment, diversification across maturity buckets, segments of the fixed income market, and geographies will likely be rewarded, as attempting to call a top in yields and going all-in at that juncture is ill advised. Treasuries, both short and longer-dated issues, can play a valuable role, as can exposure to asset- and mortgage-backed securities along with investment grade and high yield corporate bonds, all of which should perform relatively well assuming the U.S. economy remains resilient. Abroad, for the first time in at least a half-decade, we are looking for opportunities to increase exposure to developed market sovereign bonds as total return can be attractive on a currency-hedged basis should the U.S. dollar remain strong in the coming year(s).

Credit Risk Still Preferable To Interest Rate Risk – For Now. Credit spreads on high yield corporate bonds widened and bonds cheapened over the back-half of December as portfolio rebalancing pulled capital out of riskier segments of the fixed income market that had outperformed over the balance of the year as a general risk-off tone took hold. However, high yield corporate bonds have fared well on both an absolute and relative basis to kick off the new year, recovering approximately half of what the Bloomberg U.S. Corporate High Yield Index lost in December as investors jumped at the chance to clip a 7.5% coupon after a pre-Christmas pullback.

The shorter duration profile of the High Yield Index has also provided a tailwind for the asset class as investors remain more comfortable taking credit risk than interest rate risk amid continued signs of sticky inflation. Undoubtedly, the upgrade cycle experienced in 2024 has increased conviction in the sub-asset class, as upgrades outpaced downgrades 2.5 to 1 over the course of the year but leaves the index weaker to start 2025. And with changes to immigration and trade policy likely in the coming months, and at least to some degree potentially additive to inflation, investors may demand higher yields to compensate them for moving into longer duration Treasuries and investment-grade corporate bonds. As investors grow more comfortable with policy shifts and the inflation outlook in the coming quarters, at some point it will likely be appropriate to extend portfolio duration to lock in higher yields farther out on the curve. However, we would be in no rush to do so as catalysts capable of forcing yields substantially lower and boosting total return for investors in higher quality bonds over the near-to-intermediate term are absent, in our view.

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