

***When will the Budget Deficit Start to Matter to US Markets?***

Next year it will start to matter. The haggling over extending and modifying the Tax Cuts and Jobs Act will not be easy. The bill will come later in 2025 than earlier. That is because the budget math just isn't there for many things Republicans would like to do and the negotiations are going to get messy. Any disregard for budgetary sanity with an already large budget deficit (about 6.5% of GDP in a growing economy) will lead to some punishment from the financial markets and the US would for the 1<sup>st</sup> time experience some very modest credit risk for long-dated treasuries.

**Prediction:** The positive economic benefits from tax cuts will be far less than anticipated as the reality of budget dynamics cap the extent of the executive tax cut plan. The stock market will be disappointed by that.

***Will it be Difficult to get US Inflation Down to the 2% Target?***

Yes, but there won't be a reacceleration. Inflation has been sticky due to service prices in our economy, not goods prices. In fact, good prices have been negative YOY but goods prices, ex-food and energy commodities, only account for 18.5% of the CPI weighting. Goods prices are not nearly as relevant as service prices, but they do matter. Tariffs or even the anticipation of tariffs will lead to goods price inflation. Worker shortages in certain industries to the extent they develop from government policy would be inflationary as well. Meanwhile, psychological inflation that works its way through the service economy will persist for some time. However, the biggest impediment to inflation is affordability. Affordability challenges which will be as relevant in 2025 as they have been this year will put a lid on any meaningful reacceleration of inflation.

**Prediction:** Core CPI (3.3% YOY) and PCE YOY (2.8% YOY) trends will remain stubbornly higher than Fed target early in 2025 due to some of the factors mentioned above but by the end of 2025 structural challenges to affordability will outweigh those factors and inflation will resume its trend down toward target.

***Will Europe Move Toward a More Cohesive Approach to Addressing Structural Growth Challenges?***

Yes. The second Trump election win is going to be a catalyst for Europe to put in place structural reforms that strengthen the EU and allow it to exist separate from the US. Political turmoil in core European nations like France and Germany are concerning but one still needs to wait and see what the economic consequences are from strong political divisions. In the US, many investors would say our government works best when divided, even if it leads to a whole lot of posturing and delay. In Germany, we might see some increased spending in 2025, that would be welcome. Stock prices are depressed in Europe, any renewed confidence in European economies could lead to strong performance of European stocks, particularly cyclical ones.

**Prediction:** Buy European cyclicals, a very contrarian call for 2025.

### ***Can China Move Past its Housing Crisis and Reignite Consumer Confidence?***

Chinese authorities are very well aware of what happened in Japan after its economy faltered in the late 90's. A lack of consumer confidence combined with poor demographics led to two decades of a low growth economy with minimal inflation. Chinese overcapacity matched with depressed consumer sentiment is a challenging set up. In addition, China could be looking at more tariffs from the US. However, per capita GDP is still quite low in China, much lower than it was in Japan when it ran into economic trouble, and that is a major catalyst for increased consumption.

**Prediction:** China will be able to stabilize its economy and consumer spending will grow at a modest rate in 2025, not a robust rate, but one strong enough to create some earnings growth for Chinese consumer stocks and those will provide decent returns.

### ***How Pervasive Will New Tariffs be and How Disruptive Would a Trade War be?***

It is difficult to tell if the tariff threats are negotiation tactics or we will be seeing a lot of new tariffs in 2025. New tariffs at a low double-digit rate would be modestly disruptive to our economy. Affordability is already a challenge for many and tariffs could push some into a difficult situation. But a household spends more on services than goods and tariffs would disproportionately impact goods. Tariffs are potentially more problematic for corporations than households. Tariffs will evoke a response from the targeted countries and spiral risk exists. Sanctions, suspensions, etc. are risks US companies could face from tariffs.

**Prediction:** Modest tariffs for many countries, nothing extreme, will be put in place early in 2025 as a targeted negotiating tactic but will not lead to any near-term economic breakthrough and US households and corporations will have to adjust to more tariffs.

### ***Is the Massive Boom in AI Spending Going to Generate a Meaningful ROI?***

Investors definitely are giving technology companies the benefit of the doubt here. There aren't many instances where industry capital expenditures grow at a very high rate and it doesn't lead to short-term overcapacity. Some of the major technology companies trade at a significantly higher multiple to free cash flow than they do earnings. This is because of very large capital expenditures. There is a big opportunity in AI but the tools that exist now are more like digital assistants than employee replacements and the budget for assistants is not anything close to what a budget would be for replacements. That may change in a few years but there are many very smart AI industry analysts that believe the current models are plateauing and they will need another jump in ability to become truly disruptive.

**Prediction:** History will repeat here. Technology companies and investors are spending too aggressively ahead of the opportunity. A short-term overcapacity situation will develop for models and tools, along with the processing power needed to train new models. That will lead to some stock price pain for AI companies.

### ***Has Passive Ownership Distorted the Stock Market as an Indicator of the Fair Value of a Company?***

Many studies put the passive ownership of stocks somewhere around 1/3 of ownership. While holdings data from mutual funds and ETF's is widely available, data pertaining to passive strategies managed in separate accounts is more sparse. Therefore, an exact percentage for passive ownership is not known but believed to be over 30%.

Passive investors accept the price of the stock as is and don't try to influence the price. A meaningful percentage of a company's ownership beyond passive ownership is long-term holders that do not buy and sell. It is hard to estimate this exact percentage, but it needs to be considered. In addition, many funds that are not explicitly passive investment funds invest in a manner that doesn't allow the fund to deviate meaningfully from the benchmark. Those funds are sort of quasi-passive. Then, one needs to consider the rise of quantitative fund managers that buy and sell based on several factors, many of which are not the traditional valuation metrics. Lastly, the rise of retail investors has increased the percentage of ownership in a company that buys and sells based on non-traditional factors.

Add that all up and it does appear fundamental discounted cash flow investors have become a much smaller percentage of company ownership. Why that matters is that cohort has traditionally been the ones to set the fair value price and the ones that put the brakes on sharp upwards stock moves or sharp downward stock moves. It is concerning when a large percentage of ownership does not consider a cash flow based fair value to be relevant to ownership. It can lead to excessive volatility.

**Prediction:** Go long volatility in 2025. Regardless of one's view on the economy, geopolitics, etc., the ownership structure of the stock market is now one where there is the potential for a burst in volatility.

### ***Will Bonds Provide a Good Return?***

Vanguard, one of the largest money managers in the world, recently suggested that bonds should be held at 62% and stocks at 38% is a traditional 60/40 investing approach. This is a dramatic shift and speaks volumes to the risk Vanguard sees in the equity market. If one is content with mid-single digit returns, the bond market is an excellent place to invest. When your starting yield is around 5%, a sharp 100 basis point move higher in the interest rate curve holding credit spreads constant would lead to an annual loss of a couple of percentage points but that loss would quickly be recouped the following year. Meanwhile, a 100 basis point rise in interest rates would likely have a much more pronounced downward impact on stock prices. If the starting yield of a bond were around 6%, the likelihood of a suffering a loss in a year becomes even smaller.

**Prediction:** Bonds will provide similar returns to stocks over the next 5 years with much lower risk.

***Is There Truly a US Exceptionalism Dynamic in Play for Stock Investors?***

Two things to consider. Exceptionalism in stock investments, exceptionalism in economic growth.

Does the US have some exceptional companies. Absolutely, it is impressive how large and globally powerful the US tech industry has become. But exceptionalism doesn't mean stocks are good holdings regardless of price. The excess growth that the tech powerhouses need to achieve vs. slower growth alternatives to justify 50x free cash flow yields is very large. If one were to model out in discounted cash flow analysis the free cash flow growth a company trading at 50x free cash flow would need in order to provide a better discounted return than one trading at 10x free cash flow, the excess growth is very large for a long period of time. One could reasonably be skeptical companies so large to begin with would be able to provide such outsized growth when they are already so large and dominant. There is a lot of scrutiny of these companies at their current sizes, larger would become more problematic.

The US economy is not exceptional. One could argue there is more productivity occurring in the US economy than in other developed nations. Productivity ebbs and flows. Perhaps, on a go forward basis there will be structurally slightly higher productivity in the US but one would be hard-pressed to make the case for a significant advantage. What has led to better growth in the US is the fiscal stimulus is just not stopping. While other countries pulled back meaningfully from the covid fiscal stimulus, the US continues to aggressively spend. Since the end of 2019, the total treasury public debt outstanding (not just held by public) has risen 12.2 trillion dollars while our economy has grown 7.2 trillion dollars. That is unsustainable. Debt fueled growth is hardly exceptional.

**Prediction:** The US markets are not immune from investor concern. In the next couple years, the capital markets are going to force politicians into decisions they are not comfortable with. At that point, the US will look very unexceptional.

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