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YANKE FINANCIAL, LLC NEWSLETTER WINTER 2025

The Known and the Unknown

Both Certainty and Uncertainty

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January 13, 2025

Last year, my newsletter opened with a tone of uncertainty. There was an expectation of a mild recession sometime during 2024… but no agreement on timing or severity. There was a war in the Middle East and another threatening in Ukraine. Inflation and interest rates were elevated. The icing on the cake was a presidential election year. I forecasted a year with significant volatility. By the end of the year, it was clear we had experienced one of the quietest market years of my career to date. I'm entering this year with the opposite expectation… hoping we don't get an opposite result.

Economic Perspective

2024 was another impressive year for the US economy, with real GDP growing at an above-trend pace for a fourth consecutive year. Given that consumption accounts for almost 70% of the US economy, it's no surprise that the health of the economy is closely tied to that of the consumer. Supported by impressive gains in household wealth and 20 consecutive months of positive year-over-year real wage gains, consumer spending has powered the economy forward, contributing 2.4 percentage points to the 2.8% increase in real GDP in the third quarter.

Despite higher borrowing costs, business investment has been buoyed by strong corporate balance sheets and fiscal support, while government spending has been solid. On the other hand, home-building has remained subdued due to elevated mortgage rates. The combination of a strong dollar and sluggish global economic activity has weighed on the US trade balance.

Policy uncertainty is casting a fog on the economic outlook for 2025. A change in immigration enforcement and tariff policies—depending on the degree that the incoming administration implements them—adds to uncertainty. Still, none of these policies appears to portend immediate recession and as activity in interest rate sensitive sectors normalizes and consumer spending settles at a more moderate pace, 2025 should be another year of expansion, likely at a long-term trend pace, for the US economy.

Labor Markets

After rising during the first half of 2024, the unemployment rate has stabilized. At 4.2% in November, unemployment is meaningfully above its cycle low of 3.4%, set in April 2023. That said, it is still lower than it has been almost 88% of the time over the past 50 years.

In 2025, steady economic growth should support continued job gains, reducing the risk of any further meaningful rise in unemployment. In fact, should labor force growth slow due to more restrictive immigration, unemployment might even drift lower over the course of the year.

With stable unemployment, wage growth should stabilize also. Loosening labor market slack over the past year has led to a moderation in wage growth. After peaking at 7% in March 2022, growth has continued to slow back to trend. Wages for private production and non-supervisory workers rose 3.9% year-over-year in November, putting them back in-line with the 50-year average. While slower immigration would likely put upwards pressure on wage growth, sustained strong productivity gains could help limit any pass-through to inflation.

Earnings Growth Accelerating

S&P 500 earnings are expected to have grown 9% in 2024. Analysts are projecting stronger growth of 15% and 13% in 2025 and 2026, respectively. Compared to the long-term average of 7.5%, these estimates seem a bit too rosy, particularly given the expectation for slowing nominal growth. Normalizing GDP growth could limit revenue growth, and slowing inflation could pressure margins. Nevertheless, trend-like nominal GDP growth combined with more stimulative fiscal policy should support solid earnings gains, especially when these gains broaden beyond the largest stocks.

Notably, while earnings of the Magnificent 7 companies grew by 31% in 2023 and 36% in 2024, earnings for the rest of the S&P 500 contracted by 4% in 2023… then grew by just 3% last year. 2025 should finally bring the much-anticipated broadening. Magnificent 7 EPS growth is expected to decelerate to a still strong 21%, while EPS growth for the rest accelerates to 13%. Similarly, by 1Q25, analysts are projecting positive EPS growth for 10 out of 11 sectors compared to just 4 out of 11 in the first quarter of 2023.

As lower interest rates awaken US manufacturing activity, a cyclical recovery could drive the next phase of the broadening. With this greater earnings breadth should come greater market breadth. 2025 leadership should be less narrow, reducing the risk of elevated concentration and valuations, and increasing opportunities for active investors.

Inflation

Inflation made meaningful progress towards the Federal Reserve's 2% target in 2024, allowing the Fed to kick off its rate cutting cycle. That said, downward momentum waned in the fourth quarter, sparking fears that progress on inflation has stalled. Indeed, headline CPI rose 2.7% year-over-year in November compared to 2.4% just two months prior. However, recent gains are largely due to base effects, and with little evidence that price pressures are building, inflation may resume its downward movement in 2025.

For much of the last year, core goods prices had been a steady source of deflation as supply chains remained well-managed, even with elevated geopolitical tensions. In recent months, however, prices have moved higher on a sequential basis, largely due to rising vehicle prices. That said, auto inventory-to-sales ratios have trended higher from post-pandemic lows, suggesting pressure here should fade. On the more volatile components, lower gasoline prices have weighed on energy prices while food inflation has remained mild. Moving forward, sluggish global demand limits the likelihood of a surge in either of these categories.

That brings us to the key drivers of inflation: shelter and auto insurance. Shelter inflation accounts for over a third of the CPI basket and has held stubbornly above its pre-pandemic trend. That said, real-time measures of market rents point to more normal levels of shelter inflation ahead. Auto insurance—a consistent hot spot of inflation—eased slightly in November but is still rising by 13% year-over-year.

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Continued from the front:

Overall, inflation should continue to ease in 2025. Price gains in shelter and auto insurance remain elevated, although real-time data continue to point to easing price pressures ahead.

The Fed

With inflation trending lower and the labor market softening, the Federal Reserve—attentive to both sides of its dual mandate—cut interest rates by 100 basis points in 2024. In 2025, the committee will certainly have a preference to continue easing policy until it reaches a neutral stance. However, fiscal stimulus in addition to tariff and immigration policies, if passed, could make this difficult to achieve.

At its final meeting of the year, the Federal Reserve voted to cut rates by 25 bps, reducing the federal funds rate to a range of 4.25% to 4.5%. This move was largely expected, and investors found themselves more focused on the press conference and the latest set of economic projections. In his comments, Chair Powell noted that he is optimistic about the health of the economy and that downside risks to the labor market have largely diminished. He also noted that inflation, while still moving in the right direction, has been hotter than expected in recent months.

These views were reflected in the Summary of Economic Projections, which showed a higher growth forecast and lower unemployment forecast for 2025, as well as higher inflation forecasts for 2025 and 2026. With solid economic activity and increased inflation uncertainty, the committee penciled in just two rate cuts in 2025 versus four in their prior projection. In acknowledgment that the economy may be less interest rate sensitive, the neutral federal funds rate ticked higher to 3.0%.

Today, market expectations remain more hawkish than the Fed's forecast, highlighting investors' fear that inflationary policies proposed by the incoming administration might force the Fed to consider a slower pace of policy normalization, or a pause altogether. A more gradual policy easing path seems to be the most likely outcome, limiting the downside move in rates.

Global Economy

As U.S. stocks have enjoyed an extended run of stellar performance, international stocks have long been the underdog. That said, 2025 could be their time to shine. Not only has strong US equity performance pushed valuations to lofty levels, but the US now also makes up over 65% of global equity indices despite accounting for only 25% of global GDP growth. This suggests that U.S. stocks are pricey, and it might be wise for investors to consider diversifying into other global markets.

While many international markets are facing cyclical challenges, structural tailwinds should continue to drive strong performance in select regions. Japan, for instance, is moving out of a long period of deflation, stagnant nominal growth and negative rates. Reflation in the country should support consumer spending and domestic earnings growth. While China's path ahead may be bumpy and involve trade conflicts with the US, opportunities in EM ex-China remain promising. Taiwan outperformed the US in 2023 and 2024 due to its strong ties to the technology sector and AI tailwinds and should continue to benefit from the tech-cycle boom in 2025. Robust earnings and services export growth have supported strong performance in India. While elevated valuations leave the market susceptible to a pull-back, the region's long-term investment case remains compelling.

Performance across countries has varied. By using an active approach to find the most compelling stories, investors can allocate abroad without having to compromise on performance.

Historically, international equities have traded at a discount to the US due to their value tilt, lower liquidity and economic and currency risks. However, the current discount appears larger than warranted by these factors.

Fixed-Income Markets

Investment grade and high yield corporate credit finished the year up over 3% and 8%, respectively. While this rally has left corporate credit looking expensive, there are opportunities across the asset class.

Across both investment grade and high yield, spreads are sitting near all-time highs as strong earnings growth, subdued default activity and improved credit quality have biased spreads narrower. While valuations in both sectors look expensive, and credit investors are unlikely to generate meaningful gains from narrowing spreads, investors should embrace credit for the attractive all-in yields.

Investors can take comfort in the fact that widening spreads shouldn't be an issue in 2025 either, as a benign economic backdrop and broadening earnings growth should keep them tight.

With the Fed likely to ease policy only gradually, it's difficult to make any outsized bets on duration right now. For those searching for enhanced yield and higher returns, corporate credit offers an attractive opportunity. That said, not all bonds are created equal, and an active approach to fixed income investing will be key to finding attractive relative value opportunities while balancing potentially higher risks with higher rates.

My Greatest Concern

According to the CBO, federal debt is expected to climb to nearly 120% of GDP by 2034 excluding the impacts of a TCJA extension, and nearly 130% with the extension. That is up from 98.2% in fiscal 2024. In the last five years, the debt of the US Federal Government has increased by over $14 trillion! In fact, about ¾ of the entire $36 trillion debt has been accumulated since 2008! This situation has not resulted from a drop in revenue—tax receipts are higher than ever. The US government has a spending problem and the current trajectory is unsustainable.

The incoming administration recognizes the country has a spending problem. That is why there is a plan for a Department of Government Efficiency (DOGE) headed up by Elon Musk and Vivek Ramaswamy. The mandate for this department is to root out fraud, waste, and abuse, and find areas where Federal spending may be reduced. The initial stated goal is to reduce annual Federal outlays by $2 trillion. If the effort to reduce Federal spending is successful, it may result in a reduction of some financial support for the economy. That may increase economic uncertainty in the short-term. Only time will tell how this turns out.

Summary

My long-term outlook favors equities over bonds—just don't expect higher than average gains this year. This is an environment for strong investment managers and careful stock selection. Overseas holdings may benefit long-term investors with greater growth potential. Income-oriented investments may enjoy a softening interest rate environment. Equities are my recommendation for a 10-year outlook. Balance is in favor.

Take the long view with your investment assets and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing documents, develop new plans, or do end-of-year planning, talk to an advisor soon.

Source: General economic statistics are from JP Morgan "Guide to the Markets" 1Q2025.