Equity Income Quarterly Insights

January 2025

Defying gravity

The Broadway hit *Wicked* recently made its long-awaited big-screen debut, with the musical's iconic number "Defying Gravity" receiving Hollywood's grand treatment—concluding the film with an inspiring message: defy gravity, defy limitations. In many ways, the U.S. equity market has done just that over the past two years. Despite widespread consensus in 2023 that the market would succumb to recessionary pressures—spurred by post-COVID inflation and restrictive monetary policy not seen since the early 2000s—equities instead soared, powering through challenges like a prolonged inverted yield curve, escalating geopolitical tensions, and a polarizing election, with an assassination attempt and a last minute drop out from Biden, all of which tested investor confidence. Still, the U.S. market managed to climb over 50% since the end of 2022, delivering a price return for the S&P 500 of 23.3% in 2024 according to Reuters, a clear demonstration of "defying gravity".

Easily the most noteworthy event from 4Q2024 was the election of Donald Trump and the concurrent red sweep, which fuelled optimism around mergers and acquisitions, deregulation, and potential corporate tax reforms. This resurgence in confidence—aided by pro-business expectations—sparked a revival of 'animal spirits,' leading markets higher through November However, December, brought a reality check to the market with the Federal Reserve meeting on December 18th and the accompanying summary of economic projections showing the total rate cut path being half a percentage higher and the pace of cuts being slower than expected, driven by certain Fed members including potential tariffs in their inflation forecasts as well as a general consensus from the central bank that 2025 would be a hotter economy than expected back in September. Treasury yields, which were already rising post-election on concerns about tariffs and fiscal deficits, surged higher, with the 10-year climbing above 4.6%. This yield spike raises the hurdle rate for equities; as a result, the market sold off in December. Meanwhile, the last-minute effort by the House to avert the shutdown of the federal government highlighted the ramifications of a narrow republican majority—the red sweep is strained, and forward policy will face greater obstacles than investors envisioned in November.

While pressures mounted, the stock market defied these uncertainties and ended the year with an impressive double-digit return. The outsized gains of 2023 were attributed to the "Magnificent 7," and these seven largest companies in the S&P 500 continued to drive performance in 2024, albeit at a slower pace. Goldman Sachs estimates that this group accounted for over half of the index's gains during the past two years. Their outperformance rested on strong earnings: the "Mag 7" posted 35% and 33% annual earnings growth in 2023 and 2024, respectively, in stark contrast to the –4% and 3% earnings growth for the remaining 493 companies during the same years. The result has been that the largest names have swelled to concentration levels that surpass the dot com bubble. The top ten stocks in the S&P 500 by market capitalization accounted for 38.7% of the total weight as of December 31st, 2024 according to JP Morgan. Such concentration amplifies both upside and downside risk, and after two years of radical outperformance by a handful of mega-cap names, seasoned investors are weighing strategies to mitigate that concentration risk. Looking ahead to 2025, analysts project the earnings gap will narrow to roughly six percentage points according to JP Morgan. As the broader market's earnings base recovers, we anticipate the remaining S&P 500 companies will take on a larger share of index price gains.

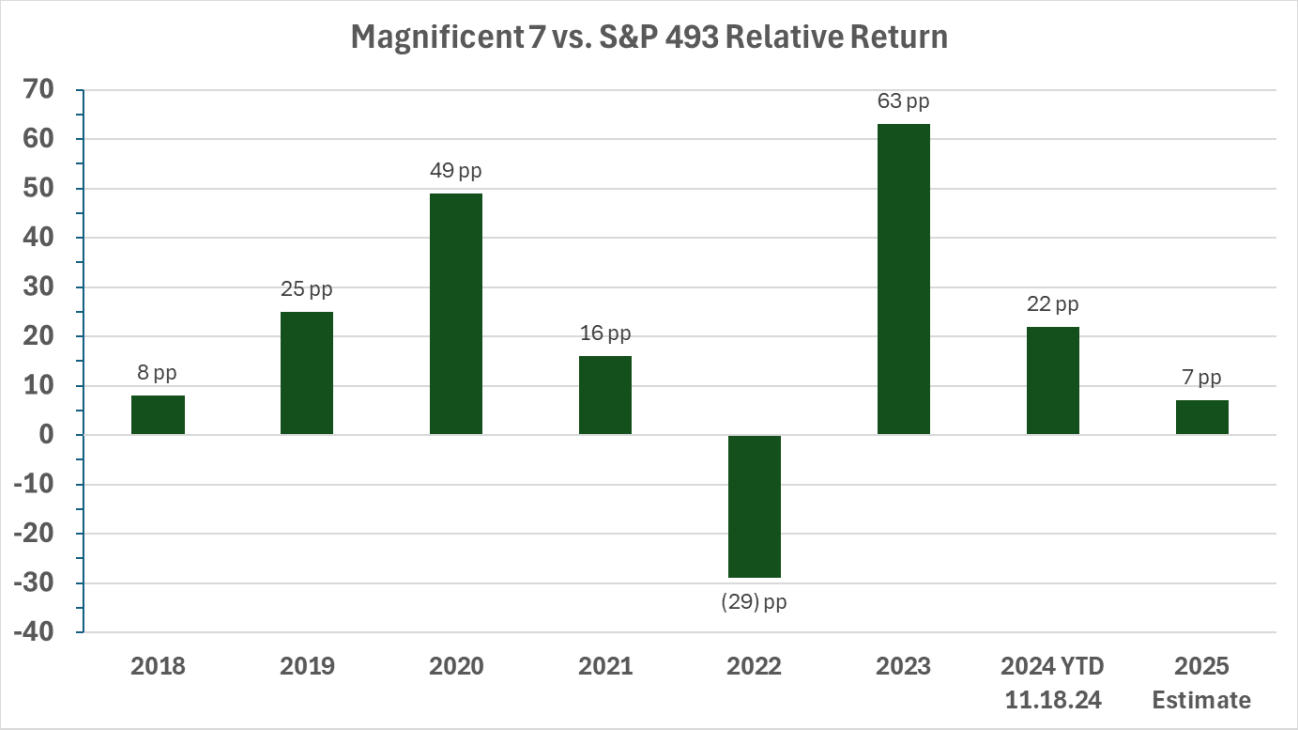
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Pondering stock markets year by year has its merits, yet ultimately, we adhere to the cadence of long-term investing and dedicate our analysis to a multiyear outlook. Advances in artificial intelligence over the past two years are laying the groundwork for what could become a technical revolution—transforming data automation, software, education, healthcare, and the broader tech landscape. Robotics and AI remain at a nascent stage, but their potential to disrupt global labour markets is material. Meanwhile, tariffs and broader anti-globalization policies could further unwind supply chains that have been in place for decades. These secular forces may be at odds with another, as technology advancements could boost productivity in the US and drive GDP higher, while possible labor market shocks and supply chain disruptions could have the opposite impact.

Much of the forementioned topics are hinged on how Trump's second term will unfold. Market narrative for 2025 is centered around the impact of the potential tariff policy, which could stoke inflation. Based on projections from the December Federal reserve meeting, members are hesitant to alter monetary policy further until uncertainty around Trump's policies are resolved—monetary policy is taking the backseat to fiscal and foreign policy. Beyond executive leadership, the US economy continues to outshine other economies and has been resilient, reverting to mean growth in moderation. We expect the third year of this bull year to be measured and wider in breadth vs the last two years as the U.S. economy normalizes to a higher-for-longer interest-rate environment.



Source: FactSet, Goldman Sachs Global Investment Research

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Global Investing Quarterly Insights

January 2025

U.S. stocks traded lower to end under 6,000 in December, a psychological milestone that was surpassed after Trump's election win and accompanying red sweep. This drop came as 10-year yields climbed above 4.5% due to Federal Reserve forecasts on December 18 predicting higher interest rates in 2025 compared to previous expectations. Despite the year-end pullback, U.S. markets rose for the fifth straight quarter, delivering a 2024 S&P 500 gain of more than 20% for the second consecutive year—the first time this has occurred since 1998–99. As shown below, the U.S. lead over emerging markets and developed international markets widened in the fourth quarter.

Fourth-quarter performance for U.S. markets was concentrated in a select few mega-cap names like Tesla and Broadcom, both of which are significant players in the AI space that has fuelled the current two-year bull run. We are hopeful that 2025 will be a year of broader participation, as more stocks and non-tech sectors are expected to see an earnings recovery. However, concentration has reached new highs, increasing the likelihood of short-term volatility. On a sector level, consumer discretionary (Tesla) led performance, while healthcare (UNH), materials, and REITs lagged. Large caps outperformed small caps by over 250 basis points.

Stocks had rallied after Trump's landslide victory and broke past 6,000 in late November but pared back to end under 5,900 for the year as forecasted monetary policy became more restrictive for 2025 in December. Market consensus now anticipates less than 2 rate cuts for 2025.

While we enter 2025 with mild optimism, risks surrounding potential tariffs, immigration policy, and geopolitical conflict present significant uncertainty, which is expected to keep investors cautious. China's struggles continue, as recent local stimulus efforts failed to win over investors and looming tariffs dominate the outlook for the world's largest net exporter.

Market Summary

Stocks	4th Quarter 2024
U.S.	23.81%
International Developed Markets ex U.S.	4.70%
Emerging Markets	7.50%
Bonds	
U.S.	1.25%
Global ex U.S.	4.97%
Real Estate (REITs)	
Global REITs	2.77%
U.S. REITs	8.10%
Global ex U.S. REITs	-7.83%

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Global Investing Quarterly Insights

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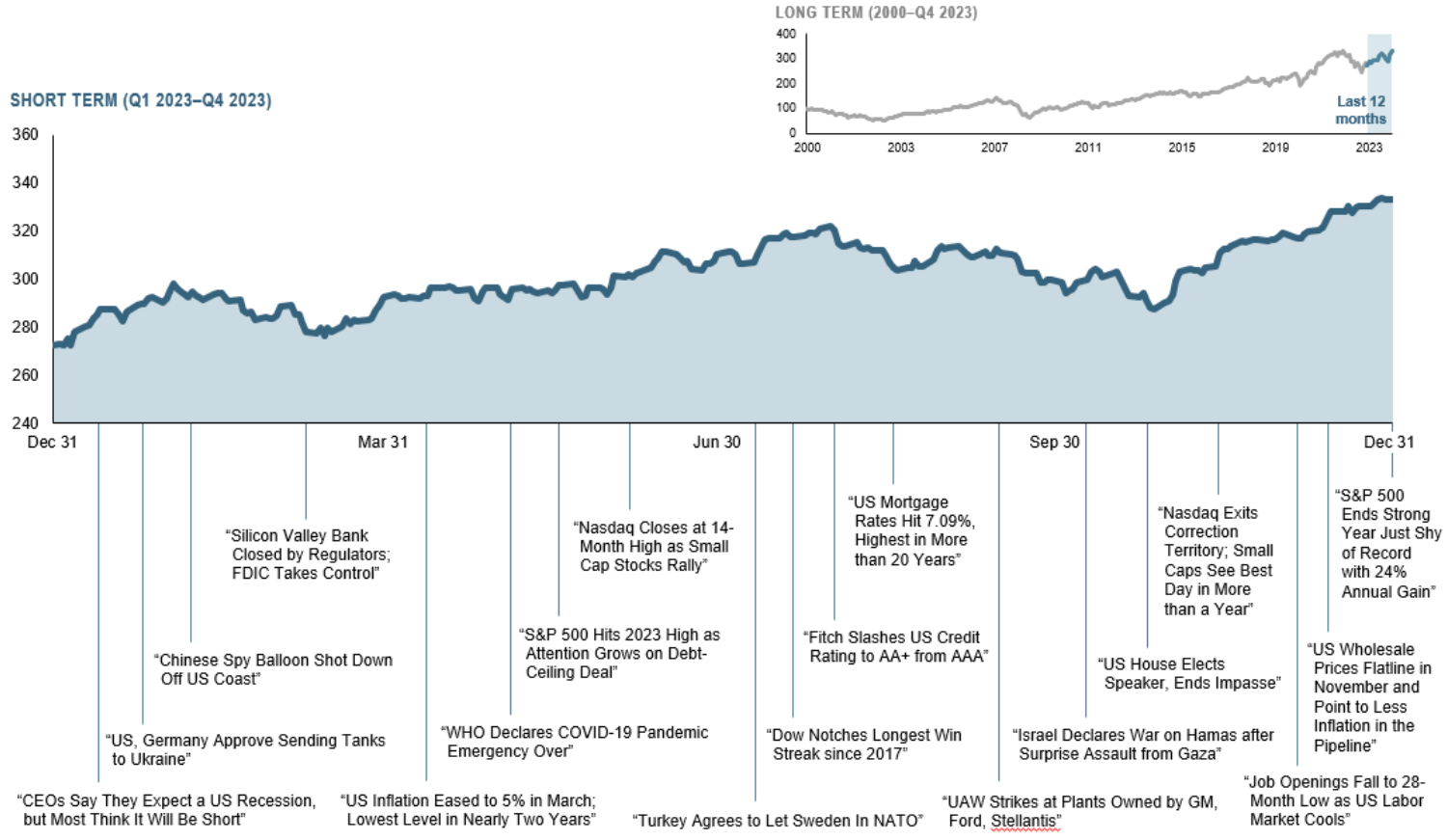
Nearly all developed-country returns were negative for the fourth quarter, apart from Israel and Singapore. Denmark and Portugal sold off by approximately 20%, and the MSCI World ex USA finished down 7.49%. International declines were driven by rising USD strength as interest rate expectations increased and Trump's potential tariffs hindered global trade. Developed international currencies depreciated against the U.S. dollar by an average of over 5%. Israel was a standout for the quarter as ceasefire talks progressed. Year-to-date, Singapore and Israel topped returns, while Portugal and Denmark rounded out the bottom. All currencies except the Hong Kong dollar declined relative to the U.S. dollar.

Emerging markets also faced challenges, with more than two-thirds posting negative fourth-quarter performance. The United Arab Emirates and Colombia were the best performers for the quarter, while Korea and Brazil were the worst, aligning with currency declines. Year-to-date, about two-thirds of emerging markets posted positive performance, led by Taiwan and Malaysia. Mexico and Brazil were the worst performers, with returns lower than -25%.

Global REITs fell sharply in the fourth quarter, erasing the gains of the previous quarter to end the year with a return of -7.83%. U.S. REITs also declined but managed to retain a portion of third-quarter gains, finishing 2024 with an 8.10% return.

World Stock Market Performance

MSCI All Country World Index with selected headlines from past 12 months



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Fixed Income Quarterly Insights

Tax-Exempt Bonds

Changing of the Guard

The 2024 presidential election resulted in a decisive victory for former and now incoming President Trump, an outcome anticipated to significantly influence fiscal policy and, in turn, the municipal bond market, particularly regarding trade and tax policy implications.

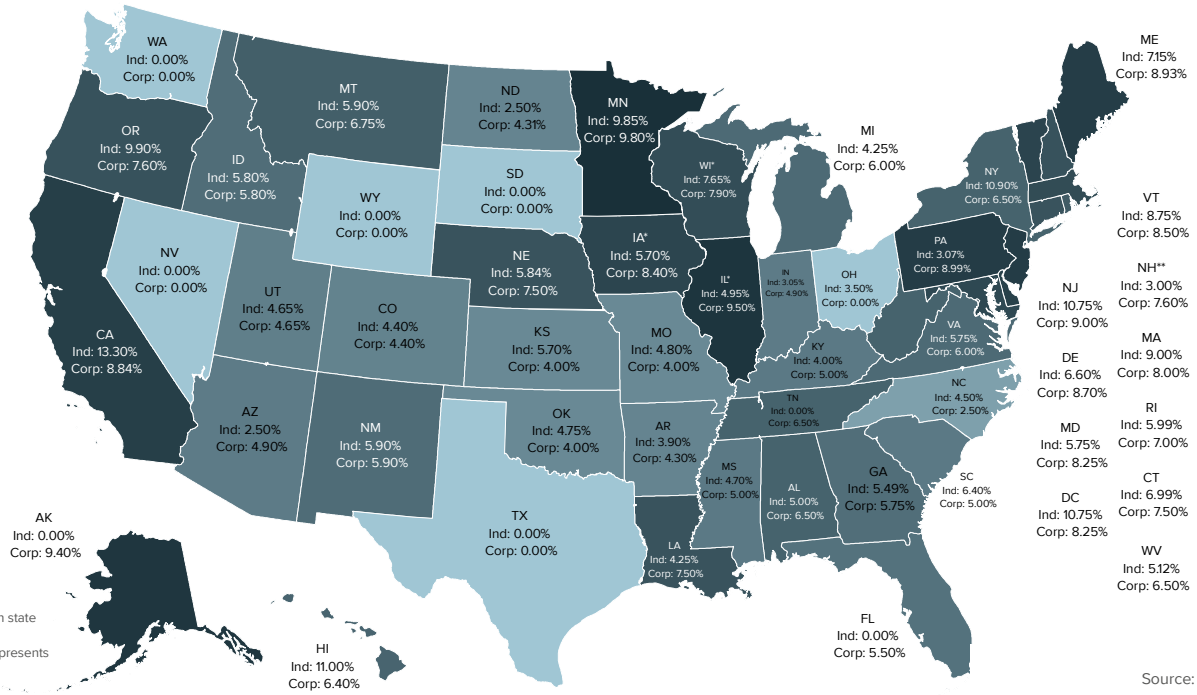
Potential corporate tax cuts under the new administration could reduce demand for municipal bonds among corporate buyers, especially in the banking sector. Lower corporate tax rates would make the tax-free income provided by municipal bonds less appealing to these investors. Conversely, individual investors—whose tax rates are unlikely to see substantial reductions—may increase their demand for municipal bonds, helping offset the decline in corporate demand.

At the same time, many state and local governments, having depleted their COVID relief reserves, will likely need to issue more bonds in the coming years. With interest rates now lower than their peaks from over a year ago, the current environment supports cheaper debt issuance, providing an opportunity for governments to address funding needs at a lower cost.

A significant growth driver for the municipal bond market will be the estimated $3.7 trillion infrastructure funding gap projected over the next decade. State and local governments are just beginning to tackle their infrastructure backlogs. While some federal funding may be allocated to these projects, most of the funding is expected to come from local bond issuance, benefiting projects such as airports, roads, and bridges.

US State Income Tax Rates

Individual and Coporate Rates



* Most municipal bonds issued in state are subject to state tax

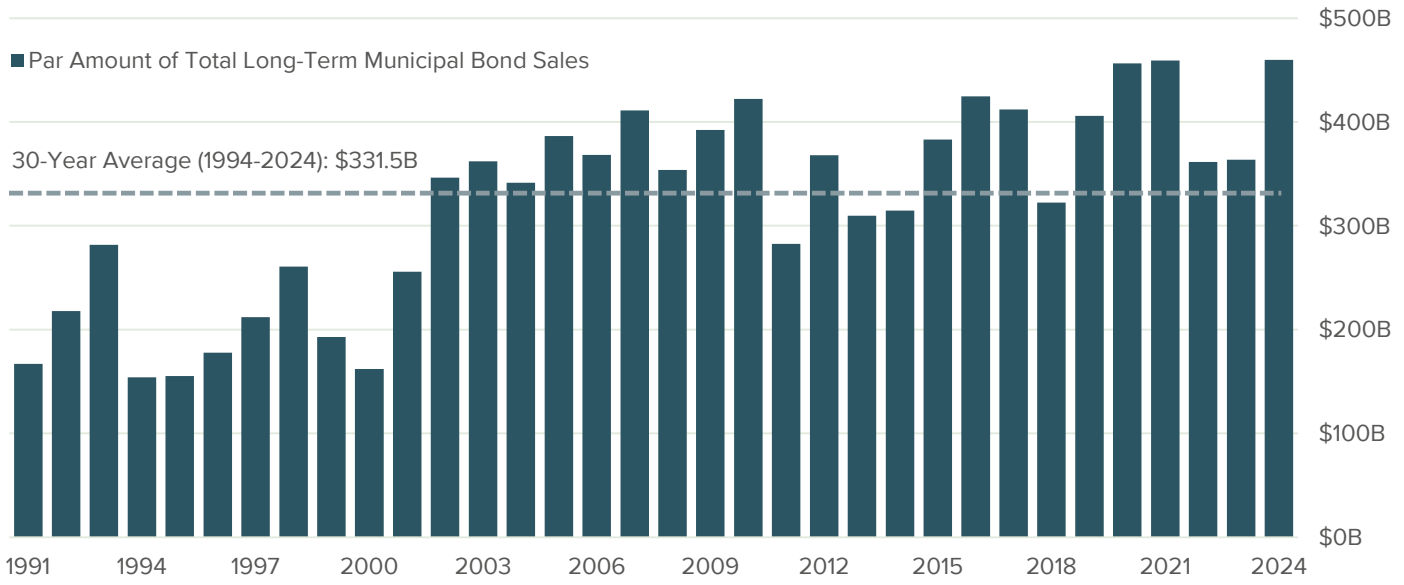
** State income tax is 0%, rate represents tax on interest and dividends

Source: Bloomberg

Fixed Income Quarterly Insights

Tax-Exempt Bonds

Above Average Municipal Bond Supply in 2024 with More Projected in Coming Year



Source: Bloomberg

Essential service revenue bonds, tied to reliable revenue sources such as electricity and water utilities, are expected to remain strong performers regardless of a recession or the imposition of new tariffs. These bonds will continue to be in high demand for their stability and dependable income streams.

As we move into 2025, the fiscal and trade policy landscape will shift under the new administration, presenting challenges for municipal bond investors. However, we believe these challenges will also create significant opportunities in the years ahead.

Strategy

In 2024, we repositioned our municipal bond strategy in response to changing market conditions. We shifted from a short-duration portfolio relative to our benchmark to a longer-duration approach, anticipating a transition from Federal Reserve tightening (raising rates) to easing (cutting rates). This shift included a move from a barbell strategy toward a more balanced allocation, increasing our exposure to the intermediate portion of the yield curve where we were previously underweight.

Our portfolios continue to prioritize high-credit-quality bonds with 5% coupon structures, aiming to deliver reliable, tax-free income while preserving liquidity and capital. Although lower-credit-quality bonds outperformed higher-grade bonds in 2024, we remain committed to quality to mitigate potential risks from an economic downturn.

Given the uncertainty surrounding trade and tax policies under the new administration, we are taking a cautious approach in further extending maturities. As policy details become clearer, we will adjust our portfolio to align with the evolving fiscal environment.

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Fixed Income Quarterly Insights

Taxable Bonds

The Bond Market Dilemma

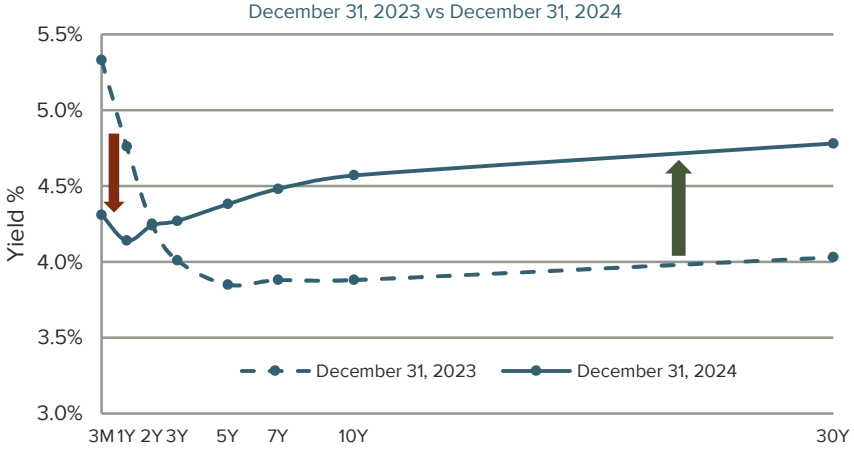
In the world of fixed income investing, the landscape can often resemble a complex maze where investors navigate through various economic indicators and monetary policies. Recently, many bond investors have found themselves perplexed by a counterintuitive phenomenon: despite the Federal Reserve's decision to cut interest rates, the intermediate and longer-term segments of the bond market are experiencing significant selloffs. This situation raises questions about the underlying dynamics of the bond market and the broader economy.

To comprehend this paradox, it's essential to recognize the Federal Reserve's role in influencing short-term interest rates. The Fed sets these rates based on the economy's performance, particularly focusing on inflation and unemployment metrics. Over the past year, inflation has notably decreased from its peak levels, prompting the Fed to justify its decision to lower the federal funds rate from a range of 5.5% to 5.25% to a more accommodating 4.50% to 4.25%. Even with this reduction, it is crucial to note that these rates still exceed current inflation levels by approximately 1% to 1.25%.

While short-term rates, defined as those spanning six months or less, have indeed declined following the Fed's initial rate cuts, the longer end of the treasury curve tells a different story. For instance, yields on 3- and 10-year treasuries have surged by nearly 1% since the first rate cut in September. This divergence begs the question: why are bond investors seemingly displeased in the face of easing?

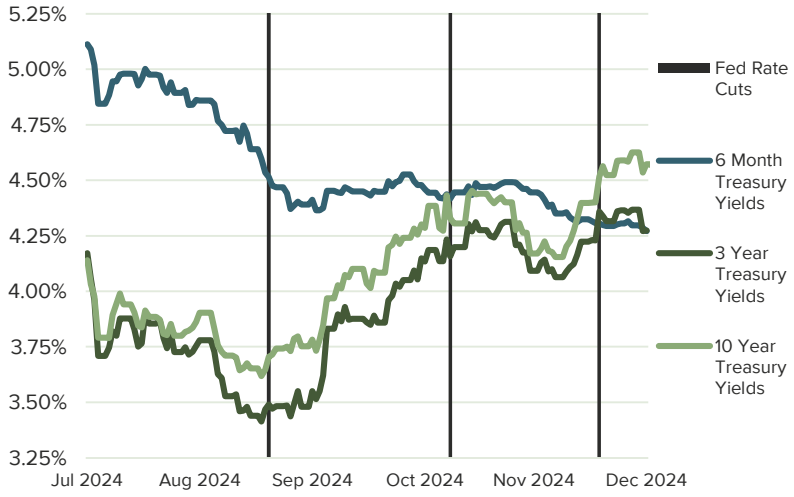
US Treasury Yield Curve

December 31, 2023 vs December 31, 2024



	3M	1Y	2Y	3Y	5Y	7Y	10Y	30Y
December 31, 2023	5.33	4.76	4.25	4.01	3.85	3.88	3.88	4.03
December 31, 2024	4.31	4.14	4.24	4.27	4.38	4.48	4.57	4.78
Change in Yield	**-1.02**	**-0.62**	**-0.01**	**+0.26**	**+0.53**	**+0.60**	**+0.69**	**+0.75**

Treasury Yields When The Fed Cuts Rates



Source: Bloomberg

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Taxable Bonds

Several key factors contribute to this sell-off in intermediate and long-term bonds:

1. Economic Resilience: The United States economy continues to demonstrate remarkable strength, marked by robust data that reflects its resilience. While inflation has moderated, it remains stubbornly elevated, and the unemployment rate hovers near historical lows. This economic vigor has led the Federal Reserve to reassess its rate-cutting trajectory, reducing the number of potential cuts for the coming year.

2. Pro-Growth Policies: The anticipated policies of the incoming administration, perceived as pro-growth, raise concerns about potential inflationary pressures. With proposals for tax cuts and regulatory rollbacks on the table, investors fear that these measures may stimulate economic activity, thereby pushing inflation higher.

3. Increased Market Volatility: The new administration's approach to international relations may introduce a new layer of volatility into capital markets. Speculations regarding increased tariffs and changes in trade dynamics could lead to uncertainty, causing investors to reassess their risk appetite.

4. Supply-Demand Dynamics: The need to address the national deficit implies a significant increase in treasury issuance, which could exacerbate supply concerns. Notably, both Japan and China, historically among the largest purchasers of U.S. bonds, are reducing their holdings, further complicating the landscape for bond investors.

Moreover, the concept of term premiums is becoming increasingly relevant. As the maturity of bonds extends, investors are demanding higher yields to compensate for the heightened uncertainty associated with longer-term commitments. This trend reflects a broader aversion to risk during tumultuous times.

Despite these challenges, it is important to acknowledge that the current rate levels still present attractive opportunities for many bond investors, particularly when viewed in the context of historical rates over the past two decades.

Strategy

Considering the prevailing fiscal policy uncertainties, our strategy remains focused on acquiring high credit quality bonds with coupon structure that are at the current market environment. We believe that maintaining proximity to our mandated benchmark duration targets is the most prudent course of action for the time being. As the marketplace evolves and clarity emerges, we will remain agile and make necessary adjustments to our bond portfolios.

In conclusion, the current landscape of the bond market illustrates a complex interplay of economic indicators and investor sentiment. While easing measures from the Federal Reserve have not translated into favorable conditions for longer-term bonds, the underlying factors driving these dynamics highlight the intricacies of fixed income investing. As we navigate through these challenges, a cautious yet strategic approach will be paramount in maximizing returns for our clients.

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