Market Strategy
by STRATEGAS A BAIRD COMPANY

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Key Takeaways from the 6 Strategas Research Areas

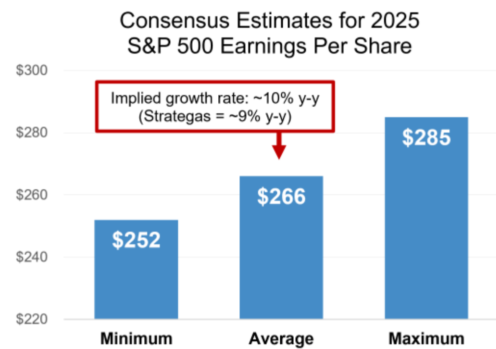
December 5, 2024

At Strategas, we look at the markets and the economy from several angles. Periodically, we gather our research areas into one note that serves as a snapshot of where we are today and an outlook for the months ahead.

INVESTMENT STRATEGY: JASON TRENNERT, CHAIRMAN, CHIEF INVESTMENT STRATEGIST

Sentiment running high. Since the election, stocks have rallied, bond yields have declined, and the dollar has strengthened. The market looks expensive compared to history, but long-term Treasury yields are relatively low, the labor market is strong, credit spreads are tight, and profits are growing (albeit unevenly). Unfortunately, the percentage of consumers expecting stock prices to be higher a year from now reached an all-time high last week (according to the Conference Board)—something to watch, as widespread optimism can be a contrary indicator. Newly elected presidents tend to enjoy a honeymoon in which the public enjoys the possibility of better times before the hard work of governing begins. Often human beings are happiest in the *anticipation* of good times and so it is with investing. For now, it looks like the prospects for continued monetary accommodation, relatively easy fiscal policy, and regulatory easing should keep animal spirits alive.

Outlook for U.S. equities. From here, returns in line with earnings growth are most likely (as opposed to multiple expansion, in which the ratio of share price to earnings also rises). We estimate that S&P 500 earnings will be up about 9% in 2025. Without fiscal reform, the spiraling expense of servicing America's debt is a concern. In the absence of productivity or employment growth, the bill for heightened spending will come due—either through higher interest rates, higher inflation, or the crowding out of public spending or private investment. The potential for higher long-term interest rates also favors stocks that can generate enough cash to grow their businesses without borrowing money.



Source: FactSet

ASSET ALLOCATION: NICHOLAS BOHNSACK, PRESIDENT, HEAD OF PORTFOLIO STRATEGY

Sector leadership continues to evolve. The backdrop looks bullish into the New Year and likely has some legs through the first quarter of 2025. Setting aside the post-election bounce, the Tech sector has struggled as sector leadership continues to evolve and broaden. As we noted last month, sector leadership remains cyclical, excluding Utilities (which continue to carry the torch for the Industrial Power Renaissance theme). While noteworthy, we have viewed the recent strength in Bitcoin and small-caps as signposts for the "anti-inflation" and Trump 2.0 "pro-growth" sentiment rather than decided pivots on fundamental grounds.

TECHNICAL STRATEGY: CHRIS VERRONE, HEAD OF MACRO AND TECHNICAL STRATEGY

Stocks. The biggest risk we see is heightened sentiment. The market's primary trend remains up, with 77% of S&P 500 issues above the 200-day moving average and seasonality a strong tailwind through January, but leadership is evolving. Tech's grip on the market has eased since summer. Cyclicals continue to carry the flag of leadership, particularly Financials and Industrials. Consumer Discretionary has also improved internally and remains dominant versus Consumer Staples.

Bonds, yen, oil, and alts. There are too many bond bears and we lean more bullish than the consensus here. U.S. 10-year yields turned away at 4.50%, while European yields break to fresh lows. Our gut says yen weakness is also on its last leg, and rate differentials also support a stronger yen. Oil remains in a weak technical position, but we are now considerably more bullish on natural gas than we had been. Gold is correcting but has the benefit of a strong longer-term uptrend with support at the 200-day average, while Bitcoin's strength continues to suggest that liquidity conditions remain abundant.

ECONOMICS: DON RISSMILLER, CHIEF ECONOMIST

Growth. U.S. data have shown rolling weakness in housing and manufacturing. We believe the path for a continued soft landing is for those parts of the economy that have been weak to turn up before those parts that have been strong (especially consumer spending) turn down. Decent corporate profit growth could help kick off a capex cycle. Lower mortgage rates should (eventually) help housing. For 2025, our odds are a 15% chance of a recession, 60% chance of soft landing / expansion, and 25% chance of upside.

Inflation. The first wave of U.S. inflation now appears to be over (and inflation expectations still look anchored). But history suggests that once inflation gets going, a second wave tends to build over the next several years (87% of the time globally). We're in the lull between waves, but remain attentive longer-term, especially to factors that have heavy weights like rents. Any significant negative U.S. labor supply shock (for example, mass deportations) would be quite concerning.

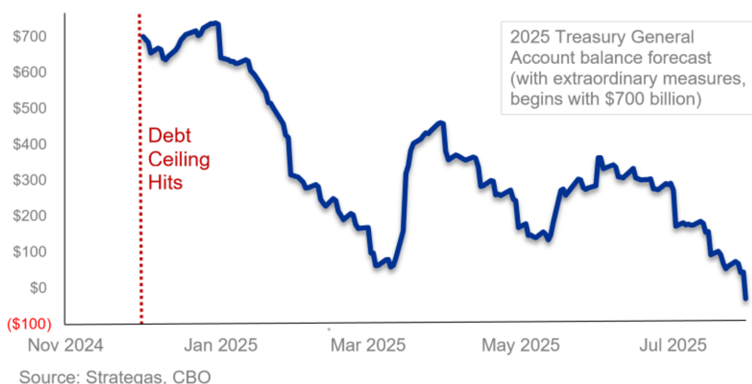
Policy. 2024 has seen a pivot to lower fed funds rates, justified first by inflation coming down and reinforced by growth slowing. 2025 should see this pattern continue. The goal should be to get monetary policy back to a neutral setting.

Risks. The fiscal supports that have allowed economic growth have not been cost free. The U.S. federal budget deficit remains large and, while there's no emergency, threatens to crowd out other economic activity (though this does not appear to be happening yet). Alternatively, inflation could return over time.

Hope. Productivity (more output per hour) can conceptually help alleviate a second inflation wave. That is to say, too much money chasing too few goods can be stymied by producing more goods. While there is promise on this front from technology advances, we would like to see the profits of both the producers of new technology (e.g., A.I.) and its users grow at the same time.

WASHINGTON POLICY: DAN CLIFTON, HEAD OF POLICY RESEARCH

The coming liquidity bazooka will cushion tariffs and/or austerity. The US debt ceiling expires January 1 but Congress is not likely to raise the debt ceiling until August. In the interim, Treasury will need to pay the government's bills from the Treasury General Account. Because the TGA is outside of the banking system, this will be what we call a liquidity bazooka—and liquidity is associated with easier financial conditions such as lower yields and a lower dollar. We estimate net liquidity will increase by $400 billion in the first quarter of 2025. For context, a 10% tariff increase on China is roughly a $50 billion drag annually. The liquidity boost won't be linear; we anticipate a liquidity squeeze in April and early May before a second round of a liquidity increases in May and the first half of June.



Higher liquidity and a lower deficit could reverse the post-election Trump trade. Trump's election was associated with higher bond yields and stronger dollar, but we anticipate that these trends will reverse as we enter 2025. Liquidity today suggests that bond yields should be lower and the move to lower bond yields has started with the selection of Scott Bessent to be Treasury Secretary. The liquidity bazooka in early 2025 should be another catalyst. Moreover, we believe the consensus view that the US budget deficit will be close to $2 trillion in fiscal 2025 is off base and the number will be lower. The main driver of the lower deficit is tax revenue growth due to much higher capital gains and corporate tax collections than is built into the consensus forecast. But spending is also coming down. Just ending student loan forgiveness would create a $150 billion year-over-year boost. Combined, we can see debt issuance falling $350 billion lower than the current forecast while rates are coming down, quantitative tightening is ending, and more foreign demand comes back into the market.

Focus should be on executive actions, not legislation. Our basket of stocks that will likely have higher earnings from deregulation efforts is up 20% since the election (this list is an analysis tool and not an investment product; the names included

in the basket are available upon request). We expect changes that do not require an act of Congress to happen quickly upon Trump taking office. This includes changes to immigration, liquified natural gas exports, banking regulations, tax preparation, Medicare Advantage, and education. Congress will struggle to move quickly on most legislation given the razor thin Republican majority in the House and the 60-vote requirement for most legislation in the Senate.

Trump will push for early action on tax cut extension but it won't be easy. At the end of 2025, Congress will face nearly $4 trillion of expiring tax changes and spending programs. Trump wants to move quickly to extend tax cuts and Republican House leaders are vowing action in first 100 days. The goal is to limit the debate on a host of tax changes such as a manufacturing tax cut, deficit concerns, and the offsets needed. This could be possible using budget reconciliation. But the Republicans' razor thin margin in the House coupled with the scale of the changes being demanded will make the process lengthier than policymakers are estimating. We don't expect Congress to go off the fiscal cliff in 2025 but we do expect the effort to take longer than 100 days and push into the summer of 2025.

Tariffs are coming in 2025, with China the priority. We see the 2024 election as a referendum on the speed of deglobalization. Under a second Trump administration, the US is poised to deglobalize faster than it would have under Harris. Last week a 10% increase to tariffs on Chinese goods was announced. The goal is to move supply chains out of China, and we expect India to be a key beneficiary. We also expect Trump to use the threat of tariffs on other countries as a negotiating tactic. His recent call for 25% tariffs on goods coming from Canada and Mexico was intended to get the other countries to collaborate with the U.S. on preventing migrants and fentanyl from crossing into the U.S.

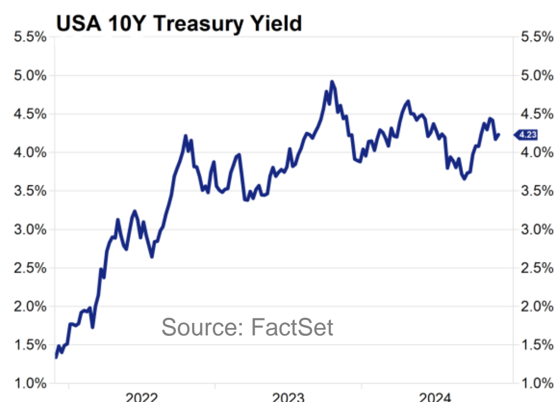
FIXED INCOME: TOM TZITZOURIS, HEAD OF FIXED INCOME RESEARCH

What comes first—liquidity or labor market changes? The question of soft landing versus recession versus no landing will again be debated in 2025, and—much like 3 months ago—the outlook for the bond market comes down to this question: What arrives first, liquidity or labor market changes? To this we can add another question: Will inflation and/or Treasury supply work against or with changes in the labor market? Our view is that all of these forces will come into play, but the time horizon matters.

Rate cuts and TGA cash. Liquidity is likely to arrive in the first quarter as more rate cuts appear to be coming, Fed balance sheet reduction appears set to stop by mid-winter, and the debt ceiling debate seems likely to delay any increase in Treasury supply at least until middle of Q2 (with coupon supply not likely to increase until Q3 or later). Alongside that, Treasury General Account cash will likely flood into banks until the debt ceiling is raised, pumping up bank reserves by anywhere from a few billion to a few hundred billion dollars over the first few months of the year. The shortage of supply, along with TGA cash and the Fed hitting pause on balance sheet reduction, should all help to flatten the yield curve, all else being equal.

Seasonality. Seasonal economic weakness seems likely in Q1, due in large part to a pending consumer hangover from the 2023 and 2024 binges, as well as a delayed restart of business spending after months of election uncertainty. These factors should be temporary but powerful enough to push yields lower across the curve in more of a parallel fashion.

Reversal for bonds. The second half of 2025 should see a reversal of fortunes for bonds, first with Treasury supply reemerging and then with consumer and business spending picking back up (particularly after tax season), assuming that the labor market has again avoided any major softening. This should help to bear steepen the curve starting in Q3, with a persistent itch for yields to push higher as 2025 transitions into 2026.



Inflation redux. Inflationary pressures should re-emerge in the second half of 2025, though may not be fully felt until the middle of 2026. Nonetheless, the bond market will be on edge at the first sign of reflation, and we expect to see breakevens make a hard move towards 3.0% for 10-year TIPS (Treasury Inflation-Protected Securities) no later than the end of 2025.

Credit and MBS. The first half of 2025 should be quite supportive for credit and mortgage-backed security (MBS) spreads, with the second half less so. But without a recession, spread-widening in the second half of 2025 should be limited to low double digits in both cases.

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