Conversations with Commerce Trust Podcast

Commerce Trust 2025 Economic and Market Outlook – December 3, 2024

David Hagee: Hello and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today we're discussing our 2025 Economic and Market Outlook with Scott Colbert, Chief Economist and Director of Fixed Income, and KC Matthews, our Chief Market Strategist here at Commerce Trust. Welcome back to the podcast gentlemen.

Scott Colbert: Hi David.

KC Matthews: Hey, David.

David: Great to have you back. Exciting time for us, we're closing out 2024. Moving into 2025. We've been working hard on putting together our Economic and Market Outlook, but Scott, let's start with the economy. It's definitely been stronger than we've anticipated. What are your thoughts as to how we're closing out 2024, and what to look for in 2025?

Scott: Well, it has been better than we thought at the beginning of the year. We would've projected growth of 1%+. But really, we're looking at aggregate growth, that's probably close to 2.5% this year. Now that's down from a very, very strong 2023 where aggregate growth was up 2.9%. But we've slowly cooled if you will. And in essence, the economic plane that the U.S. is running worked its way through that interest rate hiking process. And it worked its way through the inflation crisis a bit better than expected. And of course, there wasn't any hard landing at all, it was just basically kind of smooth sailing with just a little slowing in speed.

We expect the plane to continue to slow down and descend a little bit in 2025, as the slightly higher interest rates that we've had continue to slow economic activity, as we distance ourselves from all that huge pandemic stimulus. But nonetheless, there are a lot of positives. You'll talk about, of course, the roaring equity market returns and the improvement to consumer wealth. Employment continues to grow. And of course, if employment and incomes continue to grow, then the economy will do just fine. So, we do expect it to slow (in 2025), probably in the neighborhood of 2-2.2% from this year's 2.5%. But largely, that's just simply because we have a higher interest rate environment. And probably less help coming from the Federal Reserve (Fed), given the policies of the new administration.

David: Given that we're seeing strong economic growth, employment continues to be strong, albeit slowing growth, but still not contracting. What are our thoughts around inflation? That's been the topic that's really driven Fed policy over the past two years or so, three years, really.

Scott: Well, you know, fortunately inflation peaked more than two years ago now, and it's been coming down ever since. We did make some progress last year on inflation. But the Fed's favorite measure, the Personal Consumption Expenditures (Price) Index (PCE) is still running at 2.3% year over year as we sit here today. And the core PCE has only made 20 basis points of improvement, that's the Fed's really, really preferred measure of inflation, and it's clocking in at 2.8% year over year.

So, while we've made some improvement this past year, we probably haven't made quite as much improvement as the Fed might've hoped. And given the potential inflationary policies of the new administration, I think you're likely to see a slowdown in the number of (federal funds) fed rate cuts coming. We're likely to have one in December, but after that, there's likely to be just a few cuts next year as our economic engine continues to make forward progress, as inflation probably makes eventually some forward progress, but is slowed by the potential inflationary policies, given probably less immigration and higher tariffs.

David: I think that's an important topic to touch on. Certainly, the questions that I'm getting, I know that we've been getting as an organization have been around, "What does this second (Donald) Trump presidency mean for the economy?" Some areas that certainly worth touching on are the tariffs, whether those affect our inflation outlook, whether the employment picture radically changes, and what does all of this do for economic growth? What are your thoughts around possible impacts of this second Trump presidency?

Scott: Yes, the key three things are probably what: Taxes, tariffs, and immigration. In terms of taxes, we think it's a positive for economic growth in the sense that we know that the corporate tax rate is going to hold steady and perhaps even decline. We know that personal income taxes aren't likely to rise. We know that regulation is probably likely to ease, and all of those are positives probably for economic activity.

Offsetting that though, of course, is the inflationary tendency of any tariffs that would go up. Trump did implement some tariffs under his first term, and of course he's already, I'll use the word threatening to tariff basically everything that comes in from Mexico and Canada, which represents nearly half of our imports, (and) of course a 10% across the board tariff on China. We doubt that all of this will be implemented, and we doubt that all of it will be implemented on day one. But we don't doubt that some of it will likely occur as the year progresses. It's quite possible that tariffs add as much as a half a percent to the overall CPI (Consumer Price Index) next year.

And then in terms of immigration, of course, let's face it, more bodies used in the workforce creates what? Probably less incremental need to hire somebody if you've got more workers looking for work.

To the extent that we have less immigration, that's likely to hold the unemployment rate steady, if not, push it downward a little bit. And probably keep salary levels and raises elevated because of fewer workers to pull from the workforce pool. So that's a little bit inflationary too. So, you've got the positive growth forces from the lower tax rates and the certainty that likely comes from that, versus the uncertainty of the tariffs and the uncertainty regarding the immigration policies.

David: That's a nice tie back to our outlook for the Fed is that we've seen 0.75% of 1% of rate cuts so far. They have a meeting again in December where we anticipate, or at least the markets are pricing in about a two-thirds chance that they'll cut again, probably by about a quarter point. But as you look at these perspective policies out there, that could be a tinge inflationary that would definitely slow down the Fed in cutting rates further.

I think that sets us up nicely for the equity market discussion here. KC, we've had two great years inside U.S. securities here up over 20% in 2023, and it's trending that way for 2024. Can this continue into 2025?

KC: Yeah, we think so. Just hearing from Scott, when you look at the economic landscape, 2-2.5% is good enough to drive corporate earnings and equity prices higher. However, at the same time, you see market leadership changing. In 2024, it really was a tale of two halves, right? All of a sudden, the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla), seven of the largest companies out there really drove the market, actually represented about half, just shy of half of the return in 2024. But the first half of the year it was hard charging.

And then it was mid-year, July 16th, all of a sudden, we see this thing, the leadership change. The S&P 500 (Index) since July 16th was up about 7%. But like mid-caps, the Russell Midcap Index was up 12.4(%). And the Russell 2000 (Index), representing small companies, was up 8%. So, given the changing landscape that Scott just described, you could see a change in leadership, you could see the market broadening out.

And even though the returns might come from different areas of the market, to answer your question, yes, we could see another strong market, maybe not 20% plus. But right now, we are suggesting positive rates of return in risk-based assets such as equities in 2025.

David: As we think about equities right now, I think taking a look at some of the fundamentals behind these returns is meaningful. We haven't seen multiple expansion, meaning that people aren't paying higher valuations per se. It's moved up a little bit, but we've seen stronger corporate earnings. What's the outlook for both where we're at from a valuation perspective as well as corporate earnings for 2025?

KC: Well, valuations are becoming a bit of a concern. If you look at the S&P 500, the forward price earnings ratio is at 22 times. But as I mentioned earlier, almost half of the return came from the Magnificent Seven, which still have growth prospects well above 20%. It's worthy of watching, but if inflation dissipates, rates come down ever so slowly, as Scott suggests, it can support a higher multiple. But definitely a concern.

The drivers that we're looking at, the catalyst for 2025 will be the economic landscape. As Scott suggested, maybe a cooling, but still at 2-2.5%. And perhaps as we look forward, if President(-elect) Trump is successful in just a handful of his initiatives, you could see a GDP (gross domestic product) boost in 2026, which would be good for equity prices. But anticipated tax cuts are good for corporations in their margins, good for consumers as they have more discretionary income. The promise of deregulation would be a positive for markets, especially when you look at financials since the election, November 6th to the end of the month, financials are up almost 10%. But lower interest rates and dissipating inflation would all be drivers for earnings.

This year, 2024, corporate earnings were … we'll finish the year somewhere between 9-10%, which is fantastic. But right now, the analysts' consensus estimate for 2025 is 15-16%. At Commerce Trust, we're a little more conservative on that given some of the policy uncertainty out there. But if we get 10-12% earnings growth next year, and if it's more broad-based, it's going to be really good for markets in general.

David: So, we've talked exclusively about the U.S. market so far. As we look overseas to international equity markets, what are our thoughts on the international markets at this point?

KC: Well, what makes you look at international markets is the valuation. So, if we look at the (MSCI) EAFE Index, which is a standard international index, that index trades at 14 times earnings. But yet when you look at returns, it's been a laggard. This year, 2024 through November, EAFE's up 6.8%. And given some of the policy changes that we're going to see with the new administration that Scott just talked about with potential tariffs and domestic focused, EAFE is off 1.3% since the election.

David: That's a really positive outlook for us on equities, especially given the strong returns that we've seen over the past two years. That we still think that the backdrop for equities remains strong and conducive to higher returns, especially inside the U.S.

Let's talk a little bit about fixed income. We had kind of a wild year in fixed income, especially around that midpoint in the year where it seemed like inflation had been beaten down enough that we could see some Fed rate cuts moving around. Scott, maybe you could walk us through exactly what we've seen in the back half of 2024. And tie that into the Fed (and) our forecast for some cuts, but not as many cuts maybe as the market's pricing in.

Scott: Well, when we look back on 2024 or the first four months of the year, interest rates basically tended up because growth was better than expected, recessionary fears that everybody was worried about, and the hard landing really never even came close. So, the fixed income market that had been discounting some of those fears began to push upward, basically starting to discount the softer landing.

But then as the inflation rate continued to cool, as the year progressed, interest rates began to roll over. So now we're seeing positive returns across the board for fixed income. The short-term cash rates have come down by 75 basis points, the Two-year Treasury is still about the same as it started the year. The 10-year Treasury is a bit higher than when it started the year. But nonetheless, you've gotten close to coupon like returns so far this year. Which is better than you've been getting out of fixed income for some time.

I think this sets us up for a very, very positive year next year, in the sense that while interest rates may not fall a lot, maybe fall less in the short end than we thought, you're likely to earn your full coupon and then some in both the municipal and the investment grade markets.

David: So, I think that's a great transition point to talk a little bit about asset allocation and how alternatives could work. KC, maybe we could talk a little bit about two areas that could be return enhancers for you and talk about those just from a very high level about private equity, as well as private credit.

KC: Yeah, you bet. I mean, interest rates are relatively low valuations and public equities are just a bit stretched. So that's where alternatives come into play.

At Commerce Trust, we believe that alternatives can play a very significant role in appropriate portfolios. Many times, investors have to qualify for these investments. But given Scott's outlook that interest rates will be coming down, decent economic activity, that should lead to more M&A activity, mergers and acquisitions, and that plays right into private equity.

Private equity is nothing more than another venue of equity, it's just in a different structure. It can play a role in portfolios. We know historically it offers a return premium because with this structure, there's liquidity issues and other constraints. But nevertheless, this could be a return enhancer to many portfolios. And we think right now, given the environment and our outlook going forward, it could be an incredible opportunity.

Private credit offers cash flow. If you think about it, a Two-year Treasury is at 4.1%, the 10-year Treasury is at 4.2%. Where do investors get cash flow? And this is an asset class that can provide additional cash flow, again, with some constraints. Depending on the investor's profile and characteristics, these asset classes can play a very important role in their portfolio.

David: It looks as though as we wrap up 2024 and our outlook is being published for 2025, we continue to see strong U.S. growth coming. Mostly because we have a moderating inflationary environment that might be a little bit rocky moving forward. On the job side, it continues to be a strong jobs market, albeit slowing a little bit from the robust pace we saw in 2022 and '23, and the first half of '24.

With that, we expect the second Trump presidency to offer some benefits to the economy in terms of deregulation, possibly having some of these tariffs that could be disruptive to our inflation trend over the long term. But that translates nicely into an equity market that we think is still positioned nicely to have strong returns moving forward, even though we've had robust returns over the past couple of years.

Inside the fixed income markets, again, a solid year this year above what we've done the past couple of years. But as we move forward, because the higher interest rate environment exists, we anticipate that fixed income markets should earn a coupon or slightly better than a coupon type return moving forward.

And lastly, as we think about alternatives inside a portfolio, especially with maybe some of these equity returns being compressed after we've had a couple of great years here. Alternatives offer the opportunity not only to mitigate some risk inside the portfolio, but to also have some return enhancement, as well.

Well, thanks for the interesting discussion today, gentlemen. For more on this topic, please visit www.commercetrustcompany.com and download our 2025 Economic and Market Outlook titled, An Economic Balancing Act. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee, we'll talk again soon.

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December 3, 2024
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