FOCUS PARTNERS | WEALTH

Q1 2025

Quarterly Outlook

Perspectives on Markets and Economic Conditions

Portfolio allocations and investments are not adjusted in response to market news or economic events; however, we evaluate and report on market and economic conditions to provide our investors with perspective and to put portfolio performance in proper context.

U.S. Economy Powers Forward, Fed Policy Becomes Cloudy

Main Takeaway

The U.S. economy continued on an impressive streak in 2024 with third-quarter real GDP growth of 3.1% annualized. Growth outside the U.S. remains weak with third-quarter GDP growth in the eurozone and Japan coming in at 0.4% and 1.2% respectively. U.S. unemployment remains low, and job growth remains positive, although the pace of hiring has slowed this year. Inflation remains sticky in the U.S. as well as globally with the latest U.S. CPI reading at 2.7%, still above the Fed's 2% target.

Top Risks

Aggressive tariff policies could increase price pressures while also having the potential to lead to a larger scale trade war, which could have significant negative impacts on global economic growth. In recent months, unemployment has been rising and cyclical areas of the economy (such as manufacturing and residential construction) have been softening. The U.S. federal debt continues to be a long-term concern with the potential to force interest rates higher for much longer, especially at the long end of the yield curve.

Sources of Stability

The U.S. economy remains strong and is unlikely to experience a major slowdown in 2025. U.S. household balance sheets remain strong, which has spurred robust consumer spending. The U.S. also continues to benefit from a surge in corporate and research spending on the back of artificial intelligence (AI). This "AI boom" has spurred massive investment into the development of AI itself as well as the infrastructure supporting it, including semiconductors, data centers, and energy infrastructure.

ECONOMIC SPOTLIGHT:

While History Doesn't Repeat Itself, It Often Rhymes

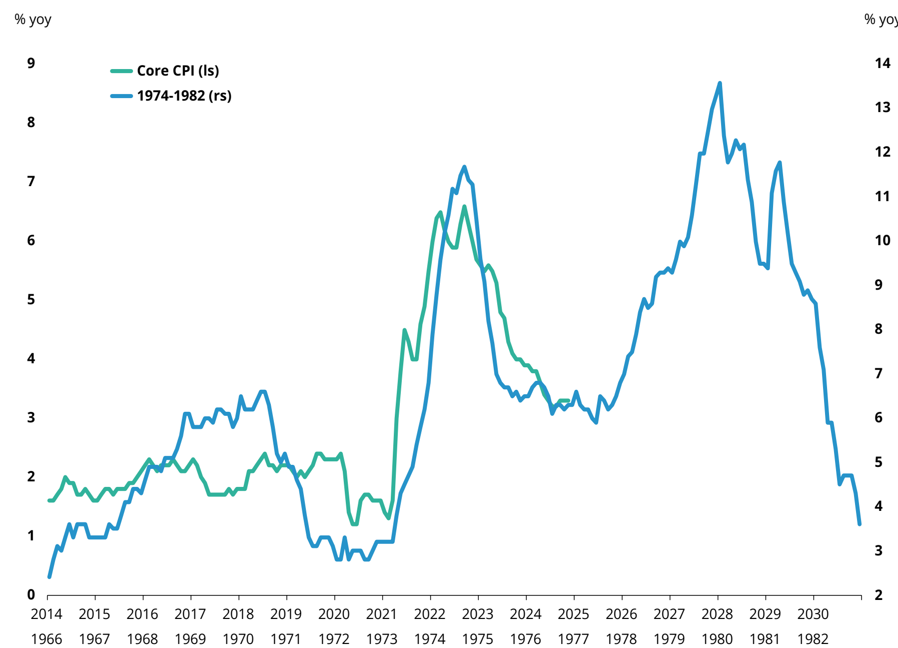
When the Federal Reserve began lowering the federal funds rate in September, it did so against a backdrop of moderating inflation and a cooling job market. Year over year, the Consumer Price Index (CPI) had declined from 3.5% in March to 2.6% by August, while over the same period, job growth slowed significantly—from a three-month average of 267,000 jobs to just 113,000.

Fast forward to today, and the picture has shifted. Year-over-year CPI ticked up slightly to 2.7% in November, suggesting inflationary pressures may not have fully subsided. Meanwhile, the labor market appears balanced, with the economy adding 212,000 jobs in November and 256,000 in December based on preliminary estimates. Layoffs remain below pre-pandemic levels, further signaling labor market stability.

As the chart shows, the current inflationary cycle bears striking similarities to the challenges the Fed faced in the 1970s. By lowering the target rate before inflation falls sustainably below its 2% goal, the Fed risks reigniting inflation, potentially necessitating even steeper rate hikes in the future.

At its most recent meeting, the Fed acknowledged the upside risks to inflation and responded by scaling back its projections for rate cuts in 2025 and 2026. Looking ahead, policymakers emphasized that they are "not on a pre-set path" and that decisions "will depend on incoming data," signaling a commitment to avoiding the policy missteps of prior Fed regimes.

Inflationary Cycle Resembles Challenges Faced in the 1970s



Source: BLS, Bloomberg, Apollo Chief Economist.

Key Areas to Watch

U.S. Economic Growth

The U.S. economy continues to show signs of strength with the Atlanta Fed forecasting fourth-quarter real GDP growth at 3.2%[1], well above the Congressional Budget Office's long-run growth estimate of 2%. Growth continues to be fueled by consumer spending, stimulative U.S. fiscal policy (such as the CHIPS Act and Inflation Reduction Act), as well as robust spending on AI, energy transitions, and data centers.

Inflation Trajectory

Inflation continues to hover above the Fed's 2% target with recent reports showing a small re-acceleration. In November, CPI came in at 0.3%, or 2.7% year over year, up from 2.5% in August. Motor vehicle insurance and shelter costs remain two of the biggest drivers of inflation over the past 12 months, having risen 12.7% and 4.7% respectively.[2]

Monetary Policy

The Fed has continued the easing process by lowering the federal funds rate by 0.25% at both its Nov. 7 and Dec. 18 meetings, leaving the fed funds target rate in the range of 4.25%-4.50%. The most recent cut has been described as hawkish as the Fed sees risks that it will take until 2027 to bring inflation down to 2%, one year longer than anticipated in September. The Fed's Dot Plot also showed the committee is expected to slow down the pace of future cuts with only two expected in both 2025 and 2026 and one cut in 2027.

Fiscal Policy

The U.S. Treasury Department's year-end budget report showed a deficit of $1.8 trillion, or 6.4% of GDP.[3] Larger fiscal deficits coupled with higher interest rates mean the U.S. government now spends more on net interest expense than on defense.[4] Unfortunately, lowering the fiscal deficit is becoming increasingly more difficult as mandatory spending on entitlement programs like Medicare and Social Security has ballooned from roughly 30% of federal spending in the 1960s to 60% today.[5]

Key Areas to Watch (Cont.)

Labor Market

The labor market has slowed this year but appears to be stabilizing. The unemployment rate has held steady at 4.1%-4.2% over the past three months, coming in at 4.2% in November.[1] Job growth bounced back from a poor October, hampered by two major hurricanes as well as labor strikes, with 256,000 jobs added in December. Labor Department data shows that the quit rate increased slightly to 2.1% in October[2] but remains on a downward trend since 2022, a sign workers have become more pessimistic.

Consumer Spending

Consumer spending remains robust at a 3.7% growth rate in the third quarter. The Conference Board's Consumer Confidence Index hit 111.7 in November, a 2.1 point jump from October's 109.6 reading. The Board's Expectations Index—which reflects consumers' short-term outlook for income, business, and labor market conditions—rose to 92.3, well above the recession-signaling threshold of 80. Compared to October, consumers were substantially more optimistic about future job availability.

Global Economy

Global economic growth outside the U.S. has been slow with the eurozone, U.K., and Japan posting GDP growth of 0.4%, -0.1%, and 1.2% respectively. Inflation has also risen globally. In response, central bankers in the U.K. and Japan held off on rate cuts while the European Central Bank lowered its target rate 0.25% to 3.00%. Looking ahead, market participants expect the eurozone, U.K., and Japan to avoid recession, but growth prospects remain challenged.

Yield Curve

Despite the Fed lowering interest rates in the fourth quarter, we saw a large uptick in yields across the Treasury curve. Yields on 2-year, 10-year, and 30-year Treasuries rose 0.23%, 0.94%, and 0.74% respectively. Yield curves also steepened with the spread between the 2-year and 10-year Treasury widening by 0.16% to 0.25%. Rates were driven higher as the market digested the likelihood that the Fed would have to pull back on the pace of future rate cuts relative to their expectations in September.

Economic and Market Snapshot

Global equity markets were a mixed bag in the fourth quarter with U.S. markets producing modest returns while international stocks were down sharply. Small value lagged over the quarter both domestically and internationally, with U.S. small value stocks underperforming the broad U.S. market by 3.69% and international small value trailing broad international markets by 0.69%.

Fixed income returns in the U.S. were negative in the fourth quarter as rates rose sharply over the quarter. The increase in rates was driven by expectations that the Fed would have to slow the pace of rate cuts in 2025 to combat sticky inflation.

Major Asset Class Returns*

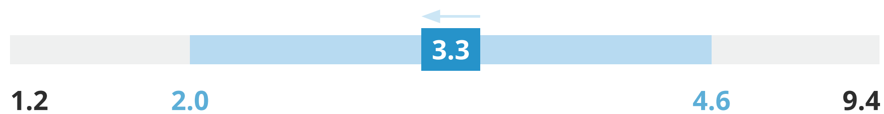
Q4 2024		Quarterly Return	Past 12 Months
Stocks			
U.S. Stocks	▲	2.6	23.8
International Stocks	▼	-7.5	4.4
Emerging Markets Stocks	▼	-7.9	7.1
Bonds			
U.S. Government Bonds	▼	-1.7	2.4
Global Bonds	▲	0.2	4.3

*See Appendix on page 8.

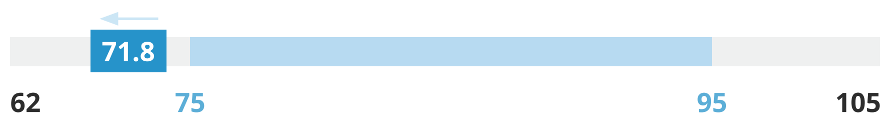
Key Economic Indicators*

Real GDP Growth (%)

Core CPI (%)

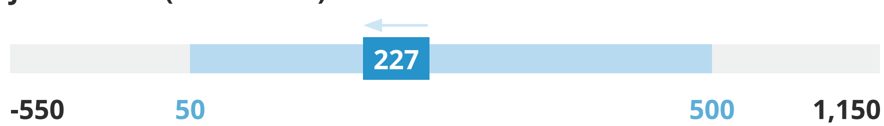


Consumer Sentiment



Unemployment Rate (%)

Jobs Added (Thousands)



Investment Planning Implications

Where do markets go from here?

Market concentration. The S&P 500 index continues to become more concentrated. The combined weight of stocks in the index that weigh 3% or more is at an all-time high of roughly 30%. Investing in the S&P 500 gives the impression that you are buying 500 different stocks and diversifying your investments, but the reality is that you are buying a highly concentrated portfolio.

New administration policies. It is far too early to assess the impact of potential new policies following Donald Trump's election as U.S. president. That said, if he does implement his key policy objectives—lower taxes, higher tariffs, and reduced immigration—that could lead to higher equity prices, higher inflation, higher interest rates, and a stronger dollar.

Interest rate volatility. The future path of interest rates became even more cloudy following the latest Federal Open Market Committee (FOMC) meeting. The Fed updated its dot plot, lowering the expected number of rate cuts in 2025 from four to two, but the market appears less optimistic with fed funds futures pointing to only one rate cut next year.

What are the investment planning implications?

Tune out the forecasts. Investors naturally want to focus on forecasting the future (which is unknowable) instead of focusing on what they can control: the risk they are taking. The start of the year is the perfect time to assess your need, willingness, and ability to take risks to make sure your plan is still best suited to meeting your long-term goals.

Overpriced growth. Valuations for large-cap growth stocks remain significantly elevated. Trailing 12-month (TTM) price-to-earnings (P/E) ratios for the Russell 1000 Growth index are at 37, well above the index's average of 24.6 (November 1999 to November 2024). Given these inflated valuations, we would expect more muted returns from this asset class over the long run.

Cash isn't king. According to the Investment Company Institute (ICI), over $6.75 trillion was sitting in money market funds as of Dec. 18, 2024, despite the fact that money market rates have declined since the Fed began cutting interest rates. The yield on the Fidelity Government Cash Reserves Fund (FDRXX) has fallen 0.70% from Sept. 17 through Dec. 31.

About the Focus Partners Team

Kevin Grogan, CFA, CFP®

Chief Investment Officer, Systematic Strategies

Kevin helps lead the firm's Systematic Investing strategies, portfolio management, and fixed income teams. He has co-authored three books on investment topics and enjoys educating others on concepts that will have a tangible effect on their financial lives.

Blerina Hysi

Director, Fixed Income

Blerina works with fixed income and advisory teams to help construct and maintain customized bond portfolios, with an eye toward finding the best way to implement comprehensive financial plans. Her duties include fixed income analysis, bond trading, and building tailored, client-focused portfolio solutions.

Brian Haywood

Investment Strategy Advisor

Brian takes pride that in an industry where decisions are often driven by commissions and not conscience, he and his team spend their time customizing portfolios on behalf of clients, upholding their fiduciary responsibility by doing what's in their best interest.

Additional economic and investment resources are available at **wealth.focuspartners.com/resources**

Appendix

Page 1:

Bureau of Economic Analysis, European Union, Reuters, Institute for Supply Management, and United States Census Bureau.

Page 2:

FRED Economic Data, Bureau of Labor Statistics, Consumer Price Index, Bloomberg, Apollo Chief Economist.

Page 3:

[1] Atlanta Fed GDPNow estimate as of December 18, 2024.

[2] U.S. Bureau of Labor Statistics. 12-month percentage change, Consumer Price Index, selected categories. August 2024.

[3] U.S. Treasury Department. "Joint Statement of Janet L. Yellen, Secretary of the Treasury, and Shalanda D. Young, Director of the Office of Management and Budget, on Budget Results for Fiscal Year 2024" October 18, 2024.

[4] Investopedia. "A Record $1.2 Trillion Interest Payments Are Blowing Up The Federal Budget," September 13, 2024.

[5] Apollo. "More Mandatory Government Spending," October 16, 2024.

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[1] U.S. Bureau of Labor Statistics. "Employment Situation Summary" December 6, 2024

[2] Brookings Institute. "The Softening Labor Market Is Still Growing" December. 5, 2024

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Major Asset Class Returns: The index representation for the Major Asset Class Returns is as follows: U.S. stocks are represented by the Russell 3000 Index, international stocks by the MSCI World ex U.S. IMI Index, emerging markets by the MSCI Emerging Markets IMI Index, U.S. government bonds by the Bloomberg Government Intermediate Total Return Index, and global bonds by the FTSE World Government Bond 1-5 Year Index. Past performance is not a guarantee of future results. Indexes are unmanaged baskets of securities that are not available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Information from sources deemed to be reliable, but its accuracy cannot be guaranteed.

Key Economic Indicators: Sources: Bureau of Economic Analysis (BEA) for real GDP growth. Real GDP is the annual rate of change of real gross domestic product, seasonally adjusted. Bureau of Labor Statistics (BLS) for core CPI. The core consumer price index (CPI) is the annual rate of change, seasonally adjusted, and excludes food and energy. Consumer sentiment is from the University of Michigan's consumer sentiment index. Unemployment rate is reported by the BLS, and jobs added is based on nonfarm payroll employment reported by the BLS. Retrieved from FRED, Federal Reserve Bank of St. Louis. For all indicators, the boxed number reflects the latest reading, and the line above the box shows the change since the last update. The shaded areas reflect normal readings compared to history (based on the 25th-75th percentile of historical measures), while areas outside the dark blue reflect more extreme readings compared to history. The ranges are based on the percentile values of historical readings for each economic figure. The lowest number reflects the 5th percentile value, the bottom of the blue range reflects the 25th percentile, the top of the blue range is the 75th percentile, and the highest value reflects the 95th percentile. All ranges are based on the full period available. To account for population and employment, the ranges presented for jobs added are based on the percent change in employment numbers, using December 2022 as the base year.