CARSON | Investment Research

Market Outlook 2025

Animal Spirits

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Welcome to Carson Investment Research's *Outlook 2025: Animal Spirits*. As we look ahead to 2025, we know the scars of high inflation in 2022 and the higher interest rates that came with it are still with us.

We've seen it in global elections, where incumbents have been rejected no matter where they fall on the political spectrum. We've seen it in consumer sentiment surveys, which have improved but remain well below pre-pandemic levels despite 3.0% annualized real GDP growth over the last two years, comparable to the 2.8% from 2017-19. And we've seen it among the market pundits, who have been incessantly touting the high risk of a recession and market declines since the Federal Reserve started hiking rates to fight inflation in 2022.

Fortunately, whatever the global mood, markets have been able to tune out much of the noise. The S&P 500 has now gained more than 20% for two years in a row, something we have not seen since the 1990s. And while higher interest rates have made it more expensive to borrow, savers have enjoyed the benefit of better returns on savings and shorter-term investments than we've seen in decades. Even core bonds have been hanging in there over the last two years. Still, even with all the good news for bulls, it's hard to say that this market has been greeted with enthusiasm.

We believe that economic momentum, an easing Federal Reserve and pro-growth fiscal policy will continue in 2025, but we may also get a lift in the national mood that economists call "animal spirits." Policy support may be the foundation, but sometimes change for its own sake can also make the difference, crossing a threshold that says we've moved on from what's been weighing on us, whether because of something inspirational or oppositional.

Animal spirits are an impulse to act, to innovate, to invest on an economic scale. They're not based on calculated self-interest, which may not have even changed. Instead, it's a shift in the deeper motivational forces that are the source of all action. On an individual scale, it's the difference between sleeping in one day and getting an early start the next. On an economic scale, it's all the small decisions that build to a virtuous cycle of economic activity.

We are not making a call that animal spirits will be unleashed in 2025, or even that they must be. Rather, we see an opportunity that might need to materialize for the economy and markets to meet their full potential and navigate the challenges to come. There are risks as well, among them a monetary or fiscal policy mistake that turns the opportunity into a "just getting by" economy. But we think the balance of the evidence points to something more optimistic.

We see an opportunity for strong economic growth to continue. Continued healthy aggregate income growth and strong household balance sheets are the foundation. But it may also be supported by an extension of the recent trend in productivity growth, allowing for strong wage growth and lower interest rates without the risk of higher inflation. It's the kind of economic base that can help stocks meet the challenge of the typically hazardous third year of a bull market and give us another year of satisfying returns for riskier assets.

'25 Forecast

- Economic momentum, helped by monetary and fiscal policy, supports earnings growth.
- High starting yields are a cushion for bonds with modest potential for rates to fall. Anticipated rate cuts may help.

RETURNS

Stocks **12-15%**

Bonds **4-7%**

The Carson Investment Research team has prepared our Outlook 2025: Animal Spirits as your guide to what we may see in the economy and markets in 2025. There is a chance to meet 2025 with energy no matter what the motivation. With the Outlook as a useful guide, we hope you find your call to action to stay on course toward meeting your financial goals, no matter the environment.

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At-A-Glance

Here we lay out our strategic and tactical recommendations for broad asset classes. These views reflect our latest views on markets, the economy, and policy.

Our starting point is the long-term strategic view, which forms the basis of our strategic allocation recommendation. These are built off our long-term views for various asset classes. We then incorporate our views on the economy, technicals, valuations, and policy outlook to generate our shorter-term tactical recommendation, which are meant to adapt to the macro environment.

		Strategic View	Policy	Economic	Technicals	Valuations	Tactical View	
EQUITIES		Overweight	Green	Green	Green	Red	Overweight	Better rate environment, resilient consumer, productivity growth may be supportive macroeconomic environment.
EQUITIES	U.S. Equities	Overweight	Green	Green	Green	Red	Overweight	US growth likely to outpace other global economies
EQUITIES	International Equities	Underweight	Gray	Red	Gray	Green	Neutral	Valuations relatively attractive but economic growth may lag; strong dollar may be a headwind
EQUITIES	Emerging Markets	Underweight	Gray	Red	Red	Green	Underweight	Policy risk, especially in China, remains a major issue; tarrifs are a risk
U.S. Equities	Large Cap	Neutral	Gray	Gray	Green	Red	Neutral	Solid companies up top but valuations lean unattractive
U.S. Equities	Mid & Small Cap	Overweight	Gray	Green	Gray	Green	Overweight	Favorable policy environment may contribute to market broadening; valuations attractive
U.S. Equities	Growth	Underweight	Gray	Gray	Green	Red	Neutral	Rich valuations a headwind but fundamentals are solid; home of many higher momentum stocks
U.S. Equities	Value	Overweight	Gray	Green	Gray	Gray	Neutral	We continue to like cyclical value sectors as the economy pushes ahead
U.S. Equities	Defensives	Overweight	Gray	Red	Red	Gray	Neutral	Not a fit with continued economic growth but low volatility stocks could be an added source of diversification
U.S. Equities	Cyclicals	Neutral	Gray	Green	Green	Gray	Neutral	Industrials may benefit from US resilience; yield curve steepening would benefit financials
FIXED INCOME		Underweight	Gray	Red	Red	Green	Underweight	We prefer stocks in a pro-growth environment
FIXED INCOME	Treasuries	Underweight	Gray	Red	Red	Green	Neutral	Moderate gains can continue given yields; diversification benefit may be reemerging
FIXED INCOME	Investment Grade Corporate	Neutral	Gray	Gray	Gray	Red	Neutral	Credit background looks strong but spreads are tight
FIXED INCOME	High Yield	Neutral	Gray	Green	Gray	Red	Neutral	Spreads are tight leading to a preference for equities
Diversifiers	Cash	Neutral	Gray	Red			Underweight	Rates still attractive but higher reinvestment risk as the Fed cuts
Diversifiers	Diversifiers	Overweight	Gray	Green	Green	Gray	Overweight	Modest exposure to gold as a hedge still merited; managed futures can add diversification

Source: Carson Investment Research 12/31/2024

ECONOMY & POLICY

The U.S. economy has just seen two solid years of growth. In fact, real GDP has grown at an annualized pace of 3.0% over the last two years (through the third quarter of 2024), which is faster than the 2017-19 pace of 2.8%.

After adjusting for inflation, the economy is now 2.6% above pre-pandemic projections made by the Congressional Budget Office (CBO) *|Chart 1|*. Incredibly, this has happened despite the severe headwind of an aggressive Federal Reserve raising interest rates from 0.25% to 5.5%.

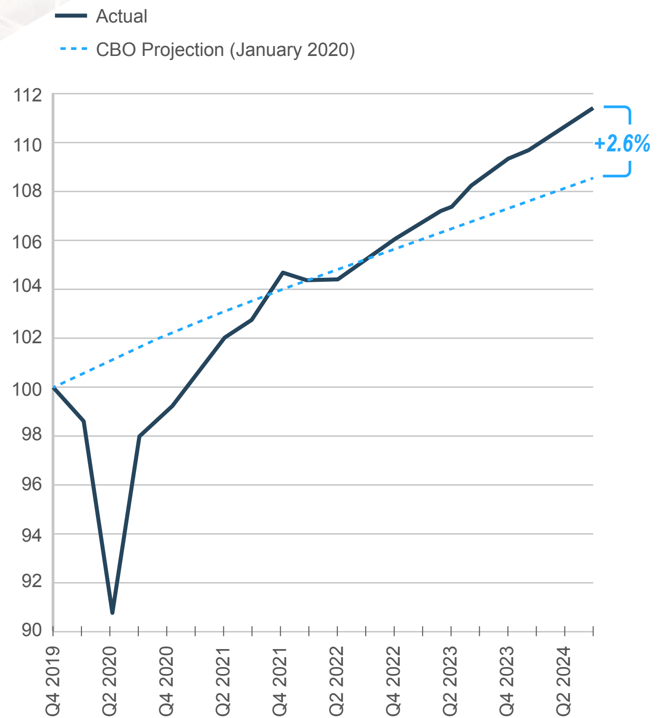
Things played out largely as we expected in 2024, as we continued to fade the numerous recession calls and maintained an overweight recommendation to stocks that has been in place since late 2022. But what lies ahead?

Our proprietary Carson Leading Economic Index (LEI) for the U.S. never pointed to recession at any point over the last two years, and it's still in strong territory as we start 2025 *|Chart 2|*. The Carson LEI includes more than 20 components that capture the dynamics of the U.S. economy, including consumption, housing, business and manufacturing activity, sentiment and financial markets. We populate an LEI for 28 other countries as well and aggregate it all together to get a picture of the global economy as well as major regions. Right now, the U.S. stands tall above almost every other major economy in the world.

Chart 1

The Economy's Grown Much Faster Than Pre-pandemic Projections

Real GDP (Index, Q4 2019 = 100)

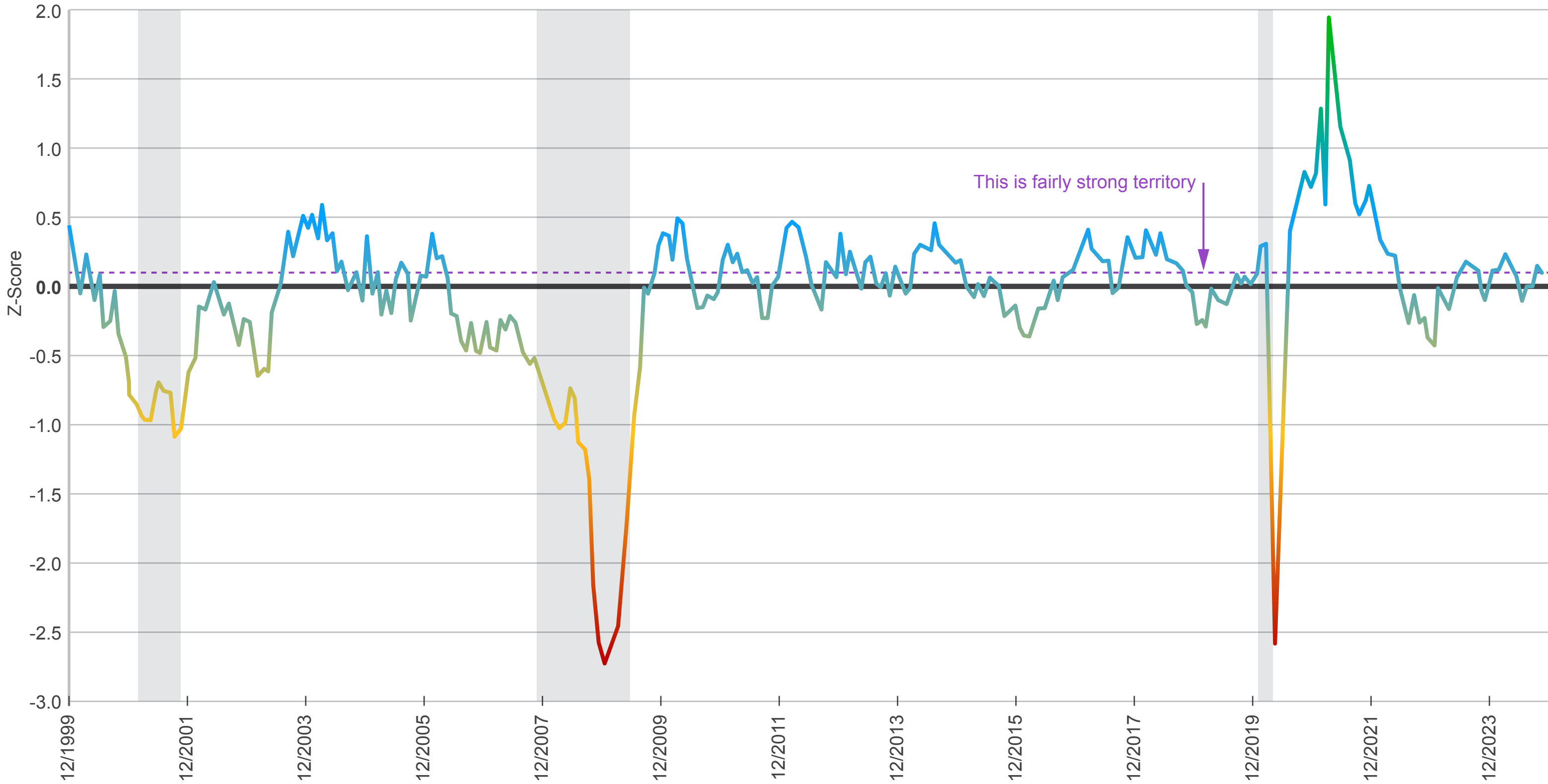


Data source: Carson Investment Research 11/30/2024
Congressional Budget Office (CBO)

Chart 2

The Economy Is On A Solid Footing

Carson Proprietary Leading Economic Index - USA



Data source: Carson Investment Research | 11/30/2024 | Shaded areas indicate U.S. recessions

Our positive outlook for 2025 does not mean there are no risks around the corner. There's a lot of policy uncertainty ahead, both on the monetary and fiscal side. The Fed is expected to cut rates, but they're going to follow the data and the pace of cuts is uncertain. On the fiscal side, the incoming Trump administration and Congress will have to work out the details of tax policy, and the administration will have to finalize a strategy around tariffs.

In order to get a clearer picture of what may happen, we'll look at the broad economy from the perspective of current strengths and weaknesses and the main threats and opportunities going forward. This allows us to think about the odds associated with different outcomes and position portfolios accordingly.

The economy is on solid footing right now — thanks to strong income growth, solid household balance sheets and strong recent labor productivity growth. That does not mean there are no potential risks. Elevated interest rates, even in the face of Fed cuts, are a big risk to the economy. Higher rates are a function of stronger growth expectations, but it's hurting sectors like housing, manufacturing and investment spending.

Looking ahead, we have potential monetary and fiscal policy opportunities that could provide a steady tailwind for markets and the economy. At the same time, threats that could upend the outlook include tariffs and resurgent inflation.

Overall, economic strengths clearly outweigh areas of weakness, and the opportunities likely have a higher probability of coming to fruition than the threats *[Chart 3]*. That doesn't mean weaknesses and threats should be ignored. They are real and we will be watching for anything that can shift the balance. But the odds favor current strengths and future opportunities playing a stronger role.

Chart 3

Looking Ahead To 2025: Assessing The US Economy

Source: Carson Investment Research 11/30/2024

STRENGTHS – WHAT THE ECONOMY HAS GOING FOR IT

Income Growth Likely to Remain Strong

To start with, it's useful to recall that consumer spending accounts for close to 70% of the economy. Consumer spending has been driven by income growth this cycle, and right now aggregate income growth (across all workers in the economy) is running at a 5.1% year-over-year pace *[Chart 4]*. That's above the strong pre-pandemic pace of 4.8%. There's no reason to expect this to pull back significantly, but we may see a shift in dynamics.

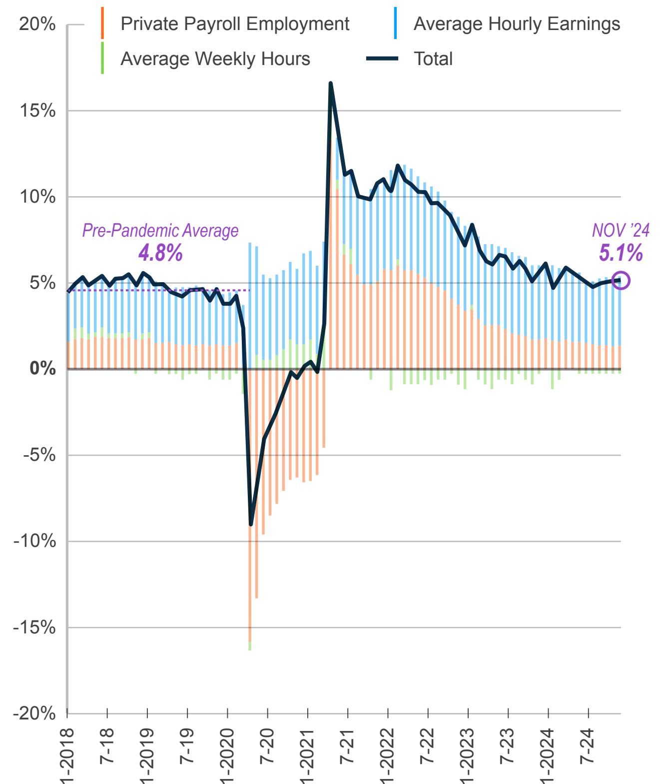
Aggregate income growth is the sum of employment growth, wage growth and the change in hours worked (which usually stays fairly steady). Going forward, aggregate income growth is more likely to be powered by strong wage growth, even as employment growth slows to a 150,000-175,000 average monthly pace.

Another reason for optimism is that we expect headline inflation to remain muted (close to the Fed's target of 2%), in no small part due to easing energy and food prices. That means real wage growth is likely to remain strong, supporting spending.

Chart 4

Aggregate Income Growth Remains Strong

Year-Over-Year Change in Aggregate Weekly Payrolls



Data source: Carson Investment Research, FRED 11/30/2024
Pre-pandemic average calculated as the average annualized growth rate between Jan 2018 and Feb 2020

Strong Household Balance Sheets May Support Spending

Household balance sheets are also in really good shape. Household net worth hit 785% of disposable income as of the second quarter of 2024, close to an all-time record |Chart 5|. This is mostly thanks to rising home prices and higher stock prices. Even if income growth pulls back, strong balance sheets give households room to maintain spending by reducing the amount they save each month.

A Potential Regime Shift for Productivity Growth

Productivity growth is also running strong — over the last six quarters (through the third quarter of 2024), productivity growth has clocked in at a 2.6% annualized pace. That's well above the 1.6% annual pace we saw between 2005 and 2019 |Chart 6|.

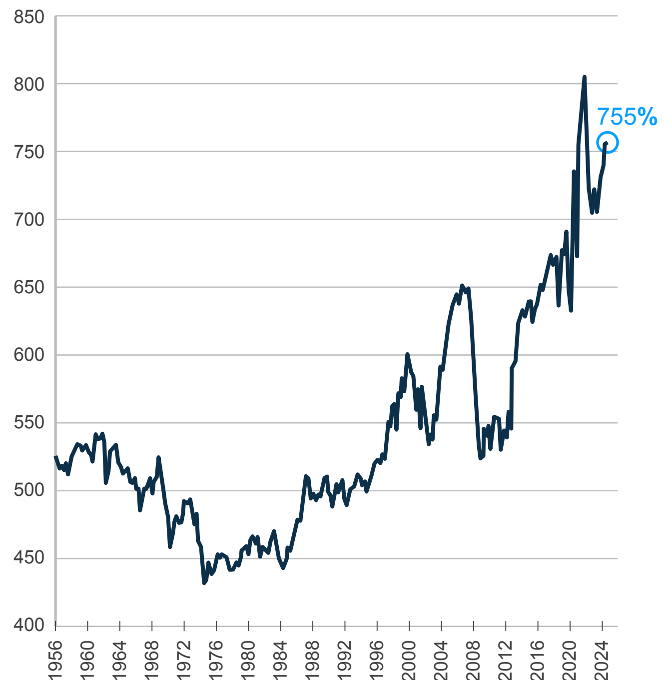
This productivity boost is something we talked about a year ago, including in our 2024 Outlook. As we discussed back then, a key factor here is a strong labor market. Relative to the population, more Americans in their prime working years (ages 25-54) are working than at any point between 2001 and 2019, and they're increasingly productive. Workers who were hired back in 2021 and 2022 have gotten a lot more productive as they have received training and stayed in their jobs (with relatively higher pay). There's also been a lot of post-COVID reallocation within the labor force, as workers switched from low-wage jobs to higher-wage industries amid strong labor demand.

Entrepreneurship is another likely factor boosting productivity, with new business formations running well ahead of what we saw in the last decade.

Chart 5

American Households Are Much Better Positioned Financially

Household Net Worth as Percent of Disposable Income

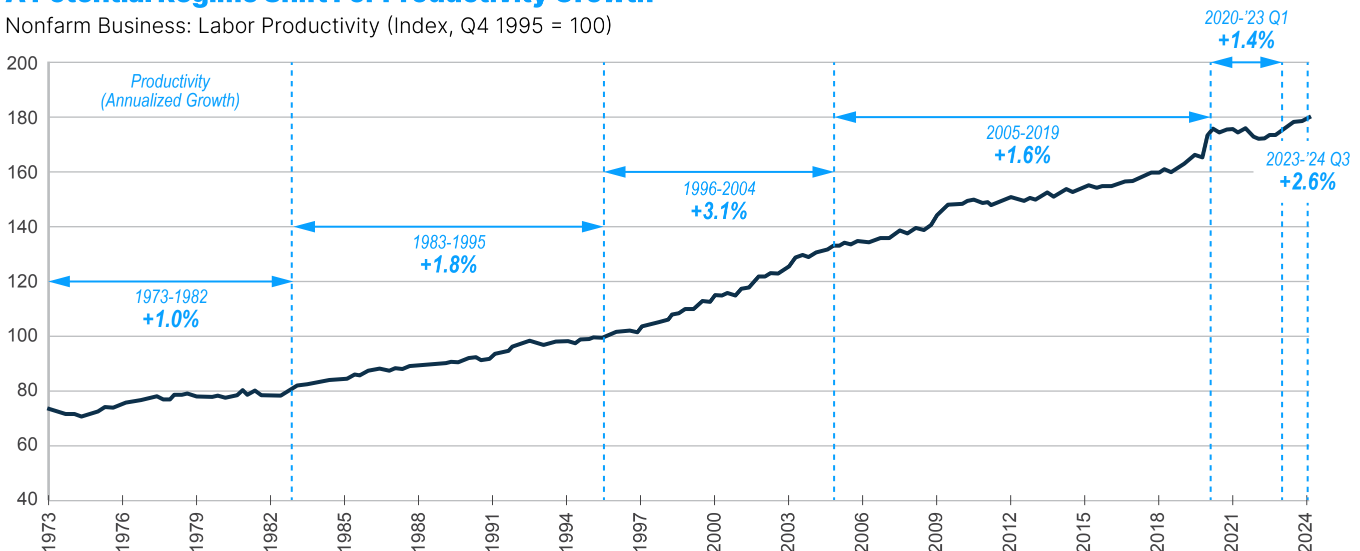


Data source: Carson Investment Research, Federal Reserve 11/30/2024
Includes households and non-profits

Chart 6

A Potential Regime Shift For Productivity Growth

Nonfarm Business: Labor Productivity (Index, Q4 1995 = 100)



Data source: Carson Investment Research, FRED 11/30/2024

New business creation also provides employees opportunities to switch jobs for higher pay. The good news is that strong productivity gains allow wage growth to remain strong without creating inflationary pressures. This dynamic has been playing out over the past year and half, and we expect it to continue into 2025.

A final point on this is that the current breakout in productivity growth, relative to the pre-pandemic trend, is likely not from increasing use of artificial intelligence (AI). Instead, it's coming on the back of a strong labor market, as we wrote above.

If anything, AI has the potential to sustain and build on these gains as we move forward. There's always a fear that new technology, including AI, will put people out of work, but periods of high productivity growth are ones in which the labor market is thriving (like in the 1990s). In fact, the biggest risk to the recent productivity trend is likely a recession, which would be accompanied by a lot of unemployment. However, for the reasons we laid out here, we believe that's a low-probability event in 2025.

House view takeaway: Overweight equities

WEAKNESSES — ELEVATED RATES A CHALLENGE

The Federal Reserve has cut rates 1.0 percentage points since September, essentially pulling back the extra "insurance hikes" it made to ensure inflation didn't remain elevated. Yet, interest rates rose sharply after the Fed's September meeting. These moves continued post-election. Rather than surging inflation expectations, a big driver has been a rerating of economic growth, primarily from much lower odds of a recession as expectations reset amid a rise in "animal spirits" that may help sustain economic momentum.

Normally, we would consider higher interest rates as a "threat," but it's an existing problem that's already causing weakness in the rate-sensitive sectors of the economy.

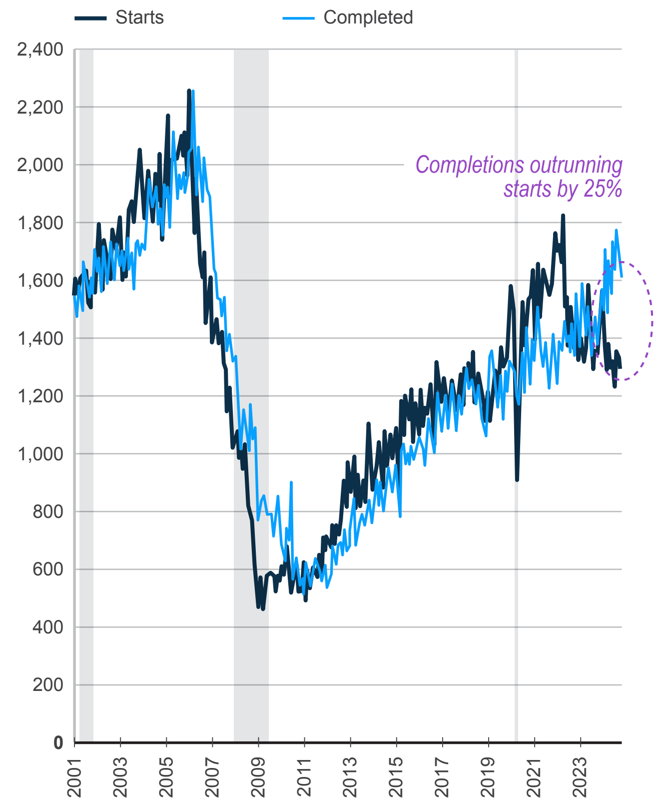
Housing Is Hurting (Again)

The weakest area of the economy is housing, which is a critical cyclical sector of the economy. And no surprise, it's highly dependent on interest rates. Thirty-year mortgage rates closely track 10-year Treasury yields (with an added spread), and they're close to 7% now. That's not conducive for housing activity as affordability has plunged — thanks to elevated rates and rising home prices. This is weighing on builder activity, and both single-family and multi-family segments are getting hit. Completions are running 25% above starts, which indicates that builders are not confident about the outlook and are more focused on just completing homes already in the pipeline instead of starting new ones *|Chart 7|*. Some fear of labor shortages due to immigration policy may also be starting to play a role.

Chart 7

Housing Starts Running Well Below Completions, Indicating Housing Pessimism Among Builders

Privately Owned Housing Units



Data source: Carson Investment Research 11/30/2024 Factset, FRED, Shaded area indicate U.S. recessions

Housing by itself should not pull the economy into a recession, but it's a drag. Residential investment pulled from GDP growth for nine straight quarters through Q1 2023, as the Fed got aggressive with rate hikes. But activity rebounded for four quarters after that as the hiking cycle ended and expectations rose for the beginning of an easing cycle. Yet mortgage rates have stayed stubbornly high, leading the residential sector to drag on GDP once again. This is likely to continue into the beginning of 2025, unless mortgage rates pull back. The "glass half full" perspective is that if rates start to ease, housing will stop being a drag, though we'll probably need to see mortgage rates under 6% to see a real boost in activity.

Lower Rates Needed for Investment and Big-Ticket Purchases

Higher interest rates adversely impact investment spending that is dependent on borrowing, and we're already seeing signs of that. Business equipment spending picked up in the middle of 2024, coinciding with a big drop in interest rates. However, with rates reverting higher, there's some risk that equipment investment flatlines (as it did in 2023).

Investment in structures boomed over the last couple of years, but this has been driven by the CHIPS Act and IRA (Inflation Reduction Act) increasing investment in manufacturing structures, specifically high-tech manufacturing. However, investment in structures outside of manufacturing has been weak. This is unlikely to rebound unless interest rates ease.

High interest rates also hinder consumers from tapping into credit, such as auto loans or even home equity, which has built up over the last few years and is relatively untapped compared to history. Overall consumer credit growth is running at just over 2% year over year, well below the 4.5% to 5% pace we saw back in 2019.

***House view:** Multi-asset portfolios need some protection against the risk of a downturn. Underweight bonds, but emphasize some intermediate maturity core bonds complemented by a small allocation to longer maturity Treasuries rather than cash.*

POLICY OPPORTUNITIES ABOUND — DON'T FIGHT THE FED, OR CONGRESS

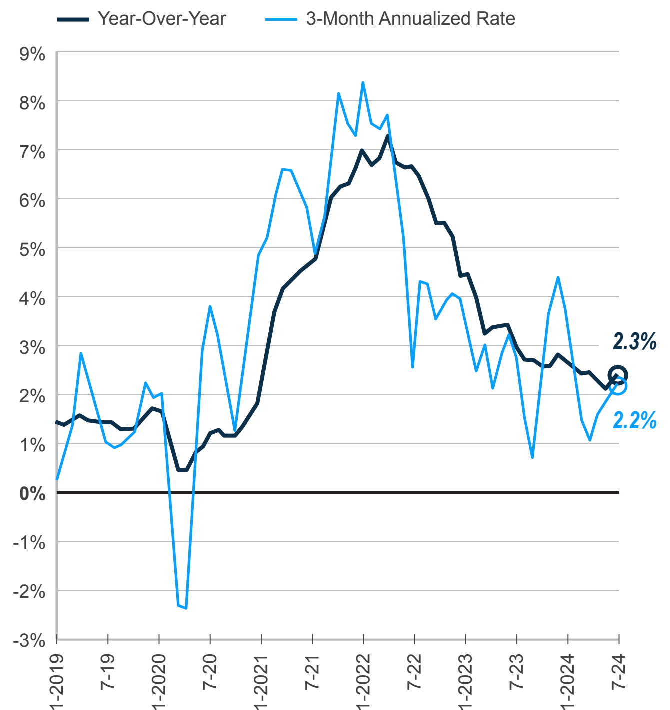
The Powell-Led Federal Reserve May Be Key in 2025

There's a question as to whether the Fed should even be easing rates when GDP growth is running at 2.5% to 3.0%. However, the Fed does not have a GDP mandate — it has a low and stable inflation mandate and a maximum employment mandate. The inflation outlook looks good going into 2025. Headline inflation, as measured by the Fed's preferred metric, personal consumption expenditure inflation (PCE), is running at 2.3% year over year, and is up just 2.2% annualized over the past three months (through October 2024) *|Chart 8|*.

Chart 8

Inflation No Longer A Problem, Which Means The Fed Can (And Should) Continue Easing Rates

Personal Consumption Expenditure Price Index (Oct 2024)



Data source: Carson Investment Research 11/30/2024 FRED, Bloomberg

The Fed does pay close attention to core inflation (excluding food and energy), but it's good to recall it actually targets headline inflation. To that end, oil prices remaining around $70/barrel (WTI) is a big positive — it's hard to worry about inflation when energy prices are muted. It matters even for core inflation, since energy feeds into items like restaurant prices and airfares. On the core inflation front, most of the excess inflation (above the Fed's 2% target) is coming from lagging shelter data and portfolio management services (due to the run-up in stock prices). The good news is there's likely more shelter disinflation coming through in 2025.

Most importantly, forward-looking measures of inflation tell us the outlook is normal:

- Wage growth is strong, but it's running close to pre-pandemic levels, which means it's unlikely to be a significant source of inflationary pressures.
- Consumer expectations of inflation have normalized (via the New York Federal Reserve).
- Business expectations of inflation are also running close to 2% (via the Atlanta Federal Reserve).

The relatively benign inflation picture should allow the Fed to focus on the employment side of its mandate. Even after their December meeting, Fed Chair Jerome Powell noted that the labor market is solid, but they don't want it to cool further.

In other words, they're putting a cap on the unemployment rate (or a floor under the economy), to the degree that it's under their control. This implies policy is likely biased toward the dovish side in 2025, and that's a big positive. Markets are currently pricing in another 0.50 percentage points of cuts through 2025, which would take the Fed funds rate to the 3.75% to 4% range. That's still well above the peak policy rate of 2.5% from the last cycle, but a stronger economy with above-trend productivity growth would imply a higher "neutral rate," the rate that's neither stimulative nor restrictive.

Powell has indicated several times that policy is too tight now, but to his credit, he admits not knowing where neutral is. He's said that they're going to feel their way toward that point and that the actual path is uncertain. The risk is that the Fed gets spooked by idiosyncratic inflation data in 2025 that keeps official data on the higher side, similar to what happened in the first six months of 2024. As we wrote above, it's our belief that elevated rates are why certain key sectors of the economy are weak, and the longer policy stays tight, the greater the chance that the weakness spreads.

Fiscal Policy — A Lot of Work to Do, but Likely to Be Market Positive

Fiscal policy could provide another tailwind in 2025. The 2017 Tax Cut and Jobs Act (TCJA) has several provisions that "sunset" at the end of 2025, mostly on the individual side but also a few on the business side. But the odds of the economy going over a fiscal cliff from automatic tax increases on January 1, 2026, have been reduced to close to zero amid Republicans capturing a majority in both chambers of Congress and the presidency. We think there's a good chance that most, if not all, of the expiring provisions will be renewed, and then some. The corporate tax rate, which was permanently reduced from 35% to 21% in 2017, may be further reduced to 15%, which would boost S&P 500 earnings per share (EPS) by about 4%.

Now, there is caution warranted given the slim 220-215 majority Republicans will have in the House, the narrowest Republican majority ever. Even in 2017, writing a tax bill took the better part of a year despite Republicans commanding a 20- to 25-seat majority in the House. The narrow House majority this time around, combined with a 53-47 majority in the Senate, means that serious spending cuts are not going to be part of the picture (as in 2017).

If defense, Medicare and Social Security are off the table, it's going to be hard to find serious savings. Another big difference between now and 2017: Deficits are already high, and the government's

interest costs are much higher, too (thanks to higher rates). Still, the path of least resistance could likely be more deficit spending. The only question is, "How much?" Republicans in Congress will actually have to settle on a deficit number before proceeding to write the tax bills. Note that permanent renewal of all expiring provisions of the TCJA could cost up to $4 trillion.

From a market perspective, deficit spending is not a bad thing in the near term, since the spending funded by all that borrowing, whether passed onto households and businesses via tax cuts (like the TCJA) or used directly for government-directed projects (like CHIPS/IRA), adds to overall spending. That eventually flows through to corporate profits, and profits are what matter for stocks. Profit growth surged over the 2016-19 period on the back of higher fiscal deficits from the TCJA. Even over the last six quarters, households have started saving more (relatively), but corporate profits rose because fiscal deficits started growing again.

Another potential positive is deregulation, though it's always hard to pinpoint precisely how this impacts markets — stocks did just as well under the Biden administration as they did during the four years under President Trump, and the more highly regulated financials and energy sectors did meaningfully better under Biden. However, an easier stance from agencies like the SEC, FTC, CFTC and even the Department of Justice could lead to a rise in "animal spirits," likely manifesting in things like increased M&A activity and IPOs (which have fallen a lot over the last two years, partly due to higher rates depressing valuations). The National Highway and Transportation Safety Agency (NHTSA) may also take a more active role in setting nationwide standards for autonomous driving technology.

Ultimately, deregulation could see more supply-side activity, including in areas like energy production. That would be positive for the inflation outlook.

***House view*: Overweight cyclical areas of the market, including mid and small caps, and sectors like financials, communication services and industrials.**

THREATS COULD UPEND THE OPTIMISM

Tariffs Are Back (Psst … They Never Went Away)

President Trump has said his favorite word in the dictionary is "tariffs." The threat of tariffs, and a retaliatory trade war, is clearly a hot topic. All else equal, tariffs will raise the price of imported goods (though it's a one-time price level increase).

But things don't work as neatly as that. For one thing, it's hard to predict what tariffs will actually be implemented, let alone their impact. The Biden administration kept in place most of Trump's tariffs from his first go-around, and even implemented a few more. Trump has discussed implementing 60% tariffs on Chinese goods and up to 20% tariffs across the board on all other imports. In our opinion, it's highly unlikely we will see anything close to this. The market reaction is likely to be quite negative. For better or worse, President Trump likely sees the stock market as a report card on his performance, and so a negative market reaction may prompt him to temper some of his proposals. Expect to see market volatility around tariff announcements (or rumors).

Targeted tariffs are more realistic, similar to 2018-19. And even back then, several companies got exemptions from the tariffs. Farmers, in fact, got direct handouts from the government to counter the adverse impact of tariffs on their revenue.

Also, bilateral tariffs may simply shift trade to other countries. Christmas tree lights offer a lesson here. When then President Trump imposed tariffs on several U.S. imports in 2018, Christmas tree lights were part of the list. This was clearly meant to hit China, which according to Bloomberg was the source of about 80% of over $500 million in annual shipments. The official source of the lights did switch, but it turns out Chinese suppliers found a way around the tariffs by exporting much of their output to Cambodia, which could then meet the ongoing U.S. demand. Since 2018, the share of imports of Christmas tree lights from Cambodia has risen from below 10% to almost 75%.

The share of U.S. imports coming from China is now just 14%, versus 22% in 2018. Yet, the share of imports from countries like Mexico, Canada and Vietnam has risen. Ultimately, if the economy grows, especially on the back of consumer spending, odds are that imports continue apace. It's highly unlikely that American firms reshore production of most consumer goods. Also, retaliatory tariffs will crimp U.S. exports (other countries have been preparing their own lists of American goods on which to impose tariffs).

Another factor here is the dollar. The dollar appreciated soon after Trump's 2016 election, but then pulled back in 2017 as the focus shifted from tariffs to tax cuts in the U.S. while signs of improving growth appeared in other developed economies. But it resumed its increase in 2018-19, making imports cheaper (and exports more expensive) even as the trade war was raging.

The non-petroleum goods deficit rose by 24% between 2017 and 2019 and surged even more after the pandemic, as Americans went on a goods spending spree even as prices rose *|Chart 9|*.

A stronger dollar could offset some of the price increases associated with tariffs. Also, the impact of tariffs is a one-time price level effect, raising prices after they're implemented but not after that (assuming there's no continuous ratcheting up of tariffs).

All in all, we're skeptical about an inflation surge in 2025 on the back of tariffs. As we noted above, there are additional disinflationary trends in the pipeline that will likely keep a lid on inflation in 2025 (including shelter). If anything, a potentially higher probability inflationary threat remains an unexpected energy price shock (like in 2022) arising from major disruptions in the Middle East, or even Russia/Ukraine. Still, the absolute odds of this are relatively low. Strong oil production increases in the U.S. and Canada should help mitigate this (keeping supply strong), along with continued weakness in China (keeping a lid on demand).

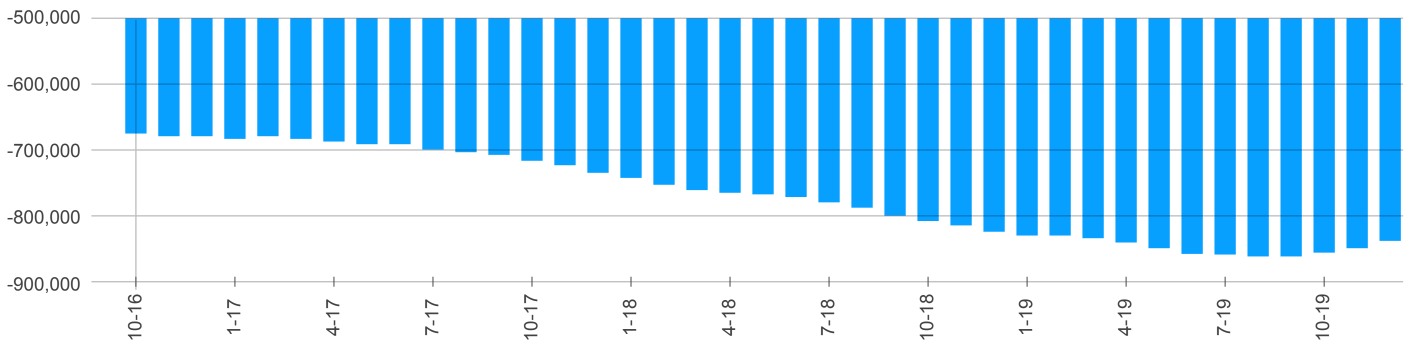
A Strong Dollar Poses Three Key Risks

While a strong dollar could help offset some of the inflationary effect of tariffs, it also poses some key risks. In fact, we would consider the possibility of continued U.S. dollar strength among the notable threats to our outlook. The dollar has appreciated by about 7% since September 2024, thanks to expectations of stronger economic growth (and higher rates) in the U.S. relative to other countries. But part of this dollar surge occurred post-election, perhaps in anticipation of tariffs. We don't have a directional forecast for the dollar, but if economic expectations increase and Fed rate cuts disappoint, we could see continued dollar strength. A strong dollar poses three key risks.

Chart 9

The Trade Deficit Surged In 2017-2019 Amid The Trade War

Trade Balance (Exports Minus Imports) - **Non-Petroleum Goods** (12-Month Moving Sum, Millions of USD)



ICE US Dollar Index - Price

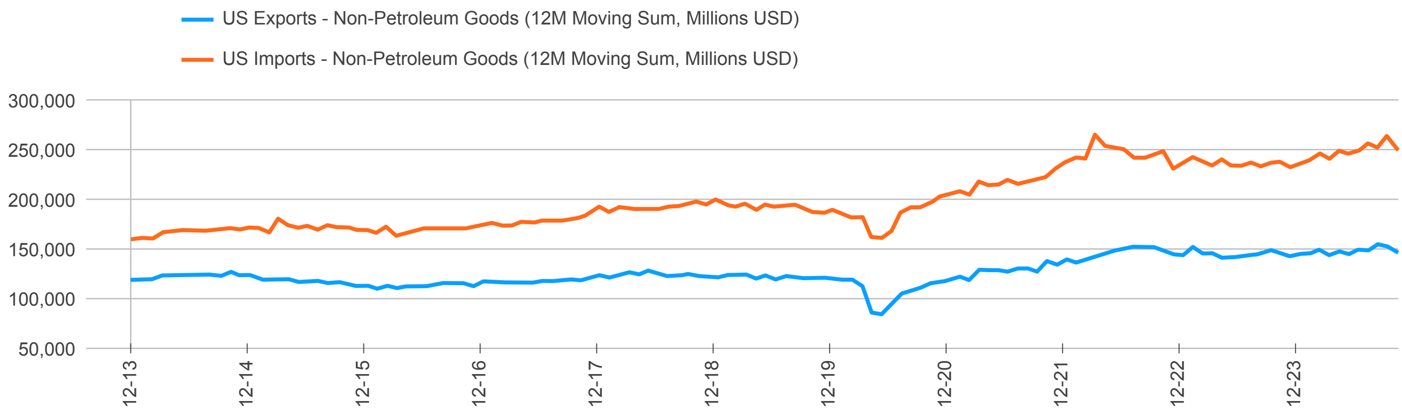
Data source: Carson Investment Research, Federal Reserve 11/30/2024

One: A strong dollar hurts U.S. manufacturing

A strong dollar makes American goods more expensive for foreigners. A strong economy by itself is going to pull in imports, more so if these imports are cheaper because of a strong dollar. This is what happened over the last two years — non-petroleum goods imports are up 8% from two years ago. On the other side of the equation, a strong dollar, along with global weakness, has led to a complete flatlining of U.S. exports — non-petroleum exports are flat relative to two years ago. The last period of broad dollar strength was 2014-19. This was a period when nominal GDP grew by 27%, and imports grew by 19% (imports would likely have been more in line with GDP if not for the pullback in 2019 amid the trade war). However, exports grew just 1% during this time *|Chart 10|*.

Chart 10

Dollar Strength Hurts US Exports And Makes Imports Cheaper



Data source: Carson Investment Research, Federal Reserve 11/30/2024

Two: A strong dollar is a headwind for U.S. company earnings

Just over 40% of S&P 500 revenues come from outside the U.S., which means companies are exposed to currency risk. A stronger dollar will reduce revenue (and profits) generated outside the U.S., and vice versa. Historically, S&P 500 earnings growth outside of recessions has a strong negative correlation to changes in the U.S. dollar *|Chart 11|*.

On the other hand, dollar weakness has historically seen a big boost to S&P 500 earnings, with 2017 a good example. The dollar fell by 10% in 2017 amid a surprise pickup in international growth, both of which helped S&P 500 earnings per share grow by 21%.

Three: A strong dollar is a headwind for international equities

You need to get two pieces right when investing in international equities.

- One, the direction of the equity basket
- Two, dollar strength versus the local currency

The data bears this out as well. International market outperformance of the U.S. becomes more likely as the dollar weakens and U.S. equities increasingly tend to outperform when the dollar appreciates *|Chart 12|*.

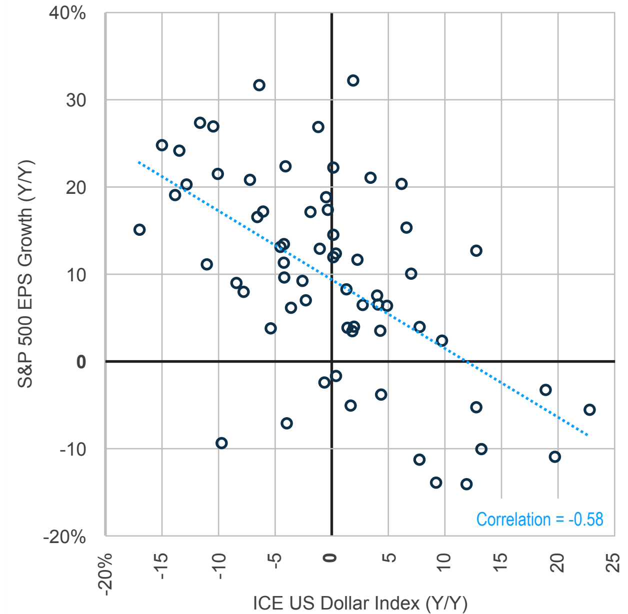
This dynamic is even stronger for Emerging Markets (EM). Part of the reason is that EM local returns are also disadvantaged by a stronger dollar. Normally, you would expect emerging markets to benefit from a weaker currency, since it makes their exports cheap in international markets, boosting demand for those goods and stimulating domestic activity.

However, it turns out there's a financial channel that offsets the trade impact. A weaker currency can lead to tighter domestic financial conditions. A lot of EM companies borrow in U.S. dollars (since it's cheaper to do so), but their revenue tends to

Chart 11

Earnings Strength Correlated With Dollar Weakness

S&P 500 EPS Growth (year over year) vs US Dollar Index (year over year)



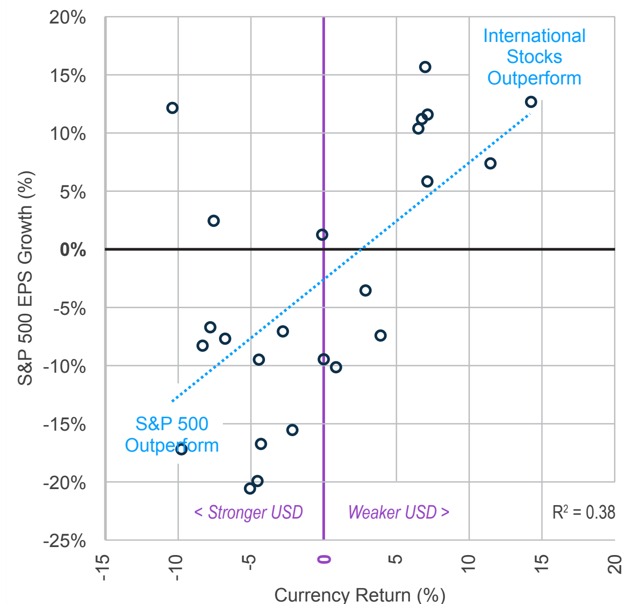
Data source: Carson Investment Research 11/30/2024 Factset, S&P Global
Uses quarterly data from Q4 2002 - Q1 2023. The periods from Dec 2007 - Dec 2010 and Mar 2020 - Mar 2022 are excluded to remove the impact of recessions.

Chart 12

A Currency Hurdle For International Equities

Excess Return (MSCI World Ex US Minus S&P 500) vs Currency Return

Annual Returns: 2001 - 2024 (Nov 15)



MSCI World Ex US Returns are net returns

be in local currency. When the dollar appreciates, it increases their debt service costs relative to revenue, thus creating a tougher domestic economic environment. So a strong dollar is a double whammy for EM equities, weighing directly on EM returns for U.S. investors while also having a potential negative impact on many EM economies.

None of this implies that the dollar is going to continue its recent surge. In fact, if growth optimism pulls back a bit, and interest rates follow, the dollar could fall, even more so if we get a positive surprise on economic data from abroad. However, there's considerable uncertainty around all of these variables. And even if the dollar doesn't fall, the current level may be too strong to stimulate manufacturing, especially if rates stay on the higher side. As in 2019, that's unlikely to throw the economy into a recession, but it's a headwind.

***House view*: Overweight U.S. equities and underweight emerging markets. To manage different types of risk given inflation uncertainty, diversify diversifiers, complementing core bond exposure with a modest allocation to long Treasuries while shifting some bond exposure to gold and managed futures.**

SUMMARY

Overall, economic strengths clearly outweigh areas of weakness, and the opportunities likely have a higher probability of coming to fruition than the threats. The balance favors continued strength for equities, which is why we're maintaining our overweight to stocks, especially U.S. stocks. Equities do have strong momentum going into 2025, but it may not be smooth sailing while Congress and the new administration fully work out policy changes. Combine this with potential risks on the horizon, and we see good reason to maintain a robust array of diversifiers in our portfolios, including bonds, gold and managed futures.

The Good Times Continue to Roll

Two years ago, we were on record that the economy would avoid a recession and we were likely in the early stages of an extended bull market. We moved to overweight stocks in December 2022. This lonely call was not well received by many, but 2023 was a great year for stock investors, with the S&P 500 gaining more than 25% and the economy surprising to the upside with nearly 6% nominal growth.

We came into 2024 expecting more strength, still an unpopular call, and remained overweight stocks. But even we were surprised by just how good 2024 was for the bulls. As we noted at the start of the year, there were many reasons to expect a good year in 2024. To list a few, the Fed was expected to start cutting rates on better inflation data. Stocks had been higher the past 10 times in an election year under a first-term president and higher the past 12 times there was a divided Congress. And year two of new bull markets has historically been quite strong.

Looking back, with all of those in play, maybe it shouldn't be so surprising the bulls were rewarded. In the end, stocks were higher by more than 20% in back-to-back years for the first time since the late 1990s, and the bull market showed little sign of slowing down.

The Dual Tailwinds

Earnings drive long-term stock gains, and when you have an economy that continues to surprise to the upside, you tend to have solid earnings. We already discussed why we expect economic growth to support markets by creating a positive environment for sales and profit growth. Here's what it looks like from the perspective of market fundamentals.

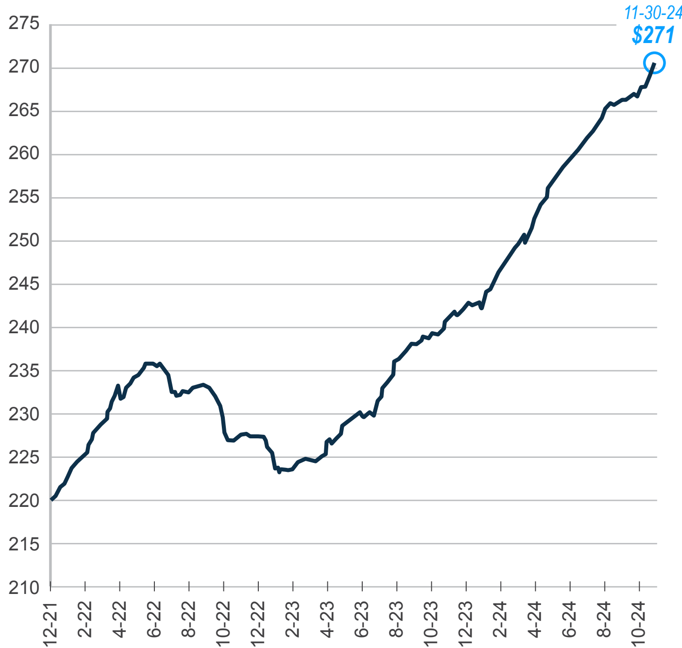
Looking at forward 12-month S&P 500 earnings we once again see new highs, now at $271 per share, up from $225 in early 2023 *|Chart 13|*. There are no easy answers when it comes to future stock performance, but when we saw earnings estimates making hew highs back in the middle of 2023, we took it as a reason to be overweight equities and believe current forward earnings growth expectations remain supportive of stock gains given the economic backdrop.

It doesn't stop there, though. Profit growth is driven by sales growth and profit margins. Margins continue to expand and are at their highest level of the cycle *|Chart 14|*. An underrated story here

Chart 13

Forward Earnings Expectations Continue To Blast Higher

S&P 500 Index - Next 12 Month Earnings Per Share

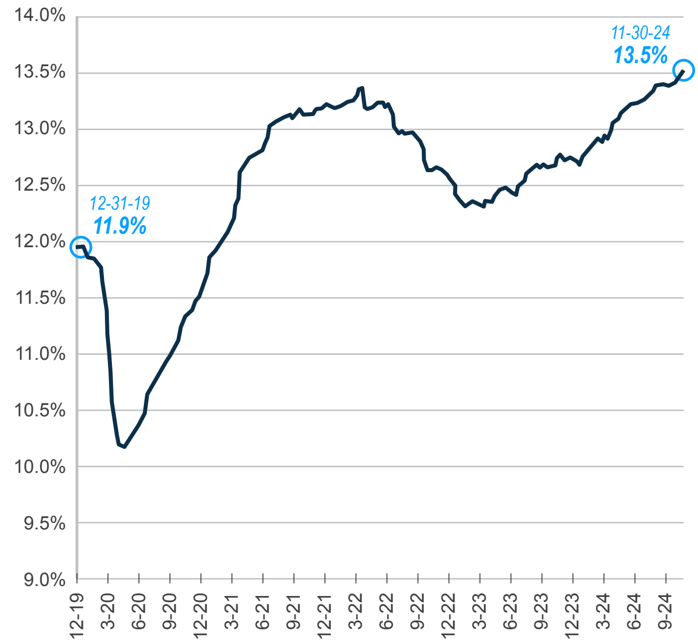


Data source: Carson Investment Research, Factset 11/30/2024

Chart 14

Margins Are At Their Highs Of The Cycle, And Well Above Pre-Pandemic Levels

S&P 500 Index - Profit Margin (Forward 12-months)



Data source: Carson Investment Research, Factset 11/30/2024
Profit margin estimated as next 12-month earnings divided by sales

is that corporate America has a lot of "operating leverage," which allows firms to expand margins as sales grow. Corporate America has more operating leverage thanks to a lot of cost cutting in 2022, especially variable costs.

2022 was a year of low productivity, as firms felt the blowback of over-hiring and overspending in 2020-21. Sales grew but margins fell, and so corporations pulled back. However, getting more conservative bore fruit in 2023 and 2024. Sales grew amid strong nominal GDP growth, but margins also expanded as a result of more operating leverage. This has also shown up in rising economy-wide productivity, and as we wrote earlier, there's no reason to believe this will not continue. That's positive for margins and profit growth going forward, even as the economy continues to grow, all of which is a great tailwind for the stock market.

Within this context, one of our big themes for 2024 was that the bull market would broaden out, which is exactly what we've seen. Whereas 2023 saw technology lead by a wide margin, 2024 saw the baton passed to other groups and the market wasn't so top heavy. All 11 sectors were up on the year and 7 sectors were up double digits. Small caps, midcaps, financials, communication services and industrials all did well, a very healthy sign of underlying strength.

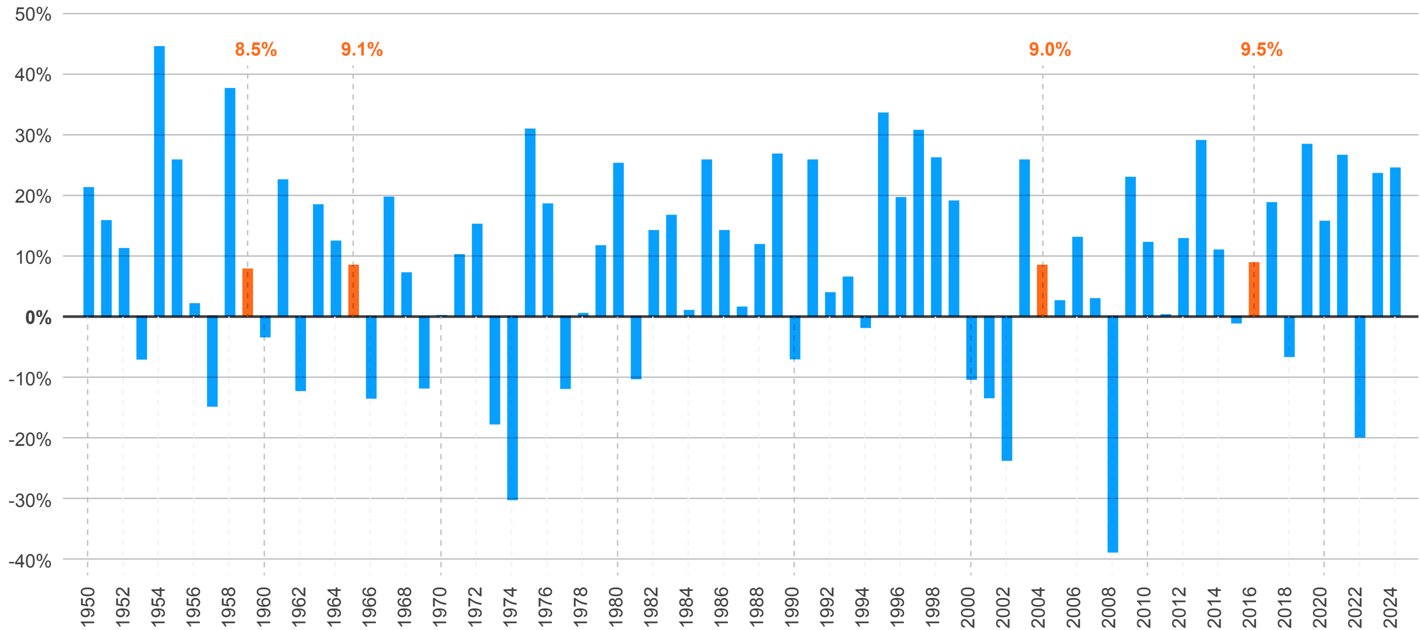
***House Views**: We expect this bull market to continue in 2025 and recommend an overweight to stocks, with an S&P 500 forecasted total return gain of 12% to 15%. Be aware though, the largest peak-to-trough pullback in 2024 was only 8.5%, so we suggest preparing for a likely double-digit correction at some point during the year.*

We expect the theme of more broad-based gains to continue, with potential leadership from small and midcaps, along with cyclical areas like financials and industrials.

Chart 15

An Average Year Isn't So Average

S&P 500 Gains Between 8-10% Are Quite Rare (1950 - 2024)



Source: Carson Investment Research, YCharts 11/30/2024 (1950 - Current)

Average Isn't So Average

We believe with the support of animal spirits, the S&P 500 is likely to exceed the typical return for the index and, depending on how strongly they manifest, we could even see upside to our forecasted target. The S&P 500 has an average return of about 9% a year, but the catch is that it rarely finishes the year in that area. The animal spirits that can accompany a bull market often enhance returns. Going back the past 75 years to 1950, only four times has the S&P 500 gained between 8% and 10% *|Chart 15|*. In fact, the average gain during an up year is more than 19%, whereas the average loss is down nearly 14%. Should stocks finish higher in 2025 as we expect, especially on the back of a solid economy, the likelihood of at least a low double-digit gain is high.

Three Other Reasons to Expect Stock Gains

The Bull Market Is Still Young

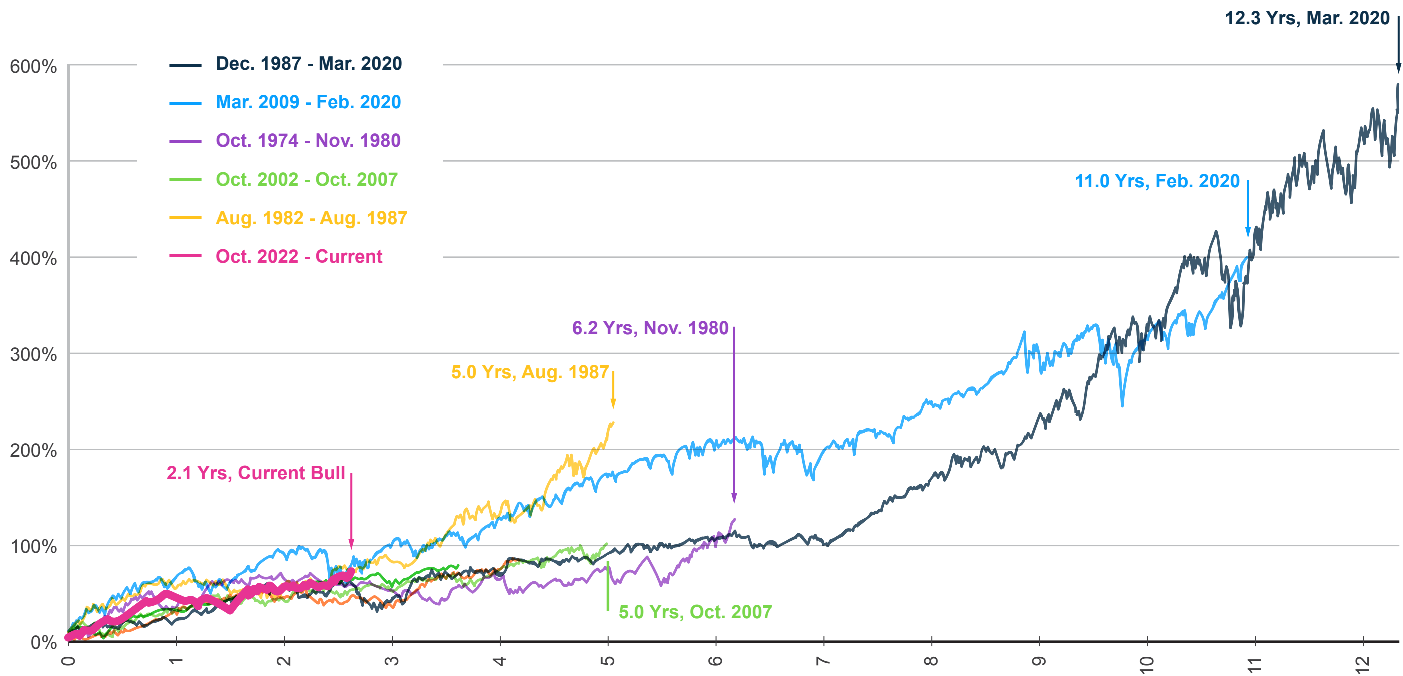
Many investors don't realize that this bull market is actually still quite young. In fact, all of 2022 and 2023 only saw the S&P 500 make one new all-time high. Taking it a step further, we saw the two closest bear markets ever in 2020 and 2022. Given the pain investors felt earlier this decade, the current bull market probably has a lot longer left than most expect.

Looking at the previous 11 bull markets, we found the average bull lasted more than five years, suggesting even though this bull market is mighty, it could have plenty of room left to run. In fact, going back 50 years, once a bull market made it into its third year, there were multiple years left every time *|Chart 16|*.

Chart 16

Once A Bull Market Gets To Two Years Old There Could Be A Lot Left

Bull Markets the Past Fifty Years That Made It to Their Second Birthday



Source: Factset, Carson Investment Research 11/30/2024

Year One (and Two) of a Re-elected President Tends to Outperform

Historically, the S&P 500 has done quite well in Year One and Year Two under a re-elected president (even better than under a new president). No, we don't think anyone should invest simply based on the presidential cycle, but we wouldn't ignore it, either, and this is another reason to expect a better-than-average year for stocks.

While it won't always happen this way, the roadmap for the presidential cycle held true to form during the Biden administration. Historically, year one does well when a new president is in office (which we saw in 2021). Then year two is weak (think 2022 and the bear market). Finally, the final two years are strong (exactly what we saw in 2023 and 2024) *|Chart 17|*.

Fed Cuts Near Market Highs Are Bullish

In early November 2024, the Fed cut interest rates with the S&P 500 near all-time highs. We found 20 other times (back to 1980) that the Fed cut with the S&P 500 within two percent of an all-time high, and stocks were higher a year later all 20 times and up an average of nearly 14%. As much as the Fed was a headwind in 2022 when it aggressively hiked to slow inflation, it has been a tailwind since July 2023 when it stopped hiking. As this easing cycle continues, lower rates are likely to provide additional support, another reason to remain bullish on stocks.

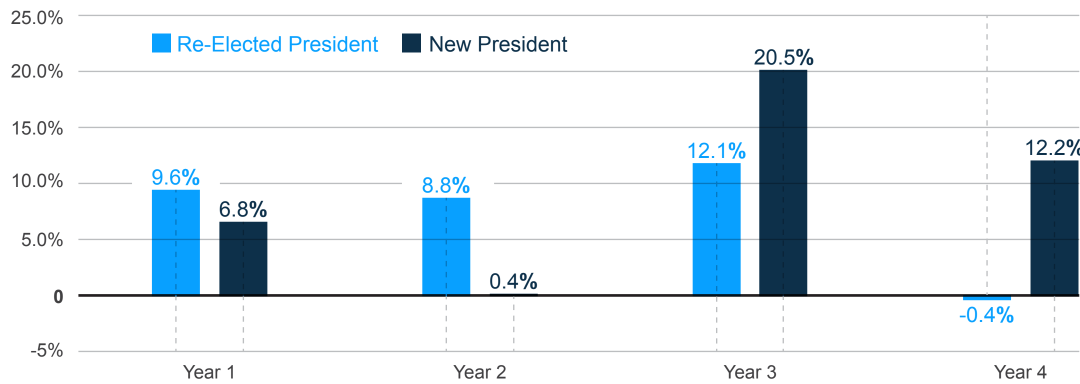
So What Are the Worries?

There are areas of concern for stocks, but based on history, consecutive years of S&P 500 gains over 20% simply isn't one of them. We found eight other times (since 1950) the S&P 500 was up 20% in consecutive years, and the following year was

Chart 17

Stocks Have Historically Done Better Under Re-Elected Presidents Early In Their Second Terms

S&P 500 Performance Based on the Four-Year Presidential Cycle (1950 - 2023)



Source: Carson Investment Research, YCharts 11/30/2024

Chart 18

Up 20% Two Years In A Row Isn't Necessarily A Reason To Be Bearish

S&P 500 Total Returns After Back-To-Back 20% Returns (1950 - Current)

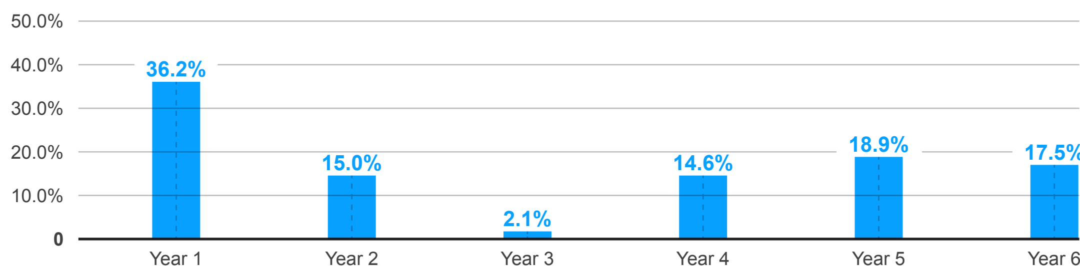
Years That Gained 20%	Year 1	Year 2	Year After Back-To-Back 20% Gains
1950 & 1951	**30.8%**	**23.7%**	**18.2%** (1952)
1954 & 1955	**52.6%**	**32.6%**	**7.4%** (1956)
1975 & 1976	**37.0%**	**23.8%**	**-7.0%** (1977)
1982 & 1983	**20.4%**	**22.3%**	**6.1%** (1984)
1995 & 1996	**37.2%**	**22.7%**	**33.1%** (1997)
1996 & 1997	**22.7%**	**33.1%**	**28.3%** (1998)
1997 & 1998	**33.1%**	**28.3%**	**20.9%** (1999)
1998 & 1999	**28.3%**	**20.9%**	**-9.0%** (2000)
2023 & 2024	**26.1%**	**26.7%**	**?**
		Average	**12.3%**
		Median	**12.8%**
		Higher	**6**
		Count	**8**
		% Higher	**75.0%**

Source: Carson Investment Research, NYU 11/30/2024

Chart 19

Third-Year Returns In Bull Markets Can Be Weak

S&P 500 Average Returns in Bull Markets (1950 - Current)



Source: Carson Investment Research, Factset 11/30/2024

higher six times and up a very respectable 12.3% on average *|Chart 18|*. Incredibly, there was a record streak of five consecutive 20% gains in the mid- to late-1990s.

From the perspective of market history, here are two concerns for stocks.

First, it's the third year of a bull market. The S&P 500 gained more than 62% the first two years of this bull market (October 2022 – October 2024). This can be common, as bull markets historically tend to see explosive gains early. But this can mean year three could be a place where bull markets slow down to catch their breath. Looking at the eight bull markets (since 1950) that made it to their third birthday, the average gain was only 2.1% in year three *|Chart 19|*. The good news is after relative weakness, larger gains going forward are common and the weight of the evidence points to a stronger year three this time around.

Chart 20

Cause For Concern? Stretched Valuations

S&P 500 Index - P/E Ratio (Next 12 Months)

Data source: Carson Investment Research, Factset 11/30/2024

Valuations are stretched. After the run the S&P 500 has had, there is no doubt that parts of the market are quite pricey. The forward S&P 500 price/earnings (P/E) multiple is above 22.0, which is near the high end of the range going back 25 years *[Chart 20]*. But there are parts of the market that aren't as pricey as the large caps names, as we discuss below.

Relative Valuations Point to Opportunities

Another fantastic year for stocks, pushing to all-time highs across a range of U.S. indices, raises a number of questions around valuations. As we mention time and time again, valuations are not a timing mechanism, but an important input into the long-term strategic view of portfolios and strategies. In times of market rotation or broadening, valuation can play an important role in identifying previously overlooked areas of the market ripe for new allocations. Valuations are also a grounding force that can act as a sanity check when animal spirits take hold, and can act as a signal for whether they've in fact taken hold or remain in hibernation.

Starting globally, we like to look at asset classes in a fully invested, long-only framework. As long-term investors, it is important to think of things relative to one another versus simply as an "on or off" switch. Surveying the asset class landscape today, relative to the global stock market, there are several important things to observe. Domestic stocks — particularly large cap growth — are priced like the strong performers they have been. Many of these names have earned and grown into their valuations, but not as a whole. This is not a new phenomenon. Large cap U.S. stocks have been expensive relative to their own history for some time, a high bar that is not always achievable going forward.

On the other hand, the relative performance laggards are notably less expensive *[Chart 21]*. International markets have been plagued with a variety of issues and have a different market makeup than we do here, with less of a tech and consumer focus, which justifies a lower multiple. That multiple, however, remains quite low even relative to history, especially on the developed side. We continue to keep an eye out here for any adjustments needed on our international underweight, particularly if we see a moderation in U.S. dollar strength.

Domestic small and mid-cap companies remain our preferred equity overweight for the following reasons:

- These companies benefit from domestic economic strength.
- They're generally shielded from global issues and dollar strength (which can be a headwind for international equities).
- They trade at particularly attractive valuations relative to large caps and their own history.

The U.S. sector story is largely consistent with the makeup of the major asset classes. Large growth, dominated by technology and tech-adjacent sectors such as communications and consumer discretionary, are on the more expensive side, and other more value-oriented sectors are less expensive as a result *|Chart 22|*.

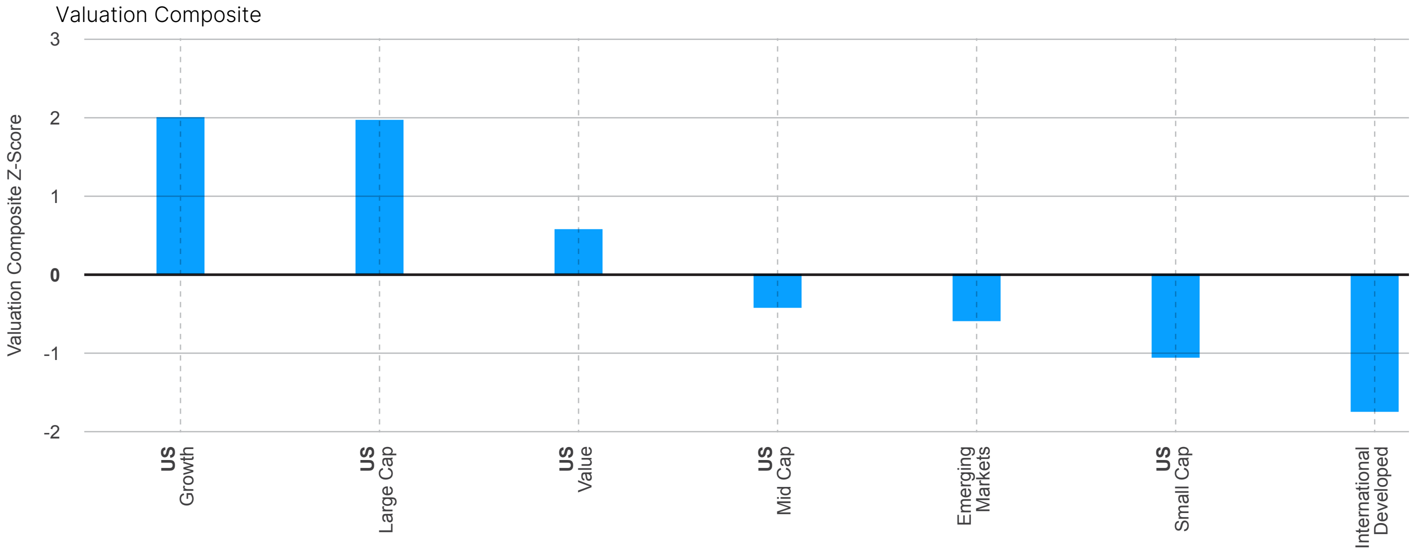
To reiterate for clarity, value-oriented sectors by definition are nearly always cheaper than growth sectors, but what we are attempting to measure here is the degree to which stocks are deviating from their average premiums or discounts. And there's clearly opportunities here, including in sectors like financials and industrials, which should also benefit from a strong economy.

***House Views**: Our sector outlook favors overweights to a mix of communication services, as the growth-oriented sector that offers a more reasonable valuation, and financials and industrials, as cyclically oriented sectors trading at a more reasonable price. Our primary underweight recommendations are real estate and consumer staples based on the economic environment. Since these are small sectors, neutral sectors will lean slightly underweight.*

Chart 21

Global Equity Relative Valuations

Valuation Composite

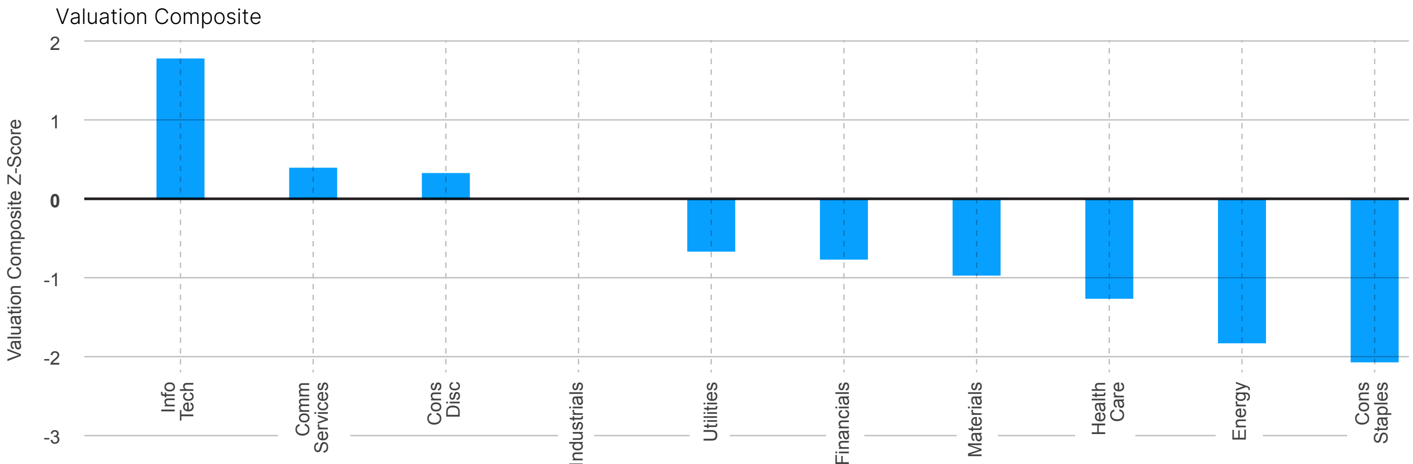


Sources: Carson Investment Research, Morningstar Direct 11/30/24 | Relative Valuations utilize P/E, P/B, P/C, P/S ratios relative to parent index

Chart 22

US Sector Relative Valuations

Valuation Composite



Sources: Carson Investment Research, Morningstar Direct 11/30/24 | Relative Valuations utilize P/E, P/B, P/C, P/S ratios relative to parent index

BONDS

High Starting Yields Provide a Cushion

For all those investors who use bonds as part of a diversified portfolios, the scars of 2022 probably have not healed. But with much higher starting yields than before the pandemic (never mind the yield lows of 2020) and the Federal Reserve expected to further cut interest rates, the overall picture for bonds continues to improve.

At the same time, rate cuts will lower the return for shorter-term bonds. They're still attractive, but with each cut, their relative attractiveness declines. At this point, we would have a decided preference for the core investment grade bonds represented by the Bloomberg US Aggregate Bond Index ("Agg"). While narrow return estimates should be taken with a grain of salt, our baseline forecast for the Agg is a return of 4% to 7% in 2025 versus a 4% to 4.5% gain for short-term Treasury bills.

Modest Downside Potential for Rates

There is a lot of uncertainty around rates right now, especially when it comes to the potential policy impact of the incoming Trump administration. There may be some potential for upward pressure on rates for both positive reasons (policy that is potentially pro-growth) and negative reasons (policy that is potentially inflationary).

Our baseline is that pro-growth policy may help sustain current growth rates but probably won't lead to meaningful acceleration. On the inflation side, right now we believe we're seeing a lot of strategic posturing on tariffs and other policies that is undoubtedly directionally correct but is more extreme than what we're likely to actually see. As we discussed when looking at the economy, we're taking a wait-and-see approach on tariffs. What we do actually know is that independent of policy, we're in a disinflationary trend with likely some meaningful catch-up for shelter inflation still to go.

Acknowledging that there is a lot of uncertainty, in a largely normal environment we would expect the 10-year Treasury yield to fall somewhat further over time from its current level, but not dramatically. In fact, the level of the 10-year yield at the end of November (4.18%) is within what we would consider the normal range even if the center of gravity is lower. But it wouldn't take much of a decline from rates for core intermediate bonds to outpace short-term instruments *[Chart 23]*.

Chart 23

Intermediate-Maturity Bonds Outperform T-Bills Even With A Small Yield Decline

One Year Change in Yields	-1.5	-1	-0.5	0	0.5	1	1.5
Projected Bloomberg US Aggregate Return	13.7	10.7	7.7	4.6	1.6	-1.4	-4.5
Projected 3-Month Treasury Return	3.8	4.0	4.3	4.5	4.8	5.0	5.3

Source: Carson Investment Research, FactSet 11/30/2024
Scenarios assume no change in spreads, a parallel change in yields, reinvestment at the current yield, and a one year holding period.
Treasury bill returns assumes evenly spaced decline every three months starting three months from now.
Indexes: Bloomberg US Short Treasury (1-3 months), Bloomberg US Aggregate Bond Index

There are a couple of reasons we see some modest downside potential for rates. First, when short-term interest rates fall with Fed rate cuts, longer-term rates also decline, but usually more slowly. Historically, from short-term yield peak to trough, long-term rates decline at about half the rate, on average.

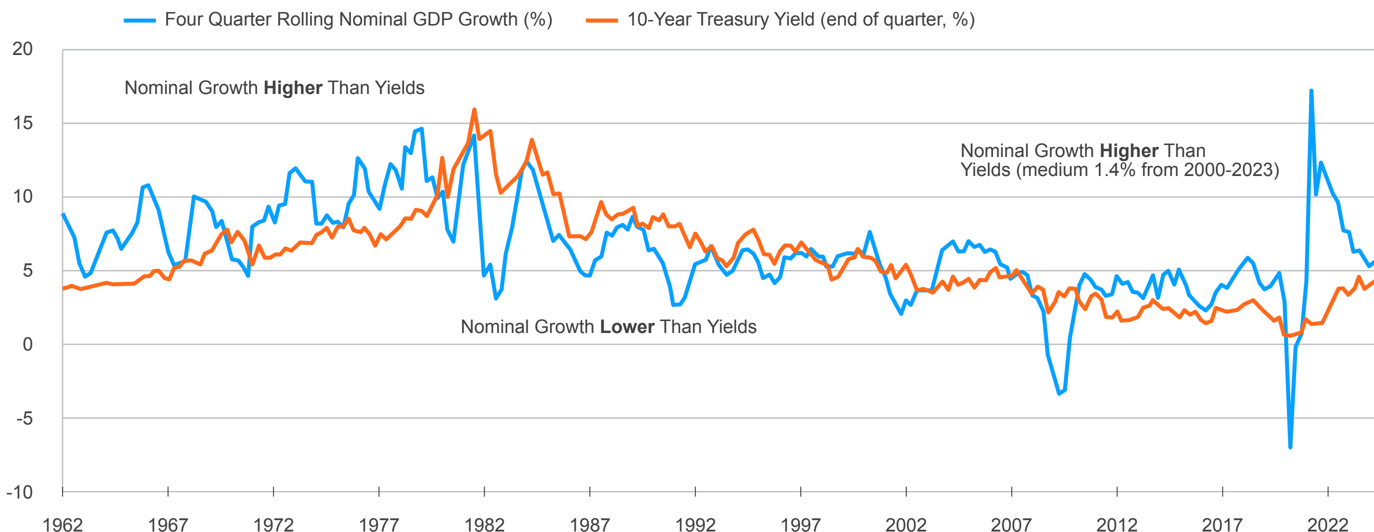
Second, since 2000, the 10-year Treasury yield has tended to run a median of 1.4 percentage points below nominal GDP *|Chart 24|*. That may have been in part due to a higher level of bond demand during a period of low correlation with stocks, so we are watching for whether that relationship changes. But with that as a baseline and expectations of good (but not great) growth and stable inflation, that would give us a center of gravity for the 10-year Treasury yield of around 4%.

At the same time, as we discussed in our 2024 Mid-Year Outlook, the neutral fed funds rate has likely moved higher than the current level in the Fed's economic projections. The topic has become central to Fed rate discussions, but the actual level of the neutral rate is a practical question, not a theoretical one, and Powell and the Fed will follow the data. Nevertheless, a higher neutral rate would mean there's not a lot of potential for the 10-year Treasury yield to move meaningfully lower than our target as long as the expansion continues.

As for the potential downside for core bonds, no movement in the 10-year yield but three rate cuts over the next year would give the Agg a small return edge over Treasury bills. It would take more than a 0.77%-point increase in the 10-year for core bonds to be negative over the next year. That

Chart 24

Since 2000 Yields Have Tended to Run Below Nominal GDP



Source: Carson Investment Research, retrieved from FRED, Federal Reserve Bank of St. Louis 11/30/2024

increase would put the 10-year at just below its peak level in October 2022, when the Fed was aggressively attacking the highest inflation in more than 40 years.

There are other things that could move the 10-year yield higher, but we've already been confronted with what can fairly be considered an extreme inflation scenario, and that's as far as yields went. With starting yields much higher, getting back to that peak yield level, which was devastating in 2022, would be disappointing in the current environment but relatively mild.

Bonds as Diversifiers Logs a Win

One of the deepest scars of 2022 was the failure of bonds to act as a diversifier. The bond market had the worst year in its history during a stock bear market. It doesn't matter if prices will move back to par over time — bonds didn't do their job when many investors needed them most.

Looking back at the history of major stock declines, bonds — long-dated Treasuries in particular — have often been one of the best diversifiers during stock selloffs, but not always. Broad commodities often see sharp declines during equity selloffs, but in 2022, commodity exposure was a far more powerful diversifier than fixed income. And gold was also a better diversifier than either during the Great Financial Crisis and in 2018 *[Chart 25]*.

The point is that bonds, especially long maturity Treasuries, are often an effective diversifier during stock declines, but it does depend on the environment, and bonds aren't the only diversifier.

More recently, we did see bonds start to return to this role. Looking at every S&P 500 decline over 5% starting with the pandemic, we can see that bonds were an effective diversifier in 2020, but then failed to outperform Treasury bills during every ensuing decline — five of them altogether covering 2022, 2023 and early 2024. Finally, during the more than 5% decline we saw in July and August 2024, long Treasuries solidly outperformed Treasury bills and even offset much of the equity market decline *[Chart 26]*.

Does this mean bonds are back as a diversifier? They may be, but it depends on the environment. Bonds struggle as a diversifier when 1) rates are low, 2) inflation moves higher and 3) the Fed has

Chart 25

The Best Stock Diversifier Depends On The Environment

Longer Maturity Bonds Are Often a Solid Candidate

Selected Index Performance **During Major Stock** Draw-downs

Start	End	S&P 500	Bloomberg US Aggregate	Bloomberg US Gov.: Intermediate	Bloomberg US Gov.: Long	Bloomberg US Treasury - Bills (1-3M)	Bloomberg Commodity Index	Bloomberg Gold
7/17/98	8/31/98	-19.2%	1.9%	2.1%	**5.1%**	0.6%	**-9.7%**	-6.3%
3/24/00	10/9/02	-47.4%	29.1%	28.7%	**38.8%**	10.5%	16.3%	12.4%
10/9/07	3/9/09	-55.3%	7.2%	13.2%	20.2%	2.7%	**-38.1%**	**21.4%**
4/29/11	10/3/11	-18.6%	5.4%	4.6%	**28.6%**	0.0%	**-20.0%**	6.3%
9/20/18	12/24/18	-19.4%	1.6%	2.0%	4.7%	0.6%	**-7.4%**	**5.1%**
2/19/20	3/23/20	-33.8%	-0.9%	3.5%	**12.5%**	0.3%	**-18.9%**	-2.5%
1/3/22	10/12/22	-24.5%	-14.4%	-8.4%	**-28.0%**	0.7%	**16.5%**	-7.5%
	Average	**-31.2%**	**4.3%**	**6.5%**	**11.7%**	**2.2%**	**-8.7%**	**4.1%**
	Median	**-24.5%**	**1.9%**	**3.5%**	**12.5%**	**0.6%**	**-9.7%**	**5.1%**

Source: Carson Investment Research, FactSet 11/30/2024 | Green and salmon shading represents the best and worst diversifier that particular stock drawdown. All indexes were effective diversifiers during the 2000-2002 so no box is shaded as "worst."

Chart 26

Long US Treasuries Have Started Playing Defense Again

Start	End	S&P 500	Bloomberg 1-3 Month US Treasury Bill	Bloomberg Long US Treasury Bond	Bonds added diversification
2/12/20	3/23/20	-33.6%	0.3%	14.0%	Yes
1/4/22	9/30/22	-29.1%	0.6%	-26.4%	No
11/30/22	12/28/22	-7.2%	0.3%	-2.3%	No
2/2/23	3/13/23	-7.5%	0.5%	-1.8%	No
7/31/23	10/27/23	-9.9%	1.3%	-13.5%	No
3/28/24	4/19/24	-5.4%	0.3%	-5.3%	No
7/16/24	8/5/24	-8.4%	0.3%	5.1%	Yes
8/30/24	9/6/24	-4.2%	0.1%	3.1%	Yes

Source: Carson Investment Research, FactSet 11/30/2024

to aggressively raise rates. The first condition has substantially improved. Our starting point on the third is already fairly elevated. Inflation is the main risk, but even in that case, we have a better environment. Still, given inflation uncertainty, we continue to recommend using part of a bond allocation for diversifiers that may be more effective in environments where bonds may struggle.

Fixed Income Valuations Show a Mixed Picture

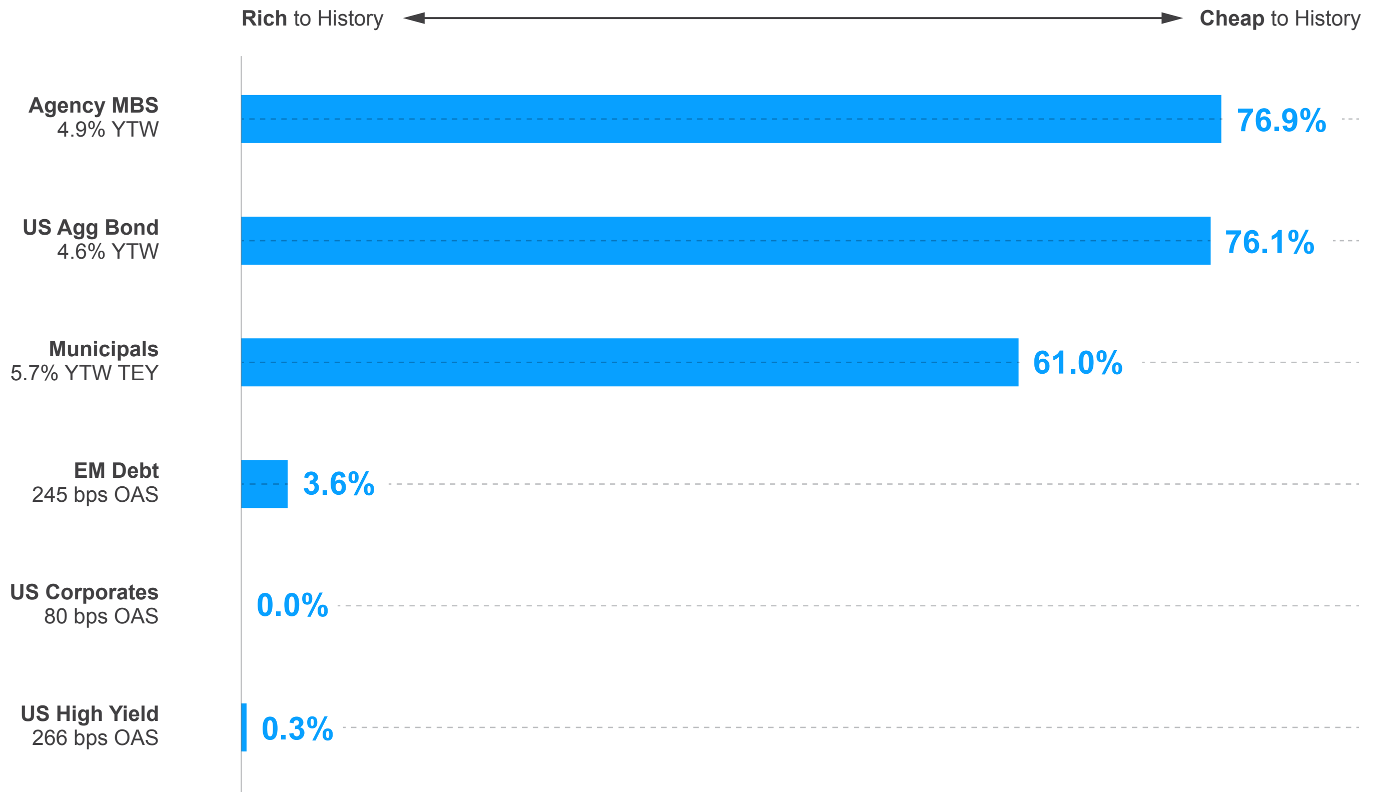
Much in the same way that equities can be valued, fixed income can also be looked at through a similar lens. However, due to a bond's price at maturity being known in advance, these deviations often resolve themselves sooner than what we see in equity markets, particularly at extremes.

Looking across fixed income markets today, there are stark bifurcations in the pricing of assets. Riskier credit sectors have seen continued inflows, and spreads (the difference between

Chart 27

Fixed Income Valuations

20-year Percentile Rank - YTW and OAS



Sources: Carson Investment Research, Factset 11/30/2024
YTW = yield to worst. OAS = option adjusted spread. TEY = Treasury equivalent yield.

the yield on a riskier bond and a comparable Treasury) continue to tighten. In fact, spreads versus comparable Treasuries have reached levels we have not seen in nearly two decades.

On the other hand, higher quality fixed income like Treasuries, mortgage-backed securities, and municipal bonds continue to offer higher yields than they have in recent memory. The widely followed Bloomberg US Aggregate Bond Index has hovered around a 5% yield for the past couple of years, levels not seen since before the Great Financial Crisis *[Chart 27]*.

This presents current opportunities in fixed income to take advantage of still elevated high-quality yields. The Fed's rate cutting path remains a bit murky, but if it continues, bonds across the yield curve may benefit. With the yield advantage of credit sectors historically low, we prefer to take our additional risk within equities and alternatives.

***House Views**: We think 2025 is a year to be positioned a little more conservatively on the bond side. That includes targeting a level of interest rate sensitivity that is a little higher than the benchmark Agg with an emphasis on quality, and even a modest allocation to longer maturity Treasuries.*

At the same time, because of the uncertainty in the environment, particularly around inflation, we continue to recommend "diversifying the diversifiers" with some selective commodity-sensitive exposure such as gold and trend following futures strategies ("managed futures").

ENHANCING PORTFOLIO MANAGEMENT

Revisiting Factors

The world of investment products has evolved in many ways over the years, and that evolution has seemingly accelerated more recently. There are nearly 4,000 U.S. exchange-traded products, each with their own index or objective (for better or worse). This is on top of tens of thousands of traditional mutual funds. It can be overwhelming, to say the least, to figure out the best way to manage portfolios. Here, we offer a couple of key ideas we have taken advantage of in recent years for enhancing security selection.

The first is the inclusion of factor investing in portfolios. Factors are general characteristics of individual stocks (or sometimes bonds) that play a role in shaping their risk and return characteristics. Quality, value, momentum, volatility, size and sometimes yield are commonly known factors. When used appropriately, gaining exposure to these factors can enhance returns and often at the same time lower risk in portfolios.

Investment factors have a degree of cyclicality, just like individual stocks, sectors and even countries. Factors can fall in or out of favor, become over or undervalued, gain or lose momentum, or simply not represent the stocks that are best suited for the current economic or corporate environment. However, over the long term, factors have been rewarded (even minimum volatility, after accounting for risk) *|Chart 28|*.

Carefully timing factor allocations requires a disciplined process and consistent analysis of variables that affect factor returns. However, factors should exhibit a degree of structural benefit through time that can be beneficial to portfolios. Take, for example, the combination of low volatility (simply, the lowest volatility stocks in a given index over a given period of time) and momentum (the best performing stocks in a given index over a given period of time). Exposure to both, if well-constructed, may allow you to play offense via momentum and defense via low volatility.

This combination can yield strong results, particularly through entire market cycles, as the risk reduction of low volatility becomes clear during downturns and matches up well with the return enhancement of momentum. *|Chart 29|* shows that a simple 50/50 combination of the two factors, with rebalancing parameters, yields a lower risk and higher return profile than the S&P 500.

Chart 28

Factor Quilt Chart

Returns for Major Factors (2008-2024)

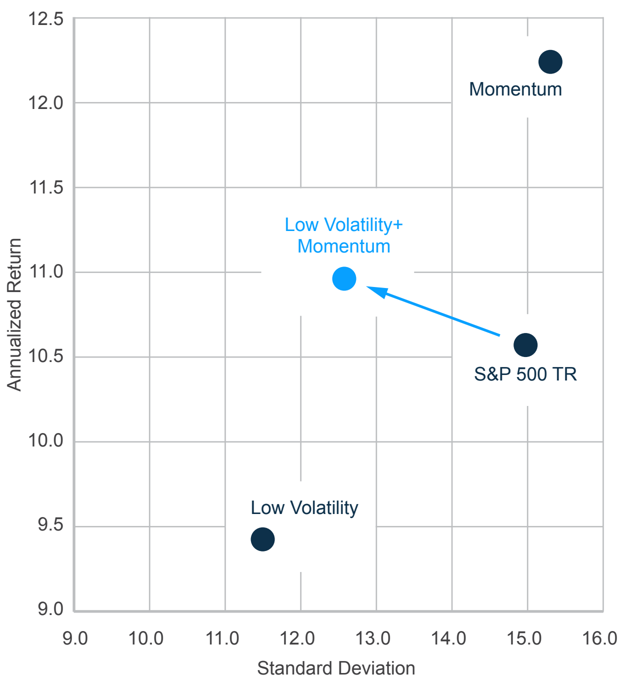
2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	Return (Since 2001)	Risk (Since 2001)
Min Vol -26.2%	Small Cap 39.1%	Small Cap 27.5%	Min Vol 11.9%	Small Cap 17.5%	Value 42.3%	Value 17.0%	Momentum 8.7%	Small Cap 19.2%	Momentum 37.2%	Min Vol 0.9%	Quality 38.4%	Momentum 29.2%	Value 28.2%	Min Vol -9.7%	Quality 35.7%	Momentum 35.4%	Quality 9.3%	Quality 14.5%
Quality -30.6%	Value 37.9%	Momentum 17.8%	Quality 7.7%	Value 16.0%	Small Cap 37.6%	Min Vol 15.8%	Quality 6.5%	Value 15.0%	Quality 25.3%	Momentum -2.0%	USA 30.9%	Quality 22.3%	Quality 27.1%	Value -14.8%	USA 26.5%	USA 27.0%	Small Cap 9.2%	Small Cap 19.6%
Small Cap -36.2%	Quality 31.0%	USA 14.8%	Momentum 5.5%	USA 15.3%	Momentum 34.0%	Momentum 14.2%	Min Vol 4.9%	USA 10.9%	Value 21.3%	Quality -3.1%	Momentum 27.4%	USA 20.7%	USA 26.5%	Small Cap -17.6%	Small Cap 17.9%	Quality 26.6%	Momentum 9.1%	Momentum 15.7%
Value -37.5%	USA 26.3%	Min Vol 13.8%	USA 1.4%	Momentum 14.3%	Quality 32.8%	USA 12.7%	USA 0.7%	Min Vol 9.8%	USA 21.2%	USA -5.0%	Min Vol 27.1%	Small Cap 18.3%	Min Vol 20.4%	Momentum -17.9%	Value 13.4%	Small Cap 21.5%	Value 7.9%	Value 17.5%
USA -37.6%	Min Vol 17.5%	Value 12.1%	Value -3.3%	Quality 13.3%	USA 31.8%	Quality 11.2%	Small Cap -4.1%	Quality 7.3%	Min Vol 18.4%	Small Cap -10.4%	Small Cap 26.7%	Min Vol 5.1%	Small Cap 19.1%	USA -19.8%	Min Vol 9.1%	Min Vol 21.4%	USA 7.8%	USA 15.4%
Momentum -41.1%	Momentum 17.1%	Quality 11.9%	Small Cap -3.4%	Min Vol 10.2%	Min Vol 24.4%	Small Cap 7.1%	Value -7.0%	Momentum 4.6%	Small Cap 16.8%	Value -11.7%	Value 26.5%	Value -1.1%	Momentum 12.6%	Quality -23.0%	Momentum 9.0%	Value 15.6%	Min Vol 7.7%	Min Vol 11.9%

Sources: Carson Investment Research, Morningstar Direct as of 10/31/2024.
Momentum, Minimum Volatility, Value, Small Cap, Quality, and USA are represented by the MSCI USA Momentum, MSCI USA Minimum Volatility, MSCI USA Enhanced Value, MSCI USA Small Cap, MSCI USA Quality, and MSCI USA Indexes respectively.

Chart 29

Factor Combination

Risk Reducing and Return Enhancing S&P Indices
2004-2024



Source: Carson Investment Research, Morningstar 11/30/2024
Low Volatility and momentum represented by the MSCI USA Low Volatility and MSCI USA Momentum Indexes.

Active Management May Be the Way to Go

In many ways, factor investing was designed to replicate active management, typically at a lower cost and in a way less prone to human error or judgment. In fact, a lot of actively managed equity portfolios can be replicated with low-cost factors. That being said, well-vetted active managers have their place in portfolios as well, especially if they provide excess returns ("alpha") over well recognized factors. The growth in active ETFs has contributed to this in very positive ways, as ETFs almost always have lower expense ratios and tax consequences relative to their mutual fund cousins.

Active management has especially shone in fixed income. For starters, fixed income indices are a lower bogey than market-cap-weighted equity indices in some ways. There would be almost no way to own all 13,731 bonds in the Bloomberg US Aggregate Bond Index, as bonds do not trade on exchanges or in readily available inventory. Similar

Chart 30

Active ETF Outperforming BM

Broad Active ETF Category	1-Year	3-Year	5-Year	Total ETFs (1yr)
All Active **ETFs**	**37.4%**	**41.0%**	**51.0%**	**792**
Allocation	42.2%	32.3%	42.1%	45
Alternative	37.9%	30.4%	42.9%	29
Commodities	53.8%	37.5%	60.0%	13
International Equity	40.4%	49.1%	58.3%	89
Miscellaneous	33.3%	14.3%	0.0%	27
Municipal Bond	**64.5%**	**45.8%**	**78.9%**	31
Nontraditional Equity	3.5%	36.8%	8.3%	172
Sector Equity	36.9%	19.6%	17.6%	65
Taxable Bond	**64.5%**	**66.9%**	**78.8%**	166
US Equity	37.1%	32.2%	45.5%	197

Source: Carson Investment Research, Morningstar 11/30/2024

to stocks, but often times much more obvious, not all of these bonds are worth owning even if you could. Also, while not owning the largest stocks may create substantial deviation from a benchmark index, not owning the largest bonds may very well be a good idea.

Additionally, many very strong active fixed income managers have come to market in the ETF wrapper. Active equity managers are following suit, but at a much slower pace due to worries about holdings transparency, front-running and structural concerns that do not apply in the same way to fixed income.

We think these concerns will continue to fade and more top-tier active equity managers will come to embrace the ETF wrapper, but in the meantime, active fixed income managers have proven in aggregate to be able to navigate the rocky recent environment for bonds quite well. The chart below shows how nearly two-thirds of all active managers in ETFs across municipal and taxable bonds have outperformed their respective benchmarks *|Chart 30|*.

While not an investment philosophy etched in stone, we believe the combination of equity factor exposure and actively managed fixed income positions — all with a careful attention to asset allocation and risk — puts investors in the best place to succeed in today's markets.

House Views**: *****Over the last two years, our view was that the economy will avoid a recession and the bull market will continue, and was beneficial from the perspective of generating excess returns from asset allocation. However, bullishness is more pervasive now and we could see more volatility in 2025. While we remain overweight equities, we are looking to potentially add excess returns by investing in factors like low volatility and momentum within equities, and actively managed strategies on the fixed income side.***

CONCLUSION

"Animal spirits" has now become a well-known part of the economic vocabulary, but as a casual term, not as part of an analytic framework. It was first coined in an economic context by the great economist John Maynard Keynes. Keynes observed that "a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectation," and called the source of this urge to act "animal spirits." That is not a rigorous argument, but it is a useful observation.

Both economies and markets are subject to virtuous and vicious cycles of activity, where optimism breeds optimism and vice versa. We believe there is currently an opportunity for a virtuous cycle of economic activity that can help sustain strong economic growth, but the opportunity is also easily squandered. That wouldn't imply a cycle of pessimism. The economic basis for continued expansion remains sound. But maybe it means something meaningfully slower than the 3.0% rate of economic growth seen over the last two years and the consecutive years of S&P 500 gains over 20%.

After navigating a pandemic and generational inflation, we think businesses crave a context where doing business is easy. Monetary and fiscal policy can play a key role in making that possible, but that also makes a monetary or fiscal policy mistake a key risk in the expansion not achieving its full potential. That could result in more volatile markets in 2025, much more so than what we saw in 2024. Throughout the year, Carson's Investment Research team will continue to monitor the economic path and the impact of policy, and suggest the portfolio positioning we believe is best suited to the environment.

The possibility of a rise in animal spirits provides important context for the year ahead. But animal spirits can be fickle, which is why we always emphasize an approach to investing that has some resilience to cycles of optimism or pessimism: maintaining a long-term perspective, building a well-balanced portfolio and working alongside a trusted financial professional who can help you stay the course. Within that framework, we hope you found Carson's Outlook 2025: Animal Spirits a useful source of investment guidance and insight to support you in the year ahead.

CARSON | Investment Research

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The Bloomberg U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The MSCI World ex-U.S. Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries -- excluding the United States. With 871 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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Carson Partners
14600 Branch St
Omaha, Nebraska 68154

carsongroup.com
888.321.0808
info@carsongroup.com