Monthly Newsletter

JANUARY 2025

Q1 OUTLOOK

Change Is in the Air

Last year, the economy grew by an estimated 2.7%, inflation dropped and the Federal Reserve cut short-term rates. All this and more helped the stock market reach new records. Can the stock market keep going higher this year? What's in store for inflation and interest rates?

Looking Back, Looking Ahead

Coming into 2024, there was an expectation the Fed would reduce short-term interest rates and normalize policy, aiming to ease the economy into a soft landing. But as the year progressed, the economy kept growing and businesses outperformed earnings expectations, while inflation fell. All this together contributed to a stellar year for equities with the S&P 500 delivering roughly 25% by year-end and reaching new all-time highs throughout the year.

As we turn to 2025, the bar is higher on all fronts. The Fed has signaled it's taking a break from further rate cuts in the near term. That's because progress on inflation continues to stagnate, with pockets around shelter and services well above target, keeping pressure on both the Fed and bond markets. After back-to-back years of 20%-plus returns for stocks and continued high earnings growth expectations for the S&P 500, investors are on edge. In these situations, any shock or significant earnings miss could cause a meaningful pullback.

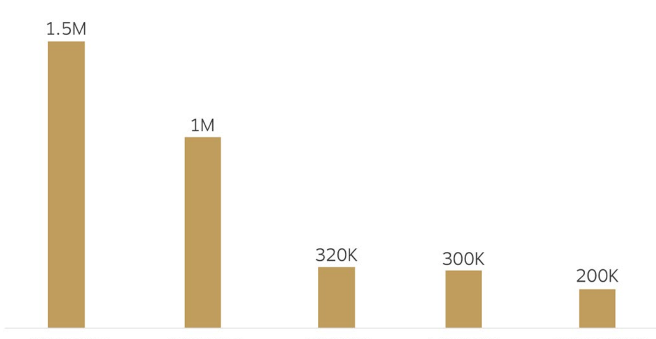
Additionally, we expect Washington, D.C., to be a plentiful source of volatility this year. From tariffs and immigration to budget and debt ceiling talks, we need to be prepared for a different market environment in 2025, as some of the trends that have contributed to the recent bull market may start to change.

Much of the change we're expecting this year is because of a new administration in the White House, a new Congress and the new policies they will introduce. We're looking at these policies through a purely economic lens and considering the potential impact on our investment strategy.

Immigration Reform and Other Policy Proposals

Restricting immigration was a central campaign issue for President Trump, but doing so may risk creating a labor shortfall and increasing inflationary pressure. According to the U.S. Bureau of Labor Statistics, in 2023, foreign-born workers, including legal and undocumented workers, accounted for 18.6% of the workforce. That's about 29 million people.

Where Do Undocumented Immigrants Work?



Source: Center for Migration Studies.

The Center for Migration Studies estimates there are as many as 8.3 million undocumented immigrants working in the economy. They work in construction, restaurants, agriculture, landscaping and food processing. A mass deportation of these workers could lead to labor shortages and may result in greater inflation. Another potentially inflationary policy could be tariffs. Across-the-board 10% tariffs on our trading partners would most likely add additional pressure on prices for goods and services (see article below for more on tariff impacts).

The Tax Cuts and Jobs Act (TCJA), enacted under Trump in 2017, is set to expire at the end of this year. The consensus at this point is that the TCJA will be extended, but the question is whether the tax cuts will go even deeper. Either way, this nets out to a potential tailwind for the stock market.

Another tailwind comes from the prospects of deregulation. There just seems to be a sense among business leaders and investors that the country is entering a business-friendly environment. This could build confidence and be positive for markets.

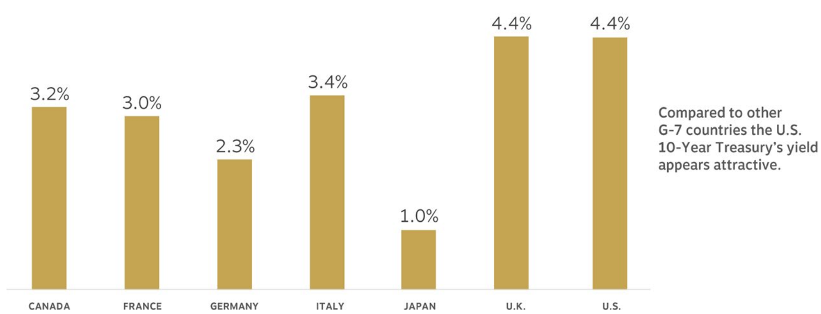
Now please remember there's still much to be determined, and our outlook could change if any of these policies are materially altered in implementation.

The Investment Landscape in 2025

Let's talk about what this means for financial markets and your financial plan. Overall, we expect global growth to remain strong this year, but the macroeconomic landscape could become more volatile. Market breadth could increase, with out-of-favor and in-favor sectors and industries trading places. This scenario, should it come to pass, is best managed by addressing your asset allocation, diversification and exposure to risk.

One area where we see potential opportunities is the bond market. Here is a chart of bond yields across the same group of G7 countries. With the recent retreat in the U.S. bond market, we think there's an opportunity to earn a meaningful return in U.S. bonds.

Comparing U.S. Bond Yields to Others



Source: FactSet as of 12/12/24.

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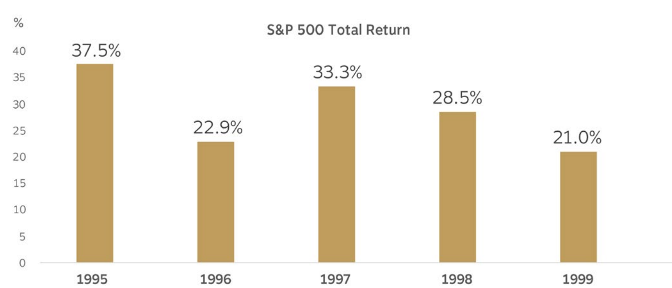
Another primary theme that could emerge in the stock market this year is a broadening of returns. This would be a big change from the last couple of years, especially here in the U.S., where market returns have been driven by those mega-cap growth stocks like the Magnificent Seven. In contrast, this year, we could see small- and mid-cap stocks start to also perform, and some of the international markets, including emerging markets, gain momentum as investors seek out opportunities in overlooked areas.

We're also closely watching the artificial intelligence (AI) trend, which has been a huge driver of gains in stocks like NVIDIA, Microsoft, Apple and others. However, there has not yet been a disruptive app or service from which these companies can meaningfully grow their earnings. We need to see a pivot to services or a reliance on AI as a general productivity enhancement for businesses for meaningful gains to continue. And, as the rise of startup AI model DeepSeek showed late in January, when it surpassed ChatGPT as the top-downloaded AI assistant on the Apple store and caused a tech sell-off, this industry is far from mature and subject to short-term shocks as the technology advances and new players gain market share.

Besides AI, what else could help your portfolio achieve another strong year?

The last time the stock market had three consecutive years of 20%-plus gains was in the late '90s. Look at this stretch in the S&P 500 from 1995 to 1999. This was an amazing run of five years during which the market returned more than 20% each year. There are some similarities between now and then. Back then, it was the dawn of the internet, and today, it's AI. As the late great American scientist futurologist Roy Amara was quoted as saying, "We tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run." Known as Amara's Law, this tendency can cause humanity and investors to struggle to consider the broader context and timeline when predicting technological advancements and doubt ourselves.

The Last Three Consecutive Years of More Than 20% Gains



Source: Bloomberg.

Corporate Earnings Must Set the Tone

But by the end of this year, the thing that will have mattered the most to the stock market is the same thing that matters the most every year: corporate earnings. In other words, will companies continue to grow earnings? And by how much? On this front, the news looks good.

Here's a chart of earnings for the S&P 500 going back to 2014. The last three bars are an estimate for last year (the results are still being tabulated), an estimate for this year and one for 2026. For 2025, earnings are expected to grow by more than 14%, which is a very robust growth rate. If the S&P 500 companies achieve these earnings estimates, the market will most likely end the year on solid footing.

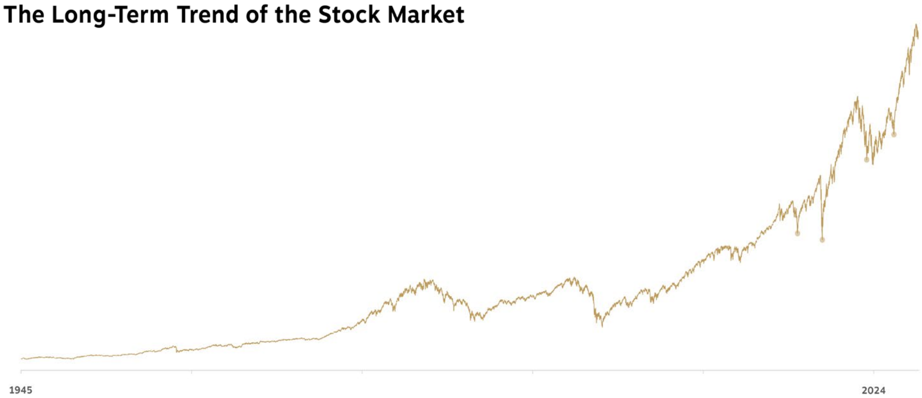
S&P 500 Earnings Growth Estimates

Source: Factset.

When we look back over the last few years, it's remarkable to consider how well the stock market has done given all the reasons that it could have or should have gone down. This year is no different, as we start off 2025 with plenty of concerns. Looming largest are inflation, geopolitical conflict and potential disruption out of Washington. But as we look across the globe at potential opportunities, it reminds us of a famous Warren Buffett quote. He said that in his 80 years of investing, he had "yet to see a time when it made sense to make a long-term bet against America."

The data backs up Buffett's quote. This chart shows the S&P 500 over the last 80 years. And you can clearly see which way the long-term trend goes. Right now is not the time to start betting against this trend. Regardless of whatever change may come our way this year in the markets, there's good reason to believe that it will work out in your favor if you focus on your long-term goals and stick with your financial plan.

The Long-Term Trend of the Stock Market



Source: Bloomberg as of 1/16/25.

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Building Your Wealth and Legacy

No matter what this year brings, we are here to help you navigate through this period of change together. Call us with questions about anything we've discussed in this article and we will review how your investment and financial plan is ready to manage the change that's ahead of us.

CRYPTOCURRENCY

Bitcoin as an Asset Class

It's been a little more than 16 years since pseudonymous founder Satoshi Nakamoto created the genesis block for bitcoin, paving the way for the crypto era. And it's been about one year since the first bitcoin exchange-traded funds (ETFs) were launched.

What exactly is bitcoin? It's the world's first widely adopted cryptocurrency, which allows secure peer-to-peer transactions without relying on traditional banking systems. Unlike services such as Venmo or PayPal, which depend on banks and other intermediaries, bitcoin operates on a decentralized network where transactions are verified through blockchain technology. This means that any two people can send bitcoin to each other directly, without needing a bank's permission or involvement.

Bitcoin as an Asset Class

Bitcoin is increasingly recognized as a unique asset class distinct from traditional investments like stocks, bonds and real estate. Its characteristics—such as decentralization, capped supply and high liquidity—contribute to its appeal among institutional investors and high-net-worth individuals. While it has gained traction as a store of value, with some investors referring to bitcoin as digital gold, its inherent volatility remains a concern for many potential investors. The cryptocurrency's price can swing dramatically within short periods, making it both an enticing and risky investment.

Institutional interest in bitcoin has grown, with many hedge funds and family offices adding it to their portfolios. Even Fortune 500 companies have now reported holding bitcoin in meaningful amounts on their balance sheets. This growing recognition reflects a broader acceptance of cryptocurrencies in mainstream finance. However, investors should be aware that bitcoin's value is largely driven by market sentiment and speculation rather than an intrinsic value or cash flow. Unlike other financial assets, crypto's value depends on what people will pay for it at a point in time based on what they think someone else will pay for it in the future. It is not backed by anything else, such as tax revenue or corporate earnings.

How To Invest in Bitcoin

For those looking to invest in bitcoin, there are several avenues available:

- **Buying bitcoin directly:** You can purchase bitcoin through cryptocurrency exchanges such as Coinbase, Kraken or Fidelity Digital Assets. This method requires setting up a digital wallet to store your bitcoin. It is important, however, to familiarize yourself with the security standards of your chosen exchange.
- **ETFs:** You might consider crypto-related ETFs, which provide exposure to bitcoin without the need to hold the cryptocurrency directly. These can be stock-based ETFs that invest in companies involved in the crypto industry or futures-based ETFs that track bitcoin's price movements. The first bitcoin ETFs were launched about one year ago and one of them—BlackRock's iShares Bitcoin Trust (IBIT)—has grown to more than $60 billion in assets. No other ETF has grown as fast.
- **Crypto-related stocks:** Another option is investing directly in stocks of public companies operating within the crypto space, such as exchanges or mining firms. This method allows

investors to bet on the growth of the industry while potentially reducing some volatility associated with direct cryptocurrency investments.

- **Private investments:** You could also consider investing in privately held companies or funds that target this part of the market. Although bitcoin is now more than 16 years old, the broader cryptocurrency ecosystem is still relatively new and many of the opportunities in the space may be available outside of public markets.

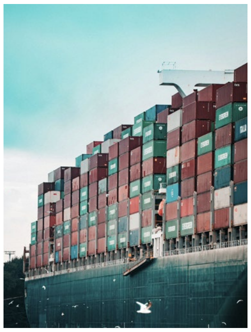
Potential Changes Under a New Trump Presidency

With the Trump administration filled with crypto-friendly appointees, there is potential for significant changes in how cryptocurrencies are regulated and perceived. President Trump has expressed ambitions to make America the “crypto capital of the planet and the bitcoin superpower of the world.” He has proposed initiatives such as establishing a strategic bitcoin reserve. Such moves could enhance legitimacy and institutional adoption of bitcoin, potentially leading to greater stability in its price.

If Congress were to provide a statutory framework for cryptocurrencies, it could further integrate bitcoin into mainstream finance, making it more accessible to all investors. However, while these proposals are promising, they also raise questions about regulatory oversight and market manipulation risks. As we look ahead, it will be essential for investors to stay informed about these developments and consider how they may impact their investment strategies.

In conclusion, while bitcoin presents exciting opportunities for investment and innovation within the financial landscape, it is crucial for potential investors to approach this asset class with caution and thorough research. The future of bitcoin could be shaped significantly by regulatory changes under new leadership.

Although we don’t invest directly in cryptocurrencies today because of the extreme volatility in bitcoin and others, we will be watching closely to see how new government regulations unfold and how this particular corner of the financial markets evolves.



POLICY ECONOMICS

What Could Higher Tariffs Mean for the Economy?

President Trump was sworn into office for the second time last week, and over the coming months, we'll see how his administration works to turn campaign promises into policy.

Two of the biggest issues he ran on were immigration reform and tariffs. We discussed the potential outcomes of changes to immigration policy last month. This issue, we review the tariff proposals put forth in the months leading up to the election while also looking back at the first round of Trump tariffs in 2017.

Our research shows that the proposed new tariffs would have far-reaching consequences for the American economy. According to the Peterson Institute for International Economics, the tariffs would reduce gross domestic product (GDP) by 0.4% to 1.5% and cost typical middle-income households approximately $1,700 annually. The Tax Foundation projects nearly 345,000 jobs lost across the economy.

While some domestic producers might benefit from reduced foreign competition, the evidence suggests the overall economic effects would be negative, with lower-income households bearing a disproportionate share of the burden.

Direct Industry Effects

The impact of proposed tariffs would vary significantly across different sectors of the economy. The automotive industry is particularly vulnerable due to the integrated nature of North American manufacturing. Vehicles typically cross borders an average of eight times during production under the United States-Mexico-Canada Agreement (USMCA), meaning tariffs would compound at each stage, significantly increasing final production costs.

Consumer electronics represents another vulnerable sector. Despite previous rounds of tariffs, the United States remains heavily dependent on Chinese imports for technology products, including smartphones, laptop computers and video game consoles. Any substantial tariff increase would influence prices in these categories.

The experience with steel tariffs during Trump's first term provides important lessons. According to Federal Reserve analysis, steel tariffs led to higher input costs that reduced employment in industries like agricultural equipment manufacturing and automotive parts production. The negative effects of rising input costs and retaliatory tariffs outweighed any benefits to protected industries.

Consumer Costs

Despite claims to the contrary, it is accepted economic fact that American consumers ultimately bear the primary burden of tariffs through higher prices. For example, a University of Chicago study found that washing machine tariffs during the previous Trump administration increased prices by $86 per unit. The impact extends beyond just the tariffed products—even dryers, which weren't subject to tariffs, saw similar price increases due to manufacturers' bundled pricing strategies.

The regressive nature of tariffs is particularly concerning. Lower-income households tend to spend a larger portion of their income on goods that would be affected by tariffs, such as clothing, household appliances and electronics. According to Treasury Department data, families in the bottom 20% of income spend nearly twice as much of their income on these goods compared with families in the top 20%.

Trade Relationships and Retaliation

Historical evidence suggests that trading partners would respond aggressively to new tariffs. During previous trade disputes, China imposed retaliatory tariffs on 58% of United States exports, with an average rate of 21%, according to Peterson Institute analysis. Agriculture was particularly hard-hit. American soybean farmers lost significant Chinese market share, with exports dropping by over 70% during the height of previous trade tensions.

The cost of managing such retaliation has been substantial. The federal government provided nearly $30 billion in subsidies to farmers affected by previous rounds of retaliatory tariffs. Major agricultural states saw their exports to China fall by up to 75% for certain commodities.

Inflation Impact

The proposed tariffs would likely have significant inflationary effects across the economy. According to Bloomberg analysis, the new tariffs would increase consumer prices by approximately 2.5%. This impact would be widespread, affecting both directly imported goods and domestically produced items that use imported components.

The inflationary effect of tariffs can work through multiple channels. When similar tariffs were previously imposed, many companies used them as cover to raise their own prices beyond the direct tariff impact. Research from the Peterson Institute shows that even a modest tariff reduction of 2% could reduce consumer price inflation by 1.3%, suggesting that larger tariff increases would exert correspondingly significant upward pressure on prices.

The Federal Reserve's response to tariff-induced inflation presents another challenge. The central bank would face a difficult choice between accommodating the price increases through looser monetary policy or maintaining its inflation targets through tighter policy that could exacerbate any economic downturn.

Investment and Growth Effects

The ripple effect from higher tariffs extends beyond direct price effects. The International Monetary Fund estimates that reversing the 2018–2019 tariffs would increase United States output by 4% over three years, suggesting significant negative growth effects from trade barriers.

Short-term impacts have been well documented. Studies show GDP reductions of 0.2% to 0.7% from previous tariffs, with particularly severe effects in export-dependent industries like aerospace manufacturing and semiconductor production. These sectors not only face direct tariff costs but also suffer from reduced access to foreign markets due to retaliatory measures.

Revenue and Fiscal Impact

The fiscal implications of new tariffs are complex. According to the Tax Foundation, previous tariffs generated $233 billion in collections through March 2024. While the proposed new tariffs are estimated to raise between $1.2 and $2.5 trillion over 10 years, these projections don't fully account for economic damage that would reduce the actual revenue collected.

The Committee for a Responsible Federal Budget analysis shows that a 60% tariff on Chinese imports (floated as a possible policy move) alone could lower projected revenue from $2.4 trillion to between negative $50 billion and positive $300 billion when accounting for reduced imports and depressed economic growth.

TARIFFS: KEY ECONOMIC IMPACTS

CATEGORY	PROJECTED IMPACT
GDP	**0.4% to 1.5% reduction**
Jobs	**Loss of 345,000 jobs**
Inflation	**2.5% increase in consumer prices**
Consumer Cost	**$1,700 annual cost per middle-income household**
Most Impacted Industries	**· Automotive (multiple border crossings compound tariff effect)** **· Consumer electronics (heavy reliance on imports)** **· Agricultural exports (vulnerable to retaliation)** **· Manufacturing using imported inputs**
Potential Beneficiaries	**· Domestic steel producers** **· Domestic aluminum manufacturers** **· Some import-competing manufacturers**
Revenue Impact	**· $1.2–$2.5 trillion potential gross revenue over 10 years** **· Could drop to between -$50B to +$300B when accounting for economic effects**
Trade Effects*	**· 58% of U.S. exports subject to retaliation** **· Average retaliatory tariff rate of 21%**

*Based on first-term Trump tariffs. Sources: Peterson Institute for International Economics, The Tax Foundation, Bloomberg, Committee for a Responsible Federal Budget, The Federal Reserve, U.S. Treasury Department.

Tariff Outcomes

Based on the information available, increased tariffs would impose substantial costs on American consumers and businesses and have a low likelihood of achieving the new administration's stated goals of job creation and industrial revival. The evidence suggests these measures would generate less revenue than projected due to economic damage, trigger retaliation that further harms United States interests, and place a disproportionate burden on lower-income households.

While some domestic producers might benefit from reduced competition, the overall economic impact would be significantly negative, affecting everything from consumer prices to job creation and long-term growth prospects.

We'll be keeping a close watch on tariff policy changes and how they might affect your investment strategy. Should higher tariffs be enacted, you may wish to review your budget, particularly if you plan on purchasing big-ticket items that could cost more. As always, we're here to talk you through any concerns or questions.