Hawkish Cuts and Stormy Skies

Donald Trump's election as the 47th president of the United States, along with a Republican sweep in Congress, set the tone for 4Q24. Despite mixed fourth quarter results driven by shifting monetary policies and fiscal uncertainties, 2024 concluded with strong annual returns supported by a resilient U.S. economy, advancements in artificial intelligence (AI), and an improved outlook for inflation which gradually became muddled. While U.S. growth remained robust, global markets contended with slowing economic momentum, political strife, geopolitical tensions, and currency volatility. The Federal Reserve delivered a widely debated "hawkish cut," and investor attention turned toward the potential impacts of the Trump administration's policies, introducing significant uncertainties for 2025 and beyond.

At the December Federal Open Market Committee meeting, the Fed implemented a 25 basis point rate cut, bringing the federal funds target rate to 4.25%-4.50% and marking the fourth rate reduction in the current easing cycle. The Fed had a cautious tone, reflecting the slower progress in achieving its 2% inflation target, and the decision was not unanimous with Cleveland Fed President Beth Hammack dissenting. The "dot plot" projections signaled two rate cuts in 2025, down from the four estimated in September. The Summary of Economic Projections for Core PCE inflation was revised upward with expectations to remain at 2.5% through 2025 (the previous median expectation was 2.2% for 2025). The 2% target inflation rate was pushed back to 2027 from 2026. Markets were volatile following the decision, with bond yields rising, stocks declining, and the dollar soaring as the anticipated trajectory of interest rates was repriced. As of quarter-end, the markets priced in a high likelihood of 1-2 rate cuts in 2025, according to the CME FedWatch tool.

Inflation edged up slightly during the quarter. The Consumer Price Index (CPI) increased 2.7% year-over-year in November from 2.4% in September, whereas core CPI remained steady at 3.3% over the same period. Shelter (+4.7% YOY), representing roughly a third of the CPI basket, continued to account for a significant portion of the increase; however, it was the smallest annual increase since February 2022. The Personal Consumption Expenditures (PCE) price index (+2.4% YOY) came in below expectations in November but was up from 2.1% in September. Core PCE ticked up to 2.8% from 2.7% in September.

The labor market showed mixed signals with the unemployment rate (4.2%) slightly increasing in November since October (4.1%). Job openings continued to decline, with the Job Openings and Labor Turnover Survey showing vacancies falling to 7.7 million in November, the lowest since 2021. Non-farm payrolls grew by 227,000 in November, a strong recovery from the 36,000 jobs gained in October, which was influenced by the Boeing strikes and hurricanes. Wage growth experienced a slight decline during the quarter, according to the Atlanta Fed's Wage Growth Tracker, but remained above its historical 20-year average.

U.S. GDP grew 3.1% in real terms in 3Q, bolstered by an increase in consumer spending growth in both goods and services as well as exports, business investment, and federal government spending. The Philadelphia Fed's Survey of Professional Forecasters estimates a 2.2% GDP growth rate for 4Q, reflecting broad expectations for the economy to cool. The Conference Board Consumer Confidence Index fell to 104.7 in December as concerns over future business conditions and job security grew. In contrast, the University of Michigan Consumer Sentiment Index showed modest growth, reflecting an improvement in buying conditions.

The U.S. federal budget deficit swelled to $1.8 trillion (approximately 6.4% of GDP) in fiscal year 2024 as elevated borrowing costs due to rising yields further strained the fiscal outlook. Contention over the federal budget led to a heated debate in Congress in the weekend leading into the Christmas holiday. Congress averted a government shutdown, with House Speaker Mike Johnson navigating through pressure from both sides of the aisle, including demands from the president-elect and his ally Elon Musk to remove the debt ceiling or otherwise shut down the government. The stopgap bill funds the government through March 2025 and omitted the president-elect's debt ceiling demand.

The uncertainty around the direction and scale of the upcoming Trump administration's economic policy continues to trigger debate and carries risk across global markets. His proposed extension of the Tax Cuts and Jobs Act and efforts to

maintain a business-friendly administration have been lauded for their potential to spur growth but criticized for potentially exacerbating the federal deficit. Trump's proposed universal tariff on all imports and concentrated tariff on Chinese goods have sparked concerns over a potential trade war, supply chain disruptions, and upward pressure on inflation. These are a few of the many unknowns that the markets may have better clarity on after Donald Trump is sworn into office on Jan. 20.

Overseas, the euro zone's GDP grew 0.4% in 3Q. Ireland (+2.0%) and Spain (+0.8%) generated the strongest growth while Germany (+0.1%) narrowly avoided a recession. Political conflict reared its ugly head in Europe. In Germany, President Frank-Walter Steinmeier ordered parliament dissolved and set elections for February following the collapse of Chancellor Olaf Scholz's coalition. In France, the prime minister was ousted in a no-confidence vote by opposing party members due to his efforts in pushing through a national budget without a legislative vote. The government collapse left the country without a clear path toward reducing its fiscal deficit (approximately 5.5% of GDP), which newly appointed Prime Minister Francois Bayrou will attempt to address while appeasing a split parliament.

Japan's GDP grew at 1.2% in 3Q, supported by robust exports and a weaker yen. The Bank of Japan kept its policy rate steady at 0.25% amid concerns over potential deflationary risks. China continued to face economic challenges, with 3Q GDP growth decelerating to 4.6%, falling short of the government's 5% target. The property sector remained a drag on growth. Exports contracted as global demand softened, further compounding economic woes. The government's extensive stimulus measures may have yet to take hold but could be offset by tariffs from the U.S. in the near-term.

Global Equity

U.S. equities delivered modest gains in 4Q24 but capped off a second consecutive year of strong annual performance. The S&P 500 Index rose 2.4% in 4Q, bringing its one-year return to an impressive 25.0%. The mega-cap "Magnificent Seven" drove equity market strength in 2024, most notably from Nvidia and Tesla, which were up 171.2% and 62.5% YTD, respectively. Sector dispersion remained a dominant theme during the quarter. Growth-oriented sectors stood out, particularly Consumer Discretionary (+14.3%) and Communication Services (+8.9%), supported by strong consumer demand. Technology (+4.8%) also posted solid gains and finished the year as the top-performing sector (+36.6%) fueled by the enthusiasm around AI. In contrast, defensive sectors struggled during the quarter. Real Estate (-7.9%), Utilities (-5.5%), and Consumer Staples (-3.2%) faced headwinds of rising interest rates and moderating inflation expectations.

Growth and Value diverged further, reflecting investor preference for growth stocks, particularly in Technology. The Russell 1000 Growth Index outperformed with a quarterly return of 7.1%, while the Russell 1000 Value Index declined by 2.0%. Small cap stocks, as measured by the Russell 2000, were flat (+0.3%) during the quarter, with growth (+1.7%) outperforming value (-1.1%).

Developed non-U.S. and emerging market equities underperformed U.S. equities in 4Q as a stronger U.S. dollar and concerns over slower global growth were headwinds. The greenback strengthened against most major currencies, with the euro (-7.2%), yen (-9.0%), and pound (-6.6%) all depreciating. The MSCI ACWI ex-USA Index fell 7.6% in 4Q and ended the year with a gain of 5.5%. In developed markets, the MSCI EAFE Index declined 8.1% in 4Q, driven by broad weakness in Europe and the Pacific. Denmark (-21.5%) and Germany (-10.5%) were key detractors. Emerging markets similarly struggled, with the MSCI Emerging Markets Index declining 8.0% during the quarter. Taiwan (+3.3%) was the standout performer, fueled by Technology. South Korea sank (-19.2%) as the country endured political upheaval with President Yoon Suk Yeol being impeached and his allies ousted after declaring martial law. Latin America faced significant challenges as Brazil (-19.4%) and Mexico (-10.6%) fell sharply due to currency depreciation and political uncertainty.

Global Fixed Income

The U.S. bond market faced challenges across most sectors in 4Q but closed out the year primarily positive. U.S. Treasury yields soared, and the yield curve (2s/10s) experienced a notable steepening in 4Q. The 10-year yield increased from 3.8% to 4.6% and the 2-year yield rose from 3.7% to 4.3% as investors priced in resilient economic data, persistent

inflation concerns, and the anticipation of continued fiscal borrowing. The Bloomberg US Aggregate Bond Index fell 3.1% but managed to eke out a modest 1.3% gain for the year. Corporates outperformed U.S. Treasuries with excess returns of 82 bps while agency-backed mortgages, facing headwinds from increased rate volatility, underperformed (-13 bps). High yield corporates outperformed investment grade (Bloomberg High Yield Index: +0.2%) and were up 8.2% for the year. High yield spreads ground tighter and continued to trade through historical averages. Leveraged loans generated better returns in 4Q (S&P/LSTA Leveraged Loan Index: +2.3%) despite an uptick in defaults, according to JP Morgan, and the sector was up 9.0% for the year.

Municipal bonds were negative for the quarter but outperformed taxable bonds (Bloomberg Municipal Bond Index: -1.2%) while annual performance was positive (+1.05%). Lower-quality municipal bonds were in line with investment grade (Bloomberg Muni High Yield Index: -1.12%) and were up 6.3% for the year. While new issuance was met with solid demand for most of the quarter, there were signs of headwinds in December as fund flows turned negative for the first time since June 2024.

Non-U.S. fixed income returns varied greatly depending on currency exposure. The U.S. dollar surged roughly 8% versus a basket of six trade-weighted developed market currencies (DXY). The Bloomberg Global Aggregate ex-US Index (Hedged) rose 0.7% in 4Q but the unhedged index fell 6.8%. Emerging market debt faced similar challenges, with the JPM GBI-EM Global Diversified Index plummeting 7.0% in 4Q, while hard-currency EM debt declined 1.9% as measured by the JPM EMBI Global Diversified Index.

Closing Thoughts

On New Year's Eve the New York metropolitan area experienced a strong thunderstorm that eased up right before the Times Square Ball dropped. The flashes lit up the night sky and the booms were strong enough to shake homes, ours included (our nine-month-old didn't appreciate my wife and I barging into her room with champagne glasses in hand to check on her). Even if you're not superstitious or one for reading tea leaves, the roaring thunder over Times Square on the night of NYE marked a fitting end to another strong year for investors and perhaps (for those that are superstitious) a sign of what's to come in 2025 given the myriad of near-term variables. There is a wide degree of potential outcomes related to monetary, fiscal, and trade policy, while politics at home and overseas could highly influence the markets amid the deglobalization trend. Whether storms produce tailwinds in investors' favor or headwinds in 2025, Callan recommends adhering to a disciplined investment process that includes a well-defined long-term asset-allocation policy. Three cheers to another strong year.