

THOUGHTS OF THE WEEK

Economy Will Remain Supportive of Markets in 2025

Happy New Year 2025!

As we start a new year it will be important to look at what lies ahead, at least from an economic perspective. And the most important issue is that the economy's fundamentals remain solid with very few misalignments that could derail it, at least for now.

Inflation: while still slow in coming down, it is close to the target. At some point during the year, Federal Reserve (Fed) officials will have to decide if the interest rate path they have chosen for the rest of the year will be enough to bring it down to the 2.0% target. Just in case, they have extended the runway for achieving the target, to 2027 rather than 2026. Hopefully, markets will be patient with the Fed.

Economic Growth: Economic growth projections remain strong, which is one of the reasons why inflation is expected to remain above target. Furthermore, positive vibes regarding the incoming Trump administration could push economic growth even higher, depending on whether the new administration is serious about the fiscal deficit or not.

Housing Market: The US housing market will continue to suffer from high mortgage rates. However, the sector's prospects seem to have improved somewhat as many, but especially those in the existing home sales market, have started to realize that waiting for lower rates doesn't seem to be the correct strategy. Still, the low supply of homes could continue to put upward pressure on home prices and make them even less affordable.

Manufacturing Sector: The sector will continue to struggle under the pressure of high interest rates. However, new investments in the construction of manufacturing plants brought about by the incentives provided by the CHIPS and IRA acts are going to start making their inroads and brighten the prospects of the manufacturing sector, even if interest rates remain high.

Service Sector: The US service economy is alive and well and has continued to move the economy forward. Although there are signs that the less well-off are struggling under high prices and high interest rates, they will continue to engage in the economy as long as jobs are plentiful and there is full employment. On the flipside, those who are better off have continued to push forward helped by higher interest payments on savings, stock market returns, equity in their homes, and a strong labor market.

Tariffs: Many argue that Trump's tariffs 2.0 are going to be very similar to the Trump tariffs 1.0 and thus have little to no effect on inflation. For that, we will have to wait and see what the actual plan is. The new tariffs have been sold as broad-based across all imported products and countries across the global economy. If that is what is finally decided, analysts will have to go back to the drawing table and update their expectations about inflation and Fed policy. For now, our inflation and Fed forecast does not include the potential for broad-based tariffs because of the uncertainty surrounding the implementation.

When we hear clients and advisors worrying about the US dollar, the US deficit, the US debt, etc., many times we remember the saying: “In the land of the blind, the one-eyed man is king.” In some sense, the US economy used to be considered the ‘one-eyed’ man in a world full of troubled economies. Of course, this explanation seems to be highly self-centered, and many could argue that the US economy can no longer be considered in this light. Many argue that China is now the biggest threat to US hegemonic claims. Thus, in order to set the record straight, let’s discuss the case of China, which is challenging US supremacy in the global economy and also what we consider to be the biggest threat to sustained economic growth.

Tariffs Are a Threat to the Chinese (Communist Party) Way of Life

Back in 2005 one of us was attending a conference in Frankfurt, Germany. One of the speakers at the conference was the Chief Economist of one of the largest global chemical companies in the world. After his presentation, the obvious conclusion to every person paying attention (not many were actually paying attention!) to his arguments on China was that China was going to be the ‘production hub’ of the global economy and the rest of the economies of the world were going to be mere observers/spectators or, what China may call today, ‘consumption hubs.’ Twenty years after that presentation, the global economy is faced with this dilemma: Will it allow that 2005 view of the global economy or would it challenge it?

As we said above, the US is not alone in claiming to be the best economy in the world as China continues to compete for the title, with good arguments to support its claim. But if we believe that the US economy is past its prime while China is the new kid on the block, we have to be careful in analyzing each country’s strengths/weaknesses. Yes, China is a force in itself, as it has continued to promote itself as the ‘production hub’ of the global economy. However, China is not the ‘consumption hub’ of the world and it relies on the rest of the world to continue buying its goods. This is a big misalignment for the Chinese and global economy, one that is going to be threatened by protective policies, i.e., tariffs, being considered across the global economy, but more specifically within the developed countries.

The largest ‘consumption hubs’ for Chinese production are the US and European economies, which are where the highest-income consumers reside. True, the rest of the countries in the world could help China as they absorb some of its production, but less developed countries cannot keep absorbing all of the goods being produced by the Chinese production hub unless goods prices continue to come down, which is a defeatist strategy if pursued over time. Thus, if this strategy continues to be implemented, it has the potential to push the Chinese economy into goods-deflation cycles.

China has become such a large producer of so many types of goods that the inability to continue to sell these goods across the global economy could generate severe issues for its economy. Furthermore, global overproduction of goods could trigger something similar to what happened during the Great Depression, although the dimensions of such an event are probably only going to be limited to China rather than to the rest of the global economy as was the case then.

One of the lessons the US (and the world) learned during the Great Depression was that Say’s Law, which argued that every supply created its own demand, was flawed, especially if income is unequally distributed and/or if households hoarded cash.

That is, if individuals do not have the incomes necessary to purchase what is being produced (i.e., highly unequal distribution of income) or if they hoard cash rather than spend it (which is what Chinese households are doing), then this creates a situation of overproduction that contributes to deflationary pressures.

This is one of the reasons why so many economists outside of China have been recommending the country develop its internal consumption market, as the current strategy is bound to fail in the long term. However, developing domestic consumption markets means improving incomes across all income levels as well as improving income distribution, which is more easily said than done and is inconsistent with production strategies that flood the global economy with ever-cheaper goods.

Thus, it is true that China is a production powerhouse and will continue to challenge other production hubs across the global economy. However, its dependence on the rest of the global economy to absorb its excess production is its Achilles heel.¹

1: Achilles heel: a weakness or vulnerability that can lead to failure, despite overall strength.

Forecast Table

	Actual			Forecast									Actual		Forecast	
	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25	1Q26	2Q26	3Q26	4Q26	2023	2024	2025	2026
Real Gross Domestic Product ¹	1.6	3.0	3.1	2.2	2.3	2.2	2.3	2.5	2.1	2.1	2.0	2.2	2.9	2.8	2.4	2.2
Real Gross Domestic Product ²	2.9	3.1	2.7	2.4	2.6	2.4	2.2	2.3	2.3	2.2	2.2	2.1	2.5			
Consumer Price Index ²	3.2	3.2	2.6	2.7	2.5	2.4	2.7	2.5	2.4	2.3	2.3	2.2	4.1	2.9	2.5	2.3
Ex-food & energy ²	3.8	3.4	3.2	3.3	3.0	2.9	2.9	2.6	2.5	2.3	2.3	2.2	4.8	3.4	2.8	2.3
PCE Price Index ²	2.7	2.6	2.3	2.4	2.2	2.2	2.4	2.4	2.4	2.3	2.3	2.2	3.8	2.5	2.3	2.3
Ex-food & energy ²	3.0	2.7	2.7	2.8	2.5	2.4	2.5	2.4	2.4	2.3	2.3	2.2	4.1	2.8	2.5	2.3
Unemployment Rate	3.8	4.0	4.2	4.2	4.3	4.4	4.4	4.4	4.4	4.4	4.3	4.3	3.6	4.0	4.4	4.4
Fed Funds Rate ³	5.50	5.50	5.00	4.50	4.50	4.25	4.00	4.00	4.00	3.75	3.50	3.50	5.1	5.1	4.2	3.7

¹ Annualized Quarter-Over-Quarter Growth

² Year-Over-Year SA Percentage Change

³ Upper Bound of the Federal Funds Target Range

Economic Releases

Durable Goods: Durable goods orders were weaker than expected in November after a revised increase in October. After a recovery rebound in durable goods orders of transportation equipment due to the strike at Boeing, the sector was in negative territory again in November. Overall, with three negative months out of the last four, this report continues to display weakness in the US manufacturing sector. While this is not positive for economic growth, the manufacturing sector accounts for ~10% of the total output of the US economy, and therefore while still hugely important, it is less impactful on the overall economy than other larger sectors. The preliminary result for durable goods orders in November was weaker than expected, down 1.1%, month-over-month, versus FactSet expectations for a 0.2% increase. October's durable goods orders were revised higher, from an increase of 0.3% to an increase of 0.8%, month-over-month. If we exclude new orders of transportation equipment (which are very large orders that skew the results), new orders decreased by 0.1% after inching up by 0.2% in October. Excluding new orders for defense, durable goods orders decreased by 0.3% after declining by 0.5% in October. Durable goods orders of manufacturing were also weak, down 1.3% in November. Capital goods declined 2.6% during the month, driven by a large 12.5% decline in defense capital goods orders. However, core capital goods (excluding aircraft) increased 0.5% in November after increasing 0.4% in October. Overall, durable goods orders declined in November, with most of the weakness driven by a large decline in defense capital goods and defense aircraft and parts.

New Home Sales: After experiencing large back-to-back monthly increases, the Consumer Confidence Index in December dropped back to the middle of the range of the last two years. While present conditions were nearly unchanged, the Index was heavily impacted by a decline in the Expectations Index, the largest drop since November 2020. However, it is important to keep in mind that this weakness resulted after the Index experienced its largest monthly increase in over two years. Overall, consumers seem less optimistic about future business conditions and incomes but remain above the threshold that usually signals a recession ahead. This is consistent with our view of an economy that is returning to normal, with positive economic growth, a healthy job market, and inflation levels that while stubborn and currently increasing, are likely to slowly head back near the Federal Reserve's 2.0% target over the next twelve to eighteen months. The Conference Board reported that the Consumer Confidence Index declined by 8.1 points in December to 104.7 from 112.8 in November. The Present Situation Index decreased 1.2 points to 140.2 while the Expectations Index declined 12.6 points to 81.1. The Conference Board indicated that "The recent rebound in consumer confidence was not sustained in December as the Index dropped back to the middle of the range that has prevailed over the past two years." The number of consumers anticipating a recession over the next 12 months remained near its lowest point since July 2022, which is when this survey component started. On the other hand, respondents who expect stock prices to increase over the year ahead hit an all-time pullback from last month's record high of 57.2% to 52.9% in December. Average 12-month inflation expectations remained stable at 5%, the lowest since March 2020. According to the Chief Economist for The Conference Board, Dana M. Peterson, "Among income groups, the decline was concentrated in consumers with household earnings between \$25K and \$100K, while consumers at the bottom and top of the income range reported only limited changes in confidence. On a six-month moving average basis, consumers aged under 35 and those earning over \$100K remained the most confident."

Economic Releases

Pending Home Sales: The large than expected increase in Pending Home Sales (PHS) was almost entirely due to a strong monthly increase in the largest region of the US, the South. This increase pushed the PHS Index to the highest level since February of 2023. We expect the Federal Reserve (Fed) to lower rates twice over the next twelve months, which is unlikely to push mortgages meaningfully lower, but our expectation of a healthy labor market and growing inventory should continue to be supportive of homebuyers. The Pending Home Sales Index increased by 2.2% in November, according to the National Association of Realtors (NAR). FactSet expectations were for a 0.8% increase in the index. On a year-earlier basis, the PHS Index was up by 6.9%. By region, the Northeast experienced a decrease of 1.3%, month-over-month, and a 5.6% increase on a year-earlier basis. The Midwest saw an increase of 0.4% during the month while it was up 1.6% compared to November of last year. The PHS Index increased in the South, up 5.2% versus October of this year and 8.5% compared to last year. Finally, the West saw the PHS Index increase by 0.5% versus October of this year and by 11.9% compared to November of last year. According to the NAR: “Consumers appeared to have recalibrated expectations regarding mortgage rates and are taking advantage of more available inventory. Buyers are no longer waiting for or expecting mortgage rates to fall substantially.”

FHFA Home Price Index: Home price appreciation remained stable on a year-over-year basis around 4.5% for the third consecutive month and it is trending lower compared to the 5.9% increase recorded last quarter. Growth in home prices is still elevated and will continue to be a headwind for inflation to decrease more quickly as shelter costs are the largest contributor. The Fed will have to be very careful with its interest rate decisions so it doesn't add more fuel to the price of homes in the coming quarters. A more cautious Fed supports our forecast of only two rate cuts in 2025. Home prices in October, as measured by the Purchase-Only FHFA Home Price Index (HPI) increased by 0.4% compared to the previous months, according to the Federal Housing Finance Agency (FHFA). At the same time, the FHFA HPI for September remained unchanged at 0.7%. The HPI overall regional picture was positive, with the exception of the Pacific region, whose HPI declined by 0.4%, and the Mountain and West North Central regions, whose HPI declined by 0.1%. The highest regional growth for the HPI was in the West South Central region, up 1.0%, followed by the East North Central region, up 0.9%, month-over-month, while the HPI in both the Middle and South Atlantic regions increased 0.5%. The East North Central and New England regions saw smaller increases during the month, up 0.3% and 0.1%, respectively. Home prices over the last twelve months have increased by 4.5% despite elevated mortgage rates continuing to put pressure on affordability. The inventory of homes for sale remains relatively low, and homebuyers, no longer expecting mortgage rates to drop significantly, are moving forward with their home purchases.

Economic Releases

Construction Spending: Construction spending was almost flat in November, month-over-month, and below consensus expectations for a 0.2% increase. Residential construction was up slightly due to an increase in construction spending in new single-family homes, while construction in multifamily units was down month-over-month. However, construction spending in both new single-family and multifamily homes was down on a year-earlier basis. Overall, residential construction spending was up due to increased spending in private residential improvements. Total construction spending remained almost unchanged in November and compared to the previous month, according to the US Census Bureau, at \$2,152.6 billion. Compared to a year earlier, construction spending increased by 3.0%. Private construction spending increased by 0.1% in November compared to the previous month, at \$1,650.7 billion as residential construction spending was up by 0.1%, to \$906.2 billion while nonresidential construction spending was unchanged in November compared to October. Public construction spending was down by 0.1%, to \$501.9 billion in November compared to an estimate of \$502.5 billion in October of 2024, as educational construction spending was down 0.2% compared to October while highway construction spending was up 0.2%, to \$142.9 billion, in November. Construction spending in new single-family units was up 0.3% during November, month-over-month, while construction spending in multifamily units was down by 1.3%, month-over-month. Compared to a year ago, both new single-family as well as new multifamily construction spending were down, by 0.7% and 9.5%, respectively. Although both new single-family and multifamily construction spending were down on a year-over-year basis, overall residential construction spending was up 3.1%, boosted by private residential improvements.

ISM Manufacturing: The ISM Manufacturing PMI was stronger than market expectations, but it nevertheless remained in contraction territory for the ninth consecutive month and for 25 months in the last 26 months. Both the Production index as well as the New Export Orders index moved from contraction in November to expansion in December while the New Orders index moved higher. However, the Employment index went further into contraction during the last month of the year while the Prices index was also higher, meaning that price pressures remain a concern. The Institute for Supply Management (ISM) Manufacturing PMI increased from 48.4 in November to 49.3 in December but remained below the 50 demarcation line between expansion and contraction. The New Orders index improved from 50.4 in November to 52.5 in December while the Production index moved into expansion, from a 46.8 reading in November to a 50.3 reading in December. The Employment index, however, went deeper into contraction, from 48.1 in November to 45.3 in December. The Supplier Deliveries index moved slightly into expansion, at 50.1 in December compared to a reading of 48.7 in November. The Inventories index was slightly higher, at 48.4 in December compared to a 48.1 reading in November but still in contraction while the Customers' Inventories index went further into contraction in December, at 46.7 compared to 48.4 in November. The Prices index moved higher, at 52.5 in December compared to a reading of 50.3 in November while the Backlog of Orders index moved higher but remained in contraction, at 45.9 in December compared to 41.8 in November. The New Export Orders index moved to the 50 demarcation point from a reading of 48.7 in November. Finally, the Imports index increased to 49.7 in December compared to a reading of 47.6 in November but remained in contraction. This was the ninth consecutive contraction month for the ISM Manufacturing PMI and the 25th contractionary reading in 26 months. However, the report indicated that “a Manufacturing PMI above 42.5 percent, over a period of time, generally indicates an expansion of the overall economy.”

Disclosures

Economic and market conditions are subject to change.

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Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Statistics. Currencies investing is generally considered speculative because of the significant potential for investment loss. Their markets are likely to be volatile and there may be sharp price fluctuations even during periods when prices overall are rising.

Consumer Sentiment is a consumer confidence index published monthly by the University of Michigan. The index is normalized to have a value of 100 in the first quarter of 1966. Each month at least 500 telephone interviews are conducted of a contiguous United States sample.

Personal Consumption Expenditures Price Index (PCE): The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The change in the PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

The Consumer Confidence Index (CCI) is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. A value above 100 signals a boost in the consumers' confidence towards the future economic situation, as a consequence of which they are less prone to save, and more inclined to consume. The opposite applies to values under 100.

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GDP Price Index: A measure of inflation in the prices of goods and services produced in the United States. The gross domestic product price index includes the prices of U.S. goods and services exported to other countries. The prices that Americans pay for imports aren't part of this index.

Employment cost Index: The Employment Cost Index (ECI) measures the change in the hourly labor cost to employers over time. The ECI uses a fixed "basket" of labor to produce a pure cost change, free from the effects of workers moving between occupations and industries and includes both the cost of wages and salaries and the cost of benefits.

US Dollar Index: The US Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" when compared to other currencies.

The FHFA HPI is a broad measure of the movement of single-family house prices. The FHFA HPI is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales or refinancings on the same properties.

Disclosures

Import Price Index: The import price index measure price changes in goods or services purchased from abroad by U.S. residents (imports) and sold to foreign buyers (exports). The indexes are updated once a month by the Bureau of Labor Statistics (BLS) International Price Program (IPP).

ISM Services PMI Index: The Institute of Supply Management (ISM) Non-Manufacturing Purchasing Managers' Index (PMI) (also known as the ISM Services PMI) report on Business, a composite index is calculated as an indicator of the overall economic condition for the non-manufacturing sector.

The ISM Manufacturing Index: The The Institute of Supply Management (ISM) Manufacturing Measures the health of the manufacturing sector by surveying purchasing managers at manufacturing firms. The survey asks about current business conditions and expectations for the future, including new orders, inventories, employment, and deliveries.

Consumer Price Index (CPI) A consumer price index is a price index, the price of a weighted average market basket of consumer goods and services purchased by households.

Producer Price Index: A producer price index(PPI) is a price index that measures the average changes in prices received by domestic producers for their output.

Industrial production: Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities. Although these sectors contribute only a small portion of gross domestic product, they are highly sensitive to interest rates and consumer demand.

The NAHB/Wells Fargo Housing Opportunity Index (HOI) for a given area is defined as the share of homes sold in that area that would have been affordable to a family earning the local median income, based on standard mortgage underwriting criteria.

Conference Board Coincident Economic Index: The Composite Index of Coincident Indicators is an index published by the Conference Board that provides a broad-based measurement of current economic conditions, helping economists, investors, and public policymakers to determine which phase of the business cycle the economy is currently experiencing.

Conference Board Lagging Economic Index: The Composite Index of Lagging Indicators is an index published monthly by the Conference Board, used to confirm and assess the direction of the economy's movements over recent months.

New Export Index: The PMI New export orders index allows us to track international demand for a country's goods and services on a timely, monthly, basis.

Gold is subject to the special risks associated with investing in precious metals, including but not limited to: price may be subject to wide fluctuation; the market is relatively limited; the sources are concentrated in countries that have the potential for instability; and the market is unregulated.

The Conference Board Leading Economic Index: Intended to forecast future economic activity, it is calculated from the values of ten key variables.

Source: FactSet, data as of 1/3/2025

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