First of all, Happy New Year! We sincerely hope that you and your family will have a blessed 2025.

December was a tough month for both stocks and bonds: the S&P 500 declined 2.4 percent and the Barclays Aggregate Bond Index declined 1.6 percent. When the Federal Reserve indicated there would be fewer rate cuts in 2025 than the market expected, just about everything fell. The sell off extended to all capitalizations and also to international stocks; the hardest hit segments were small and mid-cap stocks (they use the most short-term financing), which declined 8.3 percent and 7 percent respectively. The MSCI World ex-US lost 2.7 percent and the MSCI Emerging Markets was the best-performing equity segment, declining only 0.1 percent.

Moving forward into 2025, we remain cautiously optimistic overall. While we think inflation will remain above the Fed's target of 2 percent for the year and that the Fed is almost certain to pause rates cuts this month ,we also believe the Fed will cut rates a few more times later in the year. Furthermore, while we think economic growth in the US will moderate (Seth Carpenter, Morgan Stanley's Chief Global Economist, is predicting 2.4 percent growth for 2025, slowing to 1.9 percent in 2026), we also think anything north of 2 percent is good economic growth for a developed economy. Consider that since the financial crisis, GDP growth exceeded 2.4 percent only in about 50% of the years. Moderating inflation, falling rates, and good economic growth are not normally a recipe for a stock market crash. With regard to bonds, we hold to the maxim that if the 10-year bond yield is about the same as the sum of 10-year average inflation expectations and economic growth expectations, bonds are priced fairly. If we assume 2.5 percent inflation and 2.0 percent growth on average, then theoretically fair value on the ten-year treasury would be 4.5 percent. Currently, the 10-year bond trades at 4.62 percent. We expect positive single-digit bond returns again in 2025 with less bond market volatility than we had from 2021 to 2024.

Our cautious optimism does not mean we expect smooth sailing for the entirety of the year. Particular areas of concern remain the average investor's risk appetite and the historically lofty valuations on the mega-cap tech names – two phenomenon that could make an otherwise run-of-the-mill market correction feel anything but normal. The interplay between investor sentiment and market valuation creates the real possibility of a correction (a decline in excess of 10 percent) over a very short span of time (possibly even over the course of just a few days). We would not be shocked to see a rapid correction originate in one or a couple of the Mag 7 (that's what people actually own) and quickly spill over into all sectors as a consequence of margin calls and liquidity demands. Ultimately, we believe the risk for a brief but frightening equity pullback in 2025 is extraordinarily high, though we also think the average stock will close higher for the year and post high single-digit or low double-digit returns for calendar 2025.

Without further ado, here are our five 2025 predictions:

1) Despite some stock market volatility as earnings growth disappoints for Mega-caps during the year, bonds and stocks both post positive returns again in 2025. Morgan Stanley's Global Investment Committee's base case calls for the S&P 500 to end 2025 at around 6,500, a gain of about 10 percent from today's level (January 7th). They think the 10-year bond ends the year yielding around 3.55 percent. Our team concurs with the S&P 500 call, but given our

expectations about sticky inflation this year, the bond call feels aggressive. However, we do agree the downside risk to bonds seems limited at present yields.

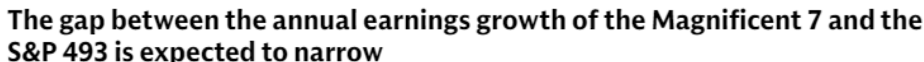
2) The US stock market experiences at least one correction this year (defined as declining more than 10 percent) from its previous high. As mentioned above and previously in our missives,

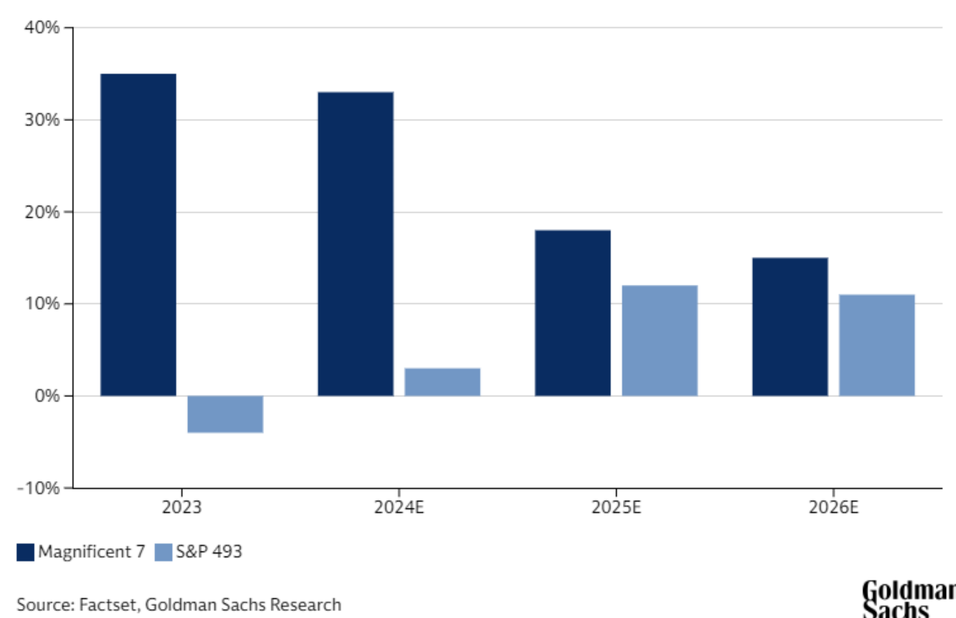
S&P 500 Target + Estimates

Landscape	2026 Earnings	Target
Bull	$329	7,400
Base	$303	6,500
Bear	$248	4,600

investors have quite the risk appetite at present. They hold more equities and riskier equities (as measured by market beta) than at any point since the technology bubble in the late 90s. As Warren Buffett reminds us: when others are greedy, we should be fearful. We chose the double pendulum as our team's sigil because it reminds us to temper the confidence that comes with expertise (previous success) with the wisdom that comes with experience (previous error). We must never fail to account for the wildness that lies in wait. As Morgan Stanley cautioned in its January On the Markets, "The consensus for 2025 and 2026 calls for a two-year earnings growth rate of 30% – roughly four times that of the past two years. Certainly, fiscal policies like tax changes and deregulation could be positive catalysts, as could recovery in rate-sensitive sectors and improving global growth, but here too, investors should be measured. Deficits are likely to constrain tax cuts, and the economy's rate sensitivity may be muted by structural factors like a frozen housing market and income/wealth inequality, as US dollar strength increasingly makes US goods unaffordable to foreigners."

3) The S&P 493 outperforms the Mag 7, the S&P equal-weighted index outperforms the cap-weighted index, and value outperforms growth. Our logic and prediction remain the same as last year. To summarize our thoughts: the gap between earnings growth between the Magnificent 7 and the Wee 493 is very likely to shrink over the next several years, both because the Magnificent 7 growth rate declines (and likely disappoints investors) and the Wee 493 earnings growth continues to accelerate (and surprises investors in a good way). Goldman Sachs wrote the following at the end of November: "Although earnings continue to weigh in favor of the Magnificent 7, macro factors such as growth and trade policy lean towards the S&P 493. Our

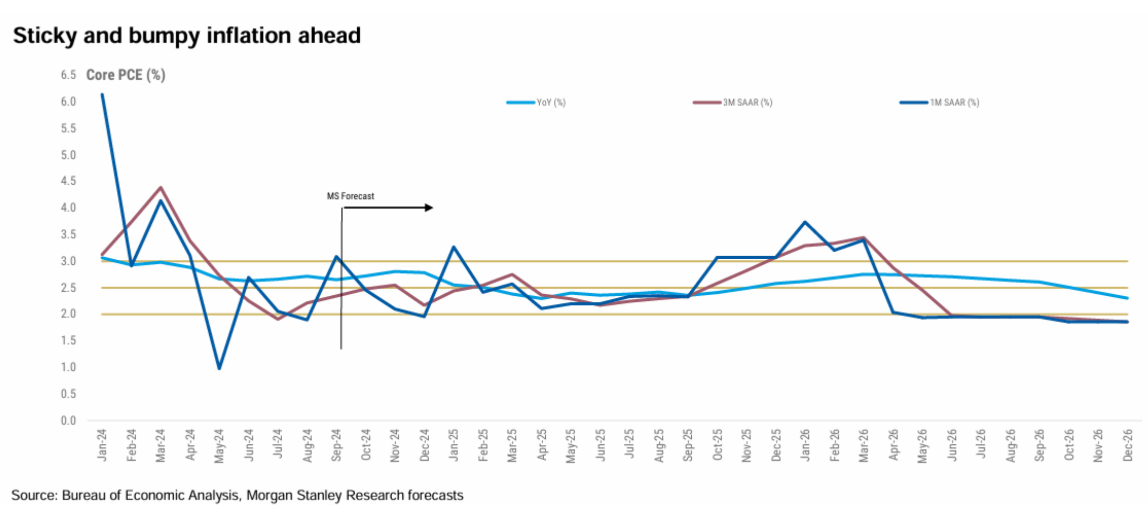




economists' expectation of a steady and above-trend pace of US growth in 2025 favors the performance of the S&P 493, which is more sensitive to changes in growth compared with the Magnificent 7."

4) Small and Mid-Cap stocks have a good 2025. The December pullback in small and mid-cap stocks occurred because the Federal Reserve took a January rate cut off the table and the market focused on the financial leverage consequences of that decision (small and mid-caps use more short-term debt than mega caps, making them more interest rate sensitive.) However, we think investors are ignoring the expansion of operating leverage. As Richard Bernstein Advisors points out, "There is a tug-of-war during every period of rising rates between companies' financial leverage and operating leverage. Financial leverage is debt financing's boost to operating income, whereas operating leverage reflects the accelerating marginal profitability of a highly capital-intensive company during an economic upturn. So, rising rates do negatively impact financial leverage of smaller companies, but stronger nominal growth (i.e., the reason rates are going up) spurs the operating leverage. History suggests smaller companies' positive operating leverage generally wins versus their negative financial leverage."

5) While headline inflation could fall on lower energy costs in 2025 (we think oil prices may decline in 2025), core inflation remains quite sticky for the year. [Morgan Stanley's Chief Economist](), Seth Carpenter, thinks "inflation continues to decelerate as expected until 1Q25 but becomes stickier afterwards. We see core PCE inflation at 2.8% (4Q/4Q) in 2024 aligned with our expectations at the beginning of the year. We have boosted our forecasts for 2025 from 2.2% (4Q/4Q) to 2.5% on tighter labor markets and further tariffs. Inflation remains above target in 2026, at 2.4% (4Q/4Q)."



Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

Ultimately, sticky inflation and decent economic growth bound interest rates in a tighter range in 2025 and constrain the Federal Reserve to only 2-3 cuts total during the year. Consequently, we are sticking with our theme of overweighting credit and floating rate over government and fixed rate -- for at least the first half of 2025. We think there is a good chance we extend this call further based on economic indicators and inflation data as the year progresses.

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