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Macro Memo

Year-End 2024

2025 Outlook: Buckle Up

2025 will be a year of change. In the final months of 2024, we witnessed the re-election of President Trump. In perhaps a surprise to many, the election was decisive enough to produce and declare a winner on election night. With the White House and both houses of Congress secured under Republican leadership, Trump and his team appear firm in their intentions to not waste a golden opportunity to enact significant policy changes. However, while Republicans will technically control Congress in the new year, their advantage in both the Senate and the House is extremely narrow. So though President Trump may have serious intentions for sweeping change, his ability to implement that change may prove a bit herky-jerky as proposed policy goes through the fits and starts of political negotiation. Establishment leaders from both sides of the aisle have already shown an unwillingness to grant unchallenged carte blanche to Trump's reforms. The political battle lines being drawn create the kind of uncertainty from which markets often jolt both higher and lower like a wild roller coaster, at least in the short term. Yet examination of macroeconomic, geopolitical, and financial market developments shows there are underlying secular trends offering investment opportunities for these changing, challenging times.

Macroeconomics:

From a macro perspective it is important to understand that, more than fundamentals, it is money that moves markets — and by money what I really mean is liquidity; and by liquidity, what I really mean is all of the balance sheet capacity in the world, including every available line of credit. Because money is fungible, liquidity is best measured on a global basis. When global liquidity is rising, it needs to find a home somewhere, and that often ends up being in investment assets, driving their prices higher. Conversely, when global liquidity is falling financial asset performance struggles.

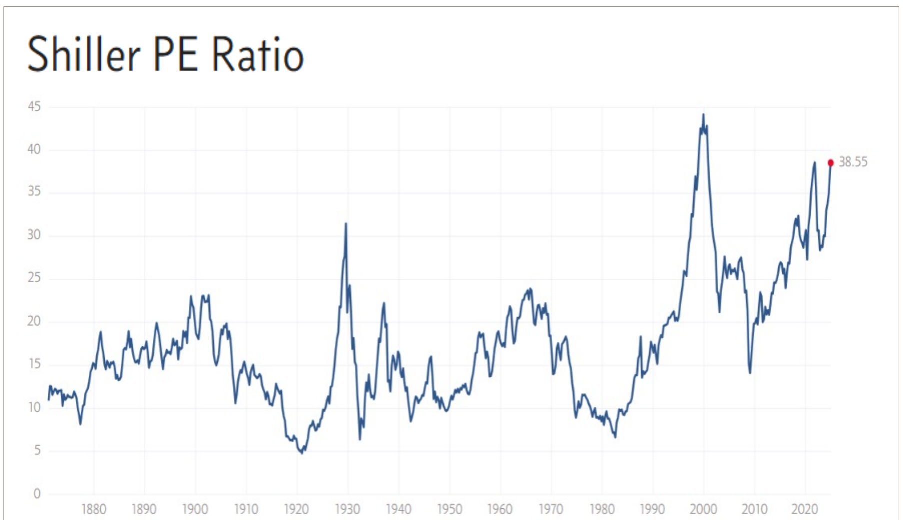
Liquidity could become an important factor in 2025. Many corporations took advantage of the very low interest rates during the COVID pandemic. Those loans are reaching the height of their maturity cycle, which means refinancing them will absorb a lot of liquidity from the system. In addition to the amount of corporate debt requiring refinancing, the US Treasury has financed much of its outstanding marketable debt with shorter term obligations, which also will require regular refinancing. According to Michael Howell of Crossborder Capital [1], beginning in 2025 global liquidity will need to expand by 8 – 10% annually for several years to accommodate these demands [2]. With US nominal GDP projected to grow at less than 4% annually [3], this kind of liquidity growth will likely prove inflationary.

The current market for 10-year Treasury bonds reflects this concern about potential inflation. When The Fed began cutting interest rates in September 2024, the 10-year Treasury yield was 3.65%. By December, Fed rate cuts added up to 100 basis points. Meanwhile, over that same period, 10-year yields counterintuitively climbed by 85 basis points. The bond market is telling the Fed it doesn't believe they have inflation under control. As 2025 unfolds we will see who got the call right.

Geopolitics:

In the world of geopolitics, President Trump acknowledged the global transition from a unipolar world to a multi-polar world by countering with the threat of punitive tariffs. These tariffs would be targeted at and levied upon those countries seeking to break away from the American system via de-dollarization. Why do other countries want to break away? Since the Global Financial Crisis (GFC) the US has, in the eyes of other countries around the world, exercised a reckless dollar policy. The unconventional monetary policy instituted by the US in the wake of the GFC undermined the purchasing power of foreign exchange (FX) reserves held as Treasury Bonds by those countries. While this motivated them to seek an alternative arrangement for global trade outside of the dollar system, the confiscation of Russia's FX reserves in response to the invasion of Ukraine intensified the perceived urgency. It was then that sovereign nations realized that their savings could be held hostage if ever they fell out of favor with Washington. It is becoming apparent the petrodollar system, which has governed global trade for the last five decades, is disintegrating. However, a firm alternative has not yet emerged.

Currency alliances are frequently accompanied by other strategic partnerships, often diplomatic and military ones. A change in currency and trade alliances reshuffles the deck of global coalitions, in this case towards a multi-polar world. Such a reshuffling is inherently uncertain and weakens trust and confidence, which are bedrocks to stability.

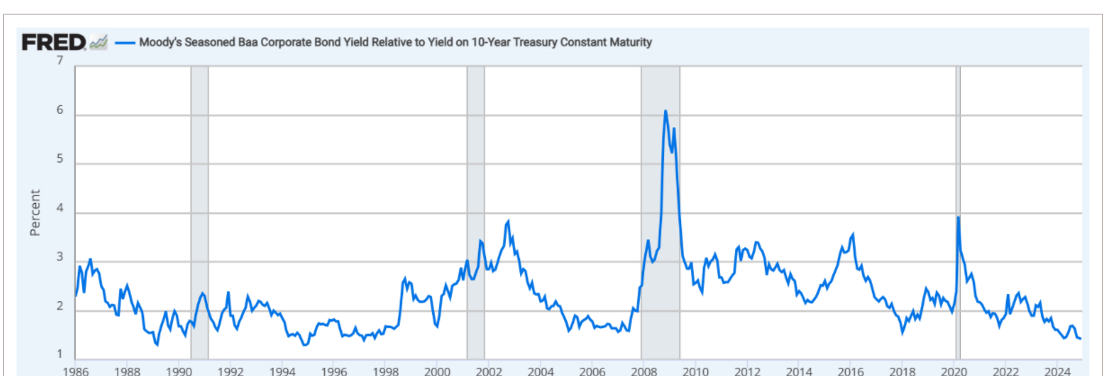


Source: Multpl.com

Financial Markets:

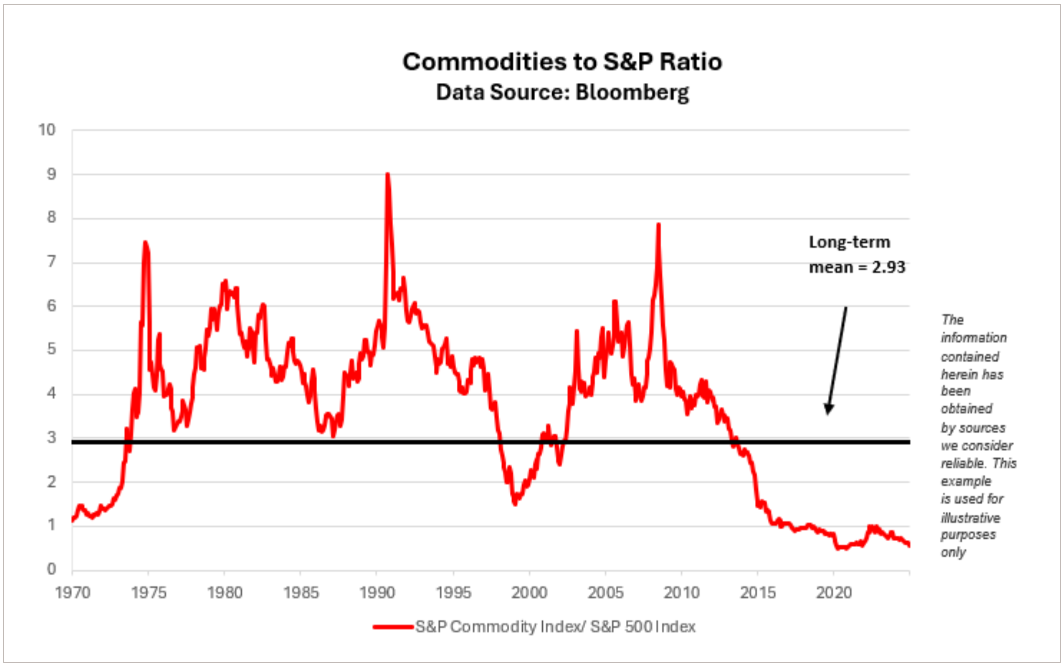
In the face of inflationary economic and destabilized geopolitical conditions, financial markets remain priced for perfection. The Shiller Price/Earnings ratio, a gauge of stock market valuations, is at the highest historical level in its 150-year history outside of the 2000 internet bubble. Other time-tested metrics confirm stocks are at frothy levels.

In addition, bond market spreads are historically tight. The US 10-year Treasury is the most quoted yield when referencing the bond market in general because it lacks default risk. All other bonds are considered of lower credit quality and are priced as a spread over Treasuries. When spreads are tight, as they are now, the market feels complacent and does not require much of a risk premium for lower quality bonds. Economic surprises can cause sudden and substantial changes in those spreads.



Source: Federal Reserve Bank of St. Louis via FRED®

Hard assets (commodities), on the other hand, remain undervalued relative to stocks. Historically, commodities have been a reliable store of value in times of inflation and geopolitical uncertainty. The chart to the left shows the



ratio of the S&P Commodity Index/S&P 500 Stock Index since 1970. When the graph is rising commodities are outperforming stocks and vice versa. Currently, commodities appear to be undervalued relative to stocks and given an outlook for rising inflation may deserve consideration.

Investors could look to precious metals, energy, and key industrial inputs like copper as hedges to potential inflation induced price fluctuations in other financial assets. Every portfolio is unique to its owner(s) and should be tailored to specific needs and willingness to assume risk.

Conclusion:

Given the issues addressed in this report, 2025 stacks up to be a year of surprises and changes. Such a backdrop could cause markets to experience greater volatility than they have recently. It could feel like a rollercoaster ride at times. An important point to remember is that rollercoasters eventually stop and, when they do, you can safely carry on with your plans. However, a sure way to get hurt on a rollercoaster is to try getting off the ride midway through. If you are not a fan of such rides, you might consider building up a larger reserve to see you through the year. I'm encouraging all my clients to put some thought into what ride you are ready, willing, and able to take before you get on– and then to adjust the risk of their portfolios appropriately. The same ride can look fun and exciting to one person and yet look just a bit too scary to another!

If you would like to discuss any of these ideas in more detail, I would welcome the conversation. Also, I would welcome your ideas regarding topics for future issues of The Macro Memo. Current ideas for upcoming issues include deeper discussions into the topics of global liquidity and the disintegrating petrodollar system. Please feel free to reach out.

[1] A firm whose mission is to monitor global liquidity
[2] https://www.ft.com/content/0a1c4332-fbe3-4f49-9a11-007646ad21b1
[3] https://www.statista.com/statistics/216985/forecast-of-us-gross-domestic-product/

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