Letter from the Chief Investment Officer

Come on Down! The Ten Themes for 2025

The past two years have been favorable for investors, with the economy and financial markets delivering all the right answers. As we step into 2025, it's a new round, and this one might be more challenging. For inspiration, we're looking to classic game shows. While financial markets are certainly not a game, these shows provide a fitting analogy for the high stakes and strategic thinking required for successful investing. Will the economy and financial markets maintain their momentum? That's the *Million-Dollar Question*! Our answer is yes, but portfolio decisions will need to be more discerning in the year ahead. As we clear the board going into a new year, here are our ten themes for investors and advisors:

1 Optimism Overload: *Family Feud* May Steal the Show

As we move into 2025, optimism abounds—from DC policy to the economy to earnings growth. Consumer confidence, business confidence, and investor confidence have soared, particularly since the election. However, this confidence masks some underlying risks. The sequence, timing, and magnitude of new policies will directly impact the economy.

Some policies, like deregulation and border enforcement, can be implemented immediately. But others, such as taxes and broad tariffs, will require Congressional approval. With a thin margin in the House, potentially as little as a one-vote Republican majority, policy passage could be contentious, much like a round of *Family Feud*. For example, when the Trump tax cuts were passed in 2017, twelve Republicans in the House voted against it. For equity investors, confidence is at a record high, leaving little room for error regarding economic disappointments, a Federal Reserve (Fed) unable to cut rates if inflation picks up, or earnings disappointments. Volatility, historically low, is likely to increase in the upcoming year.

2 Economic Enigma: *Deal or No Deal*

While economic growth is likely to moderate in 2025, we expect it to achieve its fifth consecutive year of positive growth (RJ 2025 GDP forecast: 2.4%). In the game show *Deal or No Deal*, contestants choose from briefcases containing hidden amounts ranging from a penny to $1 million. We think the recessionary 'bad cases'—such as a Fed-induced over-tightening cycle, a crash in consumer spending, and plummeting business spending—have been taken off the board.

What remains are the 'good cases' that should support economic growth: resilient consumer spending as job growth remains healthy, fiscal spending from programs like the Inflation Reduction Act and CHIPs Act, and continued investment in transformative areas like artificial intelligence. Just as contestants on the show weigh their options and hope for the best outcomes, we anticipate that these positive factors will help sustain economic growth. Assuming the Fed cooperates, the US should remain a standout compared to other developed market economies.

As in the game, though, the outcome is never certain until the last briefcase is opened. Investors must stay vigilant and strategic, ready to adapt to whatever surprises the economic and policy landscape may hold.

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3 Monetary Policy: *The Newlywed Game*

The Fed has a dual mandate—keeping inflation contained and maintaining full employment. While this is not a new relationship, the post-pandemic world has made it feel like they are newlyweds—especially given the surge in inflation that we are hopefully beyond. Just like a couple on *The Newlywed Game*, the important thing is that this 'couple' will need to live in harmony for the Fed to be able to cut interest rates and maintain the current expansion.

The economic growth we foresee should support healthy job creation. Additionally, the disinflationary environment should continue as energy prices fall, retailers promote discounts, the dollar strengthens, and hopefully, shelter prices finally start to retreat. The big wildcard will be the potentially inflationary impact of tariffs, although we believe those risks are overblown.

In the end, while we expect the Fed to cut rates twice in 2025, the focus should be less on the number of cuts and more on the result. Just as in *The Newlywed Game*, where the ultimate goal is a happy and harmonious life together, the outcome we seek is the continuation of this expansion. If this is achieved, risk assets such as the equity market should benefit. By the way, fewer Fed cuts remain supportive for savers as cash yields should average north of 4% throughout the year.

4 Bond Market *Jeopardy*: Mastering the Yield Board

In the game show *Jeopardy!*, the answer is a question. In that spirit, we say: "Moderating growth, decelerating inflation, increased volatility, and Fed easing." If you say, "What could drive interest rates lower?" you are right! And while that 'question' would have won on *Jeopardy!*, recent bond market performance has acted to the contrary. Much to the market's surprise, yields bucked the historic trend and moved higher (rather than lower) after the Fed's initial rate cut.

Here's another 'answer' for the next round of play: "Upside tariff-driven inflation, upside risk to growth, and potentially increased government spending." The correct response is: "What could drive interest rates higher?"

In this *Jeopardy!* round, the combination of these answers is why we believe longer-term interest rates will be range-bound for much of the year and end up at a similar level to where they are today (2025 year-end 10-year Treasury yield target: 4.50%). Since short-term bonds are anchored to Fed actions, continued Fed easing is likely to take short-term rates lower and steepen the yield curve. High-quality corporates and municipals are particularly attractive.

5 Equities: Is the *Price* (or P/E) *Right*?

The equity market has experienced a tremendous rally, with the S&P 500 posting consecutive annual returns of more than 20% for the first time since the late 1990s. While earnings growth has contributed, multiple expansion has been a major driver of this performance. As a result, valuations are on the more expensive side.

Think of it like *The Price Is Right*. Investors, much like contestants, need to avoid going over the appropriate price-to-earnings (P/E) multiple, as exceeding it can negatively impact their returns. The game that comes to mind is the 'Mountain Climber': the climber ascends steadily, sometimes pausing or moving cautiously, much like stock prices that rise gradually with occasional dips. Just as the climber aims to avoid falling off the edge, investors strive to make informed decisions to prevent significant losses.

While the fundamentals of the market are healthy—a strong economy, positive earnings growth, and robust corporate activity—equity market expectations need to be dialed back in the upcoming year due to high valuations and potential complacency. We expect stock prices to rise more slowly as company earnings grow faster, helping earnings catch up to current prices. We predict the S&P 500 will reach 6,375 by the end of 2025, with a price-to-earnings ratio of 23-24 times and earnings per share of $270.

6 Market Capitalization: Winning the Middle *Hollywood Square*

In the game show *Hollywood Squares*, contestants play a version of tic-tac-toe with the help of celebrities who answer questions. A common strategy, used 70%-80% of the time, is to go for the middle square. This is because the middle square offers the most combinations to win, leading to a more balanced strategy in the game.

Similarly, in the equity market, large-cap stocks have dominated over the last two years, while small-cap stocks have recently been in the headlines as beneficiaries of aggressive Fed rate cut expectations. However, mid-cap stocks could be well-positioned to outperform moving forward. Like the middle square in Hollywood

Squares, mid-cap stocks offer a balanced approach. They benefit from the strength of the US economy and are somewhat insulated from tariff exposure, with mid caps receiving 76% of their revenues from the US compared to 59% for large caps. Additionally, mid caps are expected to see strong earnings growth of around 13% in 2025 and have attractive valuations—trading at nearly the largest discount to large caps over the last 20 years.

What could further benefit mid caps over small caps is their financing structure. If the Fed is not as aggressive in cutting rates next year, small caps may not reap the benefits of much lower interest rates as investors had expected. Currently, 41% of mid-cap debt is floating rate compared to 53% for small caps. From a fundamental perspective, mid-cap companies tend to be of higher quality, with a higher percentage of companies having positive earnings compared to small caps. Additionally, mid caps have elevated exposure to the Technology and Industrials sectors, which should support their performance.

Just as contestants in *Hollywood Squares* often relied on the center square for a strategic advantage, mid-cap stocks could be the sweet spot in the equity market, balancing growth potential at an attractive valuation.

7 Sector Selection: *Are You Smarter Than a 5th Grader?*

For our favored sectors, we're going back to the basics—explaining our strategy in a way that even a fifth grader could understand, just like on *Are You Smarter Than a 5th Grader*? For 2025, our approach is simple: follow long-term macro themes and focus on sectors with the best earnings potential. This analysis highlights three key sectors: Technology, Industrials, and Health Care.

Technology is like the star student, excelling due to artificial intelligence, constant innovation, and strong corporate investment, which we believe are still in the early stages. Industrials are the reliable all-rounders, benefiting from continued government spending, the reindustrialization of the US, the AI buildout, and the re-electrification of our power system. Health Care is the underdog with hidden potential, as its attractive valuations don't seem to match the earnings power driven by increasing healthcare needs supported by demographic trends.

Just like in the game show, where you need to pick the right answers to win, investors should look for sectors with the best earnings growth. These three sectors are at the top of the class, with earnings comfortably in double-digit territory.

8 International Equities: *The Weakest Link*

On the show *The Weakest Link*, the sharp-tongued host asks a series of questions, and the contestant with the lowest score each round hears the dreaded phrase, "You are the weakest link. Goodbye." In the global equity market, the US has consistently been the top performer, much like the strongest link, outperforming other developed markets such as Europe and Japan in eight of the last 10 years. This suggests that the rest of the developed markets have often been the weakest link.

The US is likely to remain the strongest link due to superior economic growth, significantly higher earnings growth, more dynamic corporate leadership, and exposure to our preferred sectors: Technology, Industrials, and Health Care. From a ranking perspective, Japan could provide some competition and ranks just behind the US. Japan is benefiting from an improving economy, a shift away from deflation, and should gain if global growth stabilizes in the coming year. Additionally, with the Bank of Japan raising interest rates, there could be a modest appreciation of the yen, supporting dollar-based performance.

9 Selectivity: Market Gains No Longer a *Minute to Win It*

In an environment of stretched valuations—which will likely drive increased volatility and more muted returns—the quick, *Minute to Win It* gains we've seen over the past two years will be harder to achieve. Just like the game show, the next stage of the bull market will present progressively tougher challenges for investors to generate returns, making a critical eye on fundamentals essential.

We caution investors against taking on excessive risk across asset classes. Higher beta asset classes without a solid fundamental backdrop will likely face difficulties in the coming year. For example, with global growth outside the US expected to struggle, commodities (particularly oil) may encounter headwinds as demand growth remains subdued. Within the equity market, companies without positive earnings will likely come under pressure.

Additionally, we anticipate increased dispersion among winners and losers within regions, sectors, and industries. In a shifting policy landscape, 2025 will likely be a year where active management, especially in commodities, emerging markets, and small caps, proves its worth. Investors will need to stay focused and adaptable to navigate the complexities of the market.

10 Asset Allocation: Playing the *Wheel of Fortune*

Amidst the uncertainty of the coming year, it's important to remember the goal of investing: to build wealth. The aspiration of becoming a millionaire, as in *Who Wants to Be a Millionaire?* might seem modest now. When the show started in 1999, $1 million would be worth about $2 million today adjusted for inflation, and around ~$9 million adjusted for equity performance.

America's wealth has grown to record highs. But don't spin the Wheel of Fortune on your own! When you're ready to buy a vowel (i.e., make additional investments), consult with your financial advisor first. Your advisor is like the 'phone-a-friend' or 'lifeline' you can rely on to answer your questions and provide reassurance when faced with pressure-panicked headlines.

We are prepared for the challenges ahead, keeping in mind the expression that applies to all game shows and certainly to financial markets as well: "You've got to be in it to win it." Stay focused and committed!

So come on down!

Lawrence V. Adam, III, CFA, CIMA®, CFP®
Chief Investment Officer

RAYMOND JAMES