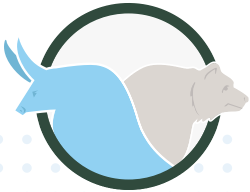
Commonwealth

2025 Outlook



Executive Summary: Resilience Amid Uncertainty

As we step into 2025, the economic and market outlook is a mix of excitement and complexity. Consumer spending is still strong, and artificial intelligence (AI) is reshaping how businesses operate, making it an interesting time for investors.

The bond market is particularly intriguing right now. The Federal Reserve's (Fed's) recent policy shifts have created some sweet spots for investors. U.S. Treasury yields look attractive, offering some of the best long-term value we've seen in years. That said, it's not all smooth sailing—the corporate bond market requires a careful eye, especially in high-yield areas where spreads are tight.

Over in the stock market, tech giants are stealing the show, powered by AI innovations that are changing the game. AI is the wild card that could completely transform how businesses operate. We're talking about potential shifts in corporate productivity and margins across virtually every industry. But here's the catch: these mega-cap tech stocks are priced with little room for error. Smart investors might want to look at mid-sized and smaller companies or explore international markets for hidden gems.

The political landscape adds another layer of complexity. We're looking at a new U.S. administration that could shake things up with potential tariff changes, tax revisions, and deregulation. Add in ongoing global tensions—particularly in regions like Eastern Europe and the Middle East—and you have a scenario that demands careful risk management.

Despite the challenges, there's real reason for optimism. Yes, the environment is dynamic, but if you remain adaptable and strategic, there are plenty of opportunities. The key is to stay informed, be flexible, and keep long-term investment goals in focus.

01 U.S. Economy: Steady Momentum Amid Slower Growth

02 Fixed Income: A Shifting Yield Landscape

03 Equity Markets: Balancing Growth and Valuation Pressures

04 Politics and Geopolitical Risks: New Administration, New Priorities

01

U.S. ECONOMY

Steady Momentum Amid Slower Growth

2024 was a year of surprising economic resilience. Despite widespread predictions for a slowdown, the U.S. economy powered through.

The labor market proved surprisingly resilient last year. Hiring slowed down, but instead of the mass layoffs everyone was bracing for, unemployment stayed steady. Even with the Fed turning up the pressure with restrictive monetary policy, employment held its ground, keeping consumer spending on track. While international trade poses challenges, domestic business and government spending provide a solid economic foundation as we enter 2025, creating a dynamic economic landscape.

Let's break down key economic drivers as we head into the new year.

Key Takeaway

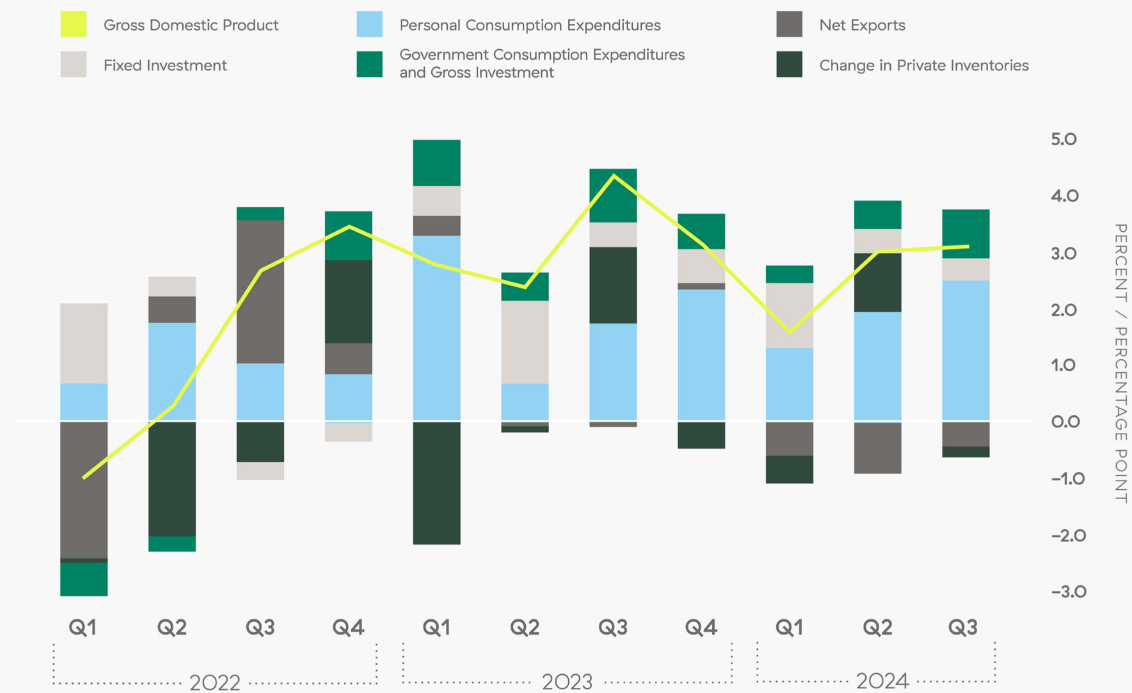
Even with uncertainties on the horizon, consumer spending should continue to drive the U.S. economy forward.

1. Consumer Spending

Consumer spending is the heart of the American economy, representing about two-thirds of overall gross domestic product (GDP). It stayed robust throughout 2024, and that strength is expected to continue into the new year. People kept their wallets open—with positive personal spending growth in the first 10 months of 2024—with consistent spending on services and goods. As you can see in Figure 1 below, personal consumption expenditures were the single largest driver of growth throughout the first three quarters of the year.

While growth is expected to moderate in 2025, even a slight uptick will continue the positive momentum of the past few years. Consumer spending growth is anticipated to slow in the new year, but this more measured pace would be welcome following three years of above-trend spending.

Figure 1. Contributions to U.S. GDP Growth



Source: Bloomberg (as of 12/29/2024). Contributions to U.S. GDP, quarter-over-quarter, seasonally adjusted annual rate.

2. Business Spending

Business spending is another fundamental component of the economy. It showed surprising strength in 2024, with positive growth in the first three quarters of 2024 supporting overall economic growth. Service sector confidence hit a two-year high in October, suggesting companies were feeling optimistic about the future as we approached year-end. Historically, when businesses feel good, they spend more—and that's exactly what we're seeing—a welcome sign for future business spending and investment.

3. Net Exports

This is where things get tricky. Rising trade deficits were a drag on the overall economy in 2024, and the 2025 forecast is uncertain. The incoming administration is likely to implement new tariffs, but the exact timing and scope of these trade restrictions are unknown. The potential for retaliatory measures from other countries adds another layer of unpredictability.

Given the uncertainty and recent lackluster results, net exports are not expected to be a major driver of growth to start 2025.

4. Government Spending

Government spending grew at a healthy rate in 2024, supporting overall economic growth. Looking ahead to 2025, while spending is expected to slow, it will still contribute positively to economic growth.

The new administration has signaled a focus on cost-cutting, although the exact details are uncertain. It is likely, however, that federal spending will look quite different this year than it did in 2024.

The Big Picture

Ultimately, the economy is in a relatively good place, thanks to resilient consumers and solid business investment. Political uncertainty does make forecasting trade and government spending a challenge. While we'll likely get more clarity as the new administration's policies take shape, the current outlook calls for steady, albeit slower, economic growth in 2025.

02

FIXED INCOME

A Shifting Yield Landscape

2024 was a year filled with changing expectations and choppy markets. After months of speculation, the Fed finally kicked off its policy easing. This change in policy, along with decreased expectations of an economic slowdown, sparked movement across the interest curve and spread environment. As a result, we see a solid opportunity set across fixed income, though investors should stay cautious and active given expensive valuations.

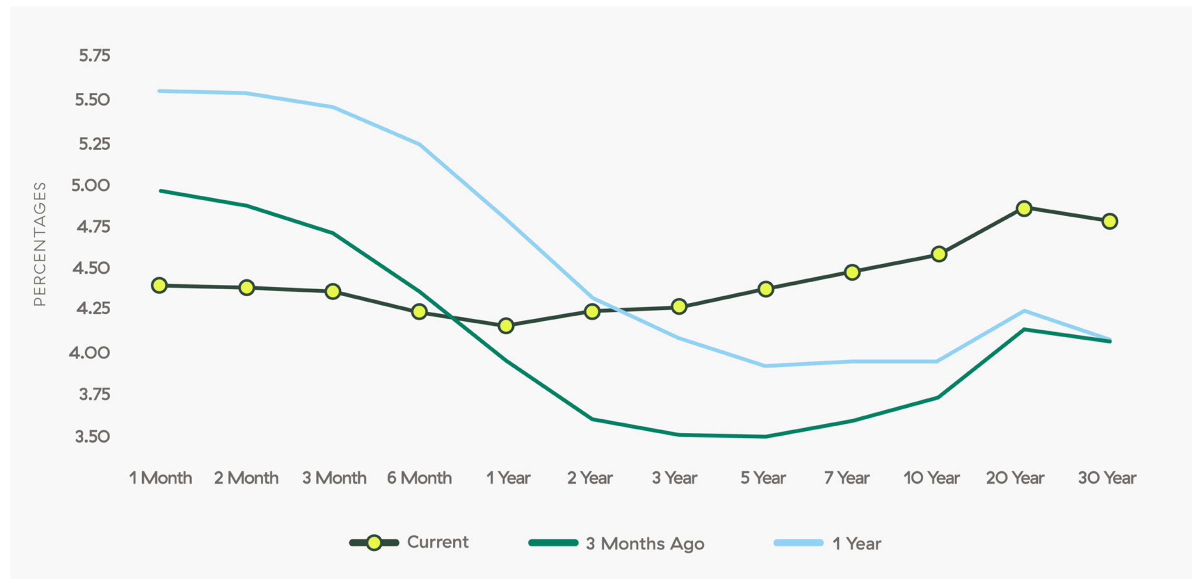
U.S. Treasury Yields Making Moves

From the start of 2024 until September, we saw most yields on the U.S. Treasury curve move noticeably lower. When the Fed made its first interest rate cut in September, we saw a *significant* move in the U.S. Treasury curve. Since the first cut, the short end of the curve has moved lower alongside the official Fed policy rate. But we also saw a quick and significant move higher in longer-term rates since the start of the fourth quarter (see Figure 2).

Key Takeaway

There are still opportunities to capture yield, but with rates and spreads constantly shifting, investors need to stay active and selective with their allocations.

Figure 2. U.S. Treasury Yield Movements



Source: U.S. Department of Treasury (as of 12/31/24)

The movement of the Treasury curve has been a short-term challenge for duration-sensitive assets, but it has made a stronger case for duration over the long haul. As short-term rates begin to drop with continued cutting from the Fed, investors can start looking further ahead to lock in current yields for longer.

But here's the catch: not all opportunities are equal. Throughout 2024, we saw notable variations in market spreads. They moved from tight to historically tight levels in below-investment-grade assets, while spreads in areas like agency mortgage-backed securities widened beyond investment-grade corporate credit. With such varying levels of compensation for credit risk, investors should be selective about where they deploy capital across markets.

Opportunities Worth Exploring

U.S. Treasuries
With yields near decade highs and a steepening yield curve, Treasuries offer an opportunity to add high-quality duration with the potential for an attractive long-term total return.

High-Quality Corporate Bonds
Despite tight spreads, the fundamentals here are still strong. The Bloomberg U.S. Corporate Bond Index was yielding about 5.35 percent (as of December 31, 2024), providing a high-quality alternative to government debt.

High-Yield Bonds
Below-investment-grade corporate credit saw spreads go to historically tight levels in 2024, driving strong performance. Fundamentals look solid, but investors should be cautious and active given the current valuations.

Municipal Bonds
Here, yields remain compelling. The Bloomberg Municipal Bond Index hit a yield-to-worst of 3.74 percent in November 2024, translating to a taxable-equivalent yield of about 5.94 percent for U.S. investors in the top federal tax bracket.

03

EQUITY MARKETS

Balancing Growth and Valuation Pressures

2025's equity performance hinges on companies' meeting sky-high expectations. Valuations have crept back toward 2020 peak levels, with earnings growth expectations justifying these prices—but leaving the market with little room for error.

Let's talk numbers. S&P 500 companies have averaged earnings per share growth of 7.5 percent since 2001. After growth of only 5 percent in 2022 and 0 percent in 2023, 2024 is expected to show above-average growth of 9 percent. The twist? The growth in 2024 was primarily from margin expansion, not revenue increases, as was the case in 2021 and 2022.

In 2025, analysts are expecting around 15 percent growth, which will continue to be driven by margin growth, with revenues only expected to grow by only 5 percent. While margins are already near pre-pandemic highs, the AI revolution could boost productivity and help increase margins.

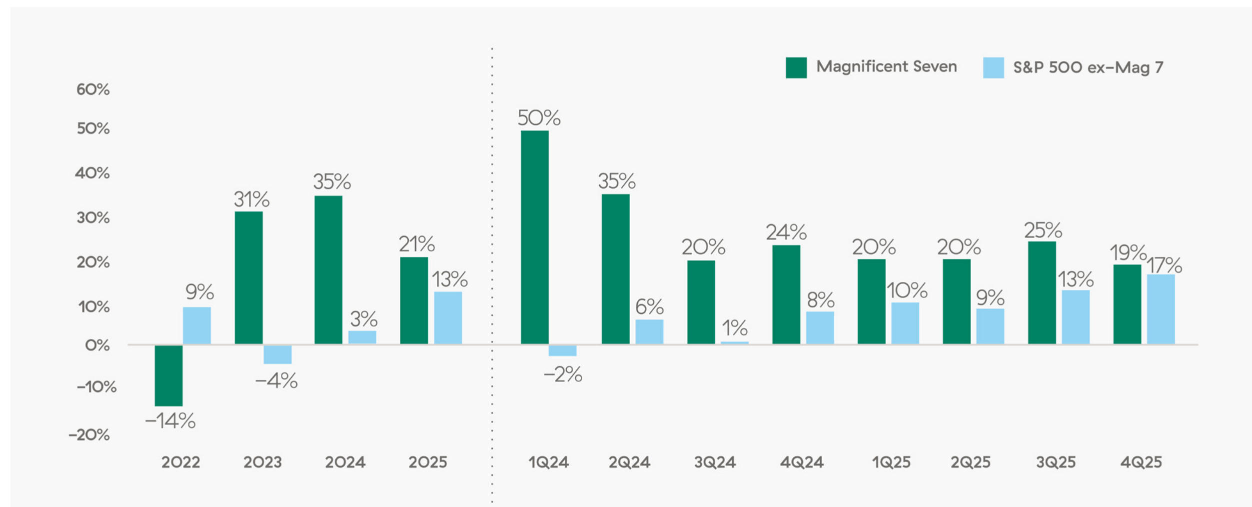
The Magnificent Seven: Driving the Market

So far, the gains from AI have been primarily felt by some of the largest companies in the S&P 500 Index. The "Magnificent Seven" tech giants—Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla—are now commanding more than 30 percent of the S&P 500 Index and will be key drivers of both earnings growth and performance in 2025, regardless of what the rest of the index does. In fact, their projected earnings growth is nearly double the rest of the index through 2025 (see Figure 3).

Key Takeaway

While high valuations pose risks, the solid earnings outlook provides cautious optimism for U.S. equities in 2025.

Figure 3. Earning Growth: Mag 7 Vs. Rest of the S&P 500



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Earnings estimates for 2024 are forecasts based on consensus analyst expectations. Share of returns represent how much each group contributed to the overall return. Numbers are always positive despite negative performance in 2022. Guide to the Markets-U.S. Data as of November 19, 2024.

But we must also consider the risk. These stocks are trading at close to a 40 percent premium to the rest of the index, meaning any missed expectations could hit hard. Over the past few quarters, companies that have missed earnings have suffered more than average—a trend we expect to continue.

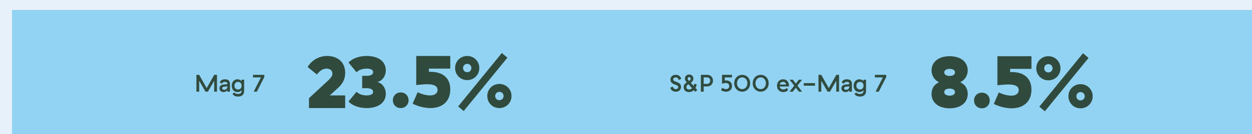
The S&P 500 should continue to appreciate in the single digits over the next year, with valuations beginning to come down—particularly for the mega-cap names—as this investment cycle decelerates. Those who are investing for growth will need to see improving profits to justify their investments and could broaden out performance.

Looking Beyond the Giants

While big tech dominates, there are other investment opportunities to consider:

- Mid-cap stocks offer similar growth potential to large-cap stocks with lower valuations.
- Small-cap stocks are showing signs of recovery after years of underperformance.
- Internationally, equities are trading at very favorable valuations. Still, the catalyst for a recovery may not come in 2025 given the possibility of increasing tariffs, and recovering economies that have lagged behind the U.S.

Profit Margins: Mag 7 Vs. Rest of the S&P 500



04

POLITICS AND GEOPOLITICAL RISKS

New Administration, New Priorities

A new U.S. administration brings uncertainty in trade, taxation, and regulation—and Washington is experiencing another dramatic power shift. But here's the reality: while political changes create buzz, it's key to look beyond the headline drama.

As 2025 begins, Washington is experiencing a power shift with President Trump's return. This time, he's entering office under different economic conditions: stronger U.S. growth, elevated inflation, and higher interest rates compared to 2017. These factors could significantly influence his administration's priorities. And with midterm elections just two years away, Republicans would obviously prefer to run on a stronger economy.

Key Takeaway

The most important investment you can make right now is staying curious, adaptable, and focused on the long term, not just the immediate future.

Critical Focus Points

Tariffs
Trump has proposed broad tariff increases: 60 percent on goods from China and 10 percent on goods from all other countries. But a more measured approach might be used to avoid triggering higher inflation. Or, potentially, the threat of tariffs could be used to negotiate trade deals that are more favorable to the United States.

Immigration
While campaign rhetoric suggested mass deportations, a gradual strategy might be employed to protect the labor pool, given the relatively high number of job openings. Or the Republican Congress may draft an immigration bill that satisfies multiple priorities of the current administration, addressing several issues in a single piece of legislation.

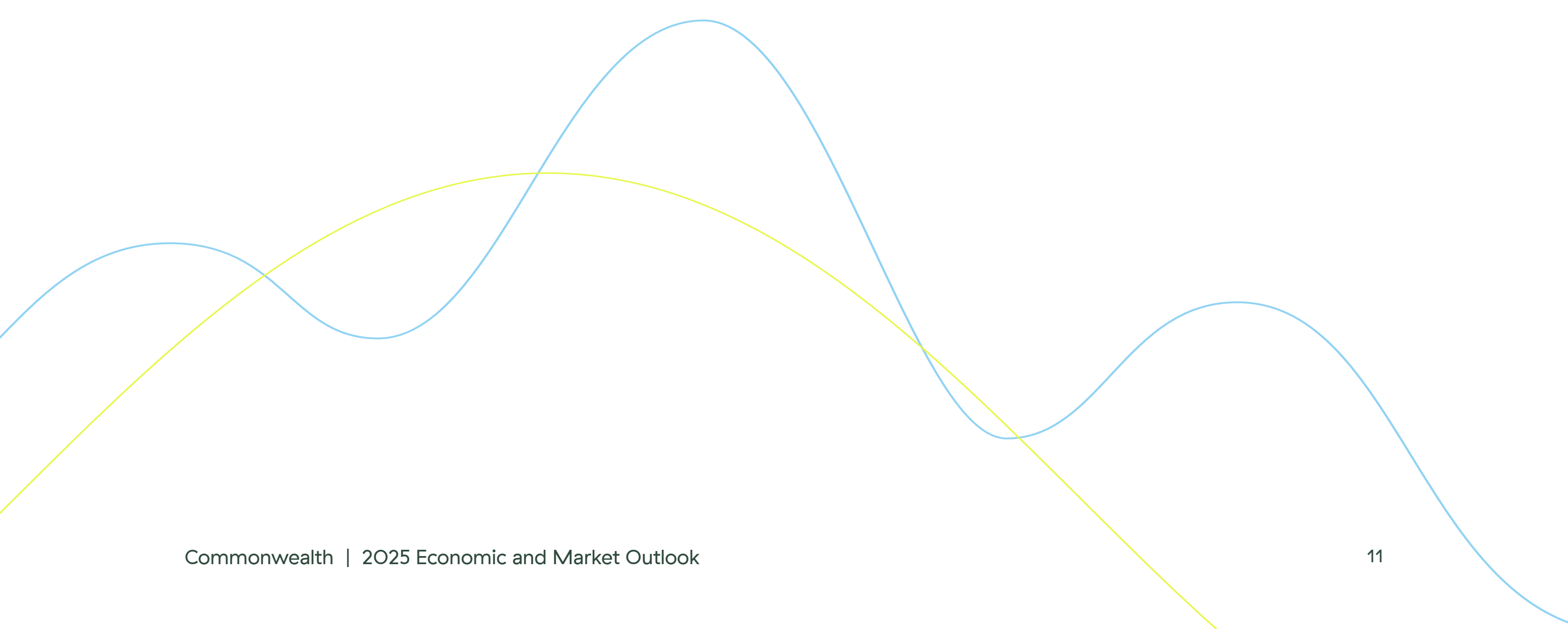
Tax Policy
The 2017 Tax Cuts and Jobs Act (TCJA) is set to sunset at the end of 2025, making tax policy a key economic issue. The Trump administration may seek to extend the bill and push for additional tax cuts, particularly the lowering of the corporate tax rate. The potential economic impacts of any new tax cuts likely won't appear until 2026.

Deregulation
The new administration and Congress will likely push to reduce regulations in key industries like the environmental, health care, and financial sectors. This deregulation could quickly boost corporate profits.

The Deficit and Government Debt
The formation of a new Department of Government Efficiency could shine a brighter spotlight on the deficit and debt. Any spending reduction efforts could prompt markets to assess impacts on economic growth and long-term interest rates.

Geopolitical Hotspots
The Russia-Ukraine war and tensions between Israel, Hamas, and Iran will remain critical in 2025. Funding decisions for Ukraine and Israel will reveal whether these conflicts might escalate or de-escalate. Further, the Trump administration's approach to Israel could significantly impact Iran relations.

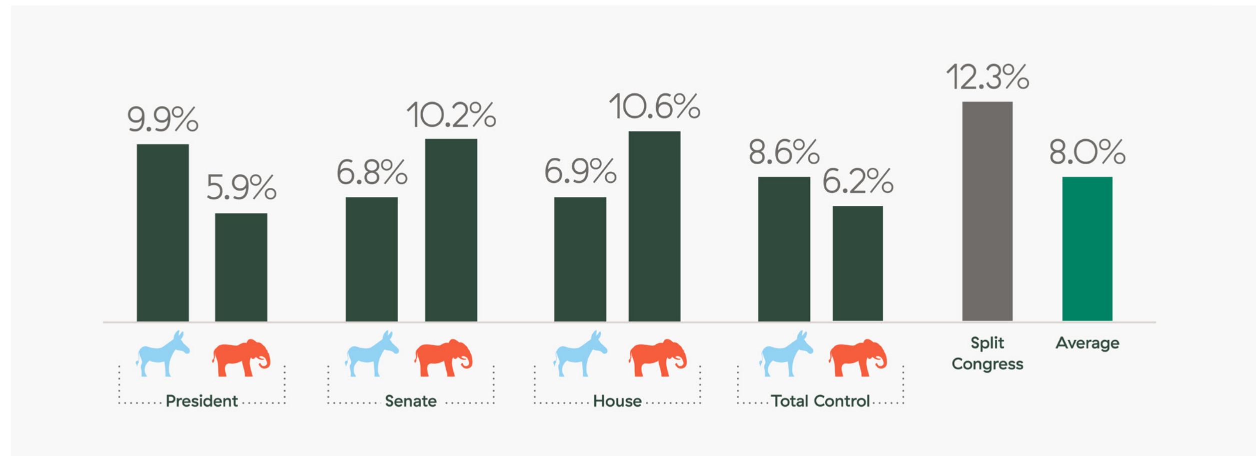
Regarding China, the administration faces a complex balancing act. While China is a crucial economic partner, it's also a significant competitor, particularly in areas like technology sharing.



The Long View

Here's something fascinating: historically, markets have shown remarkable resilience, regardless of who's in the White House. More than six decades of data show stocks tend to go up, no matter which party controls Congress or the White House (see Figure 4).

Figure 4. S&P 500 Average 2-Year Post-Election Return (Annualized), 1940—2022



Source: Mercer, Bloomberg (as of 12/31/2023)

Navigating Market Moves

There's almost always a sell-off every year at some point, no matter who controls the White House. But timing markets is hard. Over time, time stocks rise through economic ups and downs, inflation fears, and geopolitical conflicts.

Volatility and market declines always create opportunities. But they aren't always easy to find among the headlines. The key is to pay attention to political headlines but not be overly swayed by them. Stay invested, remain adaptable, and keep your eye on long-term performance.

Contributors

Brian Price, CFA®
Managing Principal,
Investment Management and Research

Chris Fasciano
Chief Market Strategist

Sam Millette
Director, Fixed Income

Rob Swanke, CFA®, CAIA
Senior Investment Research Analyst

Certain sections of this commentary contain forward-looking statements as of the date published that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Opinions are subject to change without notice.

Bonds are subject to availability and market conditions; some have call features that may affect income. Bond prices and yields are inversely related: when the price goes up, the yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. Municipal bonds are federally tax free but may be subject to state and local taxes, and interest income may be subject to federal alternative minimum tax (AMT). Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, they offer a fixed rate of return and fixed principal value. U.S. Treasury bills do not eliminate market risk.

The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Bloomberg U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The Bloomberg Municipal Bond Index serves as a benchmark for long-term, investment-grade, tax-exempt municipal bonds. All indices are unmanaged, and investors cannot invest directly into an index. Unlike investments, indices do not incur management fees, charges, or expenses.

Investments are subject to risk, including the loss of principal. Past performance is no guarantee of future results.

This communication should not be construed as investment advice nor as a solicitation or recommendation to buy or sell any security or investment product.

Commonwealth Financial Network® | Member FINRA/SIPC | Toll-Free: 800.237.0081 | commonwealth.com

Commonwealth